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11 December 2019

# Financial Regulation Monthly Breakfast Seminar

# Overview

- The BoE/FCA consultations on operational resilience, and the PRA consultation on outsourcing
- Some recent FCA/PRA enforcement cases
- FCA guidance around the transition from LIBOR
- An update on SMCR implementation

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# The BoE/FCA consultations on operational resilience, and the PRA consultation on outsourcing

Rob Moulton and Anne Mainwaring

# Operational resilience – scope

- Banks
- Building Societies
- PRA / FCA dual-regulated investment firms
- RIEs
- PSR firms
- Enhanced scope SMCR firms
- “Firms not subject to this CP should continue to meet their existing operational resilience obligations and may want to consider our proposals”

# Operational resilience – overlaps

- Business continuity planning (generally)
- Operational Continuity in Resolution (OCIR)
- Outsourcing
- SMCR
    - Boards should have “knowledge, experience and skills necessary for the discharge of their responsibilities”
    - “We expect clarity on who is responsible for operational resilience, even where firms do not have an individual performing the SMF24 function”

# Operational resilience – important business services

- Identify “important business services”
  - Disruption would cause intolerable harm to consumers or market integrity (including reputational risk)
  - Think of services like a consumer, and unpackage them (e.g. not a bank account, but: ATM; app-based; online; telephone banking)
  - E.g. a custodian has to: (1) not lose; (2) be able to transfer; (3) be able to provide valuations relating to, assets
  - Think about knock-on consequences e.g. a custodian being unable to transfer

# Operational resilience – impact tolerance

- Set an impact tolerance for each risk
- Accept disruption is inevitable and needs to be planned for (rather than pretending it can be avoided)
- Two tolerance levels for dual-regulated firms
    - Intolerable harm to consumers / market
    - Financial stability is at risk

  Just the first applies to FCA-only firms
- FCA examples: 12 hours for telephone banking; 6 hours for custodian transfer processing

# Mapping

- Identify and document the resources that deliver and support these business services e.g. telephone bank accounts
  - Key people
  - Escalation lines
  - IT
  - Voice recognition software
  - Third party call centre
  - Premises
  - Interdependencies

# Scenario testing

- A sample of severe but plausible scenarios
- Examples
  - Corruption of data
  - Unavailability of facilities / people / third party providers
  - Disruption to other market participants
- Communications strategies
  - “How they would provide important warnings or advice quickly to consumers and other stakeholders”

# Create a self-assessment document

- Which are the important business services?
- What are our tolerance levels?
- How have we mapped them?
- How have we used scenarios to test them?
- What vulnerabilities were most recently identified?
- What lessons were learned?
- Date of last review ("board should review and approve the self-assessment document regularly")

# CP30/19 – Outsourcing and third party risk management

- The CP is relevant to all UK banks, building societies and PRA-designated investment firms, insurance and reinsurance firms and groups in scope of Solvency II, including the Society of Lloyd's and managing agents, and branches of overseas banks and insurers.  Certain proposals are also relevant to credit unions and non-directive firms

# The Draft SS

- The proposals in the CP will be implemented via the Draft SS, which covers the following requirements:
  - Definitions and scope
  - Proportionality
  - Governance and record-keeping
  - Pre-outsourcing phase
  - Outsourcing agreements
    - Data security
    - Access, audit and information rights
    - Sub-outsourcing
    - Business continuity and exit plans

# Proportionality

- Firms will be required to comply with the proposed expectations in a manner appropriate to their size, internal organisation, risk profile, and the nature, scope and complexity of their activities
- Note this is separate to the concept of materiality – proportionality focuses on the characteristics of a firm, including its systemic significance; ‘materiality’ assesses the potential impact of a given outsourcing arrangement on a firm’s safety and soundness
- Whilst intra-group outsourcings are subject to the same requirements and expectations as outsourcing to service providers outside a firm’s group and should not be treated as being inherently less risky, firms may comply with some of these requirements proportionately depending on their level of ‘control and influence’ over the group company that is providing the outsourced service

# Governance and record-keeping

| | |
|---|---|
| General | The responsibilities of the board, including its involvement, as appropriate, in decisions about material outsourcing.<br>The involvement of business lines, internal control functions and other individuals (in particular, SMFs) in respect of outsourcing arrangements.<br>Links to other relevant policies (see paragraph 4.8). Documentation and record-keeping.<br>Procedures for the identification, assessment, management and mitigation of potential relevant conflicts of interest.<br>Business continuity planning (BCP) (see paragraph 4.9). Differences, if any, between the approach to:<br>- intra-group outsourcing vs outsourcing to external service providers;<br>- material vs non-material outsourcing;<br>- outsourcing to service providers regulated or overseen by the Bank, PRA or FCA vs unregulated service providers; and<br>- outsourcing to service providers in specific jurisdictions outside the UK. |
| Pre-outsourcing & on-boarding | The processes for vendor due diligence and for assessing the materiality and risks of outsourcing arrangements (including notification to the PRA where required).<br>Responsibility for signing-off new outsourcing arrangements. In particular material outsourcing arrangements. |
| Oversight | Procedures for the ongoing assessment of service providers' performance including where appropriate:<br>- day-to-day oversight, including incident reporting; periodic performance assessment against service level agreements; and periodic strategic assessments<br>- being notified and responding to changes to an outsourcing arrangement or service provider (e.g. to its financial position, organisational or ownership structures, sub- outsourcing)<br>- independent review and audit of compliance with legal and regulatory requirements and policies<br>- renewal processes |
| Termination | Exit strategies and termination processes, including a requirement for a documented exit plan for material outsourcing arrangement where such an exit is considered possible taking into account possible service interruptions (and the firm's impact tolerance for important business services) or the unexpected termination of an outsourcing agreement (see Chapter 10) |

# Governance and record-keeping

- From 31 December 2021, the EBA Outsourcing Guidelines require banks to maintain an up-to-date register of information on all their outsourcing arrangements. This should be populated with any new outsourcing arrangements entered into from 30 September 2019, while progressively adding outsourcing arrangements entered into before 30 September 2019, with a view to having a complete outsourcing register by 31 December 2021 (PRA gives guidance on completing this)
- Banks are already expected to maintain a register of their Cloud outsourcing arrangements in line with the EBA Cloud Recommendations and must continue to maintain this until the outsourcing register subsumes it by 31 December 2021

# Pre-outsourcing phase

- The PRA expects firms to:
  - Determine the materiality of every outsourcing arrangement
  - Perform appropriate and proportionate due diligence on all potential service providers
  - Assess the risks of every outsourcing arrangement irrespective of materiality
- Materiality may vary throughout the duration of an arrangement and should therefore be (re)assessed:
  - Prior to signing the written agreement
  - At appropriate intervals thereafter e.g. during scheduled review periods
  - Where a firm plans to scale up its use of the service or dependency on the service provider
  - If an organisational change at the service provider or a material sub-outsourced service provider takes place, including a change of ownership or to their financial position

# Outsourcing agreements

- All outsourcing arrangements must be set out in a written agreement
- Where there is a master service agreement that allows firms to add or remove certain services, the PRA expects every individual outsourced service to be appropriately documented (although not necessarily in a separate agreement) and recorded in the outsourcing register
- Draft SS sets out the minimum provisions the PRA expects written agreements for material outsourcings to address, including four specific chapters on data security; access, audit and information rights; sub-outsourcing; and business continuity and exit plans

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# Some recent FCA/PRA enforcement cases

Andrea Monks

# PRA Final Notice - Citi

- Financial penalty of £43.89 million for breaches of:
  - PRA Fundamental Rule 6
    - A firm must organise and control its affairs responsibly and effectively
  - Branch Return Rule
    - Incoming and third country firms must provide the PRA with specified information
  - Notifications Rule 6.1
    - Firms must take reasonable steps to ensure the information they submit to the PRA is complete and accurate
- Joint penalty against Citigroup Global Markets, Citibank N.A. and Citibank Europe Plc (the “Firms”)
- Early settlement discount – reduced penalty from £62.7m

# Findings

- Inaccuracies in:
  - Capital and leverage returns
  - Liquidity returns
  - London branch returns
- Cumulatively, the capital position was worse than originally reported to the PRA and the liquidity position was better than originally reported
- Returns were unreliable
- PRA did not have an accurate picture of the capital or liquidity position
- Pervasiveness of the errors and misstatements in the Returns raised fundamental concerns about the effectiveness of the Firms' regulatory reporting control framework
- Negatively impacted the PRA's ability to supervise the Firms

# Findings

- The systems, controls and governance arrangements that underpinned the Firms' UK regulatory reporting were not in a number of respects designed, implemented or operating effectively
- Firms failed to organise and control their affairs responsibly
- Firms failed to organise and control their compliance with UK regulatory reporting responsibly and effectively

# Themes and takeaways

- Heed the warnings
- Allocate adequate human resources and make appropriate investments
- The importance of SMCR
- Over-reliance on centralised solutions

# Slaughter and May's report into TSB

- Over the weekend of 20-22 April 2018, TSB transferred c. 5 million customers to a new platform designed, built and operated by SABIS, a sister company of TSB
- In the days that followed, TSB's internet banking and mobile app channels were unstable, almost unusable
- Problems persisted for weeks – very significantly higher than usual opportunistic fraud attacks on customers
- Magnitude and duration of problems went far beyond what was anticipated
- S&M instructed to undertake an independent review, which has concluded
    - New platform was not ready to support TSB's full customer base
    - SABIS was not ready to operate the platform

# Continuing the senior manager responsibility theme

- Big bang migration of the IT platform – not substantively discussed by the TSB Board
- TSB Board did not put “common sense challenges” to the Executive – such as why the Executive thought TSB would be “migration ready” when the evidence was otherwise
- TSB Board did not sufficiently engage in assessing, and did not provide a strong enough challenge to, the Executive’s explanations on the adequacy of testing and the Programme’s readiness
- Clear indications of the “frantic pace” at which key actions were being finalised – the TSB Board should have interrogated this
- TSB Board did not sufficiently understand the scope and complexity of the IT platform

# A possible road map for the future

- The nature, scale and complexity of TSB's IT transformation was unprecedented in the UK market
- TSB Board should have taken independent advice on the whole Programme
- TSB Board needed an independent and authoritative view on the progress of the Programme to assist the TSB Board in appropriately challenging the Executive
- TSB Board required a much greater level of independent advice – which would have made a difference to decisions made by the TSB Board at key points in the programme
- Weekend migration 22 April 2018 – S&M instructed 30 April 2018

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# FCA guidance around the transition from LIBOR

Becky Critchley

# Background

- Panel banks’ voluntary contributions of data to LIBOR will cease at the end of 2021
- 19 September 2018 Dear CEO LIBOR letter
- June 2019 Feedback Statement on the Dear CEO LIBOR letter
- FCA now sets out new webpage with Q&A on conduct risk arising from LIBOR transition
    - Governance and accountability
    - Replacing LIBOR with alternative rates in existing contracts/products
    - Offering new products with RFRs or alternative rates
    - Communicating with customers about LIBOR and alternative rates/products
    - Firms investing on customers’ behalf and LIBOR transition

# Why is it important?

- LIBOR transition is likely to impact multiple:
  - Business lines
  - Operational areas, and,
  - Geographical regions (for firms with international business)
- Impacts overall business strategy and front-office client engagement, it is <u>not</u> a narrow legal and compliance risk
- Firms should consider, in addition to conduct risk, operational, financial resilience, and business model risks

# Governance and accountability

- Firms' senior managers and boards are expected to understand the risks associated with LIBOR transition and take appropriate action to move to alternative rates ahead of end-2021
- Governance arrangements for risk management
    - Conflicts of interest
    - Is the existing conduct risk framework suitable?
- Responsible senior manager

# Replacing LIBOR with alternative rates in existing contracts/products

- What is a fair replacement?
- How? Fall backs or converting to a new rate?
- Performance of existing LIBOR contracts
- TCF
    - Not an opportunity to move customers to higher rates or “otherwise introduce inferior terms”
    - Communicate how the fall backs are expected to operate
    - Are existing amendment clauses fair under the Consumer Rights Act 2015 and do they allow a change?
    - Importance of market consensus

# Offering new products with RFRs or alternative rates

- Expectation that firms will not write new LIBOR-referencing business
- For any new business:
  - Can the risks of LIBOR be adequately explained?
  - Will all customers understand?
  - Do these products meet the needs of customers?
  - Can these products perform as customers expect?

# Communicating with customers

- Remember “clear, fair and not misleading”
- Timing
- Training for client-facing staff
- Consider obligations under existing products

# Firms investing on customers’ behalf and LIBOR transition

- Assess and manage customers’ exposure to LIBOR to protect customers’ best interests
- Impact on customers:
    - E.g. the impact on contract continuity, expected interest payments, risks of declining liquidity in LIBOR-referencing products
    - Engaging in good time with issuers of LIBOR-referencing securities, derivatives and loan counterparties
- Consider investment strategy and best execution

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# An update on SMCR implementation

David Berman

# SMCR implementation

- SMCR is now in force for almost all authorised firms
- But implementation is not the end of the story – firms must comply on an ongoing basis
- We have set out a compliance checklist of areas to verify post-implementation – useful for all firms, not just those newly subject to the regime
- Also see our guide to post-implementation considerations

# Checklist for compliance

1. Ensure processes are in place to update SMCR documentation (e.g. Statements of Responsibilities, Management Responsibilities Maps) when necessary, and that the right people are aware of the relevant triggers
2. Check processes are in place to ensure compliance with requirements that are subject to transitional periods (e.g. completing certification for existing employees, training the full population on the Conduct Rules)
3. Make sure processes and procedures are in place to assess and record where disciplinary action has been taken for breach of any of the Conduct Rules, and to report breaches to the FCA within the required timeframe (noting the different timeframes for Senior Managers vs others)

# Checklist for compliance

4. Ensure proper records are being kept to allow the firm to comply with its regulatory reference obligations under SYSC 22
5. Make sure processes are in place to perform in-year fitness and propriety assessments if circumstances require this, and that information which might affect fitness and propriety is passed to the right people
6. Have a structure in place for ongoing/periodic training of Senior Managers, Certified Persons and Conduct Rules staff, as required
7. Designate appropriate individuals within the firm to monitor SMCR developments and disseminate these as appropriate

# Checklist for compliance

8. Check that any “difficult” scenarios (e.g. a marginal fit and proper assessment, or a qualified regulatory reference) are being recorded and set a protocol for the firm to follow, to ensure consistency in decision-making
9. Make sure that those carrying out fitness and propriety assessments are kept informed of the FCA’s latest expectations (e.g. the position regarding non-financial misconduct) and the firm’s internal tolerances
10. Check information streams between HR/legal/compliance to verify that the necessary information is being passed on to help the firm comply with the SMCR (e.g. is information about a disciplinary matter passed on to assess whether there was a breach of the Conduct Rules?)

# A lesson on integrity

- Mr Forsyth – CEO of insurance firm, arranged for his wife to become an employee of the firm
- His wife was paid for providing assistance to him in his role as CEO (e.g. administrative tasks, hospitality) – this was a percentage of Mr Forsyth’s salary, and was not approved by the firm’s remuneration committee
- Payments increased over time, such that the payments to his wife were higher than the remuneration of any other employee of the firm, except Mr Forsyth

# A lesson on integrity

- The FCA found that his wife was receiving remuneration in excess of what was reasonable for the work she was undertaking, and this was deliberately arranged by Mr Forsyth in order to reduce his tax liability
- No question about Mr Forsyth’s capabilities or performance as CEO
- However, his behaviour impacted on his integrity to such an extent that the FCA decided to ban him from the industry and impose a fine of £78,318

# Private Bank Roundtable

Providing legal and compliance professionals working within private banks a quarterly update on areas directly impacting private banks and their clients. You will also have the opportunity to ask questions relating to market developments and to meet with peers.

**Next Roundtable:** Tuesday, 17 December

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