

**RECOGNISED INVESTMENT EXCHANGES AND RECOGNISED CLEARING
HOUSES SOURCEBOOK (FINANCIAL RESOURCES REQUIREMENTS)
INSTRUMENT 2012**

Powers exercised

- A. The Financial Services Authority makes this instrument in the exercise of the power in section 157(1) (Guidance) of the Financial Services and Markets Act 2000.

Commencement

- B. This instrument comes into force on 1 February 2013.

Amendments to the Handbook

- C. The Recognised Investment Exchanges and Recognised Clearing Houses sourcebook (REC) is amended in accordance with the Annex to this instrument.

Citation

- D. This instrument may be cited as the Recognised Investment Exchanges and Recognised Clearing House Sourcebook (Financial Resources Requirements) Instrument 2012.

By order of the Board
26 July 2012

Annex

Amendments to the Recognised Investment Exchanges and Recognised Clearing Houses Sourcebook (REC)

In this Annex, underlining indicates new text and striking through indicates deleted text.

2 Recognition requirements

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2.3 Financial resources

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Operational and other risks: ~~standard approach~~ components of calculation

2.3.7 G ~~The FSA considers that a UK recognised body which (after allowing for the financial resources necessary to cover counterparty and market risks) has at any time:~~

- ~~(1) liquid financial assets amounting to at least six months' operating costs; and~~
- ~~(2) net capital of at least this amount;~~

~~will, at that time, have sufficient financial resources to meet the *recognition requirement* unless there are special circumstances indicating otherwise. In considering whether a UK recognised body has sufficient financial resources in relation to operational and other risks, the FSA will normally have regard to two components: eligible financial resources and net capital.~~

Operational and other risk: UK RCHs - the standard approach

2.3.8 G (1) ~~In this standard approach, the FSA assumes liquid financial assets are needed to cover the costs that would be incurred during an orderly run down of the UK recognised body's business as such, while continuing to satisfy all the *recognition requirements* and complying with any other obligations under the Act (including the obligations to pay periodic fees to the FSA under REC 7). The FSA considers that a UK RCH which at any time holds:~~

- (a) eligible financial resources not less than the amount calculated under the standard approach; and
- (b) net capital not less than the amount of eligible financial resources calculated under (a);

will, at that time, have sufficient financial resources to meet the *recognition requirement* in respect of operational and other risks

unless there are special circumstances indicating otherwise.

- (2) ~~The calculation of operating costs may exclude non-cash costs (costs that do not involve an outflow of funds) and variable costs of the UK recognised body's exempt activities that would not be incurred if no exempt activities were performed. Fixed costs should be included in the assessment of operating costs. The FSA would normally expect the capital equal to the amount of liquid financial assets to be in the form of equity. The FSA would normally regard the amount calculated under REC 2.3.8G(1) to be a minimum amount of financial resources below which a UK RCH would be failing the recognition requirements. The FSA would normally expect a UK RCH to hold, in addition to this minimum amount, an amount constituting an operational risk buffer calculated in accordance with REC 2.3.22G.~~

Operational and other risks: ~~alternative approaches~~ UK RIEs - the standard and risk-based approach

- 2.3.9 G (1) ~~The FSA recognises that UK recognised bodies may wish to satisfy the recognition requirements in different ways. The FSA does not prescribe any particular approach to calculating financial resources or to assessing their adequacy. It is willing to discuss with each UK recognised body the most appropriate way for it to meet the recognition requirement and each UK recognised body will need to be able to show the FSA that its financial resources are at all times sufficient to meet the recognition requirement. The FSA considers that a UK RIE which at any time holds:~~

- (a) eligible financial resources not less than the greater of:
- (i) the amount calculated under the standard approach;
and
 - (ii) the amount calculated under the risk-based approach;
and
- (b) net capital not less than the amount of eligible financial resources determined under (1)(a);

will, at that time, have sufficient financial resources to meet the recognition requirement in respect of operational and other risks unless there are special circumstances indicating otherwise.

- (2) ~~The FSA would normally regard the amount calculated under REC 2.3.9G(1)(a)(i) to be a minimum amount of financial resources below which a UK RIE would be failing the recognition requirements. The FSA would expect a UK RIE to hold, in addition to this minimum amount, an amount constituting an operational risk buffer calculated in accordance with REC 2.3.22G.~~

Operational and other risks: individual guidance

- 2.3.10 G The FSA would expect to provide a UK recognised body with individual guidance on the amount of eligible financial resources which it considers would be sufficient for the UK recognised body to hold in respect of operational and other risks in order to satisfy the recognition requirements. In formulating its individual guidance, the FSA will ordinarily apply the approach described in REC 2.3.8G, for UK RCHs, and REC 2.3.9G, for UK RIEs.

Operational and other risks: eligible financial resources

- 2.3.11 G For the purposes of REC 2.3, “eligible financial resources” should consist of liquid financial assets held on the balance sheet of a UK recognised body, including cash and liquid financial instruments where the financial instruments have minimal market and credit risk and are capable of being liquidated with minimal adverse price effect.

Operational and other risks: net capital

- 2.3.12 G For the purposes of REC 2.3, “net capital” should be in the form of equity. For this purpose, the FSA considers that common stock, retained earnings, disclosed reserves and other instruments classified as common equity tier one capital or additional tier one capital constitute equity. The FSA considers that, when calculating its net capital, a UK recognised body:
- (1) should deduct holdings of its own securities, or those of any undertaking in the same group as the UK recognised body, together with any amount owed to the UK recognised body by an undertaking in its group under any loan or credit arrangement and any exposure arising under any guarantee, charge or contingent liability given in favour of such an undertaking or a creditor of such undertaking; and
 - (2) may include interim earnings that have been independently verified by its auditor.

Operational and other risks: eligible financial resources calculated under the standard approach

- 2.3.13 G (1) Under the standard approach, the amount of eligible financial resources is equal to six months of operating costs.
- (2) Under the standard approach, the FSA assumes liquid financial assets are needed to cover the costs that would be incurred during an orderly wind-down of the UK recognised body’s exempt activities, while continuing to satisfy all the recognition requirements and complying with any other obligations under the Act (including the obligations to pay periodic fees to the FSA).
- (3) For the purposes of the standard approach, the FSA would normally expect the calculation of operating costs to be based on the UK

recognised body's most recent audited annual accounts, with six months of operating costs being equal to one half of the sum of all operating costs reflected in the audited annual accounts of the UK recognised body in the course of performing its functions during the year to which the accounts relate. In calculating the gross annual operating costs, the FSA would consider it reasonable to exclude non-cash costs (costs that do not involve an outflow of funds).

- (4) The FSA considers it to be reasonable for a UK recognised body to adjust its operating expenditure calculation if, during the period since its last audited accounts were prepared, its level of operating expenditure has changed materially as documented by the current annual budget or forecast adopted by the UK recognised body's governing body.
- (5) The FSA considers that it is reasonable for a UK recognised body to adjust its operating expenditure to take account of arrangements between two or more undertakings in the same group, which are all subject to prudential regulation in the United Kingdom under which specified costs are shared or recharged among those undertakings and those costs would otherwise be double-counted in the calculation of their financial resources requirement.

Operational and other risks: eligible financial resources calculated under the risk-based approach (UK RIE's only)

- 2.3.14 G (1) The risk-based approach is intended to ensure that sufficient financial resources are maintained at all times such that a UK RIE would not be prevented from implementing an orderly wind-down as a result of the financial impacts of stress events affecting its business or the markets in which it operates.
- (2) Under the risk-based approach the amount of eligible financial resources is calculated by adding together:
- (a) the amount estimated by the UK RIE to absorb the potential business losses that a business of its nature, scale and complexity might incur in stressed but plausible market conditions; and
- (b) the amount estimated by the UK RIE to effect an orderly closure.

In this context, a business loss arises where there is an increase in cost or reduction of revenue relative to a UK RIE's expectation of its financial performance, such that a loss needs to be charged against its capital.

Operational and other risks: the risk-based assessment (UK RIEs only)

- 2.3.15 G For the purposes of calculating the risk-based approach, the FSA would

normally expect the UK RIE to provide the FSA with an annual financial risk assessment that identifies the risks to its business. As a financial risk assessment is likely to form an integral part of the UK RIE's management process and decision-making culture, the FSA would normally expect it to be approved by the UK RIE's governing body.

- 2.3.16 G The FSA would normally expect to use the financial risk assessment prepared by the UK RIE in the course of preparing individual guidance on the amount of financial resources that it considers is sufficient for a UK RIE to hold in order to satisfy the recognition requirements. The financial risk assessment would provide the basis for calculating the amount of eligible financial resources that should be held by the UK RIE under the risk-based approach.
- 2.3.17 G The financial risk assessment should be based on a methodology which provides a reasonable estimate of the potential business losses which a UK RIE might incur in stressed but plausible market conditions. The FSA would expect a UK RIE to carry out a financial risk assessment at least once in every twelve-month period, or more frequently if there are material changes in the nature, scale or complexity of the UK RIE's operations or its business plans that suggest such financial risk assessment no longer provides a reasonable estimate of its potential business losses. The FSA considers that it would be reasonable for a financial risk assessment to proceed in the following way:
- (1) Step 1: the UK RIE would identify, in writing, the risks to which the business of the UK RIE is exposed and which could have a material adverse effect on its financial position, in the light of the nature, scale and complexity of its operations and its business plans. For this purpose, it would be reasonable to refer to the categorisation of risk used under the system of risk management adopted by the UK RIE in order to meet its responsibilities under the recognition requirements referred to in REC 2.5. That description would identify which risks are indemnified or transferred by the UK RIE and which are retained and accepted.
 - (2) Step 2: the UK RIE would conduct an assessment of the potential business losses that could arise in the event that the risks identified in accordance with step 1 were to materialise. For this purpose, it would be reasonable for a UK RIE to develop, and keep under review, a stress and scenario testing plan designed to simulate the effects of a pre-determined series of events, or sets of circumstances, that would be likely to occur following the crystallisation of one or more identified risks, taking into account the systems and controls in place to mitigate those risks. The stress and scenario testing plan would:
 - (a) cover a forward-looking period of at least one year;
 - (b) consider a suitable range of adverse events and sets of circumstances, of a defined severity and duration, which could

- occur in stressed but plausible market conditions;
- (c) consider how a particular adverse event or set of circumstances could lead to or be correlated with other events;
 - (d) consider the potential for a particular adverse event or set of circumstances to affect multiple business lines;
 - (e) take into account realistic management actions to resolve such adverse events and circumstances; and
 - (f) where appropriate, involve sensitivity analysis showing the effects of changes to assumptions made about the impact of particular adverse events and circumstances.

In designing its stress and scenario testing plan, the FSA considers that it would be reasonable for a UK RIE to be guided by any risk-scoring methodology that it deploys for general risk-management purposes that might have application in evaluating the probability and impact of its risks.

The FSA would not expect a UK RIE which undertakes central counterparty clearing activities to include within its range of stress events the potential default of a participant or other entity (such as another central counterparty which is not a participant).

- (3) Step 3: the UK RIE would assess the eligible financial resources that it would need to hold to cover such potential business losses. Such eligible financial resources would enable the UK RIE to absorb any financial shocks attributable to such business risks were they to arise.

In carrying out this assessment, the FSA considers that it would be reasonable for a UK RIE to take account of any action which its senior management might plan on taking in response to a given stress event. For example, if the risk appetite of a UK RIE is such that it would not pursue recovery from a given stress event (and would instead initiate an orderly wind-down), the assessment of eligible financial resources needed in such circumstances might reasonably be limited to the costs of orderly wind-down from the point in time at which that decision would be likely to be made.

Where a UK RIE expects to be making a loss during the period covered by the financial risk assessment as a result of its anticipated business performance in normal market conditions, the business losses which are relevant to the calculation of the risk-based approach are those additional losses which the UK RIE would expect to incur in stressed but plausible market conditions.

- (4) Step 4: the UK RIE would make an assessment of the cost of orderly closure. The FSA considers that an orderly closure should normally

include an assessment of the impact of closure on the users of the markets operated by that UK RIE. For the purpose of this assessment, the FSA considers that it would be reasonable for a UK RIE to adopt the amount needed under the standard approach as its cost of orderly closure or to use its own method of calculation based on a scenario plan which comprehensively documents the costs that a UK RIE in its position might incur in order to fully implement an orderly wind-down.

- (5) Step 5: the UK RIE would produce a proposal for the amount of eligible financial resources considered to be adequate to meet the risk-based approach. Such a proposal would be based on the sum of:
- (a) the amount assessed to cover potential business losses in accordance with REC 2.3.17G(3); and
 - (b) an amount assessed to cover the cost of orderly closure in accordance with REC 2.3.17G(4).
- (6) Step 6: the UK RIE would calculate the amount available as an operational risk buffer in accordance with REC 2.3.22G. To the extent the amount available is insufficient to constitute an operational risk buffer, the UK RIE would include within its proposal the amount it would propose to hold (in addition to the sum of the amounts referred to in (5)(a) and (b)) for those purposes.

- 2.3.18 G The FSA would normally expect a financial risk assessment to include a description of the methodology applied by the UK RIE to arrive at the proposal made in accordance with REC 2.3.17G(5).
- 2.3.19 G Where a UK RIE is a member of a group, the FSA would normally expect the annual risk assessment to be accompanied by a consolidated balance sheet:
- (1) of any group in which the UK RIE is a subsidiary undertaking; or
 - (2) (if the UK RIE is not a subsidiary undertaking in any group) of any group of which the UK RIE is a parent undertaking.
- 2.3.20 G The FSA would expect to consider the financial risk assessment, any proposal with respect to an operational risk buffer and, if applicable, the consolidated balance sheet, in formulating its guidance on the amount of eligible financial resources it considers to be sufficient for the UK RIE to hold in order to meet the recognition requirements. In formulating its guidance, the FSA would, where relevant, consider whether or not the financial risk assessment makes adequate provision for the following risks:
- (1) the risks related to the administration and operation of the UK RIE as a business enterprise (whether as a result of adverse reputational effects, poor execution of business strategy, ineffective response to competition, or otherwise);

- (2) the risk that deficiencies in information systems or internal processes, human errors, management failures, or disruptions from external events will result in the reduction, deterioration, or breakdown of services provided by a UK RIE (whether as a result of errors or delays in processing, system outages, insufficient capacity, fraud, data loss and leakage, or otherwise);
- (3) the risk that the financial position of the UK RIE may be adversely affected by its relationships (financial or non-financial) with other entities in the same group or by risks which may affect the financial position of the whole group, including reputational contagion; and
- (4) any other type of risk which is relevant to that particular UK RIE.

Operational and other risks: purpose of the risk buffer

- 2.3.21 G The FSA would normally consider a UK recognised body to be failing the recognition requirements if it held financial resources less than the amount calculated under REC 2.3.8G (in respect of UK RCHs) and REC 2.3.9G(1)(a)(i) (in respect of UK RIEs). The FSA therefore expects a UK recognised body to hold an operational risk buffer of a sufficient amount in excess of this minimum, to ensure that it is at all times able to comply with its regulatory obligations.

Operational and other risks: calculation of the operational risk buffer - UK recognised bodies

- 2.3.22 G (1) The FSA would normally expect a UK RCH to hold, in addition to the minimum amount determined under REC 2.3.8G, an operational risk buffer equal to 50% of the amount calculated under REC 2.3.8G(1).
- (2) The FSA would normally expect a UK RIE to hold, in addition to the minimum amount determined under REC 2.3.9G(1)(a)(i), an operational risk buffer consistent with a risk-based approach.
- (a) Where the amount of eligible financial resources calculated by a UK RIE under REC 2.3.17G(5) (the risk-based approach) is greater than the amount of eligible financial resources calculated under REC 2.3.13G (the standard approach), and the difference is of an amount sufficient to serve the purposes of the operational risk buffer, then the FSA considers that there would be no need for a UK RIE to hold any further amount as an operational risk buffer.
- (b) Where the amount of eligible financial resources calculated by a UK RIE under REC 2.3.17G(5) (the risk-based approach) is not sufficient to provide an effective operational risk buffer over and above the amount calculated under REC 2.3.13G (the standard approach), then the FSA would expect the UK RIE to include within its annual risk assessment a

proposal to hold additional financial resources sufficient to constitute an operational risk buffer.

- (3) As the operational risk buffer is an amount in excess of the minimum financial resources sufficient to meet the *recognition requirements*, the FSA would normally not regard a *UK recognised body* that draws upon or temporarily depletes the operational risk buffer to have failed or be failing a *recognition requirement* in respect of its financial resources. However, the FSA would expect to be notified as soon as reasonably practicable if the *UK recognised body* draws upon, or intends to draw upon, its operational risk buffer.