

Operational resilience: Critical third parties to the UK financial sector

Hellios Information LTD

December 2023



PRA/BoE CP 26/23 - Operational resilience: Critical third parties to the UK financial sector

With no change to existing Operational Resilience or Third-Party Risk regulatory requirements and obligations for buyers of services, this is an additive set of obligations with the focus on the third-party supplier cohort that are yet to be designated as a Critical Third Party (CTP). The consultation phase closes on Friday 15th March 2024.

The long-awaited Consultation Paper (CP) develops the contents of the Discussion Paper (DP) on the same topic (DP 3/22) with a few adjustments to the proposals based on the feedback that the DP generated. It relates to the new powers created in section 312L (1) of the Financial Services and Markets Act 2000 (FSMA) as amended by the Financial Services and Markets Act 2023 (FSMA 2023).

The key aim of the proposed oversight regime is to;

"(3.1) Manage potential risks to the stability of, or confidence in, the UK financial system that may arise due to a failure in, or disruption to, the services that a CTP provides to firms and FMI (either individually or, where more than one service is provided, taken together). The oversight regime for CTPs seeks to achieve this overall objective by improving and overseeing the resilience of these services."

What are the headlines?

The regulators (The Bank of England, PRA and FCA) are working coordinated to deliver greater oversight on CTP and particularly on the Material services provided to UK regulated firms.

- They are setting out how a third party will be assessed as a CTP; HM Treasury will make the final decision, or 'designation', based on the criticality of services provided, concentration risk and other factors including the ease of timely switching and substitutability.
- The proposals define a set of **six Fundamental Rules** for CTP to comply with, and a more detailed set of **eight requirements** that must be met for all CTP Material services. The obligations apply to any services being provided under UK regulation and are **location agnostic**. There is no difference in requirements for UK or offshore based services.
- The paper sets out a requirement for CTP to evidence their compliance through an **annual self-assessment** return (with an initial three-month window for the first return once a CTP designation has been made). This self-assessment is comprehensive and covers a set of operational risk factors with a specific **focus on the CTPs supply chain** (down to the ninth party if they are critical to the delivery of the Material service), **cyber and technology** risks and **change management** as key drivers of resiliency issues. The ongoing **financial health** of the third party is also part of the assessment.
- As part of this assessment the CTP will be expected to develop and maintain a **strategy and testing regime** that demonstrates its ability to deliver material services within their maximum tolerable level of disruption in **severe but plausible scenarios**. The CTP should explain how it selected and developed the scenarios used, the types of testing undertaken, and specify any scenarios under which the CTP could not continue to provide the material services within their maximum tolerable level of disruption. The regulators also expect the CTP to develop and centrally coordinate an annual test of a **financial sector incident management playbook** in partnership with the recipients of its Material services (the buyers).
- The self-assessment, scenario and playbook test results should be **shared by the CTP with the firms buying their services**, at least at a summary level, so that clients have actionable information about the CTPs' compliance and risks. There are further requirements for CTPs to be fully transparent when reporting and managing an incident including the reporting of root causes and remedial actions.
- The **CTP has the responsibility** for satisfying the minimum resilience standards outlined and cannot pass them on to their clients and must appoint a **primary regulatory contact** in the UK. The costs of any skilled persons assessment activity, testing and remedial work also belong to the CTP.

What does this mean for a buyer of CTP Material services?

- *No more work, but no reduction either.* This does not impose any additional requirements on buying firms, but it also doesn't reduce the accountability or responsibility of firms under the existing regulatory obligations on operational resilience and TPRM. The proposals fit alongside DORA and US regulations for buyers, so there should be no need for a resilience 'programme' to incorporate these new changes.
- *More external data but a need to know thyself first.* There will be a greater level of reporting and transparency from CTP around the risks related to Material services, so it will help resilience teams with their understanding of their own firm's risk position, but it doesn't remove the need for a full understanding of how suppliers map onto a buyers own important business services.
- *No reporting shortcuts:* The primary data source for the regulator will continue to be the firms outsourcing register returns (with proposals to change how that reporting might work in 2024). Buyers need to work hard to provide better data to the regulators on the use of suppliers to deliver their most Material services, and the regulators plans to transform data collection in 2024 and beyond will be one to watch out for.
- *No Kite Mark short cut.* A supplier with a CTP designation will **not** necessarily mean that it is inherently more resilient, safer, or more suitable to provide a given service to a given firm or FMI than non-designated third parties providing the same or similar services. A CTP is simply under greater scrutiny.
- *No change in TPR scope.* This doesn't bring non-FS utilities into scope or other suppliers that are sufficiently regulated. The regulators are unlikely to recommend firms and FMIs for designation as CTPs if the relevant services that they provide to other firms and FMIs are subject to a level of regulation and oversight that delivers at least equivalent outcomes to their proposed oversight regime.
- *Outsourcing is an outdated term.* The proposals are location agnostic, and the scope is driven by the Materiality of the services, regardless of whether you could/did do it yourself once, and no matter where they are now provided from.
- *Watch out for CTP costs.* The proposals are explicit on the CTP ownership of skilled person review and S166 costs, but this will be expensive for the industry. Regulators estimate one-off and annual ongoing compliance costs of approximately £660,000-£930,000 (one-off) and £500,000 (annual on-going) respectively *per CTP*. This translates to total one off and annual ongoing costs of £13-19m and c.£10m respectively, based on a population of 20 CTPs as set out in HMT's Impact Assessment.

Summary:

The proposals bring the obligations of the most critical third-party suppliers into clear alignment with those of their clients. Whilst much of this information is already being shared between buyer and supplier on a point-to-point basis this will further formalise and broaden the flow of operational risk information further. Higher quality operational risk and resilience data shared by CTPs will deliver an improved and more detailed buyer view of the CTP supply chain. This comprehensive view on the end-to-end risks across a range of operational risk drives and deep into the supply chain can only help the industry become more resilient and provide a more robust and secure service to the end customer.

Hellios is excited by this move towards increased risk transparency and the drive towards testing in collaboration between buyers and suppliers. Our FSQS community is perfectly positioned to cost effectively enable the publication and controlled access of the new CTP outputs and we are already hard at work to improve the Buyer regulatory reporting experience through the application of our extensive financial services supplier community data.



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