FINANCIAL CONDUCT AUTHORITY

Finalised guidance

FG 20/1 Our framework: assessing adequate financial resources

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June 2020

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Foreword

by Megan Butler

In March 2018, we published our approach to supervision. It explains our role in ensuring fair and honest markets, why and how we prioritise our supervisory work, and how we supervise the firms and individuals we regulate.

We supervise 59,000 firms and prudentially supervise 49,000. Of these, 18,000 firms are subject to the prudential standards in the FCA handbook or European prudential legislation. These set out detailed standards, including minimum financial resources requirements.

Threshold conditions and the assessment of adequate financial resources are important components of our supervisory work. We aim to reduce the likelihood of market disruption, increase the chances firms can put things right when they go wrong, and minimise harm – to consumers and the integrity of the UK financial system – if they fail and exit the market.

The firms we prudentially supervise vary in size, business model, complexity and in the risk of harm they pose to consumers and market integrity. They serve a wide variety of retail and wholesale consumers.

This framework document aims to provide more clarity to the industry on:

- the role of adequate financial resources in minimising harm
- the practices firms can adopt when assessing adequate financial resources
- how we assess the adequacy of a firm’s financial resources

We intend to improve the way firms operate so that they can take effective steps to prevent harm from occurring, by improving controls and/or reduce the risk in their activities, and can put things right when they go wrong.

The intention is not to increase general levels of financial resources across financial services but to take a proportionate and risk-based approach to the supervision of firms. We focus on firms and sectors with the greatest potential to harm consumers, or harm the integrity of the UK financial system. In some cases, it might be necessary to increase a firm’s financial resources.

In the 5 years between 2013 and 2017, the Financial Services Compensation Scheme (FSCS) has paid a total of £846m in compensation for claims made against FCA solo-regulated firms. Over 70% of these are for firms not subject to detailed prudential standards.

The inability to compensate consumers, and the transfer of these costs to other market participants via the FSCS levy, is unfair and places an unnecessary burden on other firms. If firms have resources to match their risk, there should be fewer disorderly firm failures, with lower costs passed onto the industry via the FSCS levy. This promotes fair and effective competition in financial markets.

We expect firms to assess their adequate financial resources commensurate to the risk of harm and complexity of their business. This starts with considering whether they have enough assets to cover their debts and liabilities.

The Insolvency Act 1986 determines a firm is insolvent where it is unable to pay its debts. This includes a ‘cash flow test’ of meeting debts when they fall due, and a ‘balance sheet test’ of value of assets more than liabilities. Well-run firms, wanting to stay in business, should already be considering where this may be difficult to achieve.

For firms with limited potential to cause harm, meeting debts as they fall due may be enough to show they have adequate financial resources.

For firms with potential to cause significant harm, a more in-depth assessment is likely to be required.

During the development of this guidance we have, of course, experienced the Covid-19 (Coronavirus) pandemic. This guidance does not place specific additional requirements on firms because of Covid-19, but the crisis underlines the need for all firms to have adequate resources in place.

Introduction

Business models, culture and financial soundness are key areas of focus in our supervisory approach

Consumer confidence in financial services and the firms that provide them is vital. People expect the market to be fair, open and competitive. They also have high expectations of those who regulate these firms.

Parliament created the FCA to regulate the conduct of the UK's financial services. The FCA is also the prudential regulator for all firms apart from banks, building societies, credit unions, insurers and large investment firms.

Parliament gave the FCA a single strategic objective – to ensure that relevant markets function well – and 3 operational objectives:

- protect consumers – to secure an appropriate degree of protection for consumers
- enhance market integrity – to protect and enhance the integrity of the UK financial system
- promote competition – to promote effective competition in consumers' interests

The aim of our regulation is to serve the public interest by improving the way the UK financial system works and how firms conduct their business.

This benefits individuals, businesses, the economy, and the public.

We add public value by: enhancing trust in markets, improving how they operate, delivering benefits through a common approach to regulation, working to prevent harm and helping to put things right when they go wrong.

To deliver our objectives, Parliament gave us a range of tools and independent powers to make decisions about how best to use them.

The role of prudential supervision

Our supervision work aims to minimise harm to consumers or to the integrity of the UK financial system. Disorderly failure can cause harm through, loss of money; a loss of confidence and participation in financial markets; or where services provided are not easily replaced by other firms; or a firm cannot pay redress.

Understanding a firm's financial risks, its proximity to failure and how harm is minimised in failure is an important component of our supervisory work. Firms should undertake their own assessment of the adequacy of financial resources and have credible wind-down plans in place, because we accept that some firms will fail as a sign of markets functioning well.

To help minimise harm we can set and enforce a minimum level of capital and/or liquid resources that a firm is required to hold. We also require firms that hold client assets to protect them in the event of firm failure.

A more transparent approach to assessing adequate financial resources

This framework document explains the purpose of, and our approach to the assessment of adequate financial resources, for all FCA solo-regulated firms subject to threshold conditions and/or the Principles for Businesses (PRIN). It also provides further guidance on the meaning of 'adequate financial resources'.

It sets out:

- the role of assessing adequate financial resources
- what we look for from firms when assessing adequate financial resources
- our expectations as to the practices firms should adopt in their assessment of adequate financial resources

Chapter 1

The purpose of adequate financial resources and our approach

Our supervision work aims to avoid disorderly failure and minimise harm to consumers and to the integrity of the UK financial system. The inability of a firm to compensate consumers, and the transfer of these costs to other markets participants via the FSCS levy, is unfair and places an unnecessary burden on other firms.

Role of adequate financial resources

Adequacy of financial resources is designed to:

- enable firms to remain financially viable and to provide services through the economic cycle
- enable an orderly wind-down without causing undue economic harm to consumers or to the integrity of the UK financial system

Lack of financial prudence may cause risk. For example, poor financial management can lead to poor conduct, such as prioritising short-term revenue generation over consumers' interests. This could lead to a firm's failure and result in serious harm to consumers and financial markets.

Landscape of the FCA prudential supervision

Every firm authorised under the Financial Services and Markets Act 2000 (FSMA) must meet threshold conditions, requiring firms to have appropriate resources (see COND 2.4 Appropriate resources in the FCA handbook). This means a firm's resources (both financial and non-financial) must be appropriate to the regulated activities a firm carries on or seeks to carry on.

All FSMA firms and UK authorised firms providing payment services or issuing electronic money, are subject to the Principles for Businesses (PRIN). PRIN is a general statement of the fundamental obligations of regulated firms. It includes maintaining adequate financial resources (See Principle 4 - Financial Prudence in PRIN 2.1.1, subject to PRIN 3.1.1A).

The assessment of appropriate resources under threshold conditions considers:

- the nature and scale of a firm's business model
- the risks to the continuity of the services provided
- the impact of other members of the firm's group on the adequacy of its resources

To assess if a firm has adequate financial resources, we consider if a firm:

- has the ability to meet its debts when they fall due

For firms, other than those with limited consumer credit permissions, we also consider if a firm has:

- taken reasonable steps to identify and measure its risks
- appropriate systems and controls and human resources to measure risks prudently at all times
- access to adequate capital to support the business, and that client money and custody assets are not placed at risk
- resources which are commensurate with the likely risks it faces

Our approach to prudential supervision

We have finite resources to do our supervisory work. Our approach is proportionate and risk-based and aims to reduce harm, not eliminate it. For instance, we accept that some firms will fail, but this should be as orderly as possible.

To identify firms or sectors with the potential to create the most harm we use sources including data and intelligence, sector and portfolio views, market studies and firms themselves.

For some firms, we regularly review their own assessments of adequate financial resources; for others, we use a reactive approach to events. We also do multi-firm reviews to assess activities or products with the potential to generate harm.

How our approach applies to different firms

All firms should consider the approach set out in this framework document in a way that is proportionate to the nature, scale and complexity of their own activities.

Firms with a limited consumer credit permission who are subject to a simplified threshold condition of adequate financial resources, are required to meet debts as they fall due. These and other firms not subject to detailed prudential standards, should focus on what we look for from firms, described in Chapter 2, and consider the information in Chapter 3 to help them conduct their own assessments.

For firms subject to detailed prudential standards, this document should be considered alongside existing requirements.

Ensuring adequate financial resources

The FCA's review of and feedback regarding firms' own assessment of adequate financial resources aims to:

- ensure firms have robust systems and controls, governance, leadership and a culture that reduces the risk of harm to consumers and markets
- ensure there is a proportionate and consistent approach in the assessments of adequate financial resources
- have firms hold adequate resources that reflect the harm they may cause to consumers or UK financial markets
- reduce the likelihood that failure would impact consumers and the UK financial system
- minimise harm in the event of firms' failure as they exit the market, by having firms hold adequate resources and effective wind-down arrangements

The FCA review and feedback

The FCA may request a firm to submit its own assessment of adequate financial resources for review.

In such situations, we review a firm's own assessments of adequate financial resources and wind-down planning in a consistent and proportionate manner. The main points covered in the review are:

- does a firm have a risk management framework which includes a clear risk appetite?
- does a firm appropriately and adequately identify the risks to which it is exposed?
- how material is each risk?
- how adequate are systems and controls in place?
- has adequate use been made of stress testing in the risk assessment?
- does the risk assessment process meet the 'use test' ie is it used day-to-day and for decision making?
- does the firm have adequate financial resources based on the risks to which it is exposed?

Peer analysis is an important component of our review as it provides a 'sense check' of our judgements and conclusions. This includes:

- identification and description of a firm's peers
- a comparison of business models, strength of governance and controls and levels of financial resources
- a comparison of important judgements and decisions being made throughout the assessment

Where weaknesses are identified, we may provide feedback to the firm on:

- expected improvements to the quality of its risk management framework, controls, or wind-down planning
- guidance or a requirement for the firm to hold additional financial resources

Chapter 2
What we look for from all firms

Proportionate and regular assessment of risks

We expect a firm's assessment to be proportionate to the nature, scale and complexity of it's activities. For a firm with a very simple business model, we would not expect the assessment to be disproportionately lengthy and over-detailed.

All firms should assess the risks inherent in their business model, the potential harm that can be caused and explain how to close the business in an orderly way. We do not expect this always to be a detailed assessment, for instance where a firm has assessed that its business model results in a low potential for harm.

The assessment should:

- consider a forward-looking approach to risks and how these evolve throughout the economic cycle
- reflect the risks to which the firm is exposed and the amount of risk it poses
- be proportionate to the likelihood of the risks occurring
- ensure they are financially sound while avoiding excessive costs, which could hinder firms from carrying out their business in a viable way
- happen at least annually, reflecting the fact that the business environment is dynamic so the assessments of risk and harm should be dynamic too

Understand the business model and strategy

Every firm's business model is exposed to existing and emerging risks and vulnerabilities from changes in operational and economic circumstances. These changes can affect the sustainability and viability of a business model and business strategy.

We expect firms to understand and articulate how changes in operational and economic circumstances might affect the risks to which they are exposed and their ability to generate acceptable returns.

Prevent harm from occurring

We expect firms to understand the risks in their activities so that they can detect, identify, and rectify problems themselves by ensuring that their systems and controls, governance and culture enable them to take effective steps to prevent harm from occurring.

Put things right when they go wrong

Experience shows that market participants can make mistakes or act in bad faith. To put things right when they go wrong may require adequate financial resources.

The assessment of adequate financial resources should identify sources of potential harm, to consumers and to markets, and estimate their impact.

Firms should consider risks that may stop them putting things right when they go wrong. This includes assessing the circumstances leading to financial stress and the potential depletion of financial resources, and the inability to convert assets into 'cash' in time to pay for obligations as they fall due.

Minimise harm in failure

A firm's failure can result in serious harm to consumers and financial markets manifesting through financial loss, and an inability to access investments and services.

To reduce the impact of failure, we expect firms to consider the scenarios leading to financial stress, explore recovery options and, as a last resort, wind down its business. This is with a view that adequate resources (both financial and non-financial) are maintained while the firm exits the market in an orderly way.

Chapter 3
Our expectations of firms to reduce potential to cause harm

Financial resources

Firms are required to hold an appropriate level of capital and/or liquid resources to cover potential harm.

Capital includes elements of a firm's equity and appropriate loss-absorbing debt liabilities which rank behind general creditors, such as share capital and retained earnings, and subordinated debt.

Liquid resources are normally those that firms can convert into 'cash' as soon as needed and with minimal loss in value.

Systems and controls, governance and culture

An adequate risk management and controls framework needs to be supported by effective governance, leadership and a purpose. These elements should drive a culture that allows firms to identify, assess, manage, monitor and mitigate the risk of harm. They should help firms to anticipate problems and take effective steps to prevent them from occurring or rectify problems when they occur.

Identify and assess the impact of harm

Identifying the potential harm, to consumers and markets, should help a firm understand what can go wrong, so that it can implement controls to minimise the risk of this happening.

Firms should consider 'what if' scenarios and estimate the potential impact. This is to determine the amount and type of financial resources needed to put things right when they go wrong.

Risks that can lead to harm or impair the ability to compensate for harm done

The potential depletion of financial resources, or inability to monetise assets when needed, may impair a firm's ability to put things right when they go wrong.

Firms should identify, understand, and assess all the material risks which can affect the level of financial resources they have available, not just those which cause direct harm to customers and markets. This is important to minimise the risk of a firm not being able to put things right when they go wrong.

Viability and sustainability of the business model and strategy

Understanding a firm's business model and strategy helps identify emerging risk of harm, and if there is a misalignment between firms' profit incentive and the interests of consumers and financial markets.

The risks of harm may be heightened if firms are under significant pressure for financial performance or on the verge of failure. Understanding a firm's financial vulnerabilities and proximity to failure is important to minimise its impact.

Wind-down planning

Wind-down planning aims to reduce the impact of a firm's failure and is highly encouraged. This typically covers:

- scenarios leading a firm to wind-down its business
- potential impact on consumers and financial markets
- operational tasks required and time necessary to execute each task
- capital to absorb winding-down costs and additional losses
- liquid resources necessary to support cash outflows

1. Financial resources

Adequate capital resources

The assessment of adequate capital resources is based on how much capital is needed, which is then compared to how much capital is available.

We expect firms to have an amount of capital which, at all times, is equal to or higher than its assessment of what is necessary. This includes the type and quality of capital and its ability to be used in a going concern or wind-down situation.

What is capital

From a regulatory perspective, assessing a firm's available capital requires an understanding of the different definitions of capital.

Capital and its quality are generally defined to include elements of a firm's equity (such as share capital and retained earnings) and subordinated debt, after deductions for illiquid assets and other items, such as intangibles or investments in subsidiaries

One basic principle that applies across prudential regimes is that the assessment of capital adequacy is underpinned by accounting principles. If there are changes to the value of assets or liabilities, which are not otherwise compensated, this affects the accounting value of capital. Any resulting losses are deducted from the retained earnings which are part of a firm's common equity.

Need for capital

To assess how much capital is necessary requires a wider assessment of the risks to which firms are exposed. This assessment focuses on potential changes in the book value of assets or liabilities that would result in a loss to the firm or changes in its equity.

Expected losses should already be recorded on a firm's financial statements, either through provisions or impairment of assets. Quantifying potential changes in value of assets or liabilities, to determine capital requirements, should be based on adverse circumstances and capture unexpected losses, as well as other potential losses that haven't already be accounted for.

We expect firms to have adequate capital to:

- ensure they are able to incur losses and remain solvent or fail in an orderly way
- drive the right behaviour

This includes:

Compensation and redress schemes – consumers should be compensated for losses they have suffered as a result of a firm's misconduct. This can be awarded as part of a voluntary redress scheme set up by a firm or following determination by the Financial Ombudsman Service.

Enforcement and fines – statutory investigations or enforcement actions by the FCA, which might result in fines, are other areas for which capital is needed. This action may be taken by other authorities, for instance reflecting problems with the handling and protection of personal data.

Direct and indirect litigation costs – firms may also be required to compensate consumers or other firms seeking redress through legal action. This is more common in wholesale markets.

'Skin in the game' – adequate capital may be required to ensure firms can function in an orderly way and that their incentives align with the best interests of their clients or the wider financial markets. This should capture the level of activity performed and the potential for market disruption.

Adequate liquid resources

What are liquid resources

Unlike capital, which is clearly defined by accounting and prudential rules, the quality and availability of liquid resources depends on the ability of a firm to convert different types of available liquid resources into available 'cash' to settle debts as they fall due – particularly under stressed conditions. In determining the quality of liquid resources, a firm should consider:

- **ability to monetise liquid assets** – quality of assets and legal or operational restrictions may affect the ability, timescale and loss of value when converting assets into 'cash' in a period of stress
- **diversification of liquid resources** – depending on the circumstances, diversification may assist in monetising liquid resources quickly without incurring significant loss of value
- **currency convertibility** – the currency of liquid resources and its conversion should be assessed as a potential obstacle to meeting stressed liquidity outflows in a specific currency
- **transferability of funds** – in severely stressed circumstances, liquid resources might not be freely transferable between and within group entities, and across national borders, so adequate liquid resources should be maintained on a legal entity specific basis unless they can freely move between entities

Good quality liquid resources are those that firms can convert into 'cash' when needed and with minimum loss in value under adverse circumstances.

Need for liquid resources

Firms need adequate liquid resources to meet their debts as they fall due. Stressed circumstances could result in increased outflows and enhance risks of mismatched cash flows. These include:

- payments a firm decides to make to protect its franchise and reputation to stay in business
- debts arising from direct or indirect costs of litigation, redress or fines
- increased margin calls from exchanges, central clearings or clearing members
- payments regarding off-balance sheet commitment

2. Systems and controls, governance and culture

Role of systems and controls, governance and culture

Firm culture shapes the outcomes for consumers and financial markets. The drivers of culture, including governance, within firms should encourage behaviours that prevent harm.

A sound risk management and controls framework should allow firms and their senior management to identify, understand, manage, monitor and mitigate the risk of potential harm caused to consumers and markets.

Behaviours that drive good outcomes

The drivers of behaviour within firms include:

- the firm's purpose
- the attitude, behaviour and competence of the firm's leadership
- the firm's approach to managing and rewarding people (eg staff competence and incentives)
- the firm's governance arrangements, controls and key processes (eg for whistleblowing or complaint handling)

A firm's behaviours should be based on sound and clearly stated values that drive good outcomes. These should express a firm's strategy and approach to risk. We expect:

- the management body to bear responsibility for the firm and set its strategy
- the management body to be actively involved and engaged in the risk assessment process
- a risk culture that encourages effective challenge by promoting a range of views in the decision-making process
- a clear communication of strategies and policies to all relevant staff

Risk identification and risk appetite

The risk appetite is the overarching level of risk that a firm is willing to accept to generate acceptable returns.

Firms are expected to identify and understand the risks that arise from their activities and the way they conduct their business.

These risks should be measured, and firms should have a clear and quantified risk appetite which is communicated, understood and followed across the firm.

Risk management and controls framework

We expect firms to have a clear organisational structure, and an appropriate risk management and controls framework, where the focus should be on effectiveness, not only design, where:

- risk is considered in the day-to-day activities, including the development of new products and services, taking on new customers, and changes in the firm's business model
- the management body understands the firm's activities, how it operates, the risks it faces and the appropriateness of controls
- there are policies and procedures to identify, manage or avoid conflicts of interest, including a segregation of duties and consideration of consumer interest
- the risk function is adequately resourced and sufficiently independent to perform its duties
- the impact of the outsourcing on the firm's business and the risk it faces is considered and reasonable care is taken to supervise the discharge of outsourced functions by its contractors, noting that firms cannot contract out their regulatory obligations

3. Identifying and assessing the risk of harm

Role of identifying and assessing the impact of harm

Identifying and assessing the potential harm to consumers and markets is a fundamental part of assessing adequate financial resources. This should help a firm understand what can go wrong, both as a going and a gone concern, so that it can consider if its controls and financial resources are enough to minimise the risk of harm.

Causes of harm

Harm can manifest itself as financial services markets working poorly and not providing enough benefit to users, losses suffered by consumers, or exclusion from financial markets and services.

Poor conduct as a result of poor financial management

A firm which is under significant pressure for performance or is on the verge of failure may have an enhanced risk of causing harm, in an attempt to improve performance, by actively 'cutting corners' to enhance profits.

This may lead to harm from a consumer buying unsuitable or mis-sold products, or poor customer service.

Other examples of potential harm arise as a result of breach of mandates to enhance performance; portfolio churning to increase fees; hidden fees; or firms engaging in trading strategies that may create market disruption.

Disruption of markets' functioning

Macro-prudential and micro-prudential events may present material risk to firms' business models. This can create harm to their clients and there is a risk of significant harmful side-effects on wider financial markets, the UK economy and wider society.

Confidence and participation in financial services markets may be threatened by unacceptable conduct like market abuse, unreliable performance or disorderly failure.

Inability to pay redress or to transfer or return client money and assets

Firms' mistakes, misconduct or failure can result in losses to consumers and firms may need to compensate them for those losses.

The inability to compensate consumers, and the transfer of these costs to other market participants via the FSCS levy, is unfair and places an unnecessary burden on other firms. This can threaten the confidence and participation in financial services markets.

Poor controls, for the handling and safekeeping of client's money and assets, can result in firms being unable to return money and assets to their clients in a timely manner, or for clients to suffer shortfalls and not receive back all their money or assets. In failure, the potential for losses increases as costs of distribution by the insolvency practitioners is paid directly from the client money pool.

Disruption to continuity of service

Not adequately investing in people, processes, and systems and controls, may increase the risk of disruption in the continuity of services firms provide. This can also result from lack of substitutability in case of a firm's failure, due to the nature of services provided and its market share. Even where services are substitutable it may take time to transfer these services to another provider.

All of these examples can lead to important customer needs not being met.

What we expect from firms

Identify harm

Firms are expected to identify all significant harms related to the activities they undertake. To help them identify potential harm, firms may wish to consider relevant topic specific FCA guidance (eg operational resilience, client money & assets, remuneration practices, product governance, and others).

The following are illustrative, but not exhaustive, examples of potential harms caused by the activities of different firms:

- discretionary portfolio managers may breach their mandate, exposing investors to risks outside of their profile or losses from unsuitable investments
- platforms and custody firms may be affected by system outages causing disruption to continuity of service which may affect their customers by not being able to see the value of their assets or buy or sell investments, resulting in loss of confidence
- financial advisors may provide unsuitable advice, for example on pension transfers or other investments, such as minibonds, resulting in customers losing money from mis-selling
- SIPP operators allowing unsuitable investments in self-invested personal pensions (SIPP), may cause customers' interests not being protected and harm from losses in those investments
- firms advising on corporate finance deals may fail to apply appropriate due diligence resulting in poor outcomes to both issuers and investors
- exchanges are critical intermediaries and provide an essential service to the marketplace, system outages are likely to cause a high degree of disruption to customers and the market
- non-bank lenders may fail to check costumer's affordability, inappropriately chase them when in arrears, or have practices not in line with the costumer's best interest, resulting in bad outcomes for customers
- payment services firms failing to have resilient systems and controls may result in serious harm to consumers from disruption to continuity of service, this can be enhanced if the provider has a dominant position in the market
- principal trading firms, that do not have any clients, have the potential to cause market disruption via errors in their trading systems (eg rogue algorithms, etc)
- insurance intermediaries exposed to negligence claims which may not be covered by the firm's professional indemnity insurance policy (eg where the intermediary places business with an insurer that becomes insolvent, and there is an exclusion in the PII policy for using unrated insurers) potentially causing losses to customers and a disorderly wind-down of the intermediary

Assessing the likelihood and impact of harm

A firm's financial resources may be depleted by losses and outflows. This may impair its ability to put things right when they go wrong. By considering the likelihood and impact of things going wrong, a firm should be able to have in place adequate financial resources.

We expect firms to assess how their actions, the actions of others performing outsourced functions, or the failure of systems and controls, might cause harm to consumers or financial markets.

Firms should consider 'what-if' scenarios for the activities undertaken, the harms that can be caused and the events leading to those harms, taking into consideration the likelihood of events, that all events might not occur at the same time, and that some might be covered by insurance policies.

Firms should estimate the potential impact on their financial resources based on their knowledge and experience, which, where a firm's control framework is sophisticated enough, may be further supported by statistical models. When using such models, we expect firms to understand how appropriate the inputs and outputs of the model are, which include the scenarios and assumptions.

Firms should:

- consider the risks before the controls are taken into account
- look at each significant risk and assess what controls are in place to remove or reduce that risk
- assess how much risk of harm remains

This assessment should also inform if the risk is within or outside their risk appetite, and help the firm decide if extra controls are needed.

4. Risks that can lead to harm or impair the ability to compensate for harm done

Role of assessing additional risks to the firm

Firms should consider additional risks that may deplete the level of their available financial resources and cause harm. These risks may put the firm in financial pressure and/or impair a firm's ability to put things right when they go wrong, even where the harm has been appropriately assessed.

For example, consumers may have suffered losses as a result of firm misconduct or failure. Firms should have adequate resources to be able to provide redress. If a firm does not have resources available, due to a loss in the value of assets or a change in value of positions in financial instruments, consumers would be unable to be compensated for the harm suffered.

What we expect from firms

We expect firms to assess the potential depletion of financial resources or inability to convert assets into 'cash' in a timely manner, under adverse circumstances. Firms should consider:

- losses related to changes in book value of assets
- losses arising from failure of clients or counterparties to transactions in financial instruments
- change in value of positions in financial instruments, foreign currencies and commodities
- obligations to defined benefit pension schemes
- being unable to convert different types of resources into available 'cash' to pay for obligations as they fall due

Book value of assets

Asset values may be affected by different factors or situations, including changes in interest rates, resulting in losses to the firm that affect the amount of available capital. For example:

- realising assets below book value through sale
- impairments due to revaluations
- write-downs due to non-recoverability
- internal or external 'operational' events not related to harms

Depending on a firm's business model, it may be materially exposed to risks from assets that arise from different types of activities. For example:

- **aged debtors** – normally from receivables of fees and commissions. The chance of collecting their full amount may decrease the longer a debtor's balance remains outstanding.
- **seed capital or box positions** – this relates to holding units in investment funds to facilitate investment management business. Depending on the assets within the investment funds, firms may be exposed to increased risk of losses.

- **lending activities (including pre-funding)** – the realisable value of loans may be affected due to client default or a change in their creditworthiness.
- **illiquid assets** – this normally includes tangible assets and holdings of securities, including securitisations, which are not readily realisable, and the value of these may be severely affected under adverse circumstances.

Failure of counterparties

Counterparties may fail to settle transactions causing losses to firms. From trade date, firms are exposed to the risk related to potential losses from having to replace failed transactions in different instruments. For example:

- derivative contracts
- market standard and long settlement transactions
- repurchase transactions
- securities or commodities lending/borrowing

This risk may be enhanced where firms provide extended settlement or make use of free deliveries. Counterparties may incur losses, from sudden price changes, and be unable to fund their transactions.

Change in value of positions

Movements in market prices or other events, including operational failures, may result in losses. These relate to positions in financial instruments, which are held or traded to support a firm's business activities and generate returns. This includes:

- proprietary positions and positions arising from client servicing and market making
- positions intended to be resold short term
- positions intended to benefit from actual or expected short-term price differences

Some firms may also be exposed to potential losses from positions in foreign currencies or commodities.

The exposure to potential losses depends on a firm's portfolio composition and trading strategies. This may affect firms not only at a point in time but throughout the economic cycle, considering portfolios may change.

The stress testing frameworks and assessments should include:

- relevant types of stress tests and level of shocks that reflect the nature of a firm's portfolios, the trading strategies applied and the time it could take to hedge out or manage risks under severe market conditions
- clearly set out the premises upon which the assessment is based, and these are reconciled back to the stress tests undertaken
- reflect the adequacy of valuation adjustments in the book value

There are factors that may increase the risk of potential losses:

- distressed or illiquid positions
- positions in highly volatile markets
- exotic or non-linear derivative portfolios
- intraday trading
- events and jump-to-default
- concentrated portfolios
- significant shifts in correlation

Pension obligations

Firms may be required to make payments or other contributions to defined benefit pension schemes. In these cases, firms should consider the accounting framework and the impact of adverse circumstances in the funding status of the pension plan, due to change in value of its assets and liabilities. Unfunded plans may be exposed to higher risk.

Lack of liquid resources to meet obligations

The lack of adequate liquid resources may impair the ability of a firm to meet its debts as they fall due. Sources of risk include:

- **franchise viability** – a firm may decide to make payments that it is not legally obliged to, but does so to maintain its franchise and reputation, to avoid serious damage to the viability of its business
- **unexpected obligations** –a firm may have to pay direct or indirect costs of litigation, redress or fines, which affect a firm's liquidity position
- **funding management** – arises from the impact of stressed circumstance on a firm's liquidity position and structure of contractual cash flows, due to concentration in funding sources, acceleration of or mismatched cash flows
- **intraday and collateral management** – payment and settlement obligations should be met on a timely basis, including on an intraday basis. This includes all obligations arising from margin calls from exchanges, central clearings or clearing members regarding own positions or clients' positions for which the firm has an obligation to meet the margin call
- **off-balance sheet** – there are contractual obligations and circumstances in which a firm chooses or may be required to provide liquidity support in respect of its off-balance sheet activities

5. Viability and sustainability of the business model and strategy

Role of business model and strategy analysis

The purpose of business model and strategy analysis is to understand how a firm generates returns and the vulnerabilities that may affect its ability to generate acceptable and sustainable profits, to ensure the viability and sustainability of its business model and strategy. This includes the impact on a firm's financial resources including access and the ability to generate capital to support the business.

Firms' capital planning should consider planned growth and severe but plausible stresses. This should help identify if:

- there is a misalignment between firms' profit incentive and the interests of consumers and financial markets
- there is significant pressure for performance
- a firm's likelihood of failure matches its risk appetite

Identifying and understanding vulnerabilities

Firms' business models and strategies are exposed to existing or new vulnerabilities. Identifying and understanding these helps:

- understand how vulnerabilities can affect a firm's ability to generate acceptable returns
- develop a clear risk appetite stating which stress scenarios a firm chooses to survive
- develop a reverse stress test that tests the point of non-viability of a firm's business model

Analysing business models and strategies

An important part of a risk assessment is to understand the key components of a firm's business model and strategy. Firms should cover, for example:

- details of business lines and activities including an analysis of how important each business line is in generating profits and cash flow, how this evolved in recent years, its forecasts and concentrations in revenue streams
- details of external factors that influence the success of the business model and strategy, covering the main macro-economic variables, regulatory and market trends, and the competitive landscape
- the reliance on a firm's franchise and reputation with consumers and other stakeholders and how this drives the success of its business model
- competitive advantages over its peers, perhaps as a result of the quality of its IT platforms, or other factors such as a firm's global network, the scale of its business and the range of products and services

What we expect from firms

We expect firms to consider forward-looking financial projections and strategic plans, under both business-as-usual and adverse circumstances that are outside their normal and direct control. This helps a firm to understand the risks to viability of its business model and the sustainability of its strategy over a period of at least 3 years.

Business-as-usual

Firms should consider forward-looking financial projections under business-as-usual circumstances.

The assumptions that drive the strategy and forecasts may include plausible and consistent assumptions in areas such as macro-economic metrics, market dynamics, volume and margin growth in key products and services, segments and geographies, amongst others.

Stressed circumstances

Firms should provide forward-looking financial projections under severe but plausible adverse circumstances. These scenarios should be considered against a firm's own risk appetite for survival.

Here are some points of what 'good looks like' in terms of considering a firm's business model and strategy, under stressed circumstances, and scenario analysis:

- stress scenarios must be severe but plausible and relevant to the circumstances of a firm, its business model and the market in which it operates, including events that cause reputational damage to the firm
- based on forward-looking hypothetical events
- contain clear assumptions, when compared to business-as-usual projections, which are consistent with the macroeconomic scenarios considered
- scenario analysis and stress testing should be performed on individual business lines and portfolios, if relevant, as well as at a firm-wide level, including sensitivity analysis of material vulnerabilities in generating returns
- cover all material risks and vulnerabilities identified and analyse the impact of events of a varying nature, severity and duration on both financial resources and requirements. For most business models, the focus may be on financial resources by stressing the ability to generate profits, and maintain adequate liquid assets, rather than stressing changes to capital requirements
- estimate the effects of the stress scenario on a firm's profits and losses, and its financial position before and after taking account of realistic management actions

Reverse stress testing

A firm should consider scenarios of adverse circumstances affecting a firm's business model and strategy, where the ability to generate returns is beyond a firm's risk appetite to stay in business, or where the firm is unable to meet its legal requirements to remain solvent, determined as the point of non-viability.

A reverse stress test must result in a firm reaching a point of non-viability and should provide useful information about vulnerabilities in a firm's business model and strategy. This should help when designing measures to prevent and mitigate the risk of business failure.

Examples of these scenarios are where:

- the market loses confidence in a firm, resulting in the loss of a substantial portion of counterparties or clients
- complications arising because of material dependencies on group entities (eg services, funding, reputation, etc)
- existing shareholders are unwilling to provide new capital to the firm

The point of non-viability may be reached well before the firm's financial resources are exhausted.

6. Wind-down planning

Role of wind-down planning

Wind-down planning aims to reduce the impact of a firm's closure, related to potential harm from the inability to pay redress, inability to return or transfer client assets and money, or to interrupt continuity of service.

What we look for

Wind-down plans need to be credible and have realistic timescales and assessments of how financial and non-financial resources are maintained while the firm exits the market.

Why to wind-down

We look for the reasons where a firm's senior management would decide to wind-down its business. We consider:

- the firm's risk appetite regarding business model viability and the different scenarios in which it would decide or be forced to wind-down its business
- how different scenarios would affect financial resources available at the moment a decision is made

Qualitative assessment

A firm's wind-down planning should consider:

- operational tasks required and time necessary to execute each task, including identifying key staff and systems, dependencies from group or other third parties, and client communications
- risks to the continuity of the services provided and its impact on consumers and financial markets, by identifying firms by whom services could be provided or clients' assets transferred, and the timescales needed to do so
- the provisions in the client assets resolution pack to help speed up the return of client money and assets
- the level of both capital and liquid resources available and required as a stress situation might have depleted resources prior to a decision to wind down being made

Quantitative assessment

Estimated period – from experience, a 3-month wind down period may not be enough and, in most cases, we note that a period of at least 9 months is more realistic. The wind-down period is generally driven by a firm's activities, including size and substitutability.

Capital – firms should produce an accurate estimate of the winding-down costs and additional losses:

- **extra closure costs** – examples of these are termination penalties, redundancy costs, legal and administrative costs, including insolvency practitioners, and leases, and potential impact of pension deficits
- **potential redress and litigation costs** – firms should consider 'what if' scenarios where costs are incurred for past misdeeds
- **residual revenue** – a firm should not expect to maintain revenues at a level similar to the normal course of business and in many cases, firms may be unable to maintain a revenue stream at all
- **realisable value of assets** – the realisable value of certain assets is likely to be considerably lower than their book values, especially in the case of shorter wind-down periods

Liquid resources – experience has shown that while firms may have enough capital, they often lack liquid assets to enable them to wind-down in an orderly fashion.

Firms should consider the nature, amount and timing of necessary outflows and the quality and availability of liquid resources. This depends on the ability to convert into 'cash' different types of assets and the loss of value in doing so.

Annex 1 – Feedback statement for Our Framework: Assessing Adequate Financial Resources

Introduction

1. Our Framework: Assessing Adequate Financial Resources published for consultation in June 2019, set out the role of, and what we look for from firms when assessing adequate financial resources. It also set out our expectations as to the practices firms should adopt in their assessment of adequate financial resources. We asked for feedback in a consultation that ran from 13 June to 13 September 2019.

2. We are now publishing a final edition of 'Our Framework: Assessing Adequate Financial Resources'. This feedback statement explains how we have taken into account the consultation feedback.

3. Having considered the feedback we received, we have decided to implement most of our original proposals, but have made modifications in some areas to provide more clarity.

Responses

4. We received 23 responses from a range of stakeholders, mostly from financial services firms, financial services membership bodies and professional advisers. While we are not able to respond to every comment individually, this feedback statement summarises the key points made in the responses, and explains how we are dealing with the feedback. We give a list of the non-confidential respondents at Annex 2.

5. We have updated the following section in the 'Our Framework: Assessing Adequate Financial Resources' document:

   - *"Prevent harm from occurring":*

     - CP19/20: *We expect firms to understand the risks in their activities so that they can detect, identify, and rectify problems themselves by ensuring that their systems and controls, governance and culture* ***enable them to prevent harm from occurring****.*

     - *Finalised guidance: We expect firms to understand the risks in their activities so that they can detect, identify, and rectify problems themselves by ensuring that their systems and controls, governance and culture* ***enable them to <u>take effective steps</u> to prevent, minimise or mitigate occurrence of harm****.*

Questions we asked in the consultation

6. We asked the following questions in the 'Our Framework: Assessing Adequate Financial Resources' consultation:

Q1. Do you agree with our proposed Consultation Paper text clarifying the purpose of adequate financial resources and our approach? If not, please explain why.

Q2. Do you agree with our proposed Consultation Paper text clarifying what we look for from firms when assessing adequate financial resources? If not, please explain why.

Q3. Do you agree with our proposed Consultation Paper text clarifying our expectations as to the practices firms should adopt in their assessment of adequate financial resources? If not, please explain why.

Q4. Do you agree with the costs and benefits we have identified? If not, please explain why.

Key themes to feedback

7. The vast majority of responses supported our proposals. Most respondents welcomed the proposal and recognised the clarifications provided in CP19/20 set out a practical and logical approach to the FCA's expectations for firms to consider when assessing their financial resources. Respondents also provided feedback, asking for additional clarifications. The key themes were about:

- scope of application
- additional detailed guidance
- reference to 'prevent harm'
- cost benefit analysis

Scope of application

8. Two respondents expressed the view that the scope of application and whether it is imposing additional requirements on firms should be clarified.

Response

- The foreword and introduction to the document explains the purpose of the document, is to clarify and provide guidance on the FCA's approach to the assessment of adequate financial resources. The document is applicable to all FCA solo-regulated firms subject to threshold conditions and/or the Principles for Businesses (PRIN).
- We do not seek to impose additional requirements on firms, rather to clarify our view of the meaning of adequate financial resources by reference to best practice, to be applied by firms on a case by case basis in a proportionate way. Our intention is to give firms identifiable examples by which they can show us that they are meeting the requirements and conditions of their authorisation.

- For wind-down planning we are recommending and encouraging a best practice approach to manage the risks of disorderly failure, rather than imposing additional requirements making wind-down planning mandatory. The existence of a wind-down plan and the scope of it will be a decision to be taken in a proportionate manner by firms, depending on factors including their size, complexity and exposure to the market. CP19/20 is consistent with our Wind-Down Planning Guidance in the Handbook, applicable to firms authorised under Part 4A FSMA, but also of general relevance to all UK authorised firms prudentially regulated by the FCA.
- Our view is that encouraging best practice in wind-down planning falls legitimately beneath the operational objectives of protecting consumers, and enhancing market integrity by helping to reduce the likelihood of firms exiting the market in a disorderly fashion and minimising harm if they do.

Additional detailed guidance

9. Generally, respondents welcomed the clarification provided in our consultation, setting out a practical and logical approach for firms to consider when assessing the adequacy of their financial resources. However, some asked for more detail about specific components of risk assessment, including quantification, and how it can be applied by different sectors and types of firms. Some respondents mentioned they would be happy to help with this development in more sector specific guidance.

Response

- The objective of CP19/20 was to set out, in plain English and using high-level principles: 1) the role of adequate financial resources; 2) what we look for from firms; and 3) practices firms should adopt, when assessing adequate financial resources.
- In addition to these high-level principles of what we look for from all firms, Chapter 3 of CP19/20 already gives some more detail of the framework that we expect firms to follow or the components we expect firms to consider in their assessments.
- CP19/20 explains the purpose of, and our approach to the assessment of adequate financial resources, for all FCA solo-regulated firms subject to threshold conditions and/or the Principles for Businesses (PRIN) and/or otherwise prudentially regulated by the FCA. So, at this stage, it is not our objective to provide detailed methodologies for specific sectors and types of firms. Doing so would risk of creating a proxy for prudential standards which would also require a disproportionate use of resources and a separate CBA.

Reference to 'prevent harm'

10. Some respondents expressed the view the language setting out our expectation of firms to 'prevent harm' may be too high an expectation and suggest that expecting firms to 'take effective steps to prevent harm' is a more proportionate and reasonable expectation from firms.

    - We accept the proposed wording to be more proportionate and reasonable and decided to make amendments to the relevant sections.

Cost benefit analysis

11. Some respondents expressed views regarding the cost benefit analysis (CBA). A few respondents made points regarding the assessment of costs and the benefits, as follows:

- One respondent stated that the CBA analysis identifies costs will fall disproportionately on class 3 firms.
- One respondent said that the costs are understated for class 3 firms. This response was based on the exercise having been undertaken within a single firm.
- Two respondents said that the costs were underestimated because firms will want to engage third party consultants.
- Four respondents said that it was difficult to estimate the benefits of the guidance. This was in reference to the use of the FSCS data to illustrate the potential benefits, and the quantification limitations relating to the benefits of formalised governance and controls, additionally:
    - One respondent suggested that the benefits are not supported by evidence that the FSCS payments made as a result of the failure by class 3 firms is due to their poor planning.
    - One respondent said it was difficult to assess the quantum of benefit from a lower FSCS levy without understanding how much of the £846m paid was as a result of a failure of firms that complied with the substance of existing regulations, or to those who did not.

Response

- We recognise in the CBA that of the overall costs, class 3 firms, as a group, are the ones that are expected to incur most of the costs, both one-off and ongoing. However, this group of firms includes a much higher number of firms than class 1 and class 2 firms. This results in an estimated cost per firm which is much lower for class 3 firms than for class 1 and class 2 firms. As described within the CBA, it is possible that a number of class 3 firms will not have some elements described within the CP, as they are not subject to regular supervisory review or an ICAAP, and this has been considered within the CBA. This assumption is based on supervision experience of interacting with class 3 firms.

- Additionally, the estimated benefit is analysed with reference to the FSCS compensation paid. When analysing such payments, it is noted that class 3 firms have been responsible for 71% of the total compensation paid in the 5-year period from 2013 to 2017. This shows that the estimated overall costs and potential benefits are both related to class 3 firms.

- Cost estimates are based on the FCA's standardised cost model. This estimates costs based on an average for groups of firms and based on the people involved in the work being done. Class 3, as a group of firms, covers firms with different sizes and business models, we understand that some class 3 firms will incur higher costs than the ones estimated, while others will incur lower costs.

- We anticipate that what is described in the CP should be able to be achieved by existing staff within a firm. However, we are aware that many firms use external advisors on an ongoing or ad-hoc basis. Our standardised familiarisation and gap analysis costs are designed to allow for this, and reflect average costs that are incurred either via in-house or external expenditure. There will be firms that incur costs on either side of this average depending on their circumstances.

- The CBA recognises a range of expected benefits which are difficult to quantify. In relation to the FSCS payments, the CBA acknowledges that these are indicative of harm caused by firms which lacked adequate financial resources and appropriate risk management when they failed, and the breakeven analysis indicates that an 11.7% reduction in this harm would lead to benefits that are larger than the expected compliance costs. While the CBA does not assess the number of FSCS payments that were attributable to firms which would not have failed had firms followed this guidance, we consider that the breakeven analysis provides a reasonable assessment of the likelihood of a reduction in harm.

Annex 2 - List of non-confidential respondents

Willis Limited

Enhance Support Solutions Limited

Charles Stanley & Co

Annex 3 - Legal Statements

Compatibility Statement

1. Section 1B of FSMA requires the FCA to carry out its general functions, as far as is reasonably possible, in a way that is compatible with its strategic objective and advances one or more of its operational objectives. The FCA also needs to, so as far as is compatible with acting in a way that advances the consumer protection objective or the integrity objective, carry out its general functions in a way that promotes effective competition in the interests of consumers.

2. We are satisfied that these proposals are compatible with our general duties under section 1B of FSMA, in particular having regard to the matters set out in 1C(2) FSMA and the regulatory principles in section 3B. We think that:

   - It will help us use our resources in an efficient and economical way
   - the expectations contained within it are proportionate to the benefits
   - it supports the principle that the regulators should exercise their functions as transparently as possible

Equality and diversity considerations

3. We have considered the equality and diversity issues that may arise from this guidance. We do not consider that this guidance will adversely impact any of the groups with protected characteristics, i.e. age, disability, sex, marriage or civil partnership, pregnancy and maternity, race, religion and belief, sexual orientation and gender reassignment.

4. We will continue to consider the equality and diversity implications of this guidance during the consultation period, and will revisit them when publishing the final guidance. In the interim, we welcome any feedback to this guidance consultation on such matters.

Annex 4 - Abbreviations in this document

CBA	Cost benefit analysis
BAU	Business-as-usual
COND	Threshold Conditions
CP	Consultation Paper
CRD III	Capital Requirements Directive III
CRD IV	Capital Requirements Directive IV
FCA	Financial Conduct Authority
FSCS	Financial Services Compensation Scheme
FSMA	Financial Services and Markets Act 2000
ICAAP	Internal Capital Adequacy Assessment Process
IT	Information Technology
PII	Professional Indemnity Insurance
PRIN	Principles for Business
PV	Present Value
SCM	Standardised Cost Model
SIPP	Self-invested Personal Pensions
UK	United Kingdom