

Regulators propose resilience measures for critical third parties

AT A GLANCE

July 2022

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What's new?

- The BoE, PRA and FCA [published](#) a joint Discussion Paper (DP) on 21 July 2022, proposing measures to support the resilience of services provided by critical third parties (CTPs) to the UK financial sector.
- The [Financial Services and Markets Bill](#) (FSMB) was laid by the UK Government on 20 July 2022, and sets out a statutory framework to manage systemic risks from third party service providers (such as Cloud services and data analytics). The FSMB provides HM Treasury (HMT) with the power to designate certain providers as 'critical' in the event that disruption of their services could create financial stability risks. The FSMB also grants the UK supervisory authorities powers to oversee the material services provided by CTPs to the UK financial sector. The joint DP sets out how the UK supervisory authorities propose to use these powers to reduce the systemic risks posed by CTPs to their supervisory objectives.

What does this mean?

- The regulators acknowledge the benefits offered by third party services to firms' business models (which in turn can support supervisory authorities' objectives), but also underlines the potential risks in relation to the impact of potential disruptions on firms' resilience and wider market stability. The proposals presented in the DP build on the evolving UK regulatory approach towards firms' [operational resilience](#) and [third-party outsourcing policy](#).
- The DP proposes several measures to support oversight of designated CTPs by UK supervisory authorities. These include a framework for supervisory authorities to identify potential third party providers as critical, ahead of their formal designation by HMT: minimum resilience standards that would apply to services provided by designated CTPs; and a framework to test CTP service resilience, including scenario testing and Skilled Person reviews of CTPs. This regime will allow the relevant supervisory authority to directly oversee the services provided by CTPs to regulated firms.
- On the identification of potential CTPs, the FSMB proposes that HMT would consider the materiality of the services that the third party provides to firms and the concentration of firms to which such services were provided, as the basis for designating a third party as critical. On materiality, the DP proposes that UK supervisory authorities would consider whether a third party provided key economic or critical functions, classified in the DP. On concentration, the DP proposes that supervisory authorities consider the number, type and significance of firms that rely upon a specific third party for material services.



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- The DP also recommends that supervisory authorities consider the potential impact of service disruption or failure on their objectives, as well as assessing aggregation risk and service substitutability/ survivability.
 - In relation to minimum resilience standards, the regulators propose that designated CTPs would have to ensure that any material services they provide to firms meet these standards at all times. The DP proposes that the set of standards would include the identification of material services; the mapping of service delivery supply chains and appropriate risk management controls; regular resilience testing; active engagement with supervisory authorities; development of a financial sector continuity playbook and a post-incident communication plan; and demonstration of active learning and evolving practice from disruption incidents
 - The DP proposes that supervisory authorities establish a testing framework for CTPs, in order to gain assurance towards service resilience. On specific testing tools, the regulators propose a requirement for CTPs to conduct regular scenario testing of their ability to continue service provision in the context of severe disruption, as well as cyber-resilience testing. The DP also proposes that supervisory authorities pursue sector-wide testing exercises to test the ability of the UK financial services sector to respond to severe operational incidents, and use Skilled Person reviews to gather information from CTPs, assess their compliance with supervisory requirements, and to support enforcement monitoring.
 - The regulators also recommend ways to strengthen global regulatory and supervisory coordination to manage the systemic risks posed by CTPs, including the articulation of a global methodology to identify CTPs and global resilience standards to manage potential cross-border risks.
- ### What do firms need to do?
- The DP underlines that firms are still expected to meet current regulatory requirements in relation to their operational resilience framework, in parallel to the proposals towards CTPs. Therefore given the strengthening regulatory focus on the role of third party service providers, firms should therefore consider their dependencies in these areas, particularly as the proposals do not preclude firms from conducting their own assurance.
 - For firms which provide third party services to regulated financial institutions, the regulators' proposals are likely to bring such provision of services into scope of the UK's financial regulatory framework. Therefore firms will need to consider the operational impact of these proposals, as well as potential implications for their wider market strategy. Operational resilience has been a key focus for UK regulators in recent years and there will be considerable lessons for CTPs to learn from the experience of FS firms.

Next steps

Respondents have until 23 December 2022 to comment on the DP, after which the UK supervisory authorities will consult on their proposed rules and expectations in 2023.

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