TheCityUK

TheCityUK response to FCA CP23/30 and PRA CP26/23: Critical third parties to the UK financial sector

Introduction

TheCityUK welcomes the joint consultation paper 'Operational Resilience: Critical third parties (CTPs) to the finance sector' from the Financial Conduct Authority (FCA) (CP23/30), the Bank of England (Bank) and Prudential Regulation Authority (PRA) (CP26/23) ("**the CP**"). Overall, the proposed approach is positive. In particular efforts to ensure the regime for CTPs complements and does duplicate or not add to existing requirements on firms and financial market infrastructures (FMIs).

This response sets out some key considerations in response to the CP. This should be considered alongside the paper (see annex) we submitted to the FCA, the Bank and PRA ("**the regulators**") last year detailing how the regulators and industry can work together to ensure that the implementation of these regulations not only minimises the impact of disruption but also supports innovation and growth.

A proportionate and pragmatic approach

A proportionate approach is necessary to prevent compliance burdens from stifling innovation, and to enable institutions of different sizes and business models to compete on an equal footing. The proposal for a principles- and outcomes-based approach is a welcome step towards achieving this. The parity between the proposed CTP Fundamental Rules and the existing operational resilience obligations for firms is positive. The regulators must uphold the principle to 'not impose additional requirements on firms and FMIs but seek to complement their existing obligations on them'[1]. Proportionality should also apply to the costs incurred through the implementation of this regime. Excessive costs may result in fee increases by CTPs to firms, which could eventually be passed on to the end users. In this way, proposals in the CP to periodically review designations are welcome and will allow for the regime to evolve and respond to advancements in technologies and the ever-evolving landscape of risk. This is vital to ensure that firms can remain competitive and meet rapidly changing consumer expectations.

Regarding the responsibility of a CTP to identify and risk manage across its supply chain to the "key nth point". This is sensible. However, the regulators must be pragmatic as to how feasible and enforceable this is in practice. This will have assurance implications throughout the supply chain, including for the firms to which a CTP provides their services. Regulators should also consider the impact of this supply chain challenge on firms for not-designated third parties.

The regulators must also take a proportionate approach to their new enforcement powers, as set out in the FCA's Quarterly Consultation CP24/3 and which the Bank and PRA will also consult on in due course. Where the regulators do intend to exercise these powers, they must

[1] Paragraph 1.11

first carefully consider any potential unintended consequences of doing so. For example, situations where exercising enforcement powers could inadvertently harm the resilience of firms and FMIs using a CTP's material services and could in turn result in consumer harm or market instability.

Fundamental Rules

The proposed Fundamental Rule 6 requires CTPs to deal with regulators in an open and cooperative way. **An additional rule or extension of this rule dictating similar requirements for how the CTPs should conduct themselves, when interacting with their firm and FMI clients, would be beneficial. It would ensure that CTPs do not behave in a less open and cooperative way with their clients than they would with the regulators**. This could be worded as follows: A CTP must deal with its firm and FMI customers in an open and cooperative way in matters relating to operational resilience.

Regarding the application of the Fundamental Rules, **the regulators should maintain their focus on those material services whose interruption or failure could reasonably undermine the stability of, or confidence in, the UK financial system**. The application of Fundamental Rules to all the services that a CTP provides, including entertainment services, could dilute the regulators' focus. We recommend that the Fundamental Rules should only apply to the entities within an organisation that are part of the service model – for example, the parent company that maintains compliance/risk functions and the sub-entities that provide a direct service to customers. The regulators should also monitor for any signs that disproportionate amounts of regulatory time and resource are being devoted to overseeing non-material services, and address any concerns in rule reviews. An overly broad regime will increase implementation costs, which would likely be passed on directly to customers. Furthermore, a broad regime increases the complexity and timescales.

Operational risk and resilience requirements

We agree with the proposal for the requirements to apply to a CTP's material services only. Taking a whole entity application approach would create an undue regulatory burden on the CTPs. This risks creating a tick-box compliance-driven approach, resulting in a poorer standard of testing, and weakened operational resilience. Application to a CTP as a whole entity would also detract from the time and resources CTPs have to improve their services and innovate to produce novel services for our industry, impacting the industry's long-term competitiveness.

Severe but plausible scenarios

While the CP proposals require CTPs to test their ability to continue providing their material services in the event of a 'severe but plausible' (SBP) scenario, there is no corresponding requirement or principle for a CTP to *remain* within those maximum tolerable levels of disruption in the event of severe but plausible scenarios. **The regulators should provide greater clarity in the final rules on whether CTPs are required to remain operationally resilient throughout SBP scenarios**.

Transparency and assurance

The regulation of CTPs will support firms' own assurance processes, given the alignment of terminology and approach. However, concerns remain over continuing requirements for firms to gain assurance over the resilience of their third-party providers. Namely, a firm's ability to gain assurance in the level of detail expected by regulators and the cost burden of doing so, both in terms of time and resources. The regulators should, where possible, explore opportunities to simplify the assurance process for firms without compromising on operational resilience. A lack of transparency and information sharing from CTPs (see annex) will limit firms' and FMIs' ability to assure their own operational resilience. We support the CP's proposals for CTPs to share certain information with firms and FMIs. However, the CTPs should share their notifications and their full annual self-assessments (removing any necessary market-sensitive information), and not just a summary of these assessments.

The regulators should also review the efficacy of the new regime after an appropriate period of time, in order to evaluate how well the measures are working in practice and whether the intended outcomes are being achieved. This should include taking feedback from firms and FMIs on whether the CTPs disclosures under the regime have been beneficial. This will manage the risk of a disconnect opening between the intention of the policy and real-world practice.

Other considerations

International competitiveness and economic growth

The regulators' secondary competitiveness and growth objective should be reflected in the approach to regulating CTPs. While the improved resilience of the industry might be considered an internationally competitive advantage, too strict a regulatory framework would make the UK less attractive to CTPs and potential new entrants, giving rise to regulatory arbitrage opportunities, and risk putting UK firms at a potential disadvantage. A reduction in CTPs would also allow for decreased competition, potentially stifling innovation and allowing for increased fees from the remaining CTPs. **The regulators should, where possible, seek alignment with other jurisdictions to establish a single baseline set of operational resilience regulations.**

The designation of CTPs by HM Treasury (HMT) could inadvertently create a 'two-tiered' system for CTPs and non-designated third parties, entrenching market concentration. This is not only, as the CP identifies, a key driver of risk to the UK financial system but would ultimately harm the international competitiveness and growth of our industry. **The regulators create a mechanism for non-designated third parties to demonstrate voluntary adherence to the minimum resilience standards**, such as an option to opt-in to the regulatory regime.

Impact on the 3 lines of defence model

The 3 lines of defence (3LOD) model is well-established internationally and is a risk management model for which the regulators look to the firms they regulate (which for these purposes will include CTPs) to implement.[2] The new regime proposes risks undermining or requiring redesign of the 3LOD model as the first line of defence (the front office) will have no visibility into or control over (a) the nth party risk and how that risk is managed, (b) the choice of CTP/supplier by the firm or (c) the contractual terms agreed with the CTP/supplier. **While this is unlikely to affect any firm's compliance with its regulatory obligations, it will make the allocation of responsibilities within firms and to regulators more complex. We encourage regulators to be mindful of the challenges this poses and encourage them to consult with firms, including CTPs, on the impact to them.**

Ongoing engagement and collaboration

A key theme highlighted in our previous paper (see annex) is the need for continuous engagement and ongoing relationships between the regulators, industry and the CTPs. **Regulators, CTPs and firms/FMIs should work closely together to identify and learn from incidents, via appropriate forums. This will promote understanding around potential implications and developments, and facilitate the identification and sharing of lessons learned, helping to improve further the operational resilience of the industry**. The annexed paper sets out specific recommendations for this. Further and ongoing engagement with the Cross Market Operational Resilience Group (CMORG) will assist in refining and designing a regime that augments the UK's resilience, while keeping it internationally competitive and attractive for doing business. However, there is a question as to which forum is best placed to coordinate efforts with the CTPs, who sit outside the CMORG. TheCityUK would be happy to play an active convening role here, given the cross-industry nature of our remit.

Conclusion

TheCityUK supports steps to bring CTPs into financial services regulatory oversight. We encourage the regulators to stay closely engaged with the industry. We look forward to receiving the additional 'CTP approach document' and, in due course, the final policy statements from the regulators.

About TheCityUK

TheCityUK is the industry-led body representing UK-based financial and related professional services. We champion and support the success of the ecosystem, and thereby our members, promoting policies in the UK and internationally that drive competitiveness, support job creation and enable long-term economic growth. The industry contributes 12% of the UK's total economic output and employs over 2.4 million people – with two thirds of these jobs outside London across the country's regions and nations. It pays more corporation tax than any other sector and is the largest net exporting industry. The industry plays an important role in enabling the transition to net zero and driving economic growth across the wider economy through its provision of capital, investment, professional advice

---

[2] Under this model: the first line of defence (1LOD) is the 'risk owners', ie front line staff and operational management; the second line (2LOD) is 'risk oversight', ie the risk management and compliance functions; the third line (3LOD) is 'risk assurance', ie internal audit functions.

and insurance. It also makes a real difference to people in their daily lives, helping them save for the future, buy a home, invest in a business and manage risk.