Financial Services Regulatory Insights

UK authorities finalise operational resilience approach

HOT TOPIC

March 2021

Highlights

In the first 12 months, firms are required to map and scenario test to a level of sophistication necessary to accurately identify their important business services, set impact tolerances and identify any vulnerabilities in their operational resilience. The authorities have clarified that firms are not required to have performed the full mapping and testing exercises to the full extent of sophistication by 31 March 2022.

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Summary

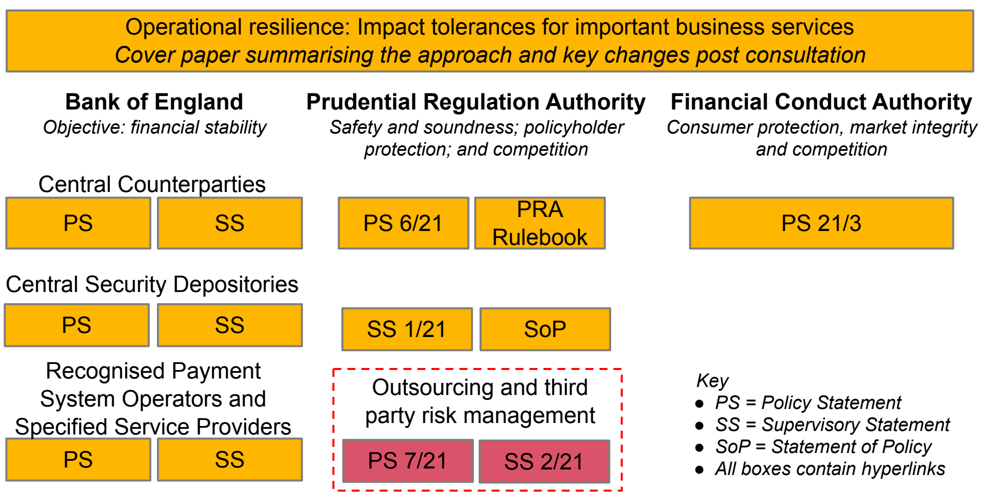
The Bank of England (BoE), Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA) (together the ‘supervisory authorities’) published their final policy and supervisory statements under the title ‘Operational resilience: impact tolerances for important business services’ on 29 March 2021. This concludes an extended period of engagement with the industry, starting from the 2018 discussion paper and followed by the 2019 consultation papers.

While there are no fundamental changes to the approach there are some helpful clarifications to the application of the policies. Firms and Financial Market Infrastructure providers (FMIs) (together referred to here as ‘firms’) will want to understand how these changes may influence their current or planned work.

Headline messages

- **Flexibility in applying the policies** - the new policy statements are designed to give firms flexibility and proportionality in applying the rules and guidance in a way which is appropriate to them, for example avoiding prescriptive taxonomies or tests.
- **Transitional arrangements -** as above the regulators have *slightly* softened their expectations in the implementation period up to 31 March 2022
- **Prevention vs response** - the messaging highlights the importance of focusing on both preventing incidents wherever possible, as well as practising response activities for when failures happen.
- **Industry collaboration**: the regulators encourage collaboration to drive good practice and acknowledge that standards may emerge over time.
- **COVID-19**: recognition that while firms have demonstrated a good degree of resilience in 2020, they need to prepare for other severe disruptions with different characteristics and which are firm specific.

The figure below sets out the package of papers which have been published. This paper focuses on the PRA and FCA approaches to operational resilience.



Context

The overall regulatory approach on operational resilience remains largely unchanged. Operational resilience refers to the ability of firms and the financial sector as a whole to prevent, adapt, respond to, recover from, and learn from operational disruptions. An operationally resilient firm is considered one which, per the consultation papers:

Prioritises the things that matter: by understanding the services it delivers to an external end user or participant and determining which are the most important given the propensity to pose an intolerable risk to the regulators' objectives. The firm should also understand the critical dependencies to deliver the service.

Sets clear standards for operational resilience: by defining the maximum tolerable level of disruption to an important business service, expressed by reference to specific outcomes and metrics.

Invests to build resilience: by testing its ability to remain within its impact tolerances and identifying where vulnerabilities need to be addressed, while being prepared to invest to build resilience.

Scope of application

The scope of the new policies remain largely as suggested in the consultation papers, namely:

FCA: banks, building societies, designated investment firms, insurers, Recognised Investment Exchanges (RIEs), enhanced scope senior managers' and certification regime (SM&CR) firms, and entities authorised or registered under the Payment Services Regulations 2017 or the Electronic Money Regulations 2011.

PRA: UK banks, building societies, PRA-designated investment firms (banks), UK Solvency II firms, the Society of Lloyd's and its managing agents (insurers).

BoE: Central Counterparties; Recognised Payment System Operators and Specified Service Providers; Central Securities Depositories.

The supervisory authorities expect those firms not subject to the new policy to meet their existing operational resilience obligations.

New points of interest

Clarification that third country branches are not in scope for the *new* policy areas but existing FCA and PRA rules apply, some of which are relevant. Payment firms which also carry out FSMA regulated activities will also be pleased to see that they do not need to include those activities if they would not be in scope on a standalone basis.

Important business services

Firms should follow the definitions of important business services (IBS) as set out by the FCA and PRA respectively, namely:

- **FCA**: IBS means a service provided by a firm, or by another person on behalf of the firm, to one or more clients of the firm which, if disrupted, could: (1) cause intolerable levels of harm to any one or more of the firm's clients; or (2) pose a risk to the soundness, stability or resilience of the UK financial system or the orderly operation of the financial markets.
- **PRA**: IBS means a service provided by a firm, or by another person on behalf of the firm, to another person which, if disrupted, could pose a risk to: (1) (where the firm is an O-SII/where the firm is a relevant Solvency II firm) the stability of the UK financial system; (2) the firm's safety and soundness; or (3) (for Solvency II firms) an appropriate degree of protection for those who are or may become the firm's policyholders.

Key considerations in identifying IBS

- All (in scope) firms will have at least one important business service that may impact the firm's safety and soundness.
- The FCA and PRA have set out minimum factors for firms to consider in identifying important business services. While these do not preclude the use of additional factors, such factors should not reduce the list of IBS.
- Firms are required to identify important business services at least annually, and after a material change to the business (e.g. starting / stopping an "activity", starting a new outsourcing arrangement, or changes to the existing service in terms of scale or potential impact.
- Business services should be articulated at a level of granularity which enables an impact tolerance to be applied and which supports management bodies in making prioritisation and investment decisions.
- Where a firm is a member of a group it is expected to identify a proportionate number of important group business services

New points of interest

IBS for dual-regulated firms: the joint cover paper indicates that a business service may only be important for one regulator if it does not meet definitions for both PRA and FCA.

Further clarification on internal services: While some examples have been previously cited as out of scope, e.g. payroll, other examples have been introduced as they support business services and are not customer-facing, e.g. settlement or treasury services.

Impact on financial stability: the PRA has narrowed the requirement for firms to consider financial stability in identifying IBS and setting impact tolerances to only those firms identified as other systemically important institutions (O-SIIs) and insurers with gross written premiums exceeding £10 billion or technical provisions exceeding £75 billion, both on a three-year rolling average.

OCIR and operational resilience: the PRA distinguishes important business services, from critical (and essential) services for OCIR which are likely to form a more comprehensive set of internal and external provided services that must continue during the process of resolution from stress to post-resolution restructuring. We have recently published a practical guide to how OCIR and resilience align.

Other PwC publications on important business services

Defining business services

Resilience and resolution

Mapping

- A firm must identify and document the necessary people, processes, technology, facilities *and* information (referred to as resources) required to deliver each of its IBS. This includes where third parties provide the resources.
- Firms should map the IBS with the aim of: identifying and remedying vulnerabilities; and enabling firms to conduct scenario testing.
- It is expected that IBS maps are updated as a minimum at least once a year or after a material change to the business.

New points of interest

Implementation period: of most significance is the slight softening of requirements in year one of the implementation period, with firms no longer expected to have '*performed mapping and scenario testing to the full extent of sophistication by 31 March 2022*'. See the final page for more information on the timeline.

Variation in approach: mapping approach is expected to vary between IBS and between firms based on the different requirements to meet the policy outcomes.

Governance and sign-off: it is expected that the Board, or equivalent management body, approves the mapping exercise.

Impact tolerances

Firms should follow the definitions of impact tolerances as set out by the FCA and PRA respectively, namely:

FCA: impact tolerances means the maximum tolerable level of disruption to an important business service, as measured by a length of time in addition to any other relevant metrics, reflecting the point at which any further disruption to the important business service could cause intolerable harm to any one or more of the firm's clients or pose a risk to the soundness, stability, or resilience of the UK financial system or the orderly operation of the financial markets.

PRA: impact tolerances means the maximum tolerable level of disruption to an important business service or an important group business service as measured by a length of time in addition to any other relevant metrics.

Key considerations in setting impact tolerances

- Firms should set a tolerance for disruption for each important business service.
- It is mandatory for impact tolerances to be set using time / duration metrics, but they can also be supplemented with additional metrics. This is particularly appropriate where IBS can continue to run at a percentage capacity of its full capability for a period of time.
- An impact tolerance should relate to a single disruption, rather than an aggregation of a number of disruptions.
- Dual-regulated firms will be expected to set and manage up to two impact tolerances for each of their important business services: one at the first point at which there is an intolerable level of harm to consumers or market integrity (FCA), and another at the first point at which financial stability (excluding small and medium-sized firms), a firm's safety and soundness, or policyholder protection is is put at risk (BoE/PRA).
- Firms are required to set impact tolerances at least annually
- Firms retain the responsibility to ensure they can remain within impact tolerances regardless of whether or not it uses third parties for the provision of an IBS.

New points of interest

FCA definition of intolerable harm: the FCA sees intolerable harm as something from which consumers cannot easily recover, e.g. where a firm is unable to put a client back into a correct financial position, post-disruption, or where there have been serious non-financial impacts that cannot be effectively remedied. Some firms may view this definition as leading to a higher tolerance threshold than previously considered.

Vulnerable customers: firms are not required to set specific impact tolerances for vulnerable customers (FCA). Vulnerable customers should be considered through the process of identifying IBS and setting impact tolerances.

Aggregate harm when multiple business services are disrupted: the simultaneous disruption of multiple important business services could mean that aggregate harm is felt more quickly and severely. Firms are therefore expected to take steps to stay within impact tolerances where multiple IBS could be impacted by a disruption of a common operational asset and where they could be impacted by an external factor disrupting multiple assets (e.g. through a cyber attack).

Application of impact tolerances for dual-regulated firms: clarification that while firms may justify setting their separate impact tolerances at the same point for the PRA and FCA, they will need to demonstrate: 1) they have considered each of the PRA and FCA objectives when setting impact tolerances; 2) how their recovery and response arrangements are also appropriate for the longer tolerance; and 3) that scenario testing has been performed with the longer tolerance in mind. The PRA also clarifies that it does not mandate that dual-regulated firms must set two impact tolerances for all important business services, e.g. where an important business service is identified to pose a risk only to the FCA consumer harm objectives.

Impact on financial stability: as stated above, the PRA no longer requires small and medium-sized firms to consider financial stability in setting impact tolerances.

Other PwC publications on impact tolerances

How to set and test impact tolerances

Scenario testing

Scenario testing: is the testing of a firm's ability to remain within its impact tolerance for each of its important business services in the event of a severe (or in the case of FMIs, extreme) but plausible disruption of its operations.

In carrying out the scenario testing, a firm must identify an appropriate range of adverse circumstances of varying nature, severity and duration relevant to its business and risk profile, and consider the risks to delivery of the firm's important business services in those circumstances.

Key considerations in scenario testing:

- Firms are expected to test using a range of severe but plausible scenarios, but not every possible scenario; and including those where they anticipate exceeding their impact tolerance to learn from them.
- Firms could consider previous incidents or near misses within the organisation, and across the financial sector as well as within other sectors and jurisdictions.
- The severity of scenarios used by firms for their testing could be varied by, for example, increasing the number of type of resources unavailable for delivering the important business service, or extending the period for which a particular resource is unavailable.
- There will be scenarios where firms find they could not deliver a particular IBS within their impact tolerance, such as if essential infrastructure (e.g. power or telecommunications) were unavailable.

New points of interest

Implementation period: of most significance is the slight softening of requirements in year one of the implementation period with firms no longer expected to have 'performed mapping and scenario testing to the full extent of sophistication by 31 March 2022'. *According to the FCA PS21/3: 'Firms will not need to have performed scenario testing of every important business service by [31 March 2022]'.*

Frequency of testing: the requirement has changed from annual scenario testing to firms being required to test when: 1) there is a material change to the firm's business, the IBS identified or the impact tolerances set against them; 2) following improvements made by the firm in response to a previous test; and 3) in any event, on a regular basis.

Industry tests: the supervisory authorities will not set industry-wide operational scenarios at this stage but will consider them as part of their longer term supervisory approach.

Testing with third parties: firms should work effectively with third parties to carry out testing where they form part of the delivery of an IBS.

Prioritising remedial action: In prioritising action to improve resilience after testing firms should consider the nature and scale of the risk that disruption to the IBS could have on the regulatory objectives, the time-criticality of the IBS, and the scale of improvement necessary to remain within impact tolerance.

Governance and self-assessment

The papers reiterate the importance of the SM&CR for establishing clear lines of responsibility and accountability for the management of operational resilience.

This includes a focus on the Chief Operations Function (SMF24), for firms where this role exists, which is required to have responsibility for managing the internal operations or technology of the firm or of part of the firm.

There are also clear expectations for a firm's board or equivalent management body in taking responsibility for delivering the policy outcomes and overseeing the firm's approach to operational resilience. This includes approving the IBS and impact tolerances set for each of them, as well as the written self-assessment.

Key considerations for the self-assessment

- Firms will be expected to maintain an up-to-date self-assessment document which outlines their resilience journey. The document should demonstrate to the relevant supervisory authority that they are meeting their operational resilience responsibilities.
- Self-assessments are not required to be submitted periodically - they need to be made available upon request.
- They should include the firm's*:
  - important business services
  - corresponding impact tolerances
  - approach to mapping and identification of resources, and how mapping is used to identify vulnerabilities and support scenario testing
  - strategy for scenario testing, including a description of the scenarios used, the types of testing undertaken and the scenarios under which firms could not remain within their impact tolerances
  - view of the vulnerabilities that threaten the firm's ability to deliver its important business services within impact tolerances, including the actions taken or planned, and justifications for their completion time
  - lessons learned exercises
  - methodologies used to undertake the above activities.

Firms should apply the principle of proportionality to the document based on, for instance, their scale and risk profile. The document should be reviewed and approved by the firm's board or equivalent management body regularly.

PRA policy and supervisory statements on Outsourcing and third party risk management

The PRA has now published its final policy statement (PS7/21) amd supervisory statement (SS2/21) on outsourcing and third party risk management. For the purpose of the operational resilience policies, firms are expected to satisfy themselves of a third-party's resilience where they support the delivery of an important business service.

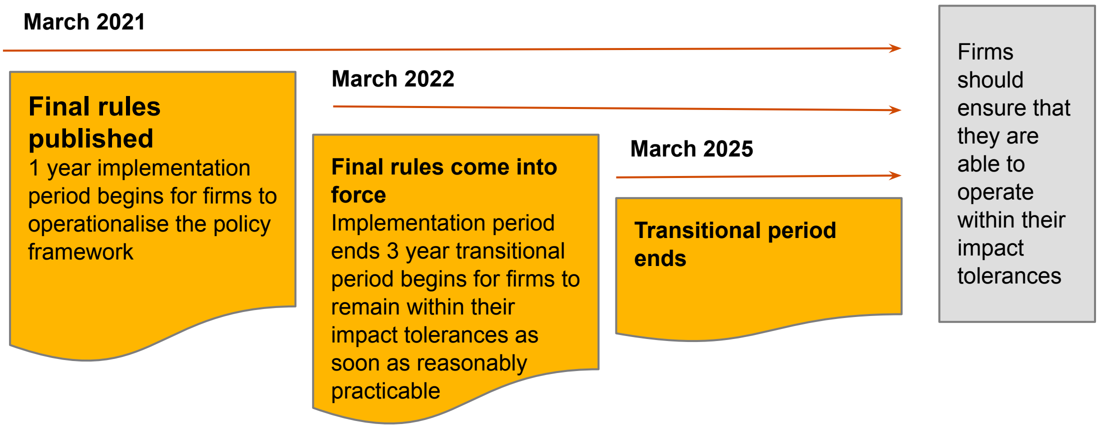
For more in-depth analysis of the proposals please visit the **PwC Hot Topic on Outsourcing.**

Impact of coronavirus (COVID-19)

The regulators have found that those firms that had mapped their IBS before the COVID-19 pandemic struck found themselves in a stronger position than their peers in identifying key workers and activating contingency plans. This has reinforced their thinking on the policy framework. It is important for firms to recognise, though, that while they may have demonstrated a good degree of resilience in 2020, they need to prepare for other severe disruptions with different characteristics and which are firm specific.

* There are variations for what documentation is required of FMIs by the Bank of England

Figure : Adapted from FCA PS 21/3



Next steps

Implementation timeline and transitional arrangements
The timeline above sets out the implementation period. While the timeline itself has not changed during the consultation there is an important clarification in regulatory expectations for the first 12 months as follows:

FCA PS 21/3: *'During the implementation period which runs to 31 March 2022, firms will only need to carry out mapping and scenario testing to a level of sophistication necessary to accurately identify their important business services, set impact tolerances and identify any vulnerabilities in their operational resilience."*

We think this acknowledges both the journeys that firms are on in understanding and applying the new regulatory framework as well as the capacity of supervisors to complete their initial assessments across a large number of firms.

It is also worth highlighting the strong warning against inaction:

FCA PS 21/3: *'Firms should not wait until the end of the 3-year transitional period to be able to remain within their impact tolerances, but rather remain within them as soon as reasonably practicable within the 3-year period. The 3-year period is a hard deadline. However a firm that is not making reasonable effort to remain within its impact tolerances during the 3-year period would be in breach of our rules.'*

What does this mean for firms?

- In-scope firms now have the final package of policy and supervisory statements which set out the regulatory requirements on operational resilience going forward.
- There is a clear timeline with an initial implementation period to 31 March 2022 followed by a period of 'reasonable time' to demonstrate that firms can remain within their impact tolerances for important business services in severe but plausible scenarios (and no later than 31 March 2025).
- We have set out some recommended actions firms can take in our paper (link below) on Preparing for new UK policies. This provides some practical steps for firms that are "starting out", those that are "work in progress", as well as "leading edge" firms. To discuss how we can help you in your resilience journey please contact us.

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Other PwC publications

PwC has published a range of papers with practical tips on how to implement the new operational resilience regulation, as well as an extensive catalogue of blogs with short opinion pieces.

Preparing for new UK policies

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