Policy Statement

PS12/13

Financial Services Authority

Financial resources requirements for Recognised Bodies

July 2012

Financial Services Authority

Contents

This Policy Statement reports on the main issues arising from Consultation Paper 11/19 (*Financial resources requirements for recognised bodies*) and publishes final guidance.

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Copies of this Policy Statement are available to download from our website – www.fsa.gov.uk. Alternatively, paper copies can be obtained by calling the FSA order line: 0845 608 2372.

Abbreviations used in this paper

BIPRU	Prudential sourcebook for Banks, Building Societies and Investment Firms
CBA	Cost benefit analysis
CP	Consultation paper
CCP	Central counterparty
CRD	Capital Requirements Directive
EMIR	European Regulation on OTC derivatives, central counterparties and trade repositories
ESAs	European Supervisory Authorities
FMI Principles	Principles for Financial Market Infrastructures
FRR	Financial resources requirement
GENPRU	General Prudential sourcebook
MiFID	Markets in Financial Instruments Directive
MiFIR	Markets in Financial Instruments Regulation
MTF	Multilateral trading facility
OTC	Over-the-counter
RB	Recognised Bodies
RCH	Recognised Clearing House
RIE	Recognised Investment Exchange
RTS	Regulatory Technical Standards

1 Overview

Introduction

1.1 In this Policy Statement, we summarise the responses received and policy conclusions reached in relation to Consultation Paper CP11/19 (*Financial resources requirements for recognised bodies*). We also present our final guidance. We are grateful for the responses received during the course of our three month consultation period.

Background

1.2 CP11/19 proposed amendments to the guidance we provide to Recognised Bodies, as set out in REC 2.3, regarding the arrangements they should make to satisfy their financial resources obligations under the Recognition Requirements. Those proposed amendments were the result of a review of the FSA's financial resources requirement (FRR) regime for Recognised Bodies, which considered the purpose of regulatory capital and concluded that our current guidance needed modernisation to ensure an optimal approach to achieving its objectives, as set out below. The review took into account existing approaches to the prudential regulation of other providers of market infrastructure and market operators, such as the UK's BIPRU regime. It also considered policy approaches being developed for forthcoming EU regulation of OTC Derivatives, Central Counterparties and Trade Repositories (EMIR) and by CPSS-IOSCO in the context of revisions to its Principles for Financial Market Infrastructures (the FMI Principles).

Responses received

1.3 We received seven responses to CP11/19, from RIEs and RCHs.

Summary of approach

Market failure analysis

1.4 In CP11/19, we considered the function of regulatory capital as envisaged by the Recognition Requirements. We concluded that, through financial resources requirements, we aim to meet two objectives: firstly, to reduce the probability of business failure of a Recognised Body (while clearly recognising that a business failure does not suggest a failure of regulation), and secondly, to ensure that a Recognised Body is at all times capable of implementing an orderly wind-down of its regulated activities. The respondents to CP11/19 agreed that this is what regulatory capital should be for.

1.5 In CP11/19, we concluded that a market failure exists. In particular, the guidance set out in REC 2.3, which was designed to accommodate the legal and commercial landscape at the time REC was created, no longer represents the optimum approach to achieving the objectives of the FRR regime and needs modernisation. In our assessment, that need was underlined by the evolution of inconsistent methodologies by Recognised Bodies in relation to the current 'standard approach', where deductions of varying types and amounts are made in the calculation of operating costs, which have cast doubt on the robustness of the standard approach as an objective indicator of the costs of orderly closure. In addition, the formulaic nature of the capital buffer supplementing the standard approach fails to provide assurance that this amount would be sufficient to absorb the business losses attributable to the specific risks that each RB incurs and accepts, while the changing industry landscape has further underscored the benefits of clearer guidance on our approach to group risk.

1.6 Most respondents to CP11/19 questioned whether a sufficient case for market failure exists, and referred to the level of broader ongoing regulatory change affecting market infrastructures. A number of respondents suggested that any shortcomings in individual FRR methodologies could be addressed bilaterally at a supervisory level.

1.7 We consider that our analysis of the effectiveness of the current regime, and conclusion that a market failure exists, remains valid. Accordingly, we consider that our approach needs modernisation and that it is appropriate to achieve this via modifications to REC in order to facilitate market transparency and a consistent approach across the RB community.

Developments since CP11/19

1.8 In CP11/19, we noted that our consultation was running in parallel with a number of broader regulatory initiatives that were considering the appropriate FRR regime for financial market infrastructures, and in particular the finalisation of EMIR (leading to the development by the ESAs of associated Technical Standards) and CPSS-IOSCO's consultation on the revised FMI Principles. In CP11/19, we noted that any changes to REC directed at CCPs should provide a stepping stone to EMIR and, consequently, modifications should not apply where they could conflict with EMIR's Technical Standards.

1.9 During the period since our consultation:

- CPSS-IOSCO has published the final FMI Principles.[1] Principle 15 of the FMI principles deals with the own capital requirements of a FMI; and
- EMIR has been finalised and work is progressing on the associated Technical Standards. On 6 March 2012, the EBA published a Discussion Paper setting out its preliminary views on an appropriate FRR regime for CCPs, to assist in the development of Regulatory Technical Standards (RTS) on Article 12 of EMIR. On 15 June 2012, the EBA published a consultation paper inviting comment on draft provisions that would constitute those RTS. It is noted that the EBA's proposals do not include a process directly comparable to the risk-based approach set out in Chapter 4 of CP11/19.

1.10 It should also be noted that the Commission's proposals for a recast MiFID, and for a new Regulation in the form of MiFIR, do not include proposals that would affect the prudential obligations of an RIE.

1.11 We have accordingly modified our proposals to take account of these further developments and, in particular, the preliminary views expressed on the future FRR regime for CCPs, consistent with the commitment made in CP11/19 to ensure that any amendments to REC provide a stepping stone to EMIR for RCHs. We also note that, while RIEs are not a category of FMI covered by CPSS-IOSCO's revised principles, we consider that the approach they adopt is an appropriate benchmark when considering the optimal regime for RIEs (particularly in the absence of any further elaboration of MiFID requirements).

Structure of this paper

1.12 This Policy Statement is structured as follows:

- **Chapter 2** sets out our policy conclusions on the enhancements to the standard approach. As proposed in Chapter 3 of CP11/19, we will retain a standard approach to calculating FRR, based on six months' operating expenses, but will modify the basis of the calculation so that allowable deductions will be limited to non-cash costs (including depreciation and amortisation). The standard approach will be established as a 'floor' to the FRR requirement.
- **Chapter 3** sets out our policy conclusions on the creation of the risk-based approach. As proposed in Chapter 4 of CP11/19, we will introduce the risk-based approach as a new pillar to the FRR calculation. However, the new pillar will apply to RIEs only. During the period leading up to the implementation of EMIR, RCHs will be expected to hold a capital buffer equal to 50% of the standard approach amount. This represents a formalisation of our current approach to minimise compliance burdens on CCPs while they focus on preparations for EMIR.

1 www.iosco.org/library/pubdocs/pdf/IOSCOPD377.pdf

- **Chapter 4** sets out the arrangements we expect to be implemented to address group risk. In the absence of a harmonised regime for EU Regulated Markets, we will not create a bespoke group consolidation regime requiring an RB's financial holding company to meet a consolidated capital requirement. Recognising the added emphasis this places on effective ring-fencing arrangements, we will instead specify that eligible assets should be held on the balance sheet of the RB, and that a deduction from eligible capital should be made for certain assets representing an investment in, or an exposure to, an undertaking in the same group.
- **Chapter 5** sets out our policy conclusions on eligible financial resources. In summary, we will maintain our current emphasis on ensuring that eligible financial resources are sufficiently liquid and funded by high quality capital.

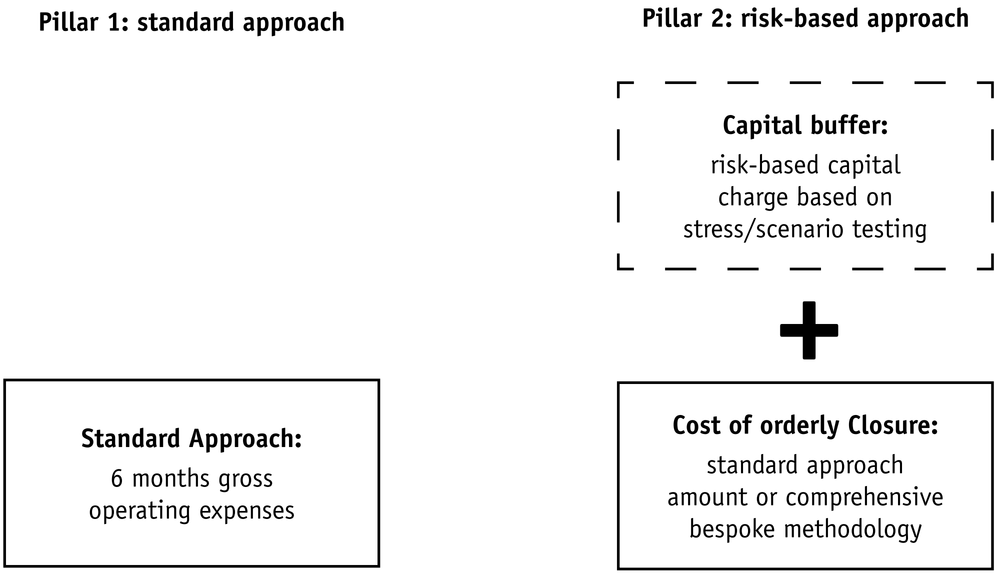
1.13 We have provided for a six-month transitional period, beginning on the date of publication of this policy statement, before applying the new guidance. We consider that this period will be sufficient to allow RIEs to prepare for the new risk-based approach, in consultation with their FSA supervisors where appropriate.

Cost benefit analysis

1.14 In CP11/19, we set out a cost benefit analysis of our proposed guidance. As noted in Chapter 3, some respondents to the consultation expressed the view that the estimate of the compliance costs of the risk-based approach included in that analysis was materially understated. Regarding our conclusion that we should apply the risk-based approach to RIEs, we consider that the existing risk management obligations of an RIE under the Recognition Requirements (as elaborated by REC 2.5) require an RIE to operate processes to identify and measure its risks wherever they arise. Consequently, our cost estimate took account only of the incremental investment necessary to develop those existing processes, to include an ability to quantify business and other risks in the form of a capital charge (as trading venue operators regulated under BIPRU are required to do). Given our conclusion that we should not apply the risk-based approach to RCHs, those entities will not be required to develop the associated capabilities and will not incur the related compliance costs. Instead, RCHs will be expected to hold a capital buffer equal to 50% of the standard approach amount, as a formalisation of our current supervisory approach. For CCPs, this arrangement will apply during the period between implementation of our revised REC guidance and the start of capital requirements under EMIR and its related technical standards.

1.15 Diagram A below sets out the elements of the FRR calculation for RIEs, as amended by our policy conclusions:

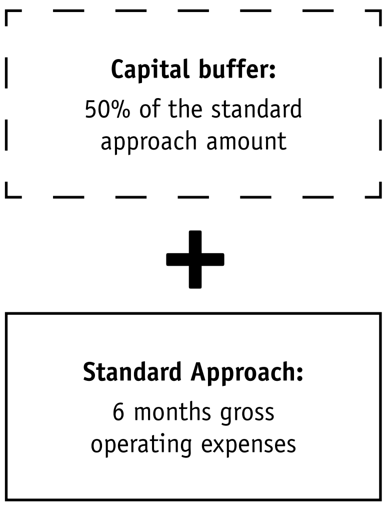
Diagram A: FRR Regime for RIEs



Minimum FRR is the higher of the pillar one and pillar two amount

1.16 Diagram B below sets out the elements of the FRR calculation for RCHs, as amended by our policy conclusions, pending the coming into effect of EMIR:

Diagram B: FRR Regime for RCHs



2

The standard approach

2.1 In CP11/19, we proposed to retain the current standard approach to the calculation of FRR, based on the holding (as eligible financial resources) of an amount equal to six months' operating costs. However, we noted the development of divergent methodologies across the RB community in relation to the calculation of operating expenses, such that deductions of differing types and amounts were made from gross cash expenses. We highlighted that, taking a broad view of current practices, allowing deductions of cash expenses from operating costs had brought into question whether the standard approach remains a sufficiently robust indicator of the funds necessary to oversee an orderly wind-down, particularly where the indicator does not allow for an assessment of the additional costs that might be incurred specifically in the course of administering such a process. In addition, we proposed that the amount indicated by the standard approach should be a 'floor' to the FRR.

2.2 Most RBs that responded on this point supported retaining the standard approach in principle, but opposed the proposal that allowable deductions should be limited to non-cash expenses (such as depreciation and amortisation). If changes were to be made, certain respondents expressed a preference to move from a wholly objective measure to a more tailored approach, under which RBs would calculate a bespoke cost of orderly closure based on use of individual scenario plans.

Our response

We have concluded that, consistent with the final FMI Principles adopted by CPSS-IOSCO, we should retain a standard approach based on an amount equal to six months' operating expenses, where in the calculation of operating expenses allowable deductions would be limited to non-cash items.

We consider that, while a six-month period is at the low end of the range upon which CPSS-IOSCO originally consulted (and is shorter than the timeframes reflected in the FRR regimes of other jurisdictions), there is no evidence to suggest that an orderly wind-down could not be achieved within six months. However, we have concluded that the inclusion of fixed and variable cash expenses in the calculation of operating costs will enhance the standard approach as a robust indicator of the financial resources necessary for an RB to operate its regulated services over that wind-down period. It is accepted that this represents a conservative approach, but we consider that when considered together with the length of the specified wind-down period and the degree of systemic importance of RBs, it provides the appropriate outcome. Further, an approach based on the inclusion of all costs incurred as a 'going concern' is consistent with reducing the probability of business failure.

An exceptional circumstance in which we will consider allowing the deduction of a cash expense is where, within a single group, two or more entities subject to prudential regulation under REC or BIPRU operate cost-sharing arrangements (for example, where an RB pays 100% of a lease and recharges a proportion of that cost to a regulated sister undertaking), if otherwise more than 100% of a particular cost would be included within the FRR of a group. In addition, it should be noted that the FSA intends to retain the discretion specified by REC 2.3.4 to consider the appropriate source of financial information from which operating expenses should be taken (for example, consistent with GENPRU, to consider whether adjustments to the amount indicated by an entity's audited accounts are necessary in light of a material change indicated by its forecast expenditure). Accordingly, if an RB has incurred an exceptional one-off cost that it would not expect to incur in the following financial period, the possibility will remain for supervisors to take this into account when considering if an RB has taken a reasonable approach to calculating operating expenses.

In line with international standards, we also consider it appropriate to establish the standard approach as an objective floor to the FRR calculation. Hence, while we agree that a bespoke estimate of the cost of orderly closure, if based on a rigorous methodology, has a role to play in the FRR regime (and would be an option available to RIEs in the calculation of the risk-based approach discussed in the next chapter), we do not believe that an RB should be deemed to meet capital adequacy standards where it held less than six-months' gross operating expenses.

3

The risk-based approach

3.1 In CP11/19, we set out that as a matter of supervisory practice, we currently expect an RB to hold financial resources equal to 150% of the amount indicated by the standard approach. These additional financial resources provide a capital buffer that allows the FSA to monitor the level of headroom maintained by an RB, over and above its core FRR requirement, while also giving an RB the ability to absorb shocks to its capital position without endangering its ability to implement an orderly wind-down or constituting a breach of REC.

3.2 We noted that a capital buffer fulfils an important purpose in ensuring that capital adequacy can be maintained at all times, so that an RB would not be prevented from implementing an orderly wind-down as a result of the financial impacts of stress events affecting its business or the markets in which it operates. However, we noted that the current formulaic approach to calculating the capital buffer lacks precision and is not calibrated according to an RB's actual exposure to potential business losses. Accordingly, CP11/19 proposed a move from a formulaic approach, which adds a 50% buffer to the standard approach, to the creation of a separate pillar to the FRR calculation referred to as the 'risk-based approach'. The risk-based approach was proposed to be based on the combination of two elements:

- an estimate of an RB's cost of orderly closure, calculated either in accordance with the standard approach or an alternative bespoke methodology (provided such methodology comprehensively and rigorously documented the RB's plans to achieve orderly wind-down); and
- an estimate of an RB's exposure to business losses in extreme but plausible market conditions. CP11/19 set out a framework for calculating the risk-based capital charge, based on the use of stress and scenario testing tools. We envisaged that, as an extension to an RB's existing arrangements to identify and measure its risks, RBs would document the financial stress events to which their businesses are subject (taking into account their business, operational, group and other risks), their likely effects on the costs or revenues of the RB, and the consequent aggregate business losses that may need to be charged against its capital in a plausible worst case scenario (referred to as

a financial risk assessment). Through applying a capital buffer equal to this estimate of potential business losses, we would ensure that the adverse scenarios which could realistically be foreseen during periods of market stress would not erode the capital necessary to achieve an orderly wind-down.

3.3 The risk-based approach would sit alongside the standard approach, so that the final FRR would be equal to the higher of the two pillars.

3.4 We also invited views on whether a capital buffer should be a core component of FRR, or be accessible (without constituting a breach of REC) to perform the role for which it was intended.

3.5 Most respondents opposed the introduction of a risk-based approach, as a new pillar of the FRR calculation. Those respondents queried whether the risk-based approach would lead to outcomes which are materially different from the existing formulaic approach, and suggested that our cost benefit analysis had materially under-estimated the costs of implementing the processes underlying it. One respondent considered that a risk-based approach could provide a more appropriate measure of FRR, if supported by clear and objective criteria (which, for example, offered sufficient clarity on the nature of the scenarios that an RB should include in its financial risk assessment).

Our response

We have concluded that a risk-based approach is an appropriate element of the calculation of the final FRR. This is consistent with the existing obligations of multilateral trading facilities whose operators are regulated under BIPRU and the final FMI Principles.

We believe that the risk-based approach will provide significant benefits that outweigh the costs of implementing the supporting processes. In particular, this approach will establish a relationship between an RB’s system of internal control, through which it seeks to identify and mitigate the risks associated with its current operations and future plans, and the level of capital it should hold to reflect the potential financial impacts of those risks. We recognise a move to a risk-based approach may not lead to a material change to FRR outcomes, but will have the additional benefits of promoting a greater understanding of how an RB’s risk profile exposes it to potential financial loss and how internal systems and controls can be deployed to mitigate those potential losses.

We note the concerns raised by respondents regarding the compliance costs associated with the implementation of the stress and scenario testing tools necessary to calculate the risk-based capital charge (which some respondents estimated to be considerably in excess of the amount included in our cost/benefit analysis). In our view, to meet its existing risk management responsibilities as articulated in the Recognition Requirements and REC 2.5, an RB should already operate systems and controls which are sufficient to identify the potential sources of financial stress to its business, wherever they arise in its activities, and provide a basis for measuring those risks (including the effectiveness of any mitigating action). We consider that the risk-based approach represents an extension of those existing arrangements in requiring RBs to adopt a process for quantifying those risks in the form of a capital charge, where an RB does not already do so, and so should be deliverable without imposing undue burdens. We note that an approach whereby an investment firm must allocate appropriate capital to its business and other risks has been a feature of MTF regulation for a number of years.

However, we have concluded that the risk-based approach should not apply to RCHs. The draft RTS upon which the EBA is consulting, which would constitute the FRR regime for CCPs under EMIR, do not appear to envisage that a CCP would need to adopt a process directly comparable to the risk-based approach in order to meet its prudential responsibilities. Consequently, the application of the risk-based approach to RCHs for the short period between implementation of our guidance and the coming into effect of EMIR could impose undue compliance burdens on those entities. Consequently, as an alternative to the risk-based approach, we have concluded that we should adopt guidance specifying that a RCH should hold a capital buffer equal to 50% of the standard approach (in effect, formalising the current supervisory practice pending the coming into effect of EMIR). A number of respondents to CP11/19 supported this approach to the calculation of the buffer.

We also note the observation that, if adopted, a risk-based approach should operate on a clear, objective and reasonable basis. We have concluded that our proposed guidance (particularly REC 2.3.14 to REC 2.3.18) provides a reasonable basis for RIEs to develop tailored financial risk assessments. However, we have concluded that it is appropriate to allow a minimum of six months for RBs to make the transition to the new regime, during which we would expect there to be constructive engagement between each RIE and its FSA supervisors. Through this engagement, we expect that the nature, scope and severity of the tailored stress scenarios that would form the basis for the financial risk assessment would be discussed and agreed, in light of the particular positioning and commercial plans of each RIE.

It is noted that the final FRR of an RIE will be equal to the higher of the pillar 1 calculation (the standard approach) and the pillar 2 calculation (the risk-based approach). Given that the pillar 2 calculation encompasses risks other than the orderly closure of an RIE, we expect that pillar 2 will generally exceed the pillar 1 amount. However, if in an exceptional case the pillar 1 amount was the higher (and therefore became the minimum FRR of an RIE), we would expect to use existing supervisory channels to agree with the RB an appropriate degree of headroom that it should maintain above the minimum FRR, to mitigate the risk of a breach of REC occurring.

We agree with the view of respondents that the capital buffer (for both RIEs and RCHs) should be accessible to perform the role for which it is intended without constituting a breach of REC.

4

Approach to group risk

4.1 CP11/19 noted that changes to the market and corporate structure in the market infrastructure sector had underlined the need for clearer guidance on how group risks should be taken into account in the calculation of FRR requirements. While the Recognition Requirements specify in this context that the FSA must take account of "…the exchange's connection with any person…", REC does not currently offer guidance on the arrangements that will be viewed as sufficient to deal with group risks. To address this position, CP11/19 proposed a range of options that included:

- measures to ensure that the eligible financial resources of an RB are ring-fenced against potential contagion risk. In particular, we proposed that all eligible financial assets should be held on the balance sheet of an RB on a fully unencumbered basis. We also asked for feedback on whether this should be supported by a provision specifying that the investment policy of an RB should not allow it to invest eligible financial resources in its own securities, or those of its parent or subsidiary undertakings;
- clarification that an RB should conduct a solo assessment of its group risks, as a result of its relationships or association with other group undertakings, as part of its calculation of the risk-based capital charge;
- the provision by an RB to the FSA of the consolidated balance sheet of its ultimate parent company, to enable supervisors to place the financial position of the RB in the context of its wider group[2] (and not for the purpose of applying a consolidated capital requirement, or any obligation, to the parent company); and
- the possibility of applying a bespoke consolidated capital calculation to the financial holding company of an RB. Given the absence of any movement towards a harmonised group consolidation regime for operators of regulated markets across the EU, we did not identify this as a preferred option.

2 For example, it is important for a supervisor to understand if equity investment in an RB is being funded by debt at the level of the parent company.

4.2 Most respondents supported measures to ring-fence the eligible financial assets of an RB. A number did not agree that REC should expressly place limits on the investment policy of an RB, while others requested clarification of the effect of our proposed guidance. Certain respondents questioned whether the provision of a consolidated balance sheet would provide much supervisory value and those that did support this provision noted that accounts prepared for other purposes (such as to meet legal, regulatory or listing obligations) should suffice. All respondents agreed with our assessment that it would be inappropriate to apply a bespoke group consolidation regime.

Our response

We agree with respondents that it would be inappropriate to consider a bespoke group consolidation regime for RBs unless this was part of a coordinated dialogue with supervisory authorities across the EU.

We have concluded that, in the absence of a bespoke group consolidation regime, it is important that effective arrangements are in place to ensure the eligible financial resources of an RB are ring-fenced against contagion risk. Consequently, we will adopt guidance specifying that eligible financial assets must be held on the balance sheet of the RB, on a fully unencumbered basis. In addition, we do not consider that an asset representing an investment in the securities of a parent, subsidiary or sister undertaking should be eligible to meet FRR, given access to such resources may be especially important during periods of stress that could be affecting the entire group. However, we do not intend to restrict the ability of an RB to invest financial resources which are in excess of those necessary to meet FRR. Consequently, we will rephrase our guidance to specify that, where an RB has invested financial resources in the securities of an undertaking in the same group (or otherwise has an exposure arising from loans made to such entities), the amount of that investment or exposure should be deducted from its eligible capital.

We have also concluded that, as part of the risk-based approach, it is appropriate for RIEs to consider the appropriateness of stress scenarios related to its relationships or association with other group undertakings and the group as a whole (such as reputational contagion). A solo assessment of group risk of this type is consistent with the existing responsibilities of investment firms under BIPRU. We expect that the nature and scope of any stress scenarios related to group risk would form part of the consultation between RIEs and FSA supervisors during the six-month transitional period.

Further, we have concluded that it is appropriate for an RIE to provide to the FSA a copy of the most recent consolidated balance sheet of its ultimate parent company, purely to facilitate supervision of the regulated subsidiary. This provision is not intended to impose any new obligations upon a group to prepare financial statements, and hence financial statements prepared for the purpose of existing legal, regulatory or listing obligations will be sufficient provided they conform to an acceptable accounting standard (as specified by REC 2.3.4).

5

Eligible financial resources

5.1 CP11/19 noted that, currently, financial resources held to meet FRR must be sufficiently liquid and funded by equity capital. In light of the importance of ensuring that financial assets will be available when needed (with little or no loss of value), and that an RB's equivalent amount of net capital is fully loss absorbing, we did not propose any changes to this position. We did, however, propose to allow the inclusion of interim earnings in the calculation of net capital where they have been independently verified by an RB's auditor.

5.2 All respondents supported the emphasis placed by REC on the maintenance of high quality capital. Some respondents requested clarification that retained earnings and other instruments classified as tier 1 capital under EU prudential requirements would qualify as eligible capital, while certain respondents considered that some forms of subordinated debt should be included. A majority of respondents supported our proposal that an RB should be able to take account of interim earnings in its calculation of net capital, but most did not agree that this should be conditioned on external verification since this is not always a feature of the preparation of interim financial statements.

Our response

We propose to adopt the guidance set out in CP11/19 in relation to eligible financial resources.

We consider, consistent with the Capital Requirements Directives (CRD) and the FMI Principles, that retained earnings constitute part of an RB's equity capital. We also consider that instruments that qualify as tier 1 capital under the CRD (which may include some forms of perpetual non-cumulative preference shares) will be eligible financial resources. We do not consider that subordinated debt is eligible to meet the FRR.

We have concluded that, consistent with the provisions of GENPRU, interim earnings may only qualify for inclusion where any foreseeable charges or dividends have been deducted and they have been independently verified by an

RB's auditor. We consider it important that capital held against FRR has been subject to a minimum level of external assurance. For clarification, we would interpret the requirement for verification in the same way as the practice note issued by the Auditing Practices Board for the purpose of GENPRU 2.2.103. This currently envisages that verification involves a degree of assurance which is lower than that given by a full audit, and accordingly an engagement to 'verify' may be taken to be a review engagement and an opinion may be given in terms of negative assurance.

Annex 1

List of non-confidential respondents

European Central Counterparty Limited

ICE Futures Europe

ICE Clear Europe Limited

LCH.Clearnet Group Limited

The London Metal Exchange Limited

London Stock Exchange plc

NYSE LIFFE

Appendix 1

Final guidance (legal instrument)

RECOGNISED INVESTMENT EXCHANGES AND RECOGNISED CLEARING HOUSES SOURCEBOOK (FINANCIAL RESOURCES REQUIREMENTS) INSTRUMENT 2012

Powers exercised

A. The Financial Services Authority makes this instrument in the exercise of the power in section 157(1) (Guidance) of the Financial Services and Markets Act 2000.

Commencement

B. This instrument comes into force on 1 February 2013.

Amendments to the Handbook

C. The Recognised Investment Exchanges and Recognised Clearing Houses sourcebook (REC) is amended in accordance with the Annex to this instrument.

Citation

D. This instrument may be cited as the Recognised Investment Exchanges and Recognised Clearing House Sourcebook (Financial Resources Requirements) Instrument 2012.

By order of the Board
26 July 2012

Annex

Amendments to the Recognised Investment Exchanges and Recognised Clearing Houses Sourcebook (REC)

In this Annex, underlining indicates new text and striking through indicates deleted text.

2 Recognition requirements

…

2.3 Financial resources

…

Operational and other risks: ~~standard approach~~ components of calculation

2.3.7 G ~~The *FSA* considers that a *UK recognised body* which (after allowing for the financial resources necessary to cover counterparty and market risks) has at any time:~~

~~(1) liquid financial assets amounting to at least six months' operating costs; and~~

~~(2) net capital of at least this amount;~~

~~will, at that time, have sufficient financial resources to meet the *recognition requirement* unless there are special circumstances indicating otherwise.~~ In considering whether a *UK recognised body* has sufficient financial resources in relation to operational and other risks, the *FSA* will normally have regard to two components: eligible financial resources and net capital.

Operational and other risk: UK RCHs - the standard approach

2.3.8 G (1) ~~In this standard approach, the *FSA* assumes liquid financial assets are needed to cover the costs that would be incurred during an orderly run down of the *UK recognised body's* business as such, while continuing to satisfy all the *recognition requirements* and complying with any other obligations under the *Act* (including the obligations to pay periodic fees to the *FSA* under *REC* 7).~~ The *FSA* considers that a *UK RCH* which at any time holds:

(a) eligible financial resources not less than the amount calculated under the standard approach; and

(b) net capital not less than the amount of eligible financial resources calculated under (a);

will, at that time, have sufficient financial resources to meet the *recognition requirement* in respect of operational and other risks unless there are special circumstances indicating otherwise.

(2) ~~The calculation of operating costs may exclude non-cash costs (costs that do not involve an outflow of funds) and variable costs of the *UK recognised body's exempt activities* that would not be incurred if no *exempt activities* were performed. Fixed costs should be included in the assessment of operating costs. The *FSA* would normally expect the capital equal to the amount of liquid financial assets to be in the form of equity~~. The *FSA* would normally regard the amount calculated under *REC* 2.3.8G(1) to be a minimum amount of financial resources below which a *UK RCH* would be failing the *recognition requirements*. The *FSA* would normally expect a *UK RCH* to hold, in addition to this minimum amount, an amount constituting an operational risk buffer calculated in accordance with *REC* 2.3.22G.

Operational and other risks: ~~alternative approaches~~ UK RIEs - the standard and risk-based approach

2.3.9 G (1) ~~The *FSA* recognises that *UK recognised bodies* may wish to satisfy the *recognition requirements* in different ways. The *FSA* does not prescribe any particular approach to calculating financial resources or to assessing their adequacy. It is willing to discuss with each *UK recognised body* the most appropriate way for it to meet the *recognition requirement* and each *UK recognised body* will need to be able to show the *FSA* that its financial resources are at all times sufficient to meet the *recognition requirement*.~~ The *FSA* considers that a *UK RIE* which at any time holds:

(a) eligible financial resources not less than the greater of:

(i) the amount calculated under the standard approach; and

(ii) the amount calculated under the risk-based approach; and

(b) net capital not less than the amount of eligible financial resources determined under (1)(a);

will, at that time, have sufficient financial resources to meet the *recognition requirement* in respect of operational and other risks unless there are special circumstances indicating otherwise.

(2) The *FSA* would normally regard the amount calculated under *REC* 2.3.9G(1)(a)(i) to be a minimum amount of financial resources below which a *UK RIE* would be failing the *recognition requirements*. The *FSA* would expect a *UK RIE* to hold, in addition to this minimum amount, an amount constituting an operational risk buffer calculated in accordance with *REC* 2.3.22G.

Operational and other risks: individual guidance

2.3.10 G The *FSA* would expect to provide a *UK recognised body* with individual *guidance* on the amount of eligible financial resources which it considers would be sufficient for the *UK recognised body* to hold in respect of operational and other risks in order to satisfy the *recognition requirements*. In formulating its individual *guidance*, the *FSA* will ordinarily apply the approach described in *REC* 2.3.8G, for *UK RCHs*, and *REC* 2.3.9G, for *UK RIEs*.

Operational and other risks: eligible financial resources

2.3.11 G For the purposes of *REC* 2.3, "eligible financial resources" should consist of liquid financial assets held on the balance sheet of a *UK recognised body*, including cash and liquid financial instruments where the financial instruments have minimal market and credit risk and are capable of being liquidated with minimal adverse price effect.

Operational and other risks: net capital

2.3.12 G For the purposes of *REC* 2.3, "net capital" should be in the form of equity. For this purpose, the *FSA* considers that common stock, retained earnings, disclosed reserves and other instruments classified as common equity tier one capital or additional tier one capital constitute equity. The *FSA* considers that, when calculating its net capital, a *UK recognised body*:

(1) should deduct holdings of its own securities, or those of any undertaking in the same *group* as the *UK recognised body*, together with any amount owed to the *UK recognised body* by an undertaking in its *group* under any loan or credit arrangement and any exposure arising under any guarantee, charge or contingent liability given in favour of such an undertaking or a creditor of such undertaking; and

(2) may include interim earnings that have been independently verified by its auditor.

Operational and other risks: eligible financial resources calculated under the standard approach

2.3.13 G (1) Under the standard approach, the amount of eligible financial resources is equal to six months of operating costs.

(2) Under the standard approach, the *FSA* assumes liquid financial assets are needed to cover the costs that would be incurred during an orderly wind-down of the *UK recognised body's exempt activities*, while continuing to satisfy all the *recognition requirements* and complying with any other obligations under the *Act* (including the obligations to pay periodic fees to the *FSA*).

(3) For the purposes of the standard approach, the *FSA* would normally expect the calculation of operating costs to be based on the *UK*

recognised body's most recent audited annual accounts, with six months of operating costs being equal to one half of the sum of all operating costs reflected in the audited annual accounts of the *UK recognised body* in the course of performing its functions during the year to which the accounts relate. In calculating the gross annual operating costs, the *FSA* would consider it reasonable to exclude non-cash costs (costs that do not involve an outflow of funds).

(4) The *FSA* considers it to be reasonable for a *UK recognised body* to adjust its operating expenditure calculation if, during the period since its last audited accounts were prepared, its level of operating expenditure has changed materially as documented by the current annual budget or forecast adopted by the *UK recognised body's governing body*.

(5) The *FSA* considers that it is reasonable for a *UK recognised body* to adjust its operating expenditure to take account of arrangements between two or more undertakings in the same *group*, which are all subject to prudential regulation in the *United Kingdom* under which specified costs are shared or recharged among those undertakings and those costs would otherwise be double-counted in the calculation of their financial resources requirement.

Operational and other risks: eligible financial resources calculated under the risk-based approach (UK RIE's only)

2.3.14 G (1) The risk-based approach is intended to ensure that sufficient financial resources are maintained at all times such that a *UK RIE* would not be prevented from implementing an orderly wind-down as a result of the financial impacts of stress events affecting its business or the markets in which it operates.

(2) Under the risk-based approach the amount of eligible financial resources is calculated by adding together:

(a) the amount estimated by the *UK RIE* to absorb the potential business losses that a business of its nature, scale and complexity might incur in stressed but plausible market conditions; and

(b) the amount estimated by the *UK RIE* to effect an orderly closure.

In this context, a business loss arises where there is an increase in cost or reduction of revenue relative to a *UK RIE's* expectation of its financial performance, such that a loss needs to be charged against its capital.

Operational and other risks: the risk-based assessment (UK RIEs only)

2.3.15 G For the purposes of calculating the risk-based approach, the *FSA* would normally expect the *UK RIE* to provide the *FSA* with an annual financial risk assessment that identifies the risks to its business. As a financial risk assessment is likely to form an integral part of the *UK RIE's* management process and decision-making culture, the *FSA* would normally expect it to be approved by the *UK RIE's governing body*.

2.3.16 G The *FSA* would normally expect to use the financial risk assessment prepared by the *UK RIE* in the course of preparing individual *guidance* on the amount of financial resources that it considers is sufficient for a *UK RIE* to hold in order to satisfy the *recognition requirements*. The financial risk assessment would provide the basis for calculating the amount of eligible financial resources that should be held by the *UK RIE* under the risk-based approach.

2.3.17 G The financial risk assessment should be based on a methodology which provides a reasonable estimate of the potential business losses which a *UK RIE* might incur in stressed but plausible market conditions. The *FSA* would expect a *UK RIE* to carry out a financial risk assessment at least once in every twelve-month period, or more frequently if there are material changes in the nature, scale or complexity of the *UK RIE's* operations or its business plans that suggest such financial risk assessment no longer provides a reasonable estimate of its potential business losses. The *FSA* considers that it would be reasonable for a financial risk assessment to proceed in the following way:

(1) Step 1: the *UK RIE* would identify, in writing, the risks to which the business of the *UK RIE* is exposed and which could have a material adverse effect on its financial position, in the light of the nature, scale and complexity of its operations and its business plans. For this purpose, it would be reasonable to refer to the categorisation of risk used under the system of risk management adopted by the *UK RIE* in order to meet its responsibilities under the *recognition requirements* referred to in *REC* 2.5. That description would identify which risks are indemnified or transferred by the *UK RIE* and which are retained and accepted.

(2) Step 2: the *UK RIE* would conduct an assessment of the potential business losses that could arise in the event that the risks identified in accordance with step 1 were to materialise. For this purpose, it would be reasonable for a *UK RIE* to develop, and keep under review, a stress and scenario testing plan designed to simulate the effects of a pre-determined series of events, or sets of circumstances, that would be likely to occur following the crystallisation of one or more identified risks, taking into account the systems and controls in place to mitigate those risks. The stress and scenario testing plan would:

(a) cover a forward-looking period of at least one year;

(b) consider a suitable range of adverse events and sets of circumstances, of a defined severity and duration, which could occur in stressed but plausible market conditions;

(c) consider how a particular adverse event or set of circumstances could lead to or be correlated with other events;

(d) consider the potential for a particular adverse event or set of circumstances to affect multiple business lines;

(e) take into account realistic management actions to resolve such adverse events and circumstances; and

(f) where appropriate, involve sensitivity analysis showing the effects of changes to assumptions made about the impact of particular adverse events and circumstances.

In designing its stress and scenario testing plan, the *FSA* considers that it would be reasonable for a *UK RIE* to be guided by any risk-scoring methodology that it deploys for general risk-management purposes that might have application in evaluating the probability and impact of its risks.

The *FSA* would not expect a *UK RIE* which undertakes central counterparty clearing activities to include within its range of stress events the potential default of a participant or other entity (such as another central counterparty which is not a participant).

(3) Step 3: the *UK RIE* would assess the eligible financial resources that it would need to hold to cover such potential business losses. Such eligible financial resources would enable the *UK RIE* to absorb any financial shocks attributable to such business risks were they to arise.

In carrying out this assessment, the *FSA* considers that it would be reasonable for a *UK RIE* to take account of any action which its senior management might plan on taking in response to a given stress event. For example, if the risk appetite of a *UK RIE* is such that it would not pursue recovery from a given stress event (and would instead initiate an orderly wind-down), the assessment of eligible financial resources needed in such circumstances might reasonably be limited to the costs of orderly wind-down from the point in time at which that decision would be likely to be made.

Where a *UK RIE* expects to be making a loss during the period covered by the financial risk assessment as a result of its anticipated business performance in normal market conditions, the business losses which are relevant to the calculation of the risk-based approach are those additional losses which the *UK RIE* would expect to incur in stressed but plausible market conditions.

(4) Step 4: the *UK RIE* would make an assessment of the cost of orderly closure. The *FSA* considers that an orderly closure should normally

include an assessment of the impact of closure on the users of the markets operated by that *UK RIE*. For the purpose of this assessment, the *FSA* considers that it would be reasonable for a *UK RIE* to adopt the amount needed under the standard approach as its cost of orderly closure or to use its own method of calculation based on a scenario plan which comprehensively documents the costs that a *UK RIE* in its position might incur in order to fully implement an orderly wind-down.

(5) Step 5: the *UK RIE* would produce a proposal for the amount of eligible financial resources considered to be adequate to meet the risk-based approach. Such a proposal would be based on the sum of:

(a) the amount assessed to cover potential business losses in accordance with *REC* 2.3.17G(3); and

(b) an amount assessed to cover the cost of orderly closure in accordance with *REC* 2.3.17G(4).

(6) Step 6: the *UK RIE* would calculate the amount available as an operational risk buffer in accordance with *REC* 2.3.22G. To the extent the amount available is insufficient to constitute an operational risk buffer, the *UK RIE* would include within its proposal the amount it would propose to hold (in addition to the sum of the amounts referred to in (5)(a) and (b)) for those purposes.

2.3.18 G The *FSA* would normally expect a financial risk assessment to include a description of the methodology applied by the *UK RIE* to arrive at the proposal made in accordance with *REC* 2.3.17G(5).

2.3.19 G Where a *UK RIE* is a member of a *group*, the *FSA* would normally expect the annual risk assessment to be accompanied by a consolidated balance sheet:

(1) of any *group* in which the *UK RIE* is a *subsidiary undertaking*; or

(2) (if the *UK RIE* is not a *subsidiary undertaking* in any *group*) of any *group* of which the *UK RIE* is a *parent undertaking*.

2.3.20 G The *FSA* would expect to consider the financial risk assessment, any proposal with respect to an operational risk buffer and, if applicable, the consolidated balance sheet, in formulating its *guidance* on the amount of eligible financial resources it considers to be sufficient for the *UK RIE* to hold in order to meet the *recognition requirements*. In formulating its *guidance*, the *FSA* would, where relevant, consider whether or not the financial risk assessment makes adequate provision for the following risks:

(1) the risks related to the administration and operation of the *UK RIE* as a business enterprise (whether as a result of adverse reputational effects, poor execution of business strategy, ineffective response to competition, or otherwise);

(2) the risk that deficiencies in information systems or internal processes, human errors, management failures, or disruptions from external events will result in the reduction, deterioration, or breakdown of services provided by a *UK RIE* (whether as a result of errors or delays in processing, system outages, insufficient capacity, fraud, data loss and leakage, or otherwise);

(3) the risk that the financial position of the *UK RIE* may be adversely affected by its relationships (financial or non-financial) with other entities in the same *group* or by risks which may affect the financial position of the whole *group*, including reputational contagion; and

(4) any other type of risk which is relevant to that particular *UK RIE*.

Operational and other risks: purpose of the risk buffer

2.3.21 G The *FSA* would normally consider a *UK recognised body* to be failing the *recognition requirements* if it held financial resources less than the amount calculated under *REC* 2.3.8G (in respect of *UK RCHs*) and *REC* 2.3.9G(1)(a)(i) (in respect of *UK RIEs*). The *FSA* therefore expects a *UK recognised body* to hold an operational risk buffer of a sufficient amount in excess of this minimum, to ensure that it is at all times able to comply with its regulatory obligations.

Operational and other risks: calculation of the operational risk buffer - UK recognised bodies

2.3.22 G (1) The *FSA* would normally expect a *UK RCH* to hold, in addition to the minimum amount determined under *REC* 2.3.8G, an operational risk buffer equal to 50% of the amount calculated under *REC* 2.3.8G(1).

(2) The *FSA* would normally expect a *UK RIE* to hold, in addition to the minimum amount determined under *REC* 2.3.9G(1)(a)(i), an operational risk buffer consistent with a risk-based approach.

(a) Where the amount of eligible financial resources calculated by a *UK RIE* under *REC* 2.3.17G(5) (the risk-based approach) is greater than the amount of eligible financial resources calculated under *REC* 2.3.13G (the standard approach), and the difference is of an amount sufficient to serve the purposes of the operational risk buffer, then the *FSA* considers that there would be no need for a *UK RIE* to hold any further amount as an operational risk buffer.

(b) Where the amount of eligible financial resources calculated by a *UK RIE* under *REC* 2.3.17G(5) (the risk-based approach) is not sufficient to provide an effective operational risk buffer over and above the amount calculated under *REC* 2.3.13G (the standard approach), then the *FSA* would expect the *UK RIE* to include within its annual risk assessment a proposal to hold additional financial resources sufficient to constitute an operational risk buffer.

(3) As the operational risk buffer is an amount in excess of the minimum financial resources sufficient to meet the *recognition requirements*, the *FSA* would normally not regard a *UK recognised body* that draws upon or temporarily depletes the operational risk buffer to have failed or be failing a *recognition requirement* in respect of its financial resources. However, the *FSA* would expect to be notified as soon as reasonably practicable if the *UK recognised body* draws upon, or intends to draw upon, its operational risk buffer.

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