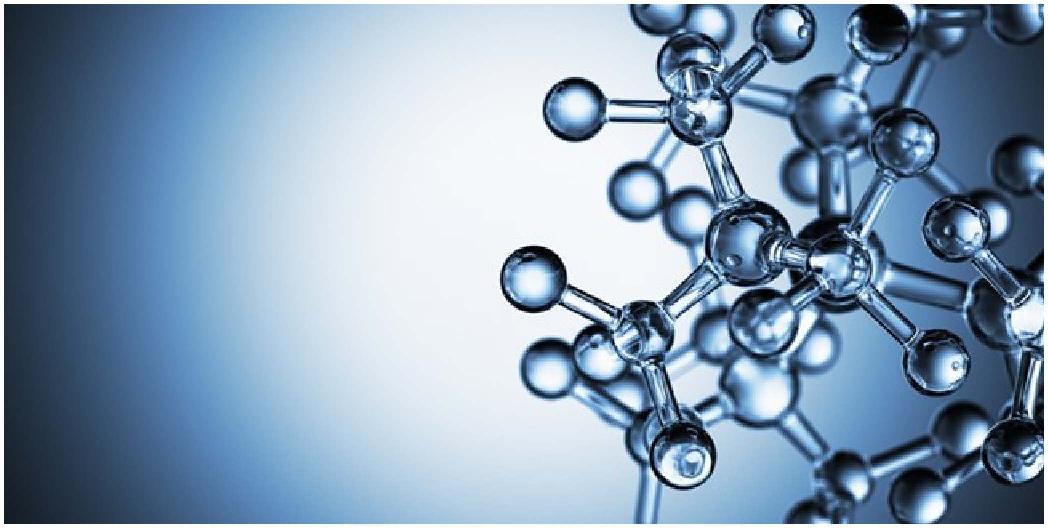
Financial services operational continuity

Overview



This short briefing is relevant to audit leaders in the financial services sector and those wishing to broaden their knowledge of the sector.

The Operational Continuity Instrument 2016/27 came into force on 1 January 2019 as part of the UK Prudential Regulatory Authority (PRA) rulebook.

We look at who this applies to, explain what it means, outline what is required and consider the role of internal auditors.

Who does this apply to?

The following is an extract from the PRA rulebook.

a ***Capital Requirement Regulation*** (CRR) firm (UK bank, a building society or a UK designated investment firm) that receives *critical services* if it fulfils any of the following conditions on 1 January of any year:

(1) the average of the *firm's* total assets it was required to report in the previous 36 months in accordance with Chapters 7 and 9 of the Regulatory Reporting Part of the *PRA* Rulebook exceeds £10bn;

(2) the average of the *firm's safe custody assets* it was required to report in the previous 36 months in accordance with SUP 16.14 of the *FCA Handbook* as amended from time to time exceeds £10bn; or

(3) the average total amount of received sight deposits it was required to report in the previous 36 months in accordance with the *ITS on supervisory reporting*, or that it would have had to report if the *ITS on supervisory reporting* had been in force, exceeds £350m.

The PRA defines critical services as "activities, functions or services performed for one or more business units of the *firm* or for the *firm* and another member of its *group*, whether by the *firm* itself, any other *group* member or a person outside the *firm's group*, the failure of which would lead to the collapse of or present a serious impediment to the performance of the *firm's critical functions."*

Failure to fully implement operational continuity requirements could lead to a section 166 or, in the worst case scenario, a firm's authority to operate/banking licence could be revoked.

What is it about?

Regulations have been tightened following the financial crisis and the collapse of banks previously thought of as secure.

Operational continuity is an enhancement to existing resolution planning requirements. It specifically addresses the continuity of critical services provided internally as part of a wider group or externally via outsourcing to third-party commercial suppliers.

Put simply, it is designed to ensure that resolution plans can actually be put into effect. For example plans to transfer a bank's operations to another entity could fall at the first hurdle if access to the head office was denied by a landlord or data systems suspended.

It is compulsory for CRR firms to have plans in place to help with resolution. Resolution is the process enabling the Bank of England to step in to make sure that a bank that is failing does so in an orderly way. It aims to safeguard public interests thereby avoiding another Northern Rock fiasco; including the continuity of the bank's critical functions, financial stability and minimise costs to taxpayers.

What is required?

Firms must identify the critical services to any critical economic function they perform in the UK.

The PRA defines critical functions as "a product/activity of the firm whose withdrawal or disorderly wind-down could have a material impact on the UK economy or financial system."

Continuity must be assured in the event that either the firm itself or its service provider goes into stress or resolution. Not all functions will be qualified as critical despite their importance to the firm itself. For example the market share of a product may be significant to the firm but not the financial system.

Banks currently use a statutory process called Ring Fence Transfer Scheme to move business between entities. Even though this is considered rigorous a greater level of understanding is demanded for the operational continuity regulation.

The European Banking Authority provides guidance on the minimum list of critical services which a bank would require in resolution. This provides the building blocks for compliance with the PRA rulebook. This list is reproduced in our supplementary auditor checklist.

What does it mean for internal auditors?

Your firm may have taken a robust approach to its initial resolution planning; in which case the new requirements will have had little or no impact on existing plans and assurance programmes. Elsewhere, compliance assurance will be required to assure the board that resolution plans are now sufficient.

Without question the financial stability of service providers is paramount. Affiliates are required to hold fixed amounts of segregated liquidity resources to ensure that the costs associated with the provision of their services continue in resolution.

Additionally, for operational continuity, there are three key risk areas for audit leaders.

Uncertainty over contractual obligations

When reviewing third-party outsourcing arrangements contractual assurance will be required to ensure services continue in the event of resolution and also recovery scenarios. CRR firms should have completed contract reviews and amendments in preparation for this regulation.

Take a moment to reflect on the following:

- **Has your firm mapped its critical services dependencies?**
- **What readiness assurance/advisory work has internal audit undertaken to date?**
- **Is further audit work planned?**
- **Has this regulatory requirement been factored into contract assurance programmes?**
- **How frequently is assurance reported to the board for critical service providers?**

Accessibility of operational assets

Assets are diverse and often located across different entities, geographies and systems. Whilst there will be a natural focus on access to funds, internal auditors should ensure that all assets are considered. Access to buildings, data and people will be as imperative in stress scenarios as access to monies. Non-proprietary assets should be of particular concern and end-to-end supply chain arrangements reviewed.

Questions to consider:

- **Have ‘step-in rights’ been factored into agreements?**
- **Can diverse assets below a threshold aggregate to a critical level?**
- **Could this be an enabler to reducing supply chain complexities?**

Restrictive organisational design

Firms often have complex structures. When providing assurance internal auditors need to think about the ease of separation of managed services where there are not strictly defined service lines. Such partitioning might be challenging for example where there are cross-subsidies for shared resources.

Think about whether:

- **There is clear accountability for critical services?**
- **Internal services are subject to SLAs with transparent costing?**
- **Critical services been restructured to ensure *arm's length charging* is in place?**

Internal audit may also wish to think about the maintenance process for operational continuity arrangements. For example how has this been embedded into new processes, change management and governance arrangements?

Regulatory return PRA109 captures the requirements. Validation of reporting may be another consideration, particularly in the first year and/or going forward after major organisational change.

Closing Thoughts

New regulations can feel like a burden to an already pressured workload. Without the operational responsibilities of colleagues, internal auditors have the space to look at them objectively. Refining continuity arrangements is an opportunity to focus anew on critical functions and services driving efficiency and effectiveness. Regulatory change also spotlights the behaviours and values of the leadership team. Audit leaders should always be looking at the big picture not simply compliance.

"Operational resilience is hard, however, given the nature of the financial system we have, it is of critical importance"

Lydon Nelson, Executive Director, Bank of England

Further reading

Bank of England – Prudential regulation

EBA Guidelines

Operational Continuity – Grant Thornton

Shared Service Functions - Deloitte