CAPCO

THE PUZZLE OF OPERATIONAL RESILIENCE, COVID-19 & REGULATION FOR FINANCIAL SERVICES

Covid-19 poses a global challenge impacting every one of us. This unprecedented and sudden pandemic crisis has put the spotlight squarely on financial services firms' operational resilience, contingency programmes and business continuity planning (BCP), whose viability and robustness are being tested with minimal preparation.

The long-term impact of the pandemic remains unknown, but the fear and uncertainty it is generating, and the immediate disruption it is causing to financial markets and firms' operations is clear to see.

Is it indeed possible to factor a pandemic into business contingency and BCP preparations? And what might be viewed as a reasonable and proportionate response given the unique challenges such a pandemic pose to financial markets. Unlike natural disasters, technical failures, malicious or criminal acts, or terrorist events, it is a challenge to accurately predict the scale and particularly the duration of such events[1].

This paper explores the impact of Covid-19 on regulation with the backdrop of operational resilience, contingency plans and BCP during this challenging time.

OPERATIONAL RESILIENCE[2]

A key priority for the Bank of England, Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA) is to put in place a stronger regulatory framework to promote the operational resilience (the Framework) of firms and financial market infrastructures (FMIs) and better protect consumer interests. In this regard, joint consultation papers were published on 5 December 2019 , with the aim of implementing regulation to increase firms' investments in operational resilience. The Framework is envisaged as supplementing firms' existing requirements to manage operational risk and have in place BCP.

The consultation period on the Operational Resilience framework has been extended beyond the original April deadline to October 2020, to allow regulated markets to maintain their focus on delivery of the critical functions they provide to the economy and their customers.

The proposed Framework details requirements around developing a resilient infrastructure, taking into account a product- or service's entire lifecycle throughout the firm. The Framework imposes strict requirement on firms to implement adequate systems and processes which has the strength to face interruption, even during severe operational events. Operational resilience is defined by the FCA as an outcome:

"The ability of firms and FMIs and the financial sector as a whole to prevent, adapt, respond to, recover and learn from operational disruptions"

The Framework's approach is to anchor a firm's operational resilience on the assumption that major operational disruptions are a given and will occur. This seeks to encourage firms and FMIs to building operational resilience by implementing robust and reliable arrangement to manage disruptions as and when they occur.

THE UK REGULATORS

The UK's financial services sector has been put under pressure by the regulator to maintain BAU in the face of the challenges arising from the pandemic.

The regulators have made clear their expectation that firms must take reasonable steps, via their business continuity plans, to ensure they are prepared to meet the challenges Covid-19 could pose for customers and staff. The regulators are expecting firms to have tested contingency plans in place to deal with major events and to take reasonable steps to meet their regulatory obligations.

The FCA has stated that it is now actively reviewing the contingency plans for a wide range of firms to (i) assess their operational risk; (ii) their ability to continue to operate affectively; and (iii) the steps taken to serve and support their customers.

Simultaneously, the regulators have acknowledged the significant impact of the pandemic. Accordingly, the regulators have announced they will deprioritise supervision of new requirements (such as SFTR, due to go live on April 11,2020) for the time being, to give firms extra flexibility to overcome the pandemic. The regulators have also postponed a number of open consultations to 1 October 2020.

It is evident that the regulators' priority is to ensure firms build their strategies around managing the risk to customers, employees and the market in an agile fashion. It is a dynamic process, which is expected to evolve as the impact of the pandemic slowly reveals itself on a day by day basis.

EU REGULATORS

The European authorities are closely monitoring the impact of Covid-19 and have recently published recommendations to the financial market on how to prepare for the impact. The European Securities and Markets Authority **(ESMA)** made the following recommendations[7]:

- Business Continuity Planning – All financial market participants should be ready to apply their contingency plans, including deployment of business continuity measures, to ensure operational continuity in line with regulatory obligations;
- Market disclosure – issuers should disclose as soon as possible any relevant significant information concerning the impacts of COVID-19 on their fundamentals, prospects or financial situation in accordance with their transparency obligations under the Market Abuse Regulation;
- Financial Reporting – issuers should provide transparency on the actual and potential impacts of COVID-19, to the extent possible based on both a qualitative and quantitative assessment on their business activities, financial situation and economic performance in their 2019 year-end financial report if these have not yet been finalised or otherwise in their interim financial reporting disclosures;
- Fund Management – asset managers should continue to apply the requirements on risk management and react accordingly.

The European Central Bank **(ECB)** issued a letter to all significant institutions , highlighting its expectation that firms will review their BCPs and consider actions to enhance preparedness to minimise the potential adverse effects of Covid-19. To this end, the ECB issued a checklist for contingency preparedness entailing:

- establishing adequate measures of infection control in the workplace, which can include systems to reduce infection transmission and worker education;
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- assessing to which extent contingency plans include a pandemic scenario which provides for scaling measures commensurate with the institution's geographic footprint and business risk for the particular stages of a pandemic outbreak;
- assessing how quickly measures foreseen under the pandemic scenario of the contingency plan could be implemented and how long operations could be sustained under such a scenario;
- assessing whether alternative and sufficient back-up sites can be established in light of possible pandemic;

- assessing and urgently testing whether large scale remote working or other flexible working arrangements for critical staff can be activated and maintained to ensure business continuity;
- proactively assessing and testing the capacity of existing IT infrastructure, also in light of a potential increase of cyber-attacks and potential higher reliance on remote banking services;
- assessing risks of increased cyber-security related fraud, aimed both to customers or to the institution via phishing mails, etc.; and
- entering into a dialogue with critical service providers to understand whether and to ascertain how services continuity would be ensured in case of a pandemic.

The EU authorities' approach highlights that initial measures put in place for ordinary operational resilience, contingency planning and BCP will not be sufficient to mitigate the challenges posed by the pandemic, hence the immediate implementation of additional measures.

US REGULATORS

On 10 March 2020, the New York State Department of Financial Services issued four sets of guidance to banks regarding their preparedness for the Covid-19 outbreak[9]. The UK has not yet seen such a heightened response, either from EU or UK regulators, but we can expect similar measure to follow in the wake of the current crisis to build pandemic resistant FMIs. According to the published guidance, in order to address the unique challenges posed by a pandemic, a financial institution's BCP must include:

1. A **preventive program** to lower the chances of significant operational disruption from a pandemic event;
2. A **documented strategy** to scale contingency efforts in line with the impacts at particular stages of a pandemic outbreak, and for re-introducing personnel into the workplace;
3. A **comprehensive framework** of facilities and systems that provide for business continuity if large numbers of an institution's staff are unavailable for extended periods;
4. A **testing program** to ensure that an institution's pandemic planning practices and capabilities are effective and will allow critical operations to continue;
5. An **ongoing oversight** strategy to ensure pandemic policies include the most recent, relevant information from governmental sources and the institution's monitoring program[10].

   In addition to the potential New York State Department of Financial Services reviews and audit that are outlined in the published guidance, all regulated institutions must submit a plan of preparedness to manage the risk of disruption to its services and operations by 10 April 2020.

SENIOR MANAGERS ACCOUNTABILITY

The senior management of a firm has overall responsibility for the functioning of that firm's important business services and the impact tolerances. The board is required to approve these measures if it is satisfied that the firm's strategies, processes and systems are suitable for sound business continuity. The FCA and PRA require the board to have sufficient knowledge, skill and experience to meet its operational resilience responsibilities, to ensure that senior management's ability to discharge their oversight duties are subject to proper scrutiny.

The senior management function **(SMF)** rules in the PRA Rulebook and the FCA Handbook require firms to appoint managers with responsibility for specific areas and each of the firms' business functions and activities. There are existing responsibilities specified in the Senior Managers Regime, for example SMF24 for operational resilience and SMF2 for financial resilience, which must be approved by the regulator[11]. The FCA has confirmed that they do not require firms to have a single senior manager responsible for their coronavirus response. Firms should allocate these responsibilities in the way which best enables them to manage the risks they face[12].

WHAT SHOULD FIRMS CONSIDER IN PREPAREDNESS FOR COVID-19

1. **REGULATORY REQUIREMENTS**
   Firms need to update their business operations in line with the recent Covid-19 communication from the UK and EU regulators. Firms must ensure timely reports are submitted to the authorities. FCA expects firms to take all reasonable steps to meet their regulatory obligations even during the pandemic, and firms must assess where leeway exists to delay obligations and reallocate resources to Covid-19 related operations.

They also need to understand where there is a requirement to take action to ensure it is done in the best practise manner required by financial services firms. A record should be kept to demonstrate to the regulator proportionality and best practise in respect of decisions taken. This will be important in the event of a challenge by the regulator once business returns to normal. See the Principles of Good Regulation by FCA.

2. **IMPORTANT BUSINESS SERVICES**

   Firms must identify the important business services that, if disrupted, could cause harm to consumers or the market. They should map and document the people, processes, technology, facilities and information which contributes to the delivery of important business services; and adjust the impact tolerances for each important business service function, quantifying the maximum tolerable level of disruption caused by Covid-19. When mapping this task in light of Covid-19, firms will identify their vulnerabilities. In assessing this for Covid-19, the balancing task is to build an agile strategy on how best to relocate and apply the necessary resources, which are critical to delivering the impotent business services. The strategy should be flexible, yet robust to meet this rapidly changing environment.

   The FCA expect firms to be able to: (i) enter orders and transactions promptly into their systems; (ii) use recorded lines with trading; and (iii) give staff access to the compliance support they need. When planning to deliver important business services during the pandemic, firms must bear in mind the practicalities and impact of large amounts of staff falling ill or being bound to work from home and the impact of this on firms' internal systems and network, including risk to their cyber security and market abuse.

3. **TESTING**

   The FCA expect all firms to have contingency plans to deal with major events and that the plans have been tested. Firms must take action to remain within the impact tolerances through a range of severe, but plausible disruption scenarios, including a sudden pandemic. This should be built into the firms' risk assessment for BAU processes. In this event, Covid-19 is the exam question that has allowed for no preparation and revision time.

   Firms are required to document the details of their testing, including assumptions made and risk assessed during this process. The realistic testing task during the Covid-19 time would be how to best minimise the impact of disruption. Firms should deploy quick and effective alternatives to reduce the amount of disruption caused by Covid-19.

4. **COMMUNICATION**

   When disruption occurs, firms are expected to communicate clearly with its stakeholders, in particular consumers, to advise on alternative means to access services if required. Having an effective communications strategy in place will assist to prevent and mitigate the impact caused by the disruption. For as long as Covid-19 is with us, especially while everyone is housebound, communication will be vital at all levels within a firm. Firms needs to activate or create their communication strategies and policies for each stakeholder group, whether employees, clients, investors, regulators, creditors, banks, underwriters or trustees. Communication is key when BAU is suspended. It is also important to be transparent with all stakeholders during the pandemic, to retain their confidence and trust and to allow them to cooperate and engage with the firm where possible.

   The FCA is expecting firms to treat customers fairly during the Covid-19 situation. This means first communicating with them and then publishing relevant policies, such Covid-19 provisions.

5. **GOVERNANCE**

   Firms needs to revisit their governance procedure considering Covid-19, to allocate the new responsibilities accordingly and to ensure they are sufficiently solid to withstand the Covid-19 issues. This includes implementing new policies and creating new functions where needed in light of the pandemic.

   Firms needs to assess if the person responsible for this task during the pandemic is adequately trained to deliver the necessary reports to the board, to assist them in making the right decisions for their business and customer. Where there is a lack of knowledge and skill, the firms must ensure they either provide the necessary training to responsible person or, in the interests of time, outsource this function.

CONCLUSION

Covid-19 has touched every aspect of the financial markets. The UK financial market, founded on concepts, practices and precedents that date back to the 17th century has weathered many challenges, but the current pandemic ranks among the most serious and vexing. The entire industry is being tested at a grand scale, across all its functions and capabilities.

The Operational Resilience framework was proposed to implement change where needed, to make firms more robust in the face of potential disruption. A sudden pandemic was not exactly front of mind for regulators when the Framework was drafted.

Firms are in the spotlight and must ensure they manage all their duties and responsibilities through the current crisis. The hope is that this Covid-19 driven disruption will be short-lived, and that markets will return to normal before too long. In the interim, firms must comply with their regulatory obligations to their best ability; provide fair solutions to customers; meet their financial obligations; communicate with their stakeholders; manage their employees and boards; create new policies; and review their business models - all the while trying to maintain a semblance of business as usual.

There is also the consideration that this is not just about managing though to the other side of the pandemic. This crisis will inevitably change our world; to what degree remains to be seem, but firms must prepare to meet more onerous expectations around disaster recovery in the future.

Preparation – as ever will be key and leaning from the lessons of the current crisis and making adjustments or enhancements to their processes sooner rather than later, will ensure firms maintain a strong grip and focus on their businesses going forward.

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