Operational Continuity in Resolution (OCIR)

Keeping critical services running
What is operational continuity?

Concerns over banks deemed ‘too big to fail’ are leading to improved regulation around resolution planning. In 2016 the PRA issued PS21/16 and SS9/16, outlining new requirements to ensure firms are able to operate effectively throughout periods of stress or during resolution.

Resolution is the process the Bank of England follows to manage the failure of financial institutions. When an organisation goes into resolution, a number of obligations must be fulfilled to meet both regulatory and customer requirements. Operational continuity plans ensure the organisation can continue to function to meet those obligations.

What are critical services?
The PRA defines critical services as those which “need to be available to one or more business units of a firm or entity of a group in order to provide functions critical to the economy”. Failure of these services could result in disorderly resolution of a firm and could adversely impact the UK’s financial stability.

These critical services may include core elements of infrastructure such as IT services, accounts or access to business premises.

Who’s affected?
The new requirements around operational continuity come into effect from January 2019 and will apply to UK banks, building societies and PRA-authorised firms who have met the following criteria over the last three years:

- Total assets worth more than £10 billion
- Average safe custody assets over £10 billion
- Average total sight deposits received exceed £350 million

The PRA will need evidence that an adequate framework is in place and that it is both operational and effective. Failure to fully implement operational continuity requirements could lead to a section 166 or, in the worst case scenario, the banking licence could be revoked.

“The PRA requires firms to identify and protect the critical services upon which business as usual depends.”

Critical services delivery models

There are three possible delivery models and the arrangements for operational continuity will differ accordingly:

- **Outsourced:** Where critical services are outsourced, it is important to remember that regulatory responsibility remains with the firm.

- **In group:** Where critical services are delivered within the business, operational continuity relies on a degree of independence. Providers should essentially be freestanding from the rest of the group or other business units and critical services can be delivered in one of two ways:
  - via a business unit within the firm
  - outsourced to a dedicated and separate legal entity within the wider group.

- A combination of the above.
Operational continuity – at a glance

Operational continuity aims to improve governance of critical services, ensuring they are designed with resolution in mind. Services should be clearly documented, contractually protected and have adequate liquidity to continue under stressed conditions.

To support these goals, the PRA have provided guidance across each of the following areas:

- **Financial resilience**: Firms should have adequate liquidity to enable critical services to continue uninterrupted during resolution.
- **Operational resilience**: Group entities must have the operational resilience to continue under stressed conditions or resolution or during restructuring.
- **Contractual service provisions**: Critical services should be contractually outlined and cannot be altered when entering resolution.
- **Objective service level agreements**: Objective SLAs must be in place even if the service is undertaken by an internal business unit and should be on an arms-length basis.
- **Access to operational assets**: Firms should clearly outline how access to operational assets such as premises will continue to be available.
- **Charging structures**: Charging structures for critical services should be simple and easily transferable.
- **Governance arrangements**: Provider should have adequate management structures enabling the services to operate regardless of the resolution processes.
- **Prevention of preferential treatment**: An entity under stress or resolution must not be given preferential treatment, as this may have a detrimental effect on other entities within the group.
- **Reporting requirements**: The PRA has introduced a new regulatory return (109) to capture the elements of operational continuity.
Financial resilience

Whether critical services are delivered by a third party or within the group, safeguards must be put in place to protect the financial resilience of the provider. Their finances may be negatively affected by the stress event or resolution, and service provision may be compromised as a result.

During a period of stress or during resolution, a critical services provider may be exposed to the following risks:

• Loss of revenue due to lack of payment by the client during resolution
• Reduced demand for services from a client in resolution, potentially leading to overheads which exceed revenue
• Increased employee costs for redundancy or retention payments
• Wind-down and restructuring costs
• Write down of relationship specific assets

A firm may mitigate these risks through a variety of means, depending on the method of critical services delivery.

Key considerations

The organisational method selected will influence the way financial resilience risks are mitigated.

Within the group

Where critical services are provided within the firm or wider group, the firm must ensure adequate liquidity and be able to absorb losses. As such:

• Firms are expected to maintain liquidity resources of at least 50% of the annual overheads for critical services
• These assets must be held independently from other group liquid assets, either with a third party or as custody assets within another group entity
• These assets may not be double counted against the High Liquid Asset (HQLA) under the Capital Requirement Directive IV (CRD IV) and Capital Requirements Regulation (CRR)

Outsourced

Where critical services are outsourced, adequate due diligence should be undertaken to ensure sufficient financial resilience.

How Grant Thornton can help you meet regulatory expectations:

Where the critical services provider is located in a group, the regulator will need evidence of sufficient financial resources to provide critical services during stress, resolution and post-resolution.

We can:

• Help to prepare this documentation
• Advise on details for inclusion
• Offer assurance that the evidence is sufficient for regulators.
Operational assets and resilience

Where in-group models are used for critical services, the organisation must have the business resilience to ensure these services can continue to run should any group entity fail. This may include access to operational assets such as premises or data.

Operational resilience

Critical services delivered by a specialist business unit or dedicated group entity are likely to be heavily affected by resolution or failure of a group entity. Measures must be taken to ensure services can remain operational throughout.

In these instances, firms should ensure the service provider:

- Has sufficient contingency planning and business resilience procedures
- Has adequate staff and expertise to conduct post-resolution restructuring where necessary
- Operational resilience is not affected by the loss of key business

Operational assets

During resolution, maintaining access to operational assets may be particularly troublesome for firms who are using group models for critical services.

Operational assets may include licences, leases or access to intellectual property. Often leases or other contracts are negotiated at group level, so maintaining access to them may be difficult for subsidiaries or other group entities in the case of resolution.

Key considerations

- Firms need to identify their critical services
- Firms must map the critical services from suppliers to recipients

How Grant Thornton can help you meet regulatory expectations:

The regulator will want to see comprehensive mapping and appropriate reporting of critical services.

We can:

- Help to map critical services
- Offer advisory services regarding the necessary detail and evidence required for reporting
- Provide assurance over critical services maps and the associated reporting processes

Key considerations

- Firms need to identify the operational assets which support the critical services
- Firms must be able to articulate how they can access these assets in times of stress or resolution

How Grant Thornton can help you meet regulatory expectations:

Regulators will need clear evidence that operational assets will continue to be available to the organisation. In some cases they may expect key operational assets to be owned by the firm.

We can:

- Provide advisory services for best practice management of operational assets
- Facilitate reporting processes
- Offer assurance over how operational assets are managed and evidenced to the regulator
Contractual arrangements and fees

Critical services should be clearly identified and protected through contractual arrangements, Service Level Agreements and transparent fee structures. How this is achieved will differ depending on whether the service is provided in-group or via a third party. Regardless of the method, they should be designed with the creation of transitional agreements and post-resolution restructuring in mind.

**Contractual obligations**

Critical services should be protected by robust contracts, the terms of which cannot be altered during resolution or a stress event. However, this is a two way arrangement and is dependent on the firm continuing to uphold their financial obligations.

**Fee structures**

Fee structures for critical services should also be transparent and – if provided via an internal business unit or group entity – should be on an arms-length basis. For services delivered by internal business units, this pricing structure would form the basis of an external contract following resolution. Where services are delivered by a dedicated group entity, critical services contracts and fee structures should be readily transferrable to another body.

**Transition**

Where services are transferred to another body, the original service provider should be prepared to continue to provide resources for a reasonable time frame.
Service Level Agreements (SLAs)

Regardless of the organisational structure, SLAs should be objective and on third party terms. Both of these factors will help a firm to create a transitional service agreement at short notice and support potential restructuring.

Delivered by a business unit within a firm

Where critical services are provided by a business unit, the terms and internal charging structure should be well documented and include details of:
- The business units/entities delivering and receiving the service
- Transition arrangements for resolution

Delivered by a third party or specified group entity

Where services are delivered by a separate legal entity, SLA’s should include:
- Details of the services, the provider and recipient
- Means of measuring the service provided
- Metrics and key performance indicators
- Pricing structure which should be on arms-length terms for easy transferal of services
- Details of onward provision to other services or sub-contracting
- Confirmation that terms of service and financial arrangements should not change under stressed conditions or resolution

Key considerations

- Renegotiation of contract with service providers
- Provision of clear rate schedules showing arms-length pricing
- Structuring fees to support planned business growth
- Ensuring that the firm can still respond to commercial pressures
- Stranded costs
- Inclusion of transition clauses in contracts
- Where critical services are shared, apportionment rules to prevent preferential treatment

How Grant Thornton can help you meet regulatory expectations:

The regulator will need evidence of contractual arrangements supporting provision of critical services throughout resolution and an inventory of contracts for all delivery models. They will also require evidence of a transparent and arms-length fee structure.

We can:
- Advise on the contractual provisions required
- Offer contract assurance services to ensure the contracts are robust, fit for purpose and transferrable
Governance arrangements and preferential treatment

Where critical services are delivered from within a group, operational continuity relies on a degree of organisational independence, which can essentially be freestanding from the rest of the group or other business units. In addition to clear contracts, SLAs and arms length fee structures, stand alone governance arrangements enable critical services to be delivered throughout resolution.

Governance arrangements

The critical services provider should be governed by senior management and there should be a degree of operational independence surrounding those staff members:

- They should not perform significant duties for other group entities
- Where multiple roles are held, those regarding critical services must be prioritised
- A critical service provider should not overly rely on staff members paid by other members of the group
- Third party services providers should have suitable governance and outsourcing arrangements

Key considerations

- The critical services provider must be able to demonstrate that its governance is sufficiently independent of other entities within the group
- The regulated entities have an obligation in terms of the PRA’s Rulebook, in particular SYSC 8 to ensure outsourced activities are properly governed and controlled

How Grant Thornton can help you meet regulatory expectations:

Regulators will expect evidence to demonstrate that the governance structure of the critical services provider enables it to make decisions independently of the interests of other group entities. They will also need evidence that regulated entities have the necessary control and infrastructure to ensure outsourced activities meet regulatory requirements.

We can:

- Offer advisory services around the design and implementation of governance structures for critical services providers
- Provide assurance that existing governance structures enable independent decision making processes
- Review governance procedures around outsourced activities and offer assurance that regulatory obligations are fulfilled
**Preferred treatment**

In addition to organisational independence, in group providers must not give preferential treatment to any entity under stress or resolution. Preferential treatment could divert necessary resources from other group entities, thus increasing the likelihood of them experiencing a period of stress in turn. During stressed conditions, or resolution of a group entity, the critical services provider should act in accordance with the contractual and SLA terms.

**Key considerations**

- The service agreements should not contain clauses which would obligate the critical services provider to provide services to one entity to the disadvantage of another.
- The critical services provider management should be sufficiently independent of the service recipients to ensure that they are not influenced to override conditions of contracts to prefer stressed entities.

**How Grant Thornton can help you meet regulatory expectations:**

The regulator will need documentation to clearly outline the terms of services.

We can:

- Offer advisory and assurance services regarding how best practice governance arrangements can reduce the risk of preferential treatment being given.
- Provide assurance over your existing governance procedures to prevent preferential treatment.
- Review your documentation to ensure it is fit for purpose.
Case study

Supporting operational continuity planning for a top tier bank

Our client

Our client is a global top tier bank who required support to implement their operational continuity plan. They had decided to migrate their infrastructure activities into a separate group entity and needed to ensure the new service structure met regulatory requirements and enabled them to:

- Retain control over the critical activities
- Ensure the services adhered to group standards
- Check that service recipients had effective oversight

What did we do?

We conducted a gap analysis of the operational continuity requirements against the proposed organisational structure; highlighting any strengths or weaknesses of the approach. The project covered a wide range of critical business activities across the globe and we assessed:

- The relationships between the service provider, its clients and third parties
- How the service provider could remain both financially and operationally resilient
- The independence of management to ensure no preferential treatment would be given under extreme conditions

How we added value

Our subject matter experts drew on significant risk and sector expertise to deliver an added value approach. They challenged the suitability of operational continuity arrangements and assessed the potential risks should any group entity face resolution. This resulted in our client modifying the structure of the proposed service entity to improve viability and resilience in extreme conditions.
How operational continuity differs from current arrangements

Operational continuity introduces a number of new requirements on firms, including:

- Arms-length SLAs with clauses ensuring they remain in force even through resolution
- Accent on transfer pricing between the providers and recipients of services
- Ensuring access to operational assets such as IT infrastructure despite resolution
- Financial resilience of the service provider
- Maintenance of a liquidity buffer of at least 50% of the annual fixed overhead requirement
- Independence of the governance of the service provider to ensure that no recipient is preferred
- If the critical services are outsourced, the firms will have to ensure compliance with SYSC8
- Additional regulatory reporting requirements

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<th>Recovery plans</th>
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Operational continuity is not about simply meeting regulatory requirements. It is about finding practical solutions to keep critical operations running smoothly during stressed conditions or resolution, enabling the business to focus on recovery or post-resolution planning. Our tailored approach finds an implementation which works for you, taking into account the scale and complexity of your organisation.

Our team of experienced risk specialists can support your operational continuity planning. From design through to implementation, we can help develop a practical approach which complements your existing business practices and adds value at every stage.

We can assist your operational continuity implementation in the following areas:

• Identifying and mapping your critical services
• Improving your financial and operational resilience under stressed conditions
• Improving business continuity arrangements so that they are appropriate during stressed conditions or resolution
• Establishing effective contractual arrangements and clear pricing structures
• Measuring operational and financial resilience of external providers
• Providing assurance over the operational continuity framework and process and their alignment with changing regulatory requirements
• Assisting with, and providing assurance on, the regulatory return
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