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Dear Andrew

Re: Skilled Person Reviews under section 166 of the Financial Services and Markets Act 2000

Thank you for your letter of 23 June where you ask for information on the use of our power to require a report by a skilled person under section 166 of the Financial Services and Markets Act.

Skilled person reviews are an important supervisory tool; our handbook and supervisory practice require us to consider, amongst other factors, the proportionality of a skilled persons review in terms of the cost and scale of issue.

With regard to the specific questions raised in your letter, I enclose a detailed set of information which addresses each of these turn. I trust that the responses are helpful, but please let me know if you require anything further.

Yours sincerely,

Martin Wheatley
Chief Executive

FCA use of skilled person reviews under section 166 of FSMA

Overview

A skilled person can either be appointed by the regulated firm (and approved by the FCA) or appointed directly by the FCA. In either case, the FCA has control over the scope of the review and the regulated firm pays the skilled person's costs.

We have internal controls to ensure the effectiveness, consistency and proportionality of skilled person reviews, including: (a) a panel of vetted skilled person firms (attached at Annex 1); (b) clear internal processes, including a Central Skilled Person team to provide challenge and quality assurance to supervisors who are commissioning a review; (c) a centralised database of all s166 reviews commissioned; (d) regular briefings to skilled person firms; and (e) quarterly and annual management information and statistics which are published on the FCA's website.

Whilst some industry commentators express concern that the FCA is substantially increasing its use of Skilled Person Reviews that is not borne out by the facts. Over the past few years the number of skilled person reviews per year has not significantly increased, and it is not our strategic aim to significantly increase the use of s166s going forward. In 2012/13 the FSA used skilled person reviews 113 times; this fell by more than a quarter in 2013/14 when the FCA and PRA used it in aggregate 83 times. Overall, for the period April 2013 to March 2014, we commissioned a skilled person review for only 0.2% of the number of firms we regulate.

With regard to the specific points raised in your letter of 23 June, each of these is addressed in turn below:

1. ***The cost and date of each skilled person review required by the FCA, and the cost and date of each review commissioned by the FSA in its last five years.***

We have aggregated this data by quarter in the year 2013/14 and shown the results on an annual basis in the five years between 2008/09 and 2012/13, in order to maintain confidentiality and ensure that specific regulated firms and skilled person reviews cannot be identified.

Skilled Person Reviews 2013-14		
Quarter	**Number of reviews**	**Cost of reviews**
Q1	18	£124.62m*
Q2	12	£8.45m

Skilled Person Reviews 2008-09 to 2012-13		
Year	**Number of reviews**	**Cost of reviews**
2008-09	56	£12.8m
2009-10	88	£24.7m

Q3	10	£6.91m
Q4	10	£5.68m
Total	**50**	**£145.7m***

2010-11	95	£32.2m
2011-12	111	£31.2m
2012-13	113** (14 related to IRHP)	£176.4m** (£141.5m related to IRHP)
Total	**463**	**£277.3m**

* This amount includes a review cited in the FSA 2012/13 Annual Report. However, this report was commissioned just prior to the year-end date and therefore a reliable cost estimate was unavailable at that time.

** In 2012-13, 14 skilled person reviews were attributable to the Interest Rate Hedging Product redress programme and accounted for costs totalling £141.5 million.

2. ***What is the process by which the decision is taken to require a report by a Skilled Person under section 166 of the Act?***

As stated in the FCA Handbook (SUP 5.3.2), *'The decision by the appropriate regulator to require a report by a skilled person under section 166 of the Act (Reports by skilled persons) will normally be prompted by a specific requirement for information, analysis of information, assessment of a situation, expert advice or recommendations or by a decision to seek assurance in relation to a regulatory return. It may be part of the risk mitigation programme applicable to a firm, or the result of an event or development relating or relevant to a firm, prompted by a need for verification of information provided to the appropriate regulator or part of the appropriate regulator's regular monitoring of a firm.'*

The FCA Handbook (SUP 5.3.3) further states that, *'when making the decision to require a report by a skilled person [...] the appropriate regulator will have regard, on a case-by-case basis, to all relevant factors. Those are likely to include: circumstances relating to the firm; alternative tools available, including other statutory powers; legal and procedural considerations; the objectives of the appropriate regulator's enquiries; cost considerations; and considerations relating to [the] appropriate regulator's resources.'*

In practice, a supervisor will consider a number of factors when deciding whether we require the expertise of a skilled person to undertake the work. These include:

- the scale of the issue, e.g. potential number of customers and risk of loss;
- proportionality i.e. is the cost of appointing the skilled person proportionate to the scale of the issue?;
- whether they feel there is enough information to be sure we understand the risks;

- if we can rely upon the firm to have the skills, knowledge, resource and willingness to do any investigative/remedial work itself;
- if the firm has shown the same/similar weaknesses in the past; and
- what action we have taken in similar circumstances with other firms or themes.

3. At what level of seniority is approval given for the decision?

The approval is given at Head of Department level.

4. How do you decide whether the FCA will contract the Skilled Person or whether the regulated firm will do so?

A number of factors will determine whether the FCA chooses to contract direct with the skilled person firm or whether the regulated firm is permitted to do so. The starting presumption, however, is that whenever possible it is the regulated firm who should contract with the skilled person.

The key factors to influence the final decision will include:

- whether the FCA needs to demonstrate independence and an active role in appointing the skilled person because, for example, the review is high profile, in the public domain and/or under scrutiny from third parties including Government;
- whether the FCA has serious concerns over governance in the firm and/or the fitness and propriety of senior management to nominate a skilled person on their own accord; and
- whether the firm has consistently demonstrated related, previous failings and as such the FCA does not have confidence in its ability to lead the review.

5. Does the FCA utilise the Internal Audit Departments (IAD) of regulated firms for reviewing and assessing matters of potential concern? In firms with a strong independent IAD, please explain the reasons why that IAD would not be commissioned to perform such work in preference to third party firms.

The FCA does regularly use management and firm resources (including IADs) to address the overwhelming majority of concerns and issues that arise in firms. Indeed, many more issues are dealt with by other means (such as risk management programmes and other interventions) than by focussing on using skilled person reviews – as an illustration of this, in the year from April 2013, only 50 reviews were commissioned across a population of over 25,000 regulated firms.

However, in some cases, it is not always appropriate to rely on the IADs in firms to conduct reviews in preference to skilled person, third party firms. Firstly, IADs carry with them a perceived or actual conflict of interest and cannot, in many cases, be considered as truly independent from the firm. Second, the majority of IADs in firms would not possess the necessary skills or experience to meet the criteria for being a skilled person for the purposes of making a skilled person report - though, where IADs are sufficiently qualified they may nonetheless struggle to make expert resources available for long enough to investigate and report upon what are frequently complex issues and risks. Third, and arguably most significantly, often the reason that supervisors have decided it is necessary to commission a skilled person review is precisely because, in our view, management in a firm (including its various lines of defence) has failed to properly identify or mitigate a potential issue – and, therefore, we would not be able to derive the necessary level of assurance from an IAD led review compared to a skilled person, third party review.

6. ***What consideration does the FCA give to using other tools of regulation to mitigate potential risks, such as placing specific requirements on management and boards?***

The FCA uses a wide ranging regulatory approach and series of supervisory tools to achieve its objectives and mitigate potential risks in firms. We operate a three-pillar model:

Pillar I – proactive firm supervision (the Firm Systemic Framework), the purpose of which is to assess whether the firm is being run, currently and prospectively, in a way that results in the fair treatment of customers. We have categorised firms (C1-C4) according to the potential harm they pose to FCA objectives and this drives the intensity of the supervision effort.

Pillar II – event-driven, reactive supervision, to deal rapidly and efficiently with cases of potential or actual detriment to customers or market integrity that occur outside Pillar 1 work.

Pillar III – issues and products supervision, to address issues across an industry sector.

Within this framework, the FCA has a series of supervisory tools and powers to tackle concerns that may result in poor customer 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. The FCA's intervention tools include:

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
The FCA can also 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.

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:

- 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.

We have also recently, on 19 June 2014, issued our response to the Special Measures proposal of the Parliamentary Commission on Banking Standards, *"Tackling serious failings in firms"* which sets out our enhanced supervision approach relevant to firms which present serious risks to our objectives, due to a serious failure of culture, governance or standards – in short, we will normally require the firm's Board to formally commit to remediation measures; review the remediation measures; and if we believe the Board's action to be ineffective, we may exercise our formal powers.

7. The FCA's policy on the use of skilled persons requires the regulator to have regard to the question of cost. What does this mean in practice?

8. What steps do you take to ensure that the costs to firms are kept to a minimum?

(Questions 7 and 8 have been taken together)

The FCA takes account of the cost to firms of skilled person reviews and seeks to ensure that the tool is used only where appropriate and that, when used, the costs are proportionate to the review required.

In practice, this translates to a number of actions:

1. At the outset, the supervisor considers the proportionality of appointing a skilled person to undertake the work by considering the cost of the review to the scale of the issue to be investigated. Then the terms and scope of all reviews are purposefully articulated to address only those issues about which supervisors are most concerned, thereby minimising the risk of scope-creep and the potential inclusion of non-substantial issues which could increase the cost of reviews to a regulated firm.

2. In the case of directly contracted skilled person reviews, the FCA will select a skilled person firm following a competitive tendering exercise and during which the issue of cost is a key consideration in the evaluation and selection process – in particular, (a) skilled person firms are short-listed for selection on the basis of two key criteria, namely, their technical expertise in the subject area/s under review *and* also the overall monetary cost to the firm of their proposed approach; and (b) during short-list interviews with FCA staff – involving subject matter experts and Procurement – skilled person firms are scrutinised and challenged on the factors that determine the cost of reviews, including the activities and tasks they will undertake, the number of days they propose to spend conducting the review (including report writing), the number and grade of staff participating in the review, and the charge rates of skilled person staff, including whether discounts on rates are available – with the successful firm being the skilled person firm who provides the best combination of technical expertise and cost to the firm.

3. In situations where a regulated firm contracts with the skilled person, they are directed by the FCA to our panel of skilled person firms all of whom have been vetted for technical competence in relation to key subject areas and with whom the regulated firm may liaise direct in order to negotiate the most competitive price for the review. Furthermore, regulated firms often have 'master service agreements' in place with skilled person firms and this frequently drives the cost of the review. Once the FCA receives the regulated firm's nomination, it can review the estimated costs - if they differ significantly from expectations, then the supervisor can seek clarification as to why and can review the costs of other similar reviews for comparrison. If the supervisor remains unsatisfied with the proposed costs of the review, he may further challenge the skilled person firm, for example, on whether the proposal includes items that are not within the scope of the review or on whether the skilled person firm has factored in assumptions which may not be relevant.

4. Finally, throughout the review, the skilled person firm is under a requirement to keep the FCA updated on any potential changes to anything which could mean an increase in the agreed costs before they arise. This is to ensure the costs associated with the review continue to be proportionate to the risk.

9. It appears to be the case that the significant majority of s166 commissions are awarded to the 'Big 4' Accounting firms. What is the FCA doing to promote competition and encourage smaller, specialist firms to compete for s166 mandates?

As set out in Annex A, the selection of firms on the Panel that both we and the PRA use is made up of firms of all sizes.

From April 2013 (when the FCA gained the power to contract directly with the skilled person firm) to the present day, the FCA has contracted directly with a skilled person firm on 12 occassions. When making these selections, we have appointed a diverse cross-section of firms for these reviews and have used 9 different skilled person firms. In only a quarter of these appointments (3 instances) has a review been awarded to one of the 'Big 4' firms.

Where a regulated firm is contracting with a skilled person, they retain control of the appointment and can select the skilled person firm to conduct the review, albeit the FCA will approve their choice. Since April 2013, regulated firms have been directed by the FCA to our panel of approved skilled person firms, and therefore have the opportunity to select a skilled person from a wide choice of firms. However, many still choose to appoint skilled persons from within the 'Big 4'.

10. On both a case by case basis and in aggregate, how does the FCA judge the value for money from s166 reviews?

On a case-by-case basis, the FCA judges the value for money of proposed s166 reviews (in situations where it contracts direct) by comparing proposals between skilled person firms who bid to conduct specific reviews, and judges them on the basis of their technical expertise *and* the cost of their proposed approach and work plan and compares this against the scale of the issue being reviewed.

In situations where a regulated firm contracts the skilled person, value for money is achieved when the firm approaches a range of skilled person firms, from our panel, and negotiates with them direct to achieve the best possible price.

In aggregate terms, the value for money from s166 reviews can also be judged when, on the one hand, one considers the cost of such reviews against, on the other, the comparative benefit and amount of redress achieved for customers which then follows. This is illustrated in the following two examples which show that the amount of redress secured, which may not have been achieved without skilled person firms, significantly outweighs the cost of skilled person reviews.

First, in the case of s166 reviews relating to Interest Rate Hedging Products, the final cost so far of all skilled person reviews is estimated to amount to £286 million (as these are complex reviews in which *every case* is overseen by an independent reviewer from start to finish, undertaking a detailed, bespoke assessment of all relevant evidence, to ensure fair and consistent outcomes); whereas the total redress achieved for customers as a result of such reviews amounts to £1.1 billion (to the end of May 2014), with a further estimated £1 billion due to be paid by the end of the year.

Second, the FCA's use of skilled person reports has also supported the delivery of our thematic, industry wide Payment Protection Insurance review. During 2013 and to date in 2014 the total cost of all such s166 reviews amounted to approximately £10 million (to note, not all firms who sold PPI have been subjected to a skilled person review); and the total redress achieved for customers across all regulated firms who missold this product (not just those regulated firms who participated in a skilled person review), over the same period, amounts to an estimated £6 billion.

In both cases, the important considerations are that (a) these are complex reviews and reliant on the specific expertise which skilled person firms provide; (b) the participation of a skilled person has contributed greatly to timeliness and helped ensure that customers receive redress quickly; and (c) these are highly judgemental reviews, where the right customer outcome is not always clear, and in the absence of the skilled person (i.e. had the banks carried out the review exercise on their own) the redress paid could have been lower. In both cases, the skilled person firms provide an independent view and oversight, and fairly represent the interests of customers.

11. To what extent does the FCA coordinate with the PRA in the scoping of s166 reviews in order to manage costs and efficiency?

FCA supervisors coordinate regularly with their PRA counterparts and where it is identified that the scope of a skilled person review covers the objectives and remit of both regulators then a joint scope can be discussed. We currently have one live example of a joint FCA and PRA skilled person review.

12. To what extent are these reviews used to overcome resource constraints at the FCA – either by compensating for a lack of expertise, or by helping to keep costs down?

The FCA is mindful of the need to show value for money in delivering its objectives, to operate within its funding allocation and to work with regulated firms – using a range of supervisory interventions – to deliver good customer outcomes. Skilled person reviews provide a flexible method of achieving each of these goals.

To this end, skilled person reviews can be used where the FCA requires specialist knowledge in a particular area, requires a significant market-wide or thematic review (such as in the case of the Interest Rate Hedging Products review), or where the scale of the issue is such that it may be more appropriate not to devote FCA resources to undertake this task.

However, if the FCA did not use (or commissioned fewer) skilled person reviews it would nonetheless still need to intervene to mitigate specific firm related issues and risks – and therefore in terms of costs, would need to be funded to a higher and commensurate level, and/or potentially deprioritise other areas of conduct risk supervision to stay within its funding allocation.

13. Will you publish the costs of reviews in which the FCA appoints the Skilled Person seperately from those of cases in which the firm makes the appointment?

The FCA publishes the costs of skilled person reviews every year within its Annual Report. The cost of skilled person reviews in the period April 2013 to March 2014 will be published on 9 July 2014. However, the costs for those reviews that have been contracted directly will not be listed seperately, though this is something we may consider for the 2014/15 Annual Report.

14. What oversight does the Board have of the use of s166 reviews?

The Board takes an interest in the FCA's use of the s166 tool and receives regular updates on overall supervisory activities, and where relevant this will also include its use of skilled person reports.

We plan to provide the Board with a periodic update specifically relating to our use of the s166 tool on a quaterly basis.

Annex 1 - Skilled Person Panel – 1 April 2013

The Skilled Person Panel consists of eight Lots, as shown below:

SKILLED PERSON PANEL (in alphabetical order per Lot)			
Lot 3 - Client Assets	**Lot 4 - Governance, Controls & Risk Frameworks**	**Lot 5 - Conduct of Business**	**Lot 6 - Data & IT Infrastructure**
Ashurst LLP BDO LLP with Oxera Bovill Limited Clifford Chance LLP Deloitte LLP DLA Piper UK LLP Ernst and Young LLP FTI Consulting LLP Grant Thornton UK LLP Kinetic Partners LLP KPMG LLP Littlejohn Mazars LLP Moore Stephens LLP PricewaterhouseCoopers Protiviti Limited	Baxterbruce Limited BDO LLP with Oxera Clifford Chance LLP Deloitte LLP Ernst and Young LLP Eversheds LLP FTI Consulting LLP Grant Thornton UK LLP Hogan Lovells International LLP KPMG LLP Littlejohn Mazars LLP Moore Stephens LLP Oliver Wyman PA Consulting Services PricewaterhouseCoopers LLP Promontory Financial Group Resources Global Professionals (RGP) Baker Tilly (Formerly RSM Tenon) SA Compliance Management Telos Solutions Ltd The Consulting Consortium Towers Watson Limited	ATEB Business Solutions Ltd BDO LLP with Oxera Bovill Limited Complyport Limited Deloitte LLP DLA Piper UK LLP Ernst and Young LLP Eversheds LLP FTI Consulting LLP Grant Thornton UK LLP Heather Thomas Consulting Hogan Lovells International LLP Huntswood CTC Limited KPMG LLP Macfarlanes LLP Mazars LLP Moore Stephens LLP PA Consulting Services PricewaterhouseCoopers LLP Promontory Financial Group Resources Global Professionals (RGP) Baker Tilly (Formerly RSM Tenon) Telos Solutions Ltd The Consulting Consortium Towers Watson Limited	Accenture Alvarez & Marsal Atos Consulting & Technology Baringa Partners LLP BDO LLP with Oxera Deloitte LLP Ernst & Young LLP Everisconsultancy Limited Evolve Business Consultancy FTI Consulting LLP Grant Thornton UK LLP IPL KPMG LLP Moore Stephens LLP PA Consulting Services Ltd Practicus Ltd PricewaterhouseCoopers LLP North Highland (formerly Qedis) Resources Global Professionals (RGP) Baker Tilly (Formerly RSM Tenon) The Berkeley Partnership LLP

Lot 7 - Financial Crime	Lot 8 - Prudential - Deposit Takers & RCH	Lot 9 – Prudential - Insurance	Lot 10 – Prudential – Investment Firms, Intermediaries & RIE
BDO LLP with Oxera Bovill Limited Clifford Chance LLP Deloitte LLP DLA Piper UK LLP Ernst & Young LLP Eversheds LLP FTI Consulting LLP Grant Thornton UK LLP Hogan Lovells International Kinetic Partners LLP KPMG LLP Mazars LLP Moore Stephens LLP Pannone LLP PricewaterhouseCoopers LLP Promontory Financial Group Protiviti Limited Resources Global Professionals (RGP) The Consulting Consortium	Accenture Alvarez & Marsal Baringa Partners LLP BDO LLP with Oxera Clifford Chance LLP Deloitte LLP Ernst & Young LLP Grant Thornton UK LLP KPMG LLP Management Solutions Europe Mazars LLP Oliver Wyman PA Consulting Services Parker Fitzgerald PricewaterhouseCoopers LLP Promontory Financial Group Resources Global Professionals (RGP) Sapient	Barnett Waddingham LLP Deloitte LLP Ernst & Young LLP FTI Consulting LLP Grant Thornton UK LLP KPMG LLP Management Solutions Europe Mazars LLP Milliman LLP Moore Stephens LLP NERA UK LTD Oliver Wyman Parker Fitzgerald PricewaterhouseCoopers LLP Towers Watson Limited	BDO LLP with Oxera Bovill Limited Deloitte LLP Ernst & Young LLP FTI Consulting LLP Grant Thornton UK LLP Kinetic Partners LLP KPMG LLP Moore Stephens LLP Parker Fitzgerald PricewaterhouseCoopers LLP Promontory Financial Group Resources Global Professionals (RGP) Smith & Williamson