Deloitte.

CFO briefing

FCA additional guidance for payment and e-money firms - prudential risk management

8 September 2020

MAKING AN IMPACT THAT MATTERS since 1845

Deloitte speakers

Dennis Cheng
Director

Dennis has over ten years experience advising clients in the banking, capital markets and the wealth management industry. He leads the safeguarding team within Deloitte's Audit and Assurance division in London and currently sits within the ICAEW's Safeguarding Working Group which is due to implement the new Safeguarding Audit requirements as proposed by the FCA's recent guidance.

Phil Ackroyd
Manager

Phil specialises in the compliance of e-money and payment services firms, having joined Deloitte last year from the Payments Supervision Department at the FCA. Since then he has focused primarily on firms' measures for safeguarding user funds, helping clients design their approach and carrying out outsourced internal audit reviews in this area. More broadly, he has cross-sector expertise in the evaluation of senior management, governance arrangements and risk frameworks in financial institutions.

Isabella Rodgers
Senior Manager

Isabella joined Deloitte earlier this year from the Prudential Specialists department of the FCA where she was involved in a review of the risk management practices of payment and e-money firms. She has experience of performing financial adequacy reviews of investment firms and advising on regulatory requirements, including PSD2, CRD4/5, CRR2 and IFPR.

Henry Basing
Senior Manager

Henry is a specialist in recovery, resolution and wind-down planning and advises a wide range of firms on meeting regulatory requirements, including banks, payment firms and investment managers. He joined Deloitte in 2017 after seven years at the PRA and FSA where he worked as a supervisor on recovery and resolution as well as liquidity planning. He is a member of the Association of Corporate Treasurers and previously worked as a treasury dealer.

Agenda

1. Introductory comments
2. Governance and Oversight
3. Prudential risk management
4. Wind-down plans
5. Q&A

Governance and Oversight

Senior Management Decision-making and Organisational structure

The FCA's July 2020 letter to CEOs emphasised the importance of senior management establishing sound governance frameworks to manage and regularly review the risks to which the firm is exposed.

*As a condition of authorisation, firms must have robust governance arrangements, including a clear **organisational structure** with **well-defined, transparent** and **consistent lines of responsibility.** The FCA describes governance as the procedures used in the decision-making and control of the business that provides its **structure, direction and accountability**.*

The following are features of well-managed and comprehensive risk frameworks:

Lines of Defence

1st — Documented measures to identify and control risk

- Senior managers should maintain **risk taxonomies** that are tailored to their organisation and **document the rationale for mitigation policies**.
- Regular business unit testing and standardised **risk and control self-assessments** are helpful to identify vulnerabilities.
- It is good practice for first line operational and finance committees to **regularly review management information** (including Key Risk Indicators), **record decisions** and **oversee changes to policy and procedural documentation.**

2nd — An independent risk management function

- If you operate a large and complex business, it is likely to be appropriate to operate an independent risk management function.
- The function will advise on compliance standards and interpretation of regulations, and should execute a compliance monitoring programme.
- **Risk and compliance committees** are instrumental in challenging the effectiveness of systems and controls. Their members and remit should be clearly outlined in **terms of reference**.

3rd — A well-established audit plan

- The plan should have adequate coverage of the company's risk management processes across front and back-office operations.
- **Making recommendations to address any deficiencies found** and verify their remediation.
- The **audit committee** has an important role in supervising conduct internally and safeguarding the risk management function's independence and authority.

Principles for businesses

- **Integrity.** A firm must conduct its business with integrity.
- **Skill, care and diligence**. A firm must conduct its business with due skill, care diligence and diligence.
- **Management and control.** A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management and systems
- **Customer interests.** A firm must pay due regard to the interests of its customers and treat them fairly.

Prudential risk management

Managing Prudential Risks

The FCA's temporary guidance for Payment firms reflects their increased scrutiny of the industry's risk management capabilities and concerns about financial resilience given the current stress situation.

Drivers to review approach

- *Coronavirus and safeguarding customers' funds: additional guidance for payment and e-money firms and Dear CEO letter*
- *FCA Cross-firm Review of Prudential Risk and 2020/2021 FCA Business Plan*
- *FG 20/1 FCA's Framework for assessing adequate financial resources*

Key Focus Areas for firms to review

Risk Management

- Whether firms' risk management capabilities and control environment is commensurate with the risk they run
- Whether firms have proper risk assessment process in place, including determination of materiality
- Adequate risk management framework documentation to define roles and responsibilities and approach to identification, assessment, management, monitoring and reporting of risk

Capital

- Accuracy of capital calculations and the methodology used for calculation of requirements (Method A, B, C or D)
- Assessing that firms' capital resource calculations are in line with complex CRR requirements
- Performing capital adequacy assessments and capital planning to include the risk of intra-group exposures
- Use of robust stress and scenario testing to assess risks to capital

Liquidity

- Use of robust stress and scenario testing to identify and quantify risks to liquidity and determine risk appetite
- Assessment of sources and uses of funding and any forecasted funding issues
- Assessment of the management actions available to firms during stress periods (committed lines etc.)
- Documentation of liquidity risk management and contingent funding options

Common issues across themes

Governance

Poorly defined governance & committee structures at legal entity level which lack a risk mind-set/don't provide credible challenge

Stress Testing

Inadequate use of stress testing to inform the identification of risks, risk appetite statements, capital/liquidity planning and improve controls

Intra-group risk

Lack of adherence to the regulatory perimeter with respect to financial resources, risk management and governance

Wind-down plans

Wind-down Planning

The FCA expects firms to demonstrate that they have sufficient financial resources available to wind-down the business with minimal disruption to customers and counterparties.

	Requirement	What this means for you
Funding	• To cover the solvent wind-down of the firm, Funding including the return of all customer funds	• Firms need to calculate the capital and liquidity they require to pay for the costs of the wind-down. This means producing a detailed model of wind-down, incorporating all the envisaged costs on a monthly basis in both a solvent and insolvent scenario. The outcomes will inform the firm and regulator of the likely minimum capital and liquidity required at the start of wind-down.
Triggers	• Realistic triggers to start a solvent wind-down and seek advice on entering an insolvency process	• A robust indicator framework and associated triggers helps management and the board decide when to formally consider entering into wind-down, or even entering insolvency. The indicators should cover a wide range of scenarios and the triggers be configured at points where there would be serious doubts about the firm's viability.
Counterparties	• The need for any counterparties (i.e. merchants) to find alternative providers	• Certain clients may be reliant upon the service you provide and to minimise any secondary impact of wind-down, they must be given sufficient time to identify alternative suppliers. Where possible, you should support the transfer of business to the alternative provider.
Information	• Information which would help an administrator or liquidator to quickly identify customer funds and return them as a priority	• The wind-down plan should identify where the information on customers' funds is stored and how it can be accessed. The underlying data itself should be stored in a format that can be easily-understood and used by a third party as part of wind-down. Any additional information that would be helpful to the administrator (e.g. systems, key supplier contracts) should also be made easily-available.

Identify key risks & scenario selection

Identify severe but plausible scenarios that could lead to the business needing to enter wind-down, based on the key risks that the firm faces.

Indicators & triggers

Develop an indicator framework based around identified risks that can identified when a risk is crystallising and provide a trigger to consider entering wind-down.

Governance

Develop a wind-down governance structure formalise the process by which a decision to wind-down is escalated, agreed, by whom and at what point.

Operational plan

Develop the operational plan, detailing what will happen and when, from the announcement, to the return of client funds and the cancellation of permissions.

Financial model

The financial model should be based on the operational plan, and calculate the net costs of wind-down on a monthly basis and detail available capital and liquidity.

Q&A

Deloitte.

Designed by CoRe Creative Services. RITM0510913