Payments and Digital Assets Authorisations Video Transcript- Prudential framework: Part 1

Louis Myers

- The crypto asset market has grown quickly, bringing new products, new business models, and new opportunities for innovation. Up to now, many of these activities have sat outside the Prudential framework. That meant many firms were not required to hold regulatory capital, maintain sufficient liquid assets, or plan for stressed conditions. But under the new FSMA crypto asset regime, that changes. The Prudential rules introduce clear standards designed to strengthen three key areas, firm resilience, consumer protection, and confidence in the crypto asset market. In this episode, we'll guide you through the structure of the framework and explain what it means for your firm in applying for authorisation. Hi, I'm Louis, one of the managers here at the FCA. Today, I'm joined by Joshua, and we're going to walk you through the Prudential requirements that apply to crypto asset firms. Hi, Joshua.

Joshua Olukoya

- Hi, I'm Joshua, a senior associate in the payments and digital assets team.

Louis Myers

- Joshua, there's a lot for people to understand. There are new requirements coming into effect. Let's have a think about these Prudential rules. Can you tell us a little bit more about what they are and why they're so important?

Joshua Olukoya

- Absolutely. So our Prudential rules require firms to hold adequate financial resources. Now what do we mean by adequacy? Adequacy is assessed in terms of both your capital and your liquid assets. Capital is your firm's equity and debt-absorbing liabilities ranking behind your general creditors. So your share capital, retained earnings, and

subordinated debts, for example. Liquid assets, on the other hand, are those that can be converted to cash as soon as needed with minimal loss in value. Both of these are assessed against your business, so the activities that you undertake, the size and scale of your business, the operating costs, and your relationships with other entities.

Louis Myers

- It sounds like these are really key pieces of information that we need. Can you just explain a little bit more about why it's so important?

Joshua Olukoya

- So our rules are important for three separate reasons. Firstly, our rules reduce the risk of a firm failing. If you hold adequate financial resources, you'll be better able to withstand market turbulence, and you're also less likely to face liquidation. Secondly, our rules reduce the harm done to clients and to the wider markets in the event that a firm does fail. With adequate financial resources, you'll be able to wind down in an orderly manner and to repay your clients where appropriate. Thirdly, our rules build market resilience and confidence, which is particularly important for emerging sectors like crypto assets. We want crypto firms to have a safe and stable environment that they can operate in where they can grow, innovate, and compete effectively. And for this to happen, it's essential that all firms hold adequate financial resources.

Louis Myers

- So we've just spoken there quite a lot about the reasons why the Prudential rules are so important. There's probably a lot more that we can talk about there, but let's have a think about the Prudential requirements and how they work together in practise. Could you walk us through that?

Joshua Olukoya

- Sure, so as I said before, the rules are built around a framework of own funds and liquid assets. I'll start with own funds. Own funds are split into three tiers based on their quality and permanence. Common Equity Tier 1 capital is of the highest quality and absorbs losses first. Ordinary shares are a common form of CET1 capital. Additional Tier 1 capital absorbs losses while a firm remains a going concern. Preference shares are generally eligible as AT1 capital. Tier 2 capital absorbs losses only in wind-down scenarios. Long-term subordinated debt instruments are generally eligible as Tier 2 capital. I should note here that the instruments I mentioned are examples found under each tier, but the list is not

exhaustive. The definition of own funds also prescribes certain filters and deductions under each tier, and that just helps to ensure that firms are being prudent when calculating their own funds and will be better able to withstand shocks in the market. Liquid assets, on the other hand, are those that can be converted to cash such as government bonds or gilts or just cash as soon as needed with minimal loss in value. It's essential that firms hold enough liquid resources so that they can meet their short-term obligations and withstand stress scenarios in the market.

Louis Myers

- We've got a really clear idea now about the framework, but it would be really helpful, I think, if you could explain where these rules are set out.

Joshua Olukoya

- Yes, that's very important. So the rules are set out in two separate source books. We have COREPRU and CRYPTOPRU. COREPRU sets out the overarching Prudential rules for firms. So put simply, it's the foundational source book for the core Prudential requirements. CRYPTOPRU, on the other hand, sets out the sector-specific Prudential rules for crypto asset firms.

Louis Myers

- Thanks, Joshua. So that concludes part one of our video on the Prudential framework. Please join us for part two, where we'll talk about the financial information we expect to see as part of the application.