

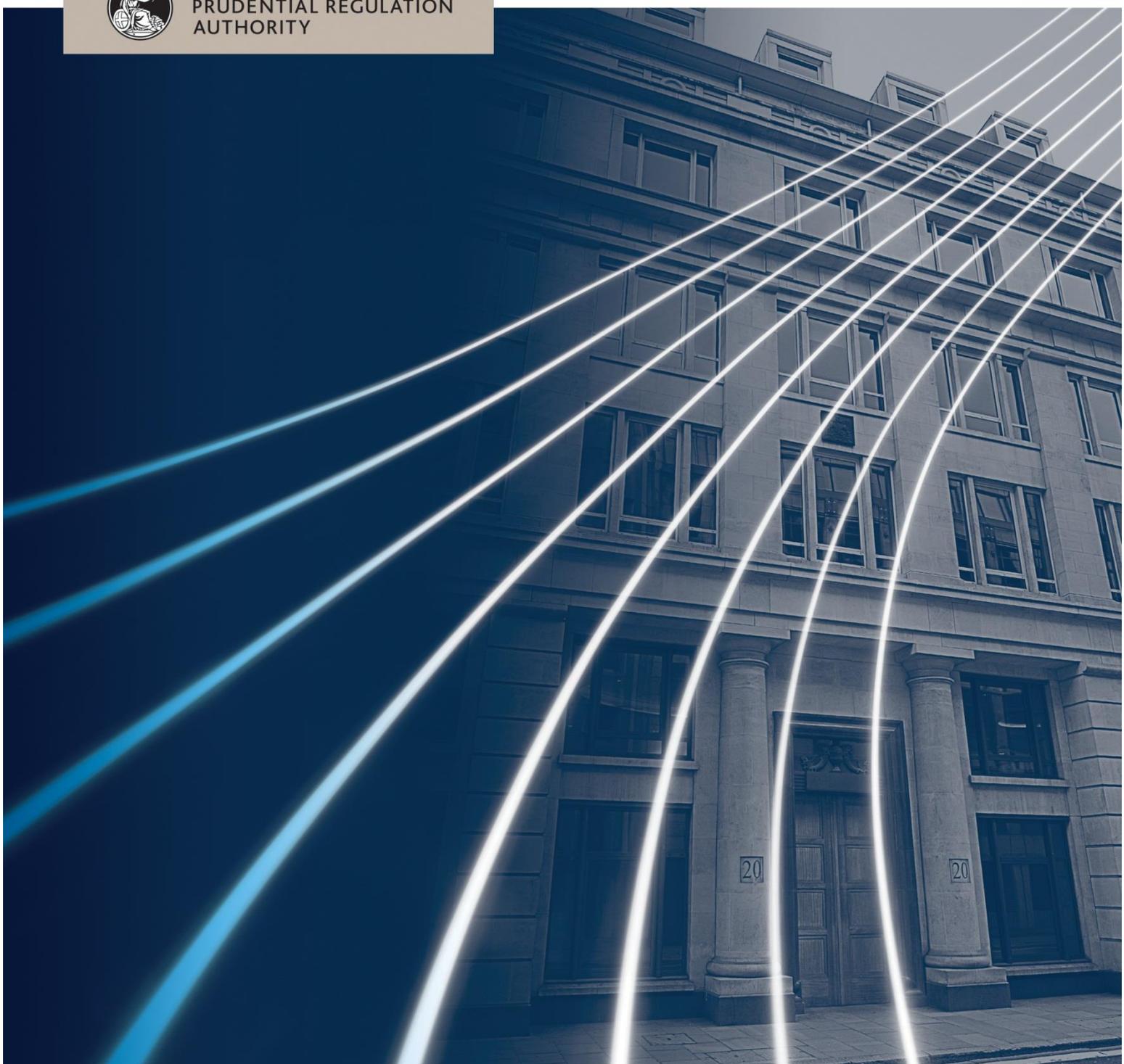
Policy Statement | PS21/16

Ensuring operational continuity in resolution

July 2016



BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY





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This policy statement (PS) provides feedback on responses received to consultation paper CP38/15 'Ensuring operational continuity in resolution' and the addendum to CP38/15. The appendices to this PS set out the final rules and supervisory statements to implement the matters consulted on in CP38/15 and the addendum to CP38/15

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1 Overview

1.1 This Prudential Regulation Authority (PRA) policy statement (PS) provides feedback to responses to CP38/15 'Ensuring operational continuity in resolution' and the addendum to CP38/15 (henceforth CP38/15).¹

1.2 In CP38/15, the PRA consulted on rules and a supervisory statement aimed at ensuring firms' operational arrangements facilitate continuity of critical services supporting functions critical to the economy in resolution. The appendices to this PS set out final rules and a supervisory statement to implement the proposals consulted on in CP38/15.

1.3 This PS is relevant to UK banks, building societies and PRA-authorized investment firms (hereinafter 'firms') which have or receive critical services supporting functions critical to the economy that need to be continued in resolution. The conditions for application of the rules is set out in rule 1.1 of the Operational Continuity Part, in Appendix 2 of this PS. Firms above the thresholds in rule 1.1 are expected to have critical services supporting functions critical to the economy that need to continue in resolution.

1.4 The PRA is required by the Financial Services and Markets Act 2000 (FSMA) to publish a statement on the impact of rules on mutuals where the final rule differs from the draft of the proposed rule.² In the PRA's opinion, the impact of the final rules on mutuals is not significantly different from the impact of the previously proposed rules on mutuals.

1.5 The PRA is required by FSMA to have regard to any representations made to the proposals in a consultation, to publish an account, in general terms, of those representations and its response to them, and to publish details of any significant differences in the rules as made.

1.6 The PRA is making a change to the financial resilience expectations set out in the draft supervisory statement. The PRA is removing the capital expectation as set out in the supervisory statement and instead the Bank of England, as resolution authority, will consider whether a loss absorbing capacity should be allocated within groups to ensure operational continuity as part of its gone concern regime. Chapter 2 of this PS sets out further detail on the change.

1.7 Overall, the PRA does not consider that the responses received to other areas of CP38/15 necessitate significant changes to its proposals. The PRA has however made minor amendments to the proposed rules and supervisory statement consulted on in CP38/15 in light of feedback received, mainly to add further clarity. Chapter 2 of this PS describes the most important issues raised by respondents and notes the main areas where the PRA has made amendments to the proposals in CP38/15.

Other publications

1.8 The PRA has also published a policy statement providing feedback on responses received to CP37/15 'The implementation of ring-fencing: prudential requirements, intragroup arrangements and use of financial market infrastructures'.³ This follows the publication of policy statement PS10/15 in May 2015, which set out the PRA's near-final rules and

1 PRA Consultation Paper 38/15 'Ensuring operational continuity in resolution', October 2015, available at: www.bankofengland.co.uk/pr/Pages/publications/cp/2015/cp3815.aspx.

2 Section 138K of FSMA.

3 PRA Consultation Paper 37/15 'The implementation of ring-fencing: prudential requirements, intragroup arrangements and use of financial market infrastructures' October 2015, available at: www.bankofengland.co.uk/pr/Pages/publications/cp/2015/cp3715.aspx.

supervisory statement on the proposals consulted on in CP19/14 in respect of legal structure, governance and the continuity of services and facilities.¹ PS20/16 'The implementation of ring-fencing: prudential requirements, intragroup arrangements and use of financial market infrastructures', sets out the final rules and supporting policy to implement the proposals consulted on in CP37/15, and the near-final rules and supervisory statements set out in PS10/15.²

1.9 The PRA has also published a further consultation on the PRA's proposed ring-fencing policy CP25/16 'The implementation of ring-fencing: reporting and residual matters'.³ CP25/16 sets out the PRA's proposals in relation to the data it intends to collect in respect of ring-fencing. CP25/16 also sets out the PRA's proposals in respect of residual ring-fencing policy matters following publication of CP37/15, including the PRA's operational continuity policy in respect of access to financial market infrastructures (FMI).

1.10 The policy contained in the underlying rules and supervisory statement has been designed in the context of the current UK and EU regulatory framework. It will come into effect on 1 January 2019. The PRA will keep the policy under review to assess what changes would be required due to intervening changes in the UK regulatory framework, including as a result of the referendum on 23 June 2016.

2 Responses

2.1 Respondents to CP38/15 were broadly supportive of the proposals however did raise a number of specific issues and questions on the details of the rules and supervisory statement. These are discussed below by topic.

Financial resilience of the critical services provider

2.2 CP38/15 stated that a firm should ensure that a critical services provider located in a group has sufficient financial resources to ensure the provision of critical services to receiving entities during stress, resolution, and after resolution, as part of post-resolution restructuring.

2.3 Respondents argued that firms have insufficient certainty as to how to comply with the requirements and questioned the interaction with other capital requirements and the liquidity regime.

2.4 The PRA maintains that a critical services provider should have sufficient resources to ensure the provision of critical services to receiving entities during stress, resolution, and after resolution, as part of post-resolution restructuring.

2.5 However, the PRA has removed the specific expectation in the supervisory statement that the service provider should be supported by capital (or positive net assets, as appropriate) equivalent to 25% of annual fixed overheads of the critical services provided by the critical services provider. This is because the PRA considers that, while sufficient financial resources are necessary, the key financial risks to the service provider would most likely arise in

1 PRA Consultation Paper 19/14 'The implementation of ring-fencing: legal structure, governance and the continuity of services and facilities', October 2014, available at: www.bankofengland.co.uk/pr/Pages/publications/cp/2014/cp1914.aspx and PRA Policy Statement 10/15 'The implementation of ring-fencing: legal structure, governance and the continuity of services and facilities', May 2015, available at www.bankofengland.co.uk/pr/Pages/publications/ps/2015/ps1015.aspx.

2 PRA Policy Statement 20/16 'The implementation of ring-fencing: prudential requirements, intragroup arrangements and use of financial market infrastructures', July 2016, available at: www.bankofengland.co.uk/pr/Pages/publications/ps/2016ps2016.aspx.

3 PRA Consultation Paper CP25/16 'The implementation of ring-fencing: reporting and residual matters', July 2016, available at: www.bankofengland.co.uk/pr/Pages/publications/cp/2016/cp2616.aspx.

resolution and therefore are better covered as part of the Bank's gone concern regime. The Bank of England, as resolution authority, will consider whether loss absorbing capacity should be allocated within groups to ensure operational continuity as part of its gone concern regime.

2.6 In addition, firms are still required to meet the General Organisational Requirements and the Outsourcing Parts of the PRA Rulebook with regard to the service provider having adequate resources. The PRA considers that this can generally be met by the critical services provider being able to absorb losses and having adequate liquidity.

2.7 On liquidity, the PRA is not changing the expectation set out in the CP. Firms are required to ensure that a critical services provider within a group is, as a minimum, supported by liquidity resources equivalent to 50% of annual fixed overheads of the critical services provided by the critical services provider.

2.8 Some respondents were concerned that the PRA proposals in CP38/15 favour business unit provision of critical services over provision from a separate group entity and external provision over group provision. The PRA is not intending to favour one business model over another and expects the financial resilience expectation to apply consistently to both types of group models.

2.9 Firms still have an obligation to consider the financial resilience of external providers under the Outsourcing Part, but the specific proposals regarding liquidity in this policy statement do not apply to external providers. External service providers tend to have a more diversified client base, increasing their ability to withstand the failure of a service recipient as compared to a service provider located in a group that has a concentrated client base.

2.10 Respondents also found the use of the term 'group provider' unclear. In some scenarios it was unclear as to whether the PRA was referring to provision of services from a separate group service provider or provision from within a business unit of a firm in scope of the rules. The PRA has clarified the language in the supervisory statement and rules in the Operational Continuity Part on how the proposals apply to different service models.

Facilitating recovery and resolution

2.11 CP38/15 set out that a firm should ensure their operational arrangements supporting critical services facilitate recovery and resolution.

2.12 Respondents requested clarity on whether all firms need to restructure to meet the requirement. Respondents also felt the supervisory statement was generally unclear as to what firms needed to do to meet the requirements and demonstrate compliance.

2.13 The PRA expects firms to structure themselves so that they can execute recovery options, resolution and post-resolution restructuring within a reasonable time. Depending on an individual firm's circumstances this may require restructuring to comply with the rules. If a firm's structure already supports recovery options and resolution, then restructuring may not be required.

2.14 The PRA considers that if a firm undertakes comprehensive mapping from suppliers of critical services to recipient entities that provide critical functions, this would enable the firm to understand which critical services need to continue in resolution. It would also allow the firm to decide which non-critical services can be discontinued or transferred if the firm is restructured.

2.15 Firms should be able to demonstrate how they have met all other rules and expectations in the supervisory statement. Paragraphs 3.3 to 3.5 of the supervisory statement clarify further the actions that firms can take in order to demonstrate compliance with the rules in Chapter 2 of the Operational Continuity Part.

Services in scope

2.16 CP38/15 defined 'critical shared services' as those services that need to be available to one or more business units of a firm or entity of a group in order to provide functions critical to the economy.

2.17 Respondents questioned whether critical services need to be shared to be within scope of the policy, given the definition states that the service, as a minimum, has to be provided only to one business unit or entity in the group.

2.18 The policy intent is that any service that supports a function critical to the economy should be within scope of the policy if the failure to continue to provide the service could create disorderly resolution and have an impact on financial stability in the United Kingdom. The PRA does not consider that the critical service always needs to be shared across several business lines or legal entities in order to have such an impact, but if the critical service is shared, it may make it harder and more complex to unwind in a recovery or resolution scenario.

2.19 The PRA has amended the terminology in rule 1.5 of the Operational Continuity Part from 'critical shared services' to 'critical services'. This aligns with the definition originally included in CP38/15 and specified in 2.16 of this PS.

Governance

2.20 In CP38/15 the PRA set out that critical services providers should have their own governance structure in place, not rely excessively on staff remunerated externally to it and should have senior staff that will continue to be available to run the critical service provider in resolution.

2.21 Respondents wanted clarity on what the PRA meant by 'senior staff' in the supervisory statement and draft rule 4.2. Respondents also wanted clarity on the proposal that the service provider should not rely excessively on staff remunerated externally to it.

2.22 The PRA has clarified in the supervisory statement that 'senior staff' relates to management of sufficient seniority in place who are responsible for the day-to-day running of the services and who could ensure the services would continue to be performed in a resolution scenario. The PRA has also clarified Operational Continuity 4.2.

2.23 The PRA has also clarified in the supervisory statement that firms should anticipate that staff responsible for the running of the services provider will still need to be remunerated in a resolution scenario. As such, the main part of their remuneration should be paid by the services provider and they should be employed by the services provider where this is a separate entity.

2.24 Respondents also asked for clarity on how the proposals relate to the ring-fencing governance rules set out in CP19/14 and PS10/15.

2.25 PS20/16 sets out final PRA policy on ring-fenced body (RFB) governance, as previously set out in CP19/14 and PS10/15. PS20/16 requires an RFB not to depend on personnel that would cease to be available in the event of the insolvency of another member of its group. It does not

prohibit an RFB from relying on staff from group entities that provide critical services to the RFB (business unit provision or separate group entity provision). If the RFB relies on certain personnel in carrying on its business, as far as reasonably practicable, those employees should not cease to be available to the RFB in the event of the insolvency of a member of the RFB's group. Factors to be taken into consideration when making this judgement could include: if there are appropriate contingency arrangements in place in the event of there being a disruption to the entity; or if the RFB does not depend on these personnel in the carrying on of its business because, for example, the services being provided by these personnel to the RFB are substitutable.

Reporting requirements

2.26 Respondents requested that the PRA clarify whether a consultation on reporting for operational continuity is planned.

2.27 The PRA expects to consult on collecting data relating to the financial resilience expectation in summer 2016. Data relating to the critical services provider's operating expenses are expected to be required. This will allow the PRA to monitor and identify the appropriate level of liquid assets the critical services provider should hold.

Application to small firms

2.28 Respondents sought clarity on how the proposals apply to smaller firms that meet the application thresholds in the rules and wanted clarity on whether a waiver process would be considered.

2.29 As set out in CP38/15 the PRA expects compliance with the rules for smaller firms to be more straightforward as they are typically less complex and have fewer functions that are critical to the economy when compared with larger firms. Smaller firms with less complex structures are less likely to have to undertake significant restructuring to facilitate recovery options and improve resolvability. Some areas of the policy may not be relevant to small firms with simple structures. For example, the non-preferential treatment expectation in the supervisory statement is less likely to apply for a small firm that only has one entity in the group if there is no possibility of preferring one entity over another.

2.30 In relation to the waiver or modification process, the PRA has a discretionary power to waive or modify rules under section 138A of FSMA where the application of rules would be unduly burdensome or would not achieve the purposes for which the rules were made, and so long as the waiver or modification would not adversely affect the advancement of the PRA's objectives.

2.31 The PRA considers that firms that have bank insolvency procedure as their preferred resolution strategy may meet the statutory test on the basis that inclusion within the rules would not achieve the purpose for which the rules were made. This is because these firms are likely to not to have critical services supporting functions critical to the economy that need to be continued in resolution.

Charging Structures

2.32 The CP set out that the PRA expects charges for critical services to be predictable, transparent and set on an arm's length basis, irrespective of a firm's operating model.

2.33 Respondents requested further detail on the meaning of arm's length and the interaction with the PRA's draft proposals in CP37/15 on intragroup transactions and exposures for ring-fenced bodies. The PRA's view is that the meaning of arms' length is well-established and

internationally recognised. As a result, the PRA does not intend to define the term but will rely on its ordinary meaning, which is consistent with the approach taken under Banking Reform Act 2013. The PRA also considers the arm's length rules to be consistent with ring-fencing requirements, but reminds firms that it is their responsibility to ensure compliance with each set of requirements.

Access to operational assets

2.34 The CP set out that firms should articulate clearly how access to operational assets supporting critical services will be maintained at the point of resolution of the firm, another group entity or the critical service provider itself.

2.35 Respondents requested an example of when the PRA may require a recipient firm to own or lease an operational asset supporting critical services as set out in paragraph 8.3 of the draft supervisory statement.

2.36 The PRA does not mandate that assets need to be owned by the critical services provider or recipient firm if the firm is able to demonstrate that it can ensure continued access in the event of resolution. Where the asset is owned by the group or another legal entity and the firm cannot adequately demonstrate that access will be maintained, the PRA may require ownership to be transferred to the critical services provider.

Contractual service provisions

2.37 The CP set out that a critical services provider should not be able to change the arrangements of service provision as a result of a firm or a member of a group entering into a period of stress or resolution.

2.38 Respondents sought clarity on what the PRA meant in draft rule 3.2(2). Rule 3.2(2) states that firms must ensure that agreements governing critical services provided must entitle the firm to continue to receive those services during the firms resolution or restructuring 'as long as the firm fulfils its obligations under the agreement'.

2.39 The PRA has clarified in Operational Continuity 3.2(1) that arrangements must remain valid after the firm has entered resolution, provided there is no default on payment obligations.

3 Cost benefit analysis

3.1 Section 138J(5) of FSMA requires the PRA to publish a cost benefit analysis of any changes to the consultation proposals which the PRA considers to be significant.

3.2 As noted in 1.6 of this PS, we have made a change to the implementation of the financial resilience policy, but it is still the intention that firms will have to ensure there are sufficient financial resources to cover the risks of the critical services provider. However, the removal of the specific expectation will afford the firms some flexibility in meeting the financial resilience expectation.

Appendices

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- 1** **Supervisory Statement SS9/16: Operational continuity in resolution, available at:**
www.bankofengland.co.uk/prs/Pages/publications/ss/2016/ss916.aspx

 - 2** **PRA RULEBOOK: CRR FIRMS: OPERATIONAL CONTINUITY INSTRUMENT 2016,**
available at:
www.bankofengland.co.uk/prs/Pages/publications/ps/2016/ps2116.aspx
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