

Chapter 2

Recognition requirements

2.3

Financial resources

2.3.1	UK	<div>Schedule to the Recognition Requirements Regulations, Paragraph 1</div> <div><div>(1) The [UK RIE] must have financial resources sufficient for the proper performance of its [relevant functions] as a [UK RIE].</div><div>(2) In considering whether this requirement is satisfied, the [FCA] must (without prejudice to the generality of regulation 6(1)) take into account all the circumstances, including the [UK RIE's] connection with any person , and any activity carried on by the [UK RIE], whether or not it is an exempt activity.</div></div>
2.3.2	UK	[deleted]
2.3.3	G	<div>In determining whether a UK recognised body has financial resources sufficient for the proper performance of its relevant functions, the FCA may have regard to:</div> <div><div>(1) the operational and other risks to which the UK recognised body is exposed;</div><div>(2) if the UK recognised body guarantees the performance of transactions in specified investments, the counterparty and market risks to which it is exposed in that capacity;</div><div>(3) the amount and composition of the UK recognised body's capital;</div><div>(4) the amount and composition of the UK recognised body's liquid financial assets;</div><div>(5) the amount and composition of the UK recognised body's other financial resources (such as insurance policies and guarantees, where appropriate);</div><div>(6) the financial benefits, liabilities, risks and exposures arising from the UK recognised body's connection with any person, including but not limited to, its connection with:<div><div>(a) any undertaking in the same group as the UK recognised body;</div><div>(b) any other person with a significant shareholding or stake in the UK recognised body;</div><div>(c) any other person with whom the UK recognised body has made a significant investment whether in the form of equity, debt, or by means of any guarantee or other form of commitment;</div></div></div></div>

(d) any *person* with whom it has a significant contractual relationship.

(7) the nature and extent of the transactions concluded on the *UK RIE*.

Accounting information and standards

2.3.4 **G** The *FCA* will usually rely on a *UK recognised body's* published and internal *management accounts* and financial projections, provided that those accounts and projections are prepared in accordance with *UK*, *US* or international accounting standards.

Counterparty and market risks: principles

2.3.5 **G** In assessing whether a *UK recognised body* has sufficient financial resources in relation to counterparty and market risks, the *FCA* may have regard to:

- (1) the amount and liquidity of its financial assets and the likely availability of liquid financial resources to the *UK recognised body* during periods of major market turbulence or other periods of major stress for the *UK financial system*; and
- (2) the nature and scale of the *UK recognised body's* exposures to counterparty and market risks and, where relevant, the counterparties to which it is exposed.

Operational and other risks: principles

2.3.6 **G** In assessing whether a *UK recognised body* has sufficient financial resources in relation to operational and other risks, the *FCA* may have regard to the extent to which, after allowing for the financial resources necessary to cover counterparty and market risks, the *UK recognised body's* financial resources are sufficient and sufficiently liquid:

- (1) to enable the *UK recognised body* to continue carrying on properly the *regulated activities* that it expects to carry on; and
- (2) to ensure that it would be able to complete an orderly closure or transfer of its *exempt activities* without being prevented from doing so by insolvency or lack of available funds.

Operational and other risks: components of calculation

2.3.7 **G** In considering whether a *UK recognised body* has sufficient financial resources in relation to operational and other risks, the *FCA* will normally have regard to two components: eligible financial resources and net capital.

2.3.8 **G** (1) [deleted]
(2) [deleted]

2.3.9

G

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

- (1) The *FCA* 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 *FCA* 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 *FCA* 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 2.3.22 G.

2.3.10

G

Operational and other risks: individual guidance

The *FCA* would expect to provide a *UK recognised body* with individual *guidance*, issued with a frequency determined in accordance with the usual prudential cycle for such bodies, communicated from time to time, 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 to satisfy the *recognition requirements*. In formulating its individual *guidance*, the *FCA* will ordinarily apply the approach described in ■ REC 2.3.9 G for *UK RIEs*.

2.3.11

G

Operational and other risks: eligible financial resources

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.

2.3.12

G

Operational and other risks: net capital

For the purposes of ■ REC 2.3, "net capital" should be in the form of equity. For this purpose, the *FCA* 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 *FCA* 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 *FCA* 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 *FCA*).
- (3) For the purposes of the standard approach, the *FCA* 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 *FCA* would consider it reasonable to exclude non-cash costs (costs that do not involve an outflow of funds).
- (4) The *FCA* 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 *FCA* 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 *FCA* would normally expect the *UK RIE* to provide the *FCA* 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 *FCA* would normally expect it to be approved by the *UK RIE's governing body*.
- 2.3.16** G The *FCA* would normally expect to use the most recent financial risk assessment prepared by the *UK RIE* in the course of preparing individual *guidance*, issued in accordance with the usual prudential cycle for such bodies, on the amount of financial resources that it considers is sufficient for a *UK RIE* to hold 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 *FCA* 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 *FCA* 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 *FCA* 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.

- (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 *FCA* 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 *FCA* 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 *FCA* 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 2.3.22 G. 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 *FCA* 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 *FCA* 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 *FCA* would expect to consider the relevant annual financial risk assessment, any proposal with respect to an operational risk buffer and, if applicable, the consolidated balance sheet, in formulating, in accordance with the usual prudential cycle for *UK RIEs*, its *guidance* on the amount of eligible financial resources it considers to be sufficient for the *UK RIE* to hold for the *recognition requirements*. In formulating its *guidance*, the *FCA* 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*.

2.3.21

G

Operational and other risks: purpose of the risk buffer

The *FCA* 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 2.3.9G (1)(a)(i) (in respect of *UK RIEs*). The *FCA* 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.

2.3.22

G

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

(1) [deleted]

(2) The *FCA* 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 2.3.13 G (the standard approach), and the difference is of an amount sufficient to serve the purposes of the operational risk buffer, then the *FCA* 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 2.3.13 G (the standard approach), then the *FCA* 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 *FCA* 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 *FCA* 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.