Summary of the FCA's "Custody and Fund Services Supervision Strategy" Letter Overview

This letter outlines the FCA's updated supervisory strategy for firms in the custody and fund services sector, with a focus on managing emerging risks and ensuring continued market stability.

Key Points of Focus

1. **Sector Importance**
   - The custody and fund services sector plays a crucial role in safeguarding assets, providing oversight, and administering £14.6 trillion of assets under custody (AuC). The FCA acknowledges the industry's role in maintaining trust in UK financial markets and emphasizes the need for high standards to preserve market stability.
2. **Sector Risks and Emerging Trends**
   - The sector faces challenges, including an increased role in outsourced services, cybersecurity threats, and changes in market infrastructure (e.g., settlement cycles, digital assets, DLT). Firms must adapt to these shifts and manage risks effectively.
3. **Supervisory Priorities**
   - The FCA's supervisory focus remains outcomes-based, targeting key risks that could affect financial markets. Key risks and actions are outlined below:

Supervisory Priorities

1. **Operational Resilience**
   - **Risk**: High operational risk in transaction processing, settlement, outsourced services, and outdated technology.
   - **Actions**: Firms must comply with Policy Statement PS21/3, setting impact tolerances (ITOLs) for business services by March 2025, ensuring they can operate within these tolerances in severe scenarios.
   - **Expectation**: Governing bodies must review and approve operational resilience self-assessments and ensure prompt response to incidents.
2. **Cyber Resilience**
   - **Risk**: Sub-optimal cybersecurity and vulnerability management, especially in light of increasing external threats.
   - **Actions**: Firms should focus on managing cyber vulnerabilities, threat detection, and recovery, utilizing penetration testing as a diagnostic tool.
   - **Expectation**: Firms should ensure governance and management information reflect a comprehensive assessment of cyber risks.

3. **Third-Party Management**
    - **Risk**: High residual risk from third-party relationships, particularly in IT services and critical business functions.
    - **Actions**: Firms must assess and map third-party risks, including concentration risks and contingency arrangements.
    - **Expectation**: Firms should have robust processes for monitoring third-party risks and avoiding over-reliance on key service providers.
4. **Change Management**
    - **Risk**: Technological transformation (e.g., automation, AI, digital assets) requires firms to adapt, or they risk operational issues.
    - **Actions**: The FCA will assess change management frameworks to ensure they align with client and consumer outcomes.
    - **Expectation**: Firms should ensure good governance, sufficient resources, and effective risk management during technological changes.
5. **Market Integrity**
    - **Risk**: Increased complexity in sanctions regimes and geopolitical risks could affect compliance.
    - **Actions**: The FCA will review firms' systems and controls related to sanctions compliance.
    - **Expectation**: Firms must ensure proper governance, due diligence, and breach reporting procedures related to financial crime risks.
6. **Depositary Oversight**
    - **Risk**: Depositaries' oversight of fund activities may be insufficient, potentially risking investor protection.
    - **Actions**: The FCA will clarify its rules on depositary duties, ensuring proactive oversight.
    - **Expectation**: Depositaries must act independently and monitor funds' adherence to regulatory requirements.
7. **Protection of Client Assets (CASS)**
    - **Risk**: Weaknesses in CASS compliance due to outdated technology and poor governance.

- **Actions**: The FCA will continue to use supervisory tools to assess and address CASS weaknesses.
- **Expectation**: Firms must review and address any CASS-related weaknesses, particularly those impacted by technological change.

Next Steps

- Firms should discuss the letter with their governing bodies and Senior Managers, ensuring actions are taken to meet FCA requirements and mitigate risks.
- The FCA will apply appropriate scrutiny to these matters in future supervisory engagements.
- For further queries, firms are encouraged to contact their usual FCA supervisor.