

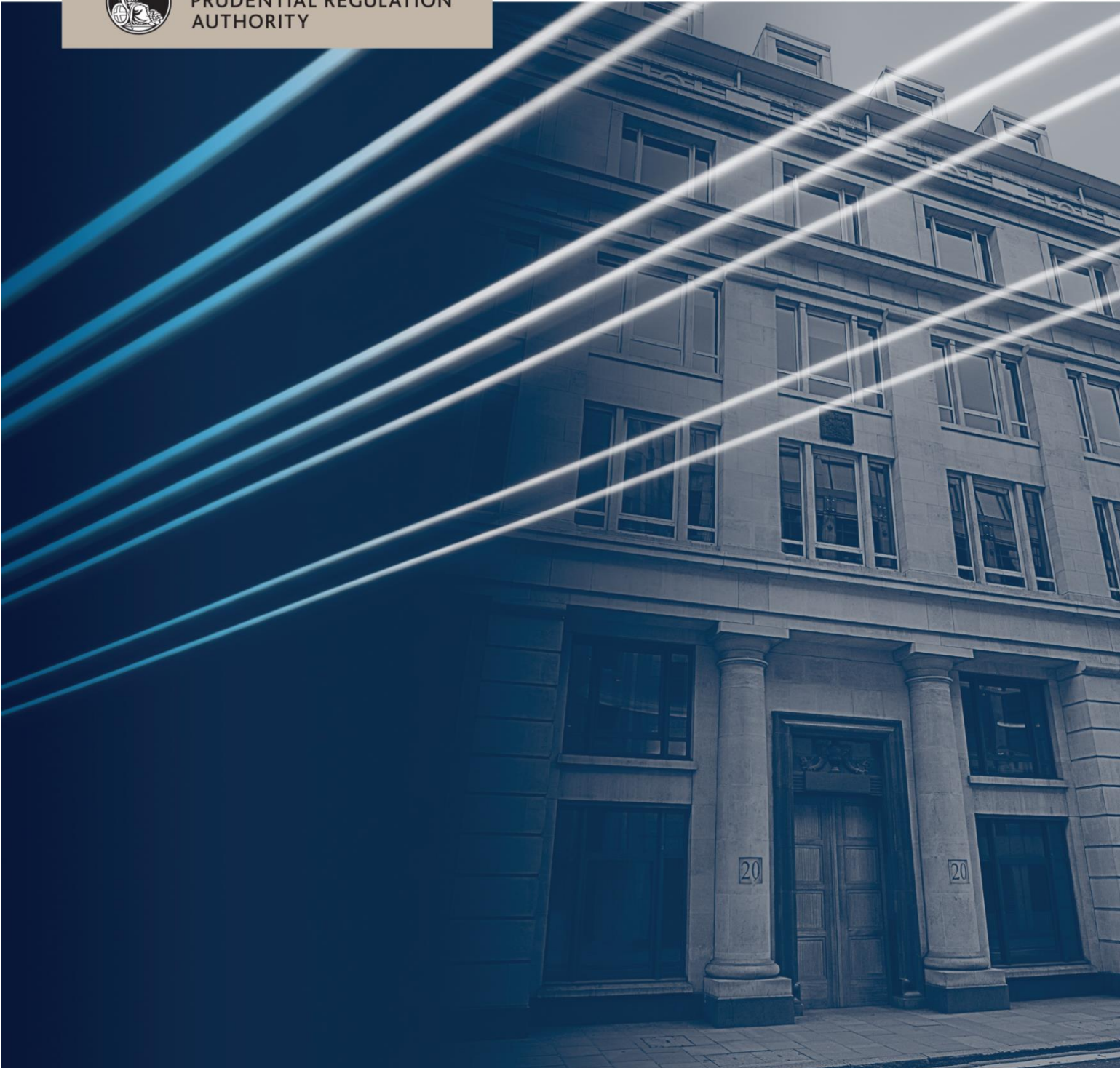
Supervisory Statement | SS9/16

Ensuring operational continuity in resolution

July 2016



BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY



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1 Introduction

1.1 This Prudential Regulation Authority (PRA) supervisory statement is relevant to UK banks, building societies and PRA-authorized investment firms (hereinafter 'firms') to which the Operational Continuity Part of the PRA Rulebook applies.

1.2 The purpose of this supervisory statement is to set out the PRA's expectations on firms to ensure operational continuity of critical services to facilitate recovery actions, orderly resolution and post-resolution restructuring.

1.3 Critical services are 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.

1.4 Providing clarity on the PRA's expectations in this area supports the PRA's general objective of promoting the safety and soundness of firms by reducing the adverse effects that the disorderly failure of a firm can have on the UK financial system.

1.5 Where necessary, the PRA may use its power under section 55M of the Financial Services and Markets Act 2000 (FSMA) to require a firm to meet these expectations. For example, if a firm has been authorised for less than three years but exceeds one of the application conditions in rule 1.1, the PRA will assess on a case-by-case basis whether the firm is in scope and therefore should comply with the Operational Continuity Part and this supervisory statement.

1.6 For non-EEA firms operating in the United Kingdom through a branch, the PRA intends to follow the same supervisory approach as that set out in SS10/14 'Supervising international banks: the Prudential Regulation Authority's approach to branch supervision'.¹ The PRA will consider the operational continuity requirements of the home authority when determining the risk appetite around the critical functions the UK branch of the non-EEA firm intends to perform or is performing in the United Kingdom.

1.7 UK subsidiaries of non-EEA firms that are PRA-authorized persons and fall within the application conditions of Operational Continuity 1.1 are expected to comply with the proposals in this supervisory statement.

1.8 This supervisory statement should be read alongside the PRA Rulebook, and does not replace the PRA's rules. A firm to which this supervisory statement is relevant will continue to be required to comply with the PRA rules that are relevant to its authorisation.

2 Operational arrangements for critical services

2.1 A firm can organise critical services in a number of ways:

- a firm can outsource critical services to an entity within its group or to an external party (non-group provider);
- a firm can operate a business unit within the firm itself that provides critical services to one or more of its business units or firms of the group; or

¹ PRA Supervisory Statement 10/14 'Supervising international banks: the PRA's approach to branch supervision, September 2014, available at: www.bankofengland.co.uk/pradocuments/publications/ss/2014/ss1014.aspx.

- a firm can use a combination of the above.¹

3 Facilitating recovery and resolution

3.1 Chapter 2 of the Operational Continuity Part requires a firm to ensure its operational structure facilitates effective recovery and resolution planning. Irrespective of operational structure, the PRA expects a firm to be able to demonstrate how its operational arrangements supporting critical services facilitate recovery and resolution, within a reasonable time.

3.2 Supervisory judgement will be required to assess whether a firm has met this expectation but as a minimum, the PRA expects the firm to articulate how it has met the expectations in 3.3 to 3.5 below.

3.3 The PRA expects a firm to be able to describe what would happen to critical services if recovery options were executed or if resolution tools were applied. This includes the examples listed below where relevant.

- How the firm's operational arrangements facilitate separability and restructuring within a reasonable time. If a firm cannot demonstrate this, the PRA will expect the firm to make changes to achieve this outcome.
- Where a firm has identified the disposal of business units or legal entities as part of its recovery strategy, how the firm's operational arrangements support the execution of recovery options within a reasonable time.
- How the firm's operational arrangements facilitate any post-resolution restructuring. For example, a firm should be able to evidence how the arrangements facilitate separability and restructuring of group entities while ensuring continuity of critical services.
- How the firm's operational arrangements facilitate separability of a ring-fenced body (RFB) and its sub-group from the other entities in the wider group.

3.4 The PRA expects a firm to undertake comprehensive mapping of critical services from providers to recipients and critical functions to provide greater clarity of what critical services need to be maintained in resolution. This may involve identifying legal entities, business lines or divisions that perform critical functions and the critical services they receive and / or provide. This mapping should also include a description of the services and information on the jurisdiction of each party, the service delivery model used, the ownership of assets, the infrastructure used, pricing and contractual arrangements.

3.5 The PRA also expects a firm to demonstrate how their operational structure supporting critical functions meets all other expectations in this supervisory statement and rules in the Operational Continuity Part.

4 Scope of Outsourcing

4.1 The PRA expects firms to refer to the rules in the Outsourcing Part of the PRA Rulebook when considering their operational arrangements supporting critical services. Outsourcing 2.1

¹ These organisational arrangements are referred to in this supervisory statement as critical services providers.

to 2.4 permit the outsourcing of critical or important operational functions provided the outsourcing of such activities does not result in:

- a transfer of responsibility from the PRA-authorized firm to the outsource provider;
- an increase in operational risk;
- an impairment of the quality of the firm's internal control; or
- an alteration to the conditions with which the firm must comply in order to be authorised.

4.2 The PRA expects that a consequence of the outsourcing rules will be that a firm that outsources critical services will continue to remain responsible for functions that require senior management judgement or decision-making that could affect the prudential soundness or risk appetite of the regulated firm. For this reason, the PRA expects these functions to be retained within the regulated firm. This reflects the principles set out in the Outsourcing Part.

4.3 The PRA would expect the firm to demonstrate to the PRA how any critical services that it outsources meet the expectation set out in paragraph 4.2 above.

5 Financial resilience

5.1 The PRA expects a firm to ensure that critical services providers have sufficient financial resources to allow continuity of provision of critical services to receiving entities during stress or resolution, and after resolution, as part of the post-resolution restructuring of any group entities. Firms should also manage the risks associated with the liabilities of critical services providers. See Outsourcing 2.6 and General Organisational Requirements 2.5.

5.2 The PRA considers that financial resources may be necessary to manage the risks that critical services providers are exposed to in a stressed scenario or resolution event, including:

- temporary loss of revenue due to suspension of payments from clients during the resolution period;
- expense-revenue mismatch during resolution, related to reduced demand for services from entities in resolution but constant fixed overheads for the service provider;
- employee costs, for example, retention and redundancy payments;
- restructuring and wind-down costs; and
- write down of intangible and relationship-specific assets.

5.3 The method by which a firm may seek to ensure the critical services provider is financially resilient may vary depending on whether the critical services provider is a group entity or a non-group provider.

Critical services provided from within the group

5.4 Where a critical services provider is located in the group, the PRA expects recipient firms or a firm (where critical services are provided from within a business unit of a firm) to ensure there are sufficient financial resources to cover all risks, including the critical services

provider's financial resilience. Generally, financial resilience is achieved by the critical services provider being able to absorb losses and having adequate liquidity.

5.5 Specifically for liquidity, the PRA expects that, as a minimum, the critical services provider within a group (provision from within a business unit of a firm or separate group entity provision) should be supported by liquidity resources equivalent to at least 50% of annual fixed overheads of the critical services provided by the critical services provider. This is a minimum expectation only and the PRA expects a firm to analyse and establish the adequate level of resources needed to ensure a critical services provider can manage the risks it is exposed to in a stress or resolution event.

5.6 The PRA expects the critical services provider to calculate its annual fixed overheads for critical services using figures resulting from the applicable accounting framework. The following may be excluded:¹

- a) fully discretionary staff bonuses;
- b) employees', directors' and partners' shares in profits, to the extent that they are fully discretionary;
- c) other appropriations of profits and other variable remuneration, to the extent they are fully discretionary;
- d) shared commission and fees payable which are directly related to commission and fees receivable, which are included within total revenue and where payment of commission and fees payable is contingent upon actual receipt of commission and fees receivable;
- e) fees, brokerage and other charges paid to clearing houses, exchanges and intermediate brokers for the purposes of executing, registering or clearing transactions;
- f) fees to tied agents in the sense of point 25 of Article 4 of the Directive 2004/39/EC of the European Parliament and of the Council;
- g) interest paid to customers; and
- h) non-recurring expenses from non-ordinary activities.

5.7 The PRA expects recipient firms or a firm (where critical services are provided from within a business unit of a firm) to ensure that liquidity resources for the provision of critical services are segregated from other group liquid assets. The resources will need to be available to the critical services provider regardless of the failure or resolution of other group entities. This may involve holding liquid assets outside the group with third parties, or if held within the group, the resources should only be securities held in custody arrangements with another group entity. The PRA expects recipient firms to be able to explain how and where such assets are held.

5.8 The segregation of assets for the operational continuity financial resilience expectation means that the assets cannot count towards a firm's high quality liquid asset buffer (HQLA) for

¹ Based on the calculation of fixed overheads set out in Commission Delegated Regulation EU 2015/488 of 4 September 2014 amending Delegated Regulation (EU) No 241/2014 as regards own funds requirements for firms based on fixed overheads.

the liquidity coverage ratio (LCR) under the Capital Requirements Directive and Capital Requirements Regulation (jointly 'CRD IV').¹ Firms can use the same types of assets that qualify under HQLA, but are not restricted to these types of assets. The PRA expects the firm to not double count the resources used to meet operational continuity expectations and CRDIV HQLA.

5.9 For an RFB, the PRA expects an RFB to have regard to the ring-fencing and secondary legislation rules when meeting the expectation for the segregation of liquid assets for financial resilience.

Critical services provided from outside the group

5.10 If the critical services a firm receives are provided by a non-group provider, the PRA expects a firm to comply with the requirements set out in the Outsourcing Part. Firms should consider the service provider's ability and capacity to perform the outsourced service reliably and professionally before the firm enters into the outsourcing contract.

6 Operational resilience

6.1 Under Outsourcing 2.6 and General Organisational Requirements 2.5, the PRA expects a firm to ensure the services will remain operational despite the failure of any group entities. This expectation applies to both types of group service models, provision from within a business unit of a firm or provision from a separate group entity. The PRA views the following as examples of how a firm could achieve this expectation:

- ensuring that the critical services provider has change capabilities and operational contingency arrangements;
- demonstrating that operational resilience is not affected by the loss of key business clusters or entities post-resolution; and
- ensuring the critical services provider has sufficient staff and expertise dedicated to the critical services provision to carry out post-restructuring activity if necessary.

7 Contractual service provisions

7.1 In accordance with Operational Continuity 3.2, a critical services provider, whether located in the group or a non-group provider, should not be able to change the arrangements of service provision as a result of a firm or a member of the group entering into a period of stress or resolution. Where there are agreements between two entities it is expected that the steps to achieve this could include:

- clauses in agreements for critical services provided by a group provider and non-group providers that allow for continued use of services in stress and resolution. Contracts or agreements remain valid after the firm or a group member has entered stress or resolution, provided there is no default on payment obligations (this does not apply if the contract ends due to an upcoming maturity date);

¹ The Capital Requirements Regulation (575/2013) (CRR) and Capital Requirements Directive (2013/36/EU) (CRD), jointly 'CRD IV'.

- clauses in agreements that allow for the continued use of such products or receipt of such services by entities following their disposal by a group for a reasonable period of time in order to support group restructuring; and
- agreements with a group provider and non-group providers that are enforceable pre- and post-resolution.

8 Objective service level agreements

8.1 The PRA expects firms, irrespective of their business model, to demonstrate that they have identified and documented the critical services they receive. The PRA's expectations vary depending on whether a separate legal entity is providing the service or if the service provision is between business units within a firm.

8.2 The PRA expects that under Outsourcing 2.7, the General Organisational Requirements Part and Fundamental Rule 8, service level agreements between business units of a firm, separate group entities or non-group providers are objective and on third party terms. Objective service level agreements help to identify operational interdependencies and may guide restructuring efforts.

8.3 The PRA expects agreements for critical services between legal entities to be well documented and include the following considerations as a minimum:

- clear parameters against which service provision can be measured;
- quantifiable and qualitative metrics and performance indicators;
- the provider and recipient(s) of the service;
- the nature of service and its pricing structure;
- any onward provision to other entities or sub-contracting to third party providers; and
- provisions that terms and pricing should not change as result of a party to the contract entering stress or resolution.

8.4 Under Operational Continuity 3.1, the PRA expects a firm to document the details of the critical services provided from one business unit of a firm to another. The minimum information expected to be documented includes details of the business area receiving and providing the services as well as the transition arrangements in resolution. This information should form the basis of transitional service agreements to facilitate the services being easily identified and transferable to another provider in resolution without interruption, should this be the preferred resolution strategy.

9 Access to operational assets

9.1 The PRA expects, under Operational Continuity 3.4, that firms should articulate clearly how access to operational assets supporting critical services will be maintained at the point of stress or resolution of a firm, another group entity or the critical services provider itself. This applies irrespective of the service model the firm has.

9.2 Types of operational assets the PRA considers should meet this expectation include but are not limited to: data, intellectual property, premises, licences and leases.

9.3 This expectation is particularly important for subsidiaries, where a subsidiary's parent company negotiates contractual arrangements at a group level.

9.4 In some cases, the PRA may expect operational assets essential to performing critical services to be owned or leased by the same firm that receives the critical services. This would only be the case where the firm cannot adequately demonstrate that it will have continued access to operational assets in resolution of any group entity.

10 Charging structures

10.1 In meeting Operational Continuity 3.3, the PRA expects charges for critical services to be predictable, transparent and set on an arm's length basis, irrespective of a firm's service model. The PRA expects a firm to be able to convert the service contracts into a third party or transitional service agreement at short notice.

10.2 If critical services are located in a separate group provider, arm's length terms can help to ensure that the contract can more easily be transferred to another service provider if needed at short notice.

10.3 If the critical services are located within a business unit of a firm, similar internal charging structures are necessary to ensure that corresponding documentation could form the basis of an external contract if the critical services provider is restructured following resolution. The PRA expects that critical services are on terms which could be readily substituted with another service provider, such that critical services could be provided on an uninterrupted basis.

11 Governance arrangements

11.1 The PRA expects firms to ensure a critical services provider located within a group (provision from within a business unit of a firm or separate group entity provision) has its own governance and management structure in place for the provision of critical services to the firm as set out in Operational Continuity 4.2. A firm should be able to articulate to the PRA the governance and management arrangements the critical services provider has in place.

11.2 The PRA expects firms to demonstrate that the critical services provider has management of sufficient seniority in place who are responsible for the day-to-day running of services and who could ensure the critical services would continue to be performed in a resolution scenario.

11.3 The critical service provider should not rely on senior staff that perform significant duties for other entities in the group. Where a member of senior staff has multiple roles within the group, the PRA expects the firm to ensure the responsibilities for critical services are prioritised in resolution.

11.4 The PRA expects the critical services provider within the group not to rely excessively on senior staff remunerated by other entities in the group. Firms should anticipate that staff responsible for the running of the service provider will still need to be remunerated in a resolution scenario. As such, the main part of their remuneration should be paid by the service provider and they should be employed by the service provider, where the critical services provider is a separate group entity.

11.5 If critical services are received from external non-group providers, the PRA expects that the provider will have suitable governance and oversight arrangements as set out in the Outsourcing Part. This includes properly supervising and adequately managing the risk associated with the outsourced critical services.

12 Prevention of preferential treatment

12.1 Under Operational Continuity 4.3 and 3.1, the PRA expects firms to be able to demonstrate that in the event of a deterioration in the financial circumstances of another group member, the group provider continues to treat the firm in accordance with:

- the existing agreement governing the critical services provision if the firm receives critical services from a separate group provider; or
- the relevant documentation if the firm receives critical services from one of its business units.

12.2 Firms should ensure that organisational structures and agreements do not require the group provider to prioritise its resources to support certain group entities over the firm.