FINANCIAL CONDUCT AUTHORITY

Our Framework:
Assessing Adequate Financial Resources

Consultation Paper
CP19/20

June 2019

How to respond

We are asking for comments on this Consultation Paper (CP) by **13 September 2019.**

You can send them to us using the form on our website at: www.fca.org.uk/cp19-20-response-form

Or in writing to:
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Contents

Foreword 3

Introduction 5

The purpose of adequate financial resources and our approach 7

What we look for from all firms 10

Our expectations of firms to reduce potential to cause harm 12

1. Financial resources 14
2. Systems and controls, governance and culture 16
3. Identifying and assessing the risk of harm 18
4. Risks that can lead to harm or impair the ability to compensate for harm done 21
5. Viability and sustainability of the business model and strategy 24
6. Wind-down planning 27

Annex 1
Questions in this paper 29

Annex 2
Cost benefit analysis 30

Annex 3
Legal Statements 43

Annex 4
Abbreviations in this document 44

Foreword
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In March 2018, we published our approach to supervision, to explain 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 48,000. 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 Consultation Paper 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 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) have paid a total of £846 million 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.

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 three 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 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), and provides further guidance on the meaning of 'adequate financial resources' under these.

The document sets out:

- the role of assessing adequate financial resources
- what we look for from firms when assessing adequate financial resources
- the FCA's 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 firms providing payment services or e-money services, are subject to the Principles for Businesses (PRIN). This is a general statement of the fundamental obligations of regulated firms. This includes maintaining adequate financial resources (See Principle 4 - Financial Prudence in PRIN 2.1.1).

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 do regular reviews of 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 document in a way that is proportionate to the nature, scale and complexity of their own activities.

For firms with a limited consumer credit permission who are subject to a simplified threshold condition of adequate financial resources, the requirement is 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 details provided in Chapter 3 as information to help them conduct their own assessments.

For firms subject to detailed prudential standards, this document should be considered in conjunction with 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' i.e. 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 of adequate financial resources to be proportionate to the nature, scale and complexity of its activities.

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 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, and how 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 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, subordinated debt and 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 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 in order 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 (e.g. staff competence and incentives)
- the firm's governance arrangements, controls and key processes (e.g. 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 harms

Firms are expected to identify all significant harms related to the activities they undertake.

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 (e.g. rogue algorithms, etc.)

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 three 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 (e.g. 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 to 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
Questions in this paper

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.**

Annex 2
Cost benefit analysis

Introduction

1. FCA supervisory work aims 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, as they exit the market in the event of failure.

2. The Consultation Paper aims to provide more clarity to the industry regarding what we believe is the role of adequate financial resources, and the focus of our approach when assessing the adequacy of a firm's financial resources.

3. The Consultation Paper also makes clear that we expect firms to consider the risks applicable to the activities they undertake, in a way that is proportionate to the scale, nature and complexity of those activities. Smaller, simpler firms are therefore not expected to incur the same level of expenditure on managing risk as larger more complex firms.

4. Our intention is to improve the way firms operate so that they can prevent harm from occurring, or put things right when they go wrong, for which financial resources may be necessary. The intention is not to increase general levels of financial resources across the landscape of financial services. However, to achieve our objectives, in some instances and by applying a targeted approach to individual firms, it may be necessary to set a level of financial resources beyond the minimum required by prudential regimes for those firms.

Problem and rationale for the intervention

5. A firm's absence of financial prudence may give rise to a number of risks. For example, poor financial management can lead to poor conduct, such as prioritising short-term revenue generation over consumers' interests. This can be 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. A lack of financial prudence can also lead to a firm's failure that may result in serious harm to consumers and financial markets.

6. The assessment of adequate financial resources is an important component of our supervisory work. We aim to be clear and transparent about our work and our expectations of firms. Therefore, we are consulting on the purpose of adequate financial resources, what we look for from firms and our expectations as to the practices firms should adopt in their assessments of adequate financial resources. This should lead to consistent and appropriate approaches that may result in a mitigation of harm to consumers and to the integrity of the UK financial system.

Our intervention and causal chains

7. The Consultation Paper explains the purpose of, and our approach to the assessment of adequate financial resources for all firms authorised and regulated by the FCA only, subject to the Principles for Businesses (PRIN) and threshold conditions, making this more transparent, by setting out:

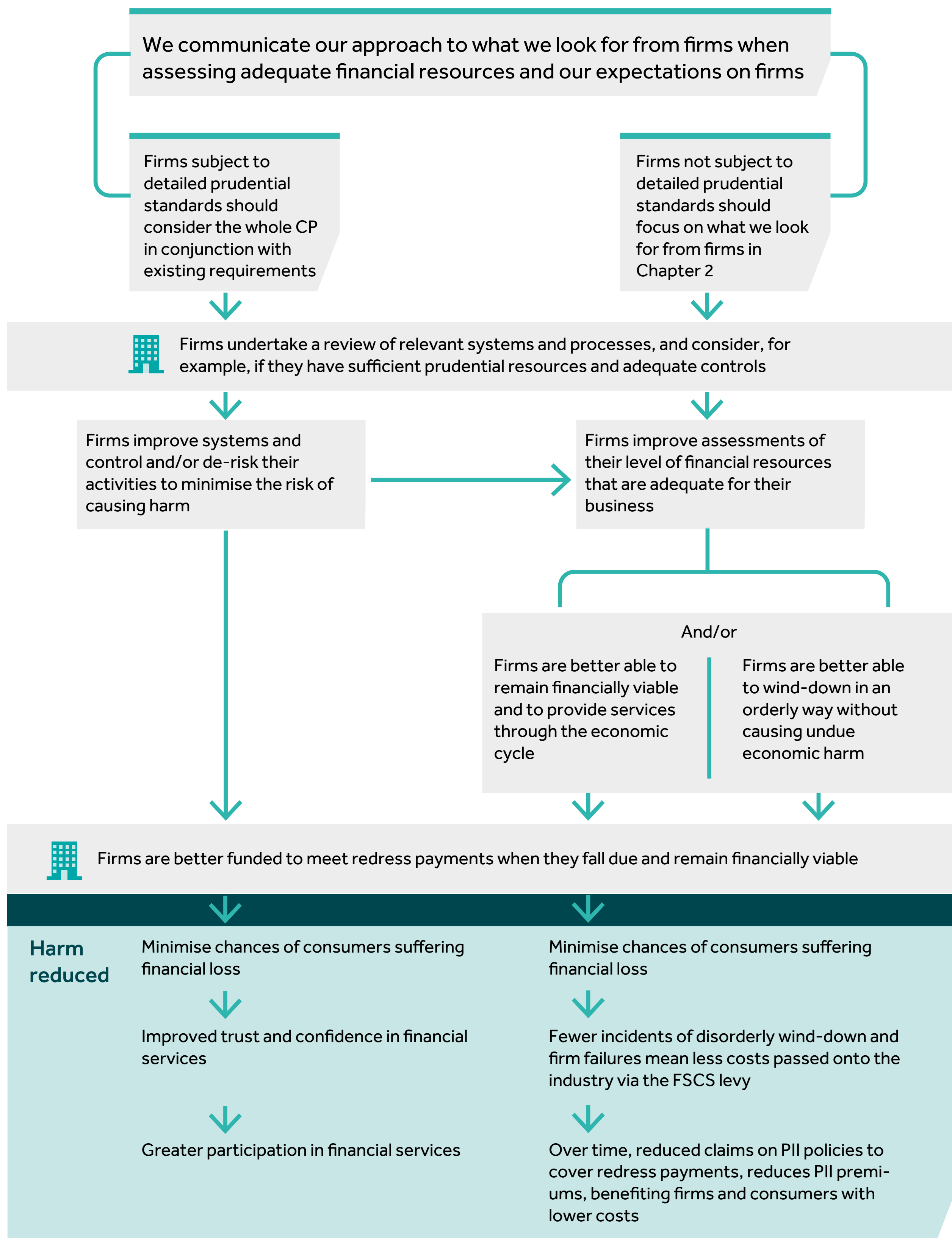
- the role of assessing adequate financial resources
- what we look for from firms when assessing adequate financial resources
- the FCA's expectations as to the practices firms should adopt in their assessment of adequate financial resources

8. As explained in the Consultation Paper, the key aims of our approach to assessing adequate financial resources are to:

- ensure firms have a clear organisational structure, and an appropriate risk management and controls framework in place, that enables them to prevent harm to consumers and markets from occurring and better run their businesses
- 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 to the integrity of the UK financial system
- reduce the likelihood that firms with the greatest potential impact to consumers and to the UK financial system will fail in a disorderly manner
- have firms hold adequate resources so that, in the event of failure, the harm as they exit the market is minimised through effective wind-down arrangements

9. Disorderly failure can result in serious harm to consumers and financial markets manifesting through financial loss, a loss of confidence and an inability to access investments and services. We expect our intervention to help improve firms' practices, making them better prepared to prevent harm or put things right when they go wrong. This should lead to a mitigation of harm to consumers or harm to the integrity of the UK financial system.

Figure 1: Causal chain



Baseline and key assumptions

10. The FCA is the prudential supervisor for approximately 48,000 regulated firms. Of these, 18,000 firms are subject to the prudential standards in the FCA handbook. Every Financial Services and Markets Act 2000 (FSMA) authorised firm, as well as a firm providing payment services or e-money services, is subject to the Principles for Businesses (PRIN). FSMA authorised firms must also meet threshold conditions. This means a firm's resources must be appropriate to the regulated activities a firm carries on or seeks to carry on.

11. The Consultation Paper itself does not impose specific obligation on firms, but merely explains the purpose of, and our approach to the assessment of adequate financial resources for all firms authorised and regulated by the FCA only, subject to the Principles for Businesses (PRIN) and threshold conditions.

12. COND 2.4 Appropriate resources in 2.4.4 G already provides some guidance regarding the relevant matters to which the FCA may have regard when assessing whether a firm satisfies this threshold condition, this includes but is not limited to:

- the ability to meet its debts when they fall due
- taking reasonable steps to identify and measure its risks
- having in place appropriate systems and controls and human resources to measure risks prudently at all times
- having access to adequate capital to support the business, and that client money and custody assets are not placed at risk
- having resources which are commensurate with the likely risks it faces

13. Some firms may have approaches to assess adequate financial resources which already address the risks arising from their business models and activities, and the potential harm they may cause to consumers or to the integrity of the UK financial system. In these cases, it is possible that firms will not need to take any further action in response to our proposed guidance, meaning our proposals would result in no, or negligible, incremental costs.

Costs

14. We set out below our view of the key areas where firms might incur additional costs. We would not expect most firms to need to make changes, and incur costs in every area.

- One off costs, namely:
  - Costs related to familiarisation and gap analysis
  - Costs related to implementation and governance changes
- Ongoing costs

15. For the purpose of the cost analysis we split the population of firms into three groups, as follows:

- **Class 1 firms – firms subject to regular supervisory review**. This group includes 166 firms that are already subject to an in depth supervisory review of their own assessment of adequate financial resources, every two to four years.
- **Class 2 firms – firms subject to an ICAAP**. This includes firms subject to prudential requirements under the Capital Requirements Directive, either CRD III or CRD IV. This group includes 2,680 firms that may be subject to our review of their own assessment of adequate financial resources on an ad-hoc basis, which are already required to perform an Internal Capital Adequacy Assessment Process (ICAAP).
- **Class 3 firms – firms not subject regular supervisory review or ICAAP**. This group includes 45,052 firms that may be subject to our review of their own assessment of adequate financial resources on an ad-hoc basis, and which are not currently required to perform an ICAAP.

Costs related to familiarisation and gap analysis

16. While recognising that many firms will already meet at least the level of expectations set out in this consultation, we do recognise that it is likely that the directors of most if not all firms will expect assurance that their own practices do not lag behind our expectations. Class 1 firms, in particular, may wish to conduct gap analysis to benchmark themselves against the consultation. This will result in some cost in terms of time firms spend reading and familiarising themselves with the consultation, and producing an analysis for the board or other committee, but we do not consider these to be material.

a. Class 1 firms – to familiarise themselves with the proposed guidance we assume that this will be read on average by 20 people across the firm, each taking slightly more than 2 hours, each working day being seven hours long, to do so. This covers legal, compliance, risk management, business operations and senior management. We estimate a cost of £332 per person per day; this is based on an average annual staff cost to the firm of £73,000 per person, divided by 220 working days.

For gap analysis, we assume this will be done by 4 people, from legal, compliance and risk management, each team member taking 4 days to review the document. We estimate a cost of £336 per person per day; this is based on an average annual staff cost to the firm of £74,000 per person, divided by 220 working days.

b. Class 2 firms – to familiarise themselves with the proposed guidance we assume that this will be read on average by 5 people across the firm, each taking slightly more than 2 hours, each working day being seven hours long, to do so. This covers legal, compliance, risk management and senior management. We estimate a cost of £382 per person per day; this is based on an average annual staff cost to the firm of £84,000 per person, divided by 220 working days.

For gap analysis, we assume this will be done by 2 people, from compliance and risk management, each team member taking 3 days to review the document. We estimate a cost of £355 per person per day; this is based on an average annual staff cost to the firm of £78,000 per person, divided by 220 working days.

c. Class 3 firms – to familiarise themselves with the proposed guidance we assume that this will be read on average by 2 people across the firm, each taking slightly more than 2 hours, each working day being seven hours long, to do so. This covers risk management and senior management. We estimate a cost of £282 per person per day; this is based on an average annual staff cost to the firm of £62,000 per person, divided by 220 working days.

For gap analysis, we assume this will be done by 1 person responsible for risk management, taking 1 day to review the document. We estimate a cost of £282 per person per day; this is based on an average annual staff cost to the firm of £62,000 per person, divided by 220 working days.

17. The estimated cost per person per day does not exactly match the estimated cost assumed in the FCA standardised cost model (SCM). For familiarisation, the estimated cost is higher than the SCM, because the SCM assumes this is done by compliance staff only. For gap analysis, the estimated cost is slightly lower than the SCM, because the SCM assumes this is done by legal staff only. In our estimate of costs related to familiarisation and gap analysis, based on our supervisory experience and the nature of the proposed guidance, we have assumed the work is done by a combination of staff which covers legal, compliance, risk management, business operations and senior management.

Table 1: Total one-off costs[1] for familiarisation and gap analysis[2]

Class 1 firms	Familiarisation	20 people take 2 hours each to read the document	£0.4m total cost
	Gap Analysis	Team size of 4 people and 4 days for each team member to review the document	£1.0m total cost
Class 2 firms	Familiarisation	5 people take 2 hours each to read the document	£2.0m total cost
	Gap Analysis	Team size of 2 people and 3 days for each team member to review the document	£6.4m total cost
Class 3 firms	Familiarisation	2 people take 2 hours each to read the document	£10.1m total cost
	Gap Analysis	Team size of 1 person taking 1 day to review the document	£14.2m total cost
Total			**£34.2m total cost**

18. The overall one-off costs related to familiarisation and gap analysis of our proposed guidance add up to approximately £34.2m.

Costs related to implementation and governance changes

19. We would expect any well-run business to devote thought to the timing and amount of cashflows to ensure that it can pay its liabilities as they fall due, or think about its vulnerability to loss of customer data for example, and firms should already assess the adequacy of their financial resources on a regular basis. However, we understand that many firms may fall short of what we look for from firms, and our expectations as to the practices firms should adopt in their assessment of adequate financial resources.

20. Costs related to implementation and governance changes do not include any costs related to gap analysis, as the shortcomings in a firm's approach should be captured within the familiarisation and gap analysis. Cost captured here only include those

1 For the calculation of costs, we have added an allowance for overheads of 30% to all time costs to account for non-wage labour costs. This allowance is only reflected in the table with the costs and not in the description of assumptions

2 For the calculation of gap analysis costs, we have included an adjustment based on the number of words in the document. The standardised cost model assumes the number of days based on a 15,000 words document. Because this document contains around 12,900 words, this results in an adjustment to the number of days each person takes

related to the implementation of necessary changes, and are expected to be as follows:

a. **Class 1 firms** are already subject to a supervisory review of their assessment of adequate financial resources. Specific feedback is already provided if the supervisory review finds that the firm is not meeting our expectations. We do not expect any significant incremental costs for this group of firms.

b. **Class 2 firms** are already required to have in place an ICAAP. This means our proposed guidance would not impose any additional requirements on them. However, because these firms are unlikely to have been subject to a supervisory review of their assessment of adequate financial resources, no specific feedback would have been provided and some of these firms may fall short of our expectations. For the purpose of cost analysis, based on our supervisory experience with these types of firms, because our proposed guidance is to be applied in a proportionate manner and, the fact that it does not impose additional requirements on Class 2 firms, we assume that one third of these firms may fall short of the expectations set out in our proposed guidance, and decide to implement changes.

   For class 2 firms deciding to implement changes, we assume this will be done on average by a project team of 6 people. This includes project management, risk management, business operations and IT, each team member spending on average 2 working days with the project. We estimate a cost of £323 per person per day; this is based on an average annual staff cost to the firm of £71,000 per person, divided by 220 working days.

   We also assume the board would like to be assured and approve the changes. We estimate and average board size of 8 members, each spending 1.5 hours. We estimate a director's hourly rate as £218. This is based on an estimated salary of £336,000 p.a., 220 annual working days, and each working day being seven hours long.

c. **Class 3 firms** should already assess the adequacy of their financial resources on a regular basis. Many, if not most of these firms are likely to be small businesses with informal governance arrangements and a lack of well-defined systems and controls. They may not have clearly articulated risk appetite and risk management frameworks, or have conducted any 'point of non-viability' assessment. For the purpose of cost analysis, based on our supervisory experience with the different types of Class 3 firms, because our proposed guidance is to be applied in a proportionate manner and, for 24,000 of Class 3 firms, the requirement is to meet debts as they fall due, we assume that half of these firms may fall short of the expectations set out in our proposed guidance, and decide to implement changes.

   For class 3 firms deciding to implement changes, we assume this will be done on average by a project team of 2 people responsible for risk management, each team member spending on average 2 working days with the project. We estimate a cost of £282 per person per day; this is based on an average annual staff cost to the firm of £62,000 per person, divided by 220 working days.

   We also assume the directors would like to be assured and approve the changes. We estimate and average of 2 directors, each spending 1.5 hours. We estimate a director's hourly rate as £68. This is based on an estimated salary of £104,000 p.a., 220 annual working days, and each working day being seven hours long.

Table 2: Total one-off costs for implementation and governance changes

Class 1 firms			Negligible. These should mostly be within BAU costs
Class 2 firms	Change management project team	On average 6 people take 2 working days working on the project	£7.5m total cost*
	Company board	On average 8 board members take 1.5 hours each	
Class 3 firms	Change management project team	On average 2 people take 2 working days working on the project	£38.9m total cost*
	Company board	On average 2 board members take 1.5 hours each	
Total costs			**£46.5m total costs***

*assumes implementation costs are incurred by 1/3 of Class 2 firms and 1/2 of Class 3 firms

21. The overall one-off costs related to implementation and governance changes of our proposed guidance add up to approximately £46.5m.

Ongoing costs

22. The proposed guidance applies to firms that are subject to threshold conditions and/or PRIN. This means that they must hold adequate financial resources, and according to the guidance provided in COND 2.4.4[3], firms should take reasonable steps to identify and measure its risks and have appropriate systems and controls and human resources to measure them prudently, at all times. Our view is that, once firms have implemented necessary changes to ensure they assess and have adequate financial resources, the costs to maintain this on an ongoing basis should be minimal and fall within BAU costs. However, for half of class 3 firms that have implemented changes, this may include a new process to confirm, on an annual basis, that the assessment is appropriate.

23. We assume that these class 3 firms will incur ongoing costs in terms of the time that directors will take to prepare for and participate in annual directors' discussions on the adequacy of financial resources, and also the cost of staff to prepare the pack for the directors. We assume that once a year, on average two directors spend 1.5 hours per meeting, and that 1 staff spends half a day preparing the pack. We estimate a director's hourly rate as £68. This is based on an estimated salary of £104,000 p.a., 220 annual working days, and each working day being seven hours long. We estimate a cost of £282 per staff person per day; this is based on an average annual staff cost to the firm of £62,000 per person, divided by 220 working days.

3 See COND 2.4.4 Appropriate resources – www.handbook.fca.org.uk/handbook/cond

Table 3: Total ongoing costs

Class 1 firms		Negligible. These should mostly be within BAU costs
Class 2 firms		Negligible. These should mostly be within BAU costs
Class 3 firms	On average 1 team member taking half day to prepare pack	£10.1m total cost per year*
	On average 2 board members take 1.5 hours each	

*assumes ongoing costs are incurred by 1/2 of Class 3 firms

24. The overall ongoing costs of our proposed guidance add up to approximately £10.1m per year.

Overall costs

25. Overall, we estimate the total costs of our proposal to amount to £80.7m of one-off costs related to firms considering our proposed guidance and implementing changes, plus £10.1m ongoing costs per year. The following table provides a breakdown of the estimated costs.

Table 4: Total overall costs

One-off costs	One-off costs of considering our proposed guidance	Class 1 firms	£1.4m total cost
		Class 2 firms	£8.4m total cost
		Class 3 firms	£24.3m total cost
	One-off costs of changing the approach to assessing adequate financial resources	Class 1 firms	Negligible. These should mostly be within BAU costs
		Class 2 firms	£7.5m total cost*
		Class 3 firms	£38.9m total cost*
Ongoing costs		Class 1 firms	Negligible. These should mostly be within BAU costs
		Class 2 firms	
		Class 3 firms	£10.1m total cost per year**

*assumes implementation costs are incurred by 1/3 of Class 2 firms and 1/2 of Class 3 firms

**assumes ongoing costs are incurred by 1/2 of Class 3 firms

Benefits

26. A clear and transparent communication of the FCA's expectations as to the practices firms should adopt in their assessment of adequate financial resources, can reinforce acceptable standards of practices and behaviours and be a critical factor in minimising harm caused to consumers or to the integrity of the UK financial system and, therefore, benefit consumers and firms, as well as the market as a whole.

27. We expect the Consultation Paper to help mitigate harm that may be caused by:

- **Poor conduct as a result of poor financial management** where harm results from a consumer buying unsuitable or mis-sold products, or poor customer service/ treatment.
- **Disruption of markets functioning** where confidence and participation in financial services markets may be threatened by unacceptable conduct such as market abuse, unreliable performance or by disorderly failure.
- **Inability to pay redress or to transfer or return client money and assets** where firms are unable to return money and assets to their clients in a timely manner, or not receive back all their money or assets.
- **Disruption to continuity of service** where important consumer needs are not being met because of gaps in the existing range of products, consumer exclusion, or lack of market resilience.

28. Minimising harm by:

- **Driving up standards in risk management and controls framework** through setting our expectations on: behaviours that drive good outcomes; the identification and understanding of the relevant risks that arise from firms' activities and the way they conduct their business, including a clear risk appetite; and robust and transparent organisational structures, and risk management and controls frameworks. A sound risk management and controls framework should allow firms and their senior management to identify, understand, manage, monitor and mitigate the risk of harm.
- **Increasing the likelihood of preventing harm** through guidance, and clear expectations on firms, on why and how they should identify and assess the potential harm to consumers and markets that can be caused by their business models and activities. This should help firms understand what can go wrong, so that they can implement controls to minimise the risk of causing detriment. By considering the likelihood and impact of things going wrong, a firm should be able to have in place adequate financial resources, minimising the harm to consumers and financial markets.
- **Increasing the likelihood of firms putting things right when they go wrong** through guidance, and clear expectations on firms, on why and how they should consider additional risks that may deplete the level of their available financial resources. These additional risks may 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 because of firm misconduct or failure. Firms should have adequate resources to be able to provide redress in such cases. An appropriate assessment of the wider material risks to which they are exposed helps firms have in place adequate financial resources available to compensate consumers for the harm suffered.

- **Appropriate wind-down planning**, firms understanding their business model's viability and the different scenarios in which they would decide, or be forced to wind-down their business. By considering how different scenarios would affect financial resources available when a decision is made and how much is necessary to wind-down the business, should help firms have in place an adequate level and quality of financial resources. This ensures that, in the event of a firm's failure, the potential harm from, for example, the inability to pay redress, inability to return or transfer client assets and money, or to interrupt continuity of service, is minimised.

- **Improved trust in financial services** as all of the above will help raise public confidence in the industry as well as clarify the FCA's expectations on firms. Financial services markets working poorly and not providing sufficient benefit to users, losses suffered by consumers, or exclusion from participation in financial markets and services damage the industry's reputation, while high consumer trust may lead to greater demand for services and advice, benefiting consumers and firms.

  Better approaches to identifying the sources and impacts of potential harm; assessing the additional risks to which the firms are exposed; and understand business model viability, its points of failure and appropriately planning for a wind-down, should lead to firms to be better positioned to pay any redress when required. This would minimise the potential for consumers to suffer financial loss and would mitigate a transfer of those costs to the whole industry via FSCS compensation payments and FSCS levy, which is unfair and places an unnecessary burden on other firms.

  Over time, sustained lower claims have the potential to reduce professional indemnity insurance (PII) premiums and lower the FSCS levy, benefiting firms and consumers, with lower costs being transferred to them.

29. Estimating and quantifying the range of potential benefits this Consultation Paper is designed to achieve is difficult, but we have sought to estimate this as best we can with available data. To do so, we have used Financial Services Compensation Scheme (FSCS) data, on compensation payments, as these indicate sums which are likely to be saved by firms applying the approach set out in a proportionate way. The FSCS sums paid out provide for a view of the harm caused by firms and potential benefits arising from the proposal in order to perform a breakeven analysis of costs and benefits.

30. Data on complaints and redress paid by financial service firms are collected by the FCA and the FSCS. Compensation payments can include an amount for the distress and inconvenience complainants have suffered.

Data on FSCS compensation

31. The FSCS is the UK's compensation fund of last resort for customers of authorised financial services firms. It may pay compensation if a firm is unable, or likely to be unable, to pay claims against it. This is usually because it has stopped trading or has been declared in default. These payments are to compensate for harm.

32. Tables 5 and 6 show the amount of compensation paid by the FSCS in the years 2013 to 2017. The amounts paid have been split on the basis of the size of total compensation per firm, and for the amounts above £500,000 for each class of firm. This shows that 68% of compensation paid above £500,000 and 71% of the total compensation paid by the FSCS relates to class 3 firms.

Table 5: FSCS compensation paid per payment size and firm group

FSCS compensation	Firm group	Number of firms	2013 £m	2014 £m	2015 £m	2016 £m	2017 £m	Total £m
Above £500k	Class 2 firms	26	36.9	70.1	84.2	38.2	10.8	240.2
	Class 3 firms	161	87.8	86.7	129.4	127.4	90.0	521.3
From £250k to £500k	Class 2 firms	5	0.1	0.6	0.3	0.3	0.6	1.9
	Class 3 firms	71	5.1	4.2	5.5	6.0	4.7	25.4
Below £250k	Class 2 firms	18	0.7	0.5	0.2	0.2	0.3	2.0
	Class 3 firms	2,145	15.4	13.3	10.4	7.8	8.2	55.0
TOTAL		**2,426**	**146.0**	**175.3**	**230.0**	**180.0**	**114.6**	**845.8**

Table 6: FSCS compensation paid per firm group

Class 2 firms	£244m of total FSCS compensation payments from 2013 to 2017 £3,318 average cost per firm	29% of total compensation paid
Class 3 firms	£601.8m of total FSCS compensation payments from 2013 to 2017	71% of total compensation paid

Conclusion: comparison of costs and benefits

33. To understand whether the proposed Consultation Paper is likely to be beneficial overall, we have compared the estimated costs of the proposal with the FSCS payments to compensate for harm. We used this to assess the percentage reduction of the harm identified, as per the FSCS payments, that would be required for the proposed Consultation Paper to breakeven. Our analysis centres on FSCS data, as indicative of the harm caused by firms lacking adequate financial resources.

34. We recognise that we have only presented an illustrative and limited estimate of harm and have to accept a degree of uncertainty inherent in our compliance cost analysis. However, by accepting these limitations, the following analysis demonstrates that the Consultation Paper is proportionate to the likely harm in financial services that our proposals seek to address.

35. To enable us to compare the costs with the illustrative harm we assume both ongoing costs and benefits occur each year over a 10-year period. Our annual estimate of harm is based on the annual average of £169.2 million of FSCS compensation payments, over the 5-year period between 2013 and 2017. This average is then reflected as a compensation of £169.2 million, £48.8 million for class 2 firms and £120.4 million for class 3 firms, for each of the years in the 10-year period.

36. To create an overall measure of the costs and benefits over the 10-year period, we converted the FSCS payments of £169.2 million in each year, broken down per class, and the ongoing annual cost of £10.1 million, to 'present values' (PV) and then added them. The PV reflects that society prefers to receive goods and services sooner rather than later and to defer costs to future generations. That is, costs incurred in the future

are valued less than costs incurred immediately.[4] This results in a total estimated PV of FSCS payments of £1,412.9 million and PV of ongoing costs of £84 million. We also include the one-off costs of £80.7 million at the start of this 10-year period, resulting in total estimated PV of compliance costs of £164.7 million.

37. The analysis indicates that a 11.7% reduction in the harm identified would lead to benefits that are larger than the compliance costs.

Table 7: Reduction in FSCS payments needed to breakeven, all firms by 10-year present value

Firm group	Compliance cost PV, £m	PV of FSCS payments, £m	Required reduction in harm to breakeven
Class 1 firms	1.4	-	-
Class 2 firms	16.0	407.5	3.9%
Class 3 firms	147.3	1,005.4	14.6%
Total	**164.7**	**1,412.9**	**11.7%**

38. Our proposed intervention aims to improve the way firms operate by better managing their risks and better assessing the adequacy of their financial resources, so that they are better funded to meet redress payments when they fall due and remain financially viable. We believe it is reasonable to expect that, by having one third of Class 2 firms and half of Class 3 firms implementing changes to their governance and risk management, and for these Class 3 firms to confirm on an annual basis that their assessment is appropriate, there is scope for a reduction in FSCS payments equivalent to at least the breakeven point illustrated above.

39. We accept that there are uncertainties and limitations in estimating the exact degree to which the expected change in behaviour and practices leads to reductions in FSCS payments. However, overall, it is reasonable to expect our proposed intervention to result in net benefits for consumers and the UK financial system.

4 We use 3.5%, the interest rate used by HM Treasury for policy appraisal.

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

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
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

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