Non Executive Director Roundtable

Prudential Risk Governance

Wed 31st January
Wed 7th February
Wed 14th February

FCA’s Prudential Supervision

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Prudential supervision

A lack of financial prudence can give rise to a number of risks

- Poor financial management can incentivise poor conduct, such as prioritising short-term revenue generation over customer interests
- Ultimately, firm failure can result in serious harm to customers and/or markets

Harm the FCA seeks to mitigate via prudential supervision

- Disorderly failure disrupts continuity of service to customers
- Disruption to market functioning
- Failure of customers to get their money back ie client money, redress etc.

Prudential supervision

FCA Universe of firms

- 46,000 firms for which we are prudentially responsible
- For 18,000 firms there is a prudential sourcebook in the FCA handbook
- 3,500 firms where a “Pillar 2” regime is applicable (BIPRU & IFPRU)
- 1,000 firms captured by the Capital Requirements Regulation (IFPRU)

Prudential Supervision

- Understanding a firm’s financial risks is an important component of our supervisory work
  - Regular risk assessment of most significant firms
  - Cross-firm risk assessments
  - Integral to business model/portfolio analysis
  - Ongoing monitoring of financial soundness
  - Orderly wind down planning

Appropriate financial resources

The Financial Services and Markets Act sets out the Threshold Conditions for a firm to be authorised.

- A firm's resources must be appropriate in relation to the regulated activities that it carries on or seeks to carry on.

- The matters which are relevant in determining whether a firm has appropriate resources include:
  - the nature and scale of the business carried on;
  - the risks to the continuity of the services provided; and
  - membership of a group and any effect which that membership may have.

  'appropriate' means sufficient in terms of quantity, quality and availability.

  'resources' means for example provisions made for liabilities, how risks are managed and the skills and experience of its management".

- A firm has adequate financial resources if it is capable of meeting its debts as they fall due.

Orderly Failure

- Because we accept that some firms will fail, having credible wind down plans in place is important.

- Where we identify the failure of the firm would result in harm to consumers or markets we seek to ensure that any failure would be managed in an orderly way.

- A credible plan should consider the financial and non financial resources needed to achieve orderly wind down.

The Investment Firm Review

EU Commission has published its proposals to create a new prudential regime for MiFID investment firms.*

- The European rules aim to ensure there is appropriate and proportionate prudential arrangements for investment firms.
- The regime creates 3 “classes” of firms. Pillar 1 calculated as:
    - Class 2, the higher of minimum capital, Fixed Overhead Requirement, or K-factor;
    - Class 3, the higher of minimum capital or Fixed Overhead Requirement.
- Firms and national competent authorities will remain responsible for assessing the adequacy of requirements.
- There will also be a minimum liquidity requirement based on 1 month fixed overheads, complimented by a Pillar 2 regime.
- Next steps: EU will refine the proposals through 2018.

*https://ec.europa.eu/info/law/better-regulation/initiatives/com-2017-790_en
https://ec.europa.eu/info/law/better-regulation/initiatives/com-2017-791_en

FCA's Prudential Focus

- Risk management & governance for prudential risks that are embedded in day to day practices.
- Risks to capital are appropriately identified, quantified and mitigated.
- Consideration and assessment of liquidity risks.
- Wind down plans are credible and are linked to stress testing.
- Regulatory returns are accurate.

N/B The above examples and the examples on the next page are not exhaustive.

ICAAP Observations

Practices which facilitate the supervisory review and evaluation process	Practices which tend to necessitate follow up
— Board engagement and evidence of challenge from NEDs. In depth training on specific topics for Board members	— Tick box process. Seen as a regulatory document, not an embedded process
— Concise and clear ICAAPs with a focus on the key risks	— Consultants writing ICAAP document
— First-line of defence taking full ownership of the risks. Risk function provides robust independent challenge	— Risk functions not having the expertise to challenge /absolve responsibility for challenging technical aspects
— Detailed rationale to help support the assumptions/figures within the assessment	— Business plans to grow significantly but ICAAP reduces/maintains capital
— Stress testing scenarios relevant to firms' activities	— Assessments considers “business as usual” events rather than “severe but plausible”
— Explanation of why use of a models is appropriate, the key inputs to the models and sensitivity analysis	— Using complex models to quantify risk, when not necessary or understood
— Clearly explained link between liquidity risk appetite, risks, resources and contingency funding plan	— Little consideration or quantification of liquidity risks

Expectations of a Wind Down Plan

- An effective wind-down plan aims to enable a firm to cease its regulated activities with minimal adverse impact on customers, counterparties and/or the wider market.
- Firms may want to consider what events would be likely to make it no longer viable and assess whether firm has adequate financial resources for an orderly wind-down especially under challenging circumstances.
- The plans should be supported by effective governance including governing body approval and be updated regularly.
- It should anticipate the effect on employees, clients or counterparties and other suppliers.
- Timelines should be realistic and include a suitable communication plan.
- Appropriate assumptions about revenues and costs in wind-down.

Further information in the FCA's wind down planning guidance published December 2016. *

* https://www.handbook.fca.org.uk/handbook/WDPG.pdf

Accurate Regulatory returns

A significant number of firms submit returns that contain inaccurate and/or incomplete data. Some common basic errors we observe:

- Using incorrect units or not reporting cumulatively where appropriate;
- Failure to submit certain returns; or
- Component parts do not add up.

The information in returns informs the decisions we make:

- Help us understand firms' business models, financial positions and risk exposures;
- Data used to identify trends within and across sectors;
- Data in the returns forms an integral part of firms' risk management frameworks.

Accuracy of returns influences our assessment of the quality of firms' risk management.