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Client briefing
Operational resilience: FCA and PRA policy statements

Introduction

How the new FCA and PRA policy statements may impact firms

On 29th March 2021, the Financial Conduct Authority (FCA) and Prudential Regulation Authority (PRA) published their final policy statements on operational resilience[1]. The new rules are designed to assist firms in focusing and enhancing their operational resilience activity. A reminder of the core policy requirements is set out in the appendix.

Overall, there is little deviation between the initial consultation papers and the policy statements, however, both regulators have provided useful clarification throughout, following substantial feedback across the industry. In addition, the regulators have taken the opportunity to align key terminology and definitions where relevant.

The final rules and parts will come into force on 31st March 2022. This gives firms 12 months to comply with the new requirements. Specifically, firms will be required to have completed the following:

- identified their important business services,
- set impact tolerances, and
- commenced testing to identify weaknesses in their operational resilience environment.

The regulators also confirm that beyond 31st March 2022 they will be able to initiate supervisory activities, meaning firms must ensure their annual self-assessment document is available on 1st April 2022 if requested.

As expected, a 3-year transition window to March 2025 will be granted to firms, beyond which they must be able to remain within their impact tolerances. This means that while firms must be compliant with the rules and parts by 31st March 2022, there is no expectation that all weaknesses will have been remedied by that time. There are expectations, however, that firms should be able to remain within their impact tolerances as soon as reasonably practical.

In this paper we have highlighted the key points from the FCA and PRA policy statements (PS21/3 & PS6/21) and explored how this will impact firms as they look to implement the requirements before the regulatory deadline.

1 The FCA issued Policy Statement 21/3 (PS21/3) and the PRA published Policy Statement 6/21 (PS6/21), confirming the rules first proposed in Consultation Paper 19/32 (CP19/32) and Consultation Paper 29/19 (CP29/19) respectively. Whilst not referenced in this article, the Bank of England has also published individual policy and supervisory statements outlining the requirements for FMIs as well as their expectations for outsourcing and third party management in Policy Statement 7/21.

Policy statement considerations

The following is a summary of our view on the key policy statement extracts, including the practical considerations for firms as they progress through their implementation phases:

Important business services

Broadly consistent with consultation papers. SME threshold introduced. Internal services should be mapped instead.

Policy extracts

FCA statement

Internal services should not be identified as important business services, rather they should be included in the firm's mapping of resources and scenario testing of important business services if deemed critical to their delivery.

- Firms are not required to identify all their business services before identifying which are important.
- The term 'intolerable' when defining important business services only refers to intolerable levels of harm to consumers (and not to intolerable levels of risk to market integrity).

PRA statement

- Firms should not use additional criteria over and above those set out by the regulators to identify their important business services, if that would result in a reduction in the list of important business services identified.
- Small and medium sized firms will not need to assess their potential impact on financial stability when identifying important business services.
- The distinction between important business services and the concepts of critical functions and critical services under existing Operational Continuity in Resolution (OCIR) regulation.

FCA/PRA alignment

- Review important business services annually at a minimum, or sooner if a significant change occurs.
- The definition of an 'important business service' has been amended to align with the FCA, and clarify that a service could be delivered wholly or in part by another person.

Considerations for firms

Overall the approach for identifying important business services is broadly unchanged versus the approach articulated in the consultation papers, and as such the work that firms have already undertaken will remain relevant.

The exception is for small and medium sized firms where there has been a helpful reduction in scope by the PRA, such that they no longer need to assess their potential impact on financial stability when identifying important business services. The regulators have also clarified that firms do not need to identify all business services before determining those that are important (although they may wish to), which may reduce the workload for firms in some instances.

Some helpful clarifications and affirmations have been provided on the approach for internal services (which should be included within mapping if relevant, rather than being deemed a standalone important business service), and on the criteria for identifying an important business service, which firms should reflect.

Impact tolerances

PRA guidance on the scope of applying Impact Tolerances. Third-parties considered critical in setting tolerances.

Policy extracts

FCA/PRA alignment

- There is no further definition of intolerable harm, other than the regulators qualifying that it constitutes harm from which consumers cannot easily recover and in that way is clearly distinct from 'harm' and 'inconvenience'.
- Firms are expected to set their impact tolerances in a way that addresses the potential for broad harm to be caused across multiple Important Business Services by a disruption.

PRA statement

- Dual-regulated firms should set a maximum of 2 Impact Tolerances for their Important Business Services but the PRA has reduced the scope of the applicability of its Impact Tolerance for financial stability by setting criteria to establish the firms for which this consideration should apply.
- If an Important Business Service is identified to pose a risk only to the FCA consumer-harm objectives then it would not be necessary to set a PRA Impact Tolerance, albeit that a clear rationale would be required to support this assessment.

Considerations for firms

Generally the approach to defining Impact Tolerances outlined in the consultation papers is unchanged and has been adopted into the Policy Statements, meaning that where work has been undertaken it will remain relevant to the compliance requirements that enter into force on March 31st 2022.

Nevertheless, it is interesting to note the clarification for dual regulated firms on the application of both an FCA and PRA Impact Tolerance. Given the qualification that the PRA has provided on the scope of its application, work now needs to be undertaken to assess the relevance of a PRA Impact Tolerance for each Important Business Service. Even if it is concluded that a PRA Impact Tolerance is not appropriate, the rationale for such a decision needs to be clearly documented for review.

Finally, as had been largely expected, firms are being guided by their regulators to consider, and where possible involve, critical third parties in their setting of Impact Tolerances. This means increased due diligence and engagement over the next 12 months to ensure that Impact Tolerances are defined with a clear line of sight on the dependency on, and resilience of, those third parties.

Mapping

Greater clarity around resources, third-parties. FCA allows for a staged approach over 4 years, to achieve detailed mapping.

Policy extracts

FCA/PRA alignment

- Both regulators clarify that mapping should be updated at least once a year or if there is a material change.
- Confirm that use of outsourcing and third-party providers for an important business service would not create a vulnerability in meeting the firm’s impact tolerances.

PRA statement

- Firms need to understand where they are reliant on sub-outsourcing arrangements and if these arrangements pose a threat to operational resilience. At a minimum firms need to monitor the sub-outsourced providers involved in the provision of important business services and ensure the service provider oversees any material outsourcing.

FCA statement

- Mapping must be undertaken by 31 March 2022 only to the extent necessary to identify important business services, set impact tolerances and identify any vulnerabilities in their operational resilience. Firms will have until 31 March 2025 to continue mapping to a greater degree of sophistication.

Considerations for firms

Broadly the overall mapping requirements haven’t changed, although helpful additional detail is provided on the definition of resources and the treatment of outsourcing and third-party providers, as well as sub-outsourcing providers. In response, firms will need to refine their existing third-party oversight and risk frameworks in order to embed resilience within them, and ensure there is a clear view of the key dependencies on third parties and the implications of this on the resilience of a firm’s important business services.

The clarity on the required level of detailed mapping in the first year will help firms to scope what approach they take in the short term, versus longer term considerations around more complex mapping and tooling approaches.

Scenario testing

Frequency of testing is not mandated. Involvement of third-parties is expected.

Policy extracts

FCA/PRA alignment

- The regulators do not mandate annual scenario testing of the ability of Important Business Services to remain within Impact Tolerance but instead reiterate that scenario testing should be proportionate to the scale and complexity of the firm and its Important Business Services.
- Additionally, both regulators have reinforced the expectation that firms work with their third parties to test the ability to operate within Impact Tolerance, using their mapping to identify where severe but plausible disruption to those third parties may have material implications on their Impact Tolerance.

Considerations for firms

Clarifications around the frequency of scenario testing will be welcomed by many industry participants concerned about the operational burden of establishing a scenario testing capability. However, the overall emphasis on the importance of that capability in understanding resilience and preparing for disruption is significant.

Firms will need to think about the breadth of the scenarios that they defined within their testing plan given that it is such a pivotal management tool in understanding resilience during disruption. In addition, they will need to think about how they bring their critical third parties to the table for testing exercises or, where that is not possible, how they obtain the necessary data from those third parties to support robust test outcomes and a true understanding of resilience.

Communications

Policy extracts

FCA statement

- The choice of communication method should take account of the circumstances, needs and vulnerabilities of customers and stakeholders.

Considerations for firms

There is little change to the communication requirements outlined in the consultation papers, however firms should consider the suitability of their communications plans for vulnerable customers.

Governance and Self-Assessment

Board approval remains key. Self-Assessments must be ready within a year.

Policy extracts

FCA/PRA alignment

- From a broad governance perspective, both regulators have maintained the emphasis on Board approval and ownership of critical elements of operational resilience strategy – even down to the FCA reinforcing the need for the Board to have sight of and sign-off responsibility for the mapping of Important Business Services.
- The regulators have broadly pushed the definition of the Self-Assessment document on to firms to determine as appropriate and proportionate, albeit they have reasserted the minimum contents as were set out in their CPs.
- Self-Assessment does not need to be submitted on a defined cycle but must be ready for review from 31st March 2022.

Considerations for firms

Fundamentally, there isn't a huge amount of additional insight or clarification provided through the Policy Statement, other than to reinforce the significance of Board involvement in the overall understanding and management of resilience across an organisation.

Firms still need to develop their own approach to constructing their Self-Assessment document in a way that doesn't create an overly burdensome administration requirement but that does provide all of the supporting rationale that the regulatory authorities are looking for in terms of the understanding of resilience and the remediation of vulnerabilities across an organisation.

Group considerations

No need to aggregate impact tolerances at group level.

Policy extracts

FCA/PRA alignment

- Firms need to identify individual important group business services delivered by entities of the UK group, and set an appropriate impact tolerance for them. They do not need to aggregate impact tolerances for the group overall.
- There is no requirement to prioritise an important group business service over an important business service.

Considerations for firms

The clarification in the Policy Statement is certainly helpful in reducing some of the potential complexity in having to roll-up Impact Tolerances into a meaningful expression at Group level. Nevertheless, the need to rationalise the Group vs. Entity dynamic across the Important Business Service inventory will take time and can only be meaningfully completed at the point at which an initial inventory has been developed for all relevant UK entities.

For significant UK financial services groups, this means that there is a need to accelerate the finalisation of the inventory in order to make sensible decisions about the services that sit at Group level. This rationalisation will place a particular emphasis on the consistency of the underlying resource profile required to deliver the service within individual entities. Where the resources become too diverse from a Group perspective, the ability to set Impact Tolerances that are robust across a range of 'severe but plausible' scenarios will be a complex challenge.

Global requirements

PRA sees alignment, in principle, with Basel. Firms should be vigilant for international inconsistencies, as well as good practice that may be transferable across regimes.

Policy extracts

A number of regulators across the globe are consulting on enhanced operational resilience requirements.

PRA statement

The Basel Committee on Banking Supervision (BCBS) consultation is explicitly referenced.

Despite some differences in terminology, the PRA considers there is alignment on the core principles:

- a distinction between operational risk and operational resilience;
- operational resilience as an outcome that firms continually need to work towards;
- the importance of operational resilience for both financial stability and the safety and soundness of firms;
- the concept of a risk or impact tolerance to define what may be acceptable that does not assume zero failure; and
- the use of scenario testing to assure resilience.

The PRA will continue to engage with international policy development processes and it is realistic to assume that there will be local differences in implementation, and it is reasonable that different jurisdictions will have different views on what they consider critical or important. As long as the principles are aligned, firms and their supervisors should be able to work effectively across borders.

Considerations for firms

As a general approach, firms should review the FCA/PRA proposals against any international requirements they may be subject to. Firms will want to identify where there are areas of consistency and where there are differences between geographical requirements.

By understanding the consistencies across geographies, firms will be able to establish a set of baseline global principles for all geographies their organisation operates within.

Where there are observable inconsistencies in the global policy landscape, firms will necessarily need to focus on adapting their Resilience Framework as required by the local jurisdiction in the immediate term. Nevertheless, there will be opportunities to consider where the requirements of a specific regulator could be considered good management practice or an enhancement to the approach employed by other regulators. In these instances, as long as there is no direct contradiction with other jurisdictions, firms may potentially wish to incorporate these into the base requirements.

Conclusion

The policy statements will provide much needed clarity on existing points of contention, however they also mark the start of a countdown to compliance that is fast approaching.

There is acknowledgement across the industry that there is already a substantial amount of change being undertaken. When considered against a COVID-19 backdrop, the size and complexity of the task should not be underestimated.

For organisations who are at the beginning of their journey, there is critical thinking and internal discussion required to ensure the implementation is effective and efficient. The clarifications and detail contained within the policy statements should prove useful inputs, however transitioning the requirements into operational activity takes time and effort. These firms must accelerate their implementation now to ensure that the large volume of operational change can be delivered by March 2022.

For firms who have already begun their implementation journey, there is now an opportunity to pause and reflect on whether the scope and approach of their programmes is sufficient to enable them to meet the requirements within the stated timelines. Some of the clarifications provided in the policy statement may enable firms to tackle previously impassable hurdles or require firms to revisit work they have already completed.

Authors and contact details

At Baringa Partners we have extensive experience in helping Financial Services organisations to develop and refine their Operational Resilience Strategy, Operating Model and Frameworks, as well as supporting on the implementation of all the key requirements outlined by the regulators.

If you have any questions or would like to discuss further, please reach out to one of our experts.

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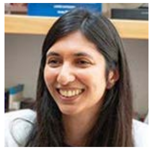

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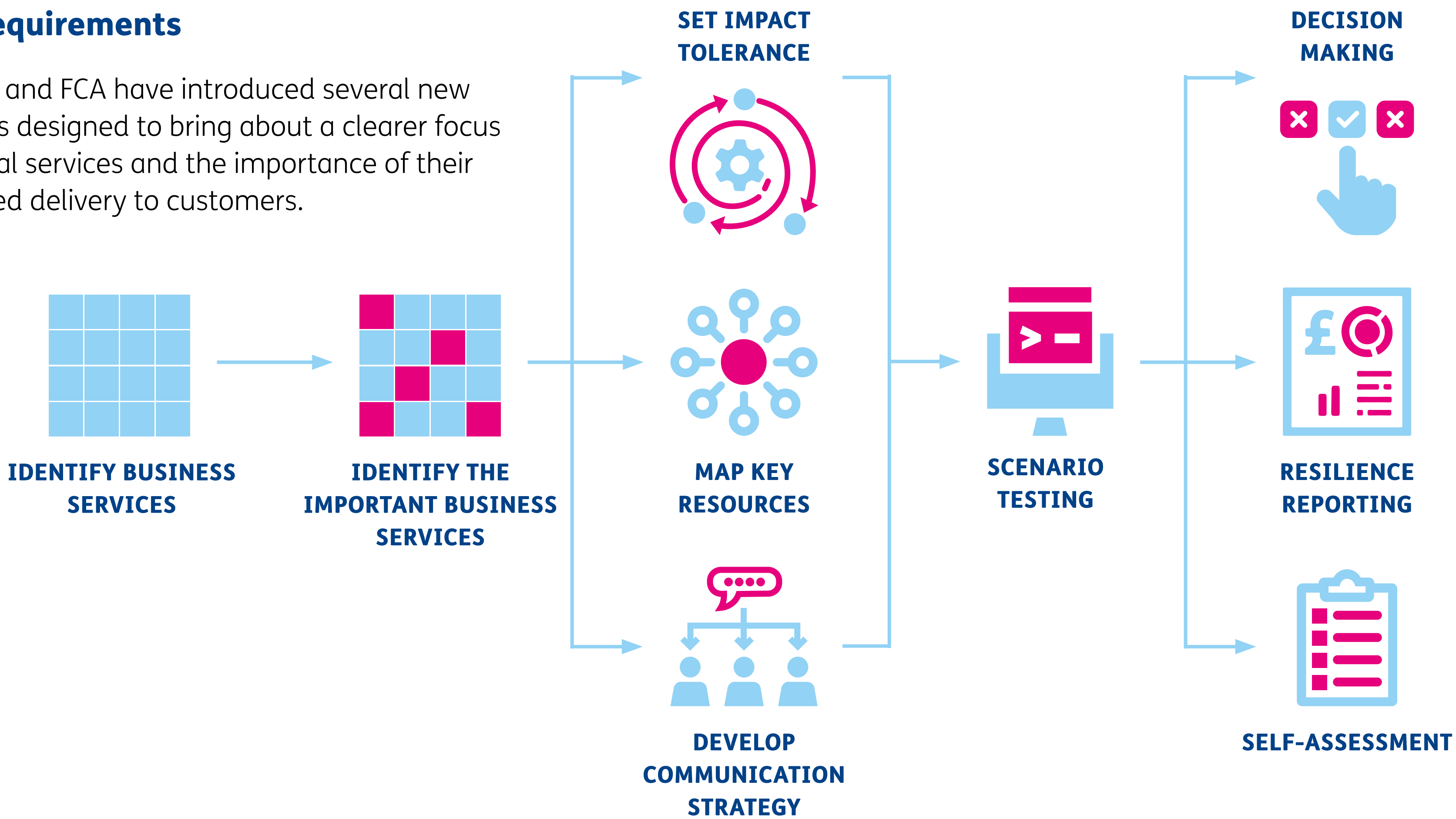
Appendix - Regulatory expectations

This figure summarises the key requirements set out across the policy statements:

Core requirements

The PRA and FCA have introduced several new concepts designed to bring about a clearer focus on critical services and the importance of their continued delivery to customers.



About Baringa Partners

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We use our industry insights, ideas and pragmatism to help each client improve their business.

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