Consultation Paper

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Financial Services Authority

Financial resources requirements for Recognised Bodies

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FSA®

Financial Services Authority

Contents

	Abbreviations used in this paper	3
1	Overview	5
2	The function of capital	9
3	The standard approach to operational risk	11
4	A risk-based approach	15
5	The charateristics of eligible capital	28
6	Scope and implementation	31

Annex 1: Stress and scenario testing
Annex 2: Overview of final FRR calculation
Annex 3: Cost-benefit analysis
Annex 4: Compatibility statement
Annex 5: List of questions

Appendix 1: Draft Handbook text

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The Financial Services Authority invites comments on this Consultation Paper. Comments should reach us by 6 January 2012.

Comments may be sent by electronic submission using the form on the FSA's website at: www.fsa.gov.uk/Pages/Library/Policy/CP/2011/cp11_19_response.shtml.

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Abbreviations used in this paper

CBA	Cost benefit analysis
CCP	Central counterparty
CP	Consultation Paper
CRD	Capital Requirements Directive
DCM	Designated Contract Market
DCO	Derivatives Clearing Organisation
EMIR	European Regulation on OTC derivatives, central counterparties and trade repositories
ICG	Individual capital guidance
MTF	Markets in Financial Instruments Directive
MTF	Multilateral trading facility
RCH	Recognised Clearing House
RIE	Recognised Investment Exchange
The Commission	European Commission

1 Overview

Introduction

1.1 In this paper, we are consulting on modifications to the guidance we provide to Recognised Bodies, in relation to the financial resources we expect a Recognised Body to hold to help mitigate its operational and other risks.

The current regulatory framework

1.2 The current financial resources requirements for Recognised Bodies, comprising Recognised Investment Exchanges (RIEs) and Recognised Clearing Houses (RCHs), are currently set by HM Treasury through Recognition Requirements. The relevant Recognition Requirement for an RIE states that:

(1) The exchange must have financial resources sufficient for the proper performance of its functions as a recognised investment exchange.
(2) In considering whether this requirement is satisfied, the Authority must (without prejudice to the generality of regulation 6(1)) take into account all the circumstances, including the exchange's connection with any person, and any activity carried on by the exchange, whether or not it is an exempt activity.

1.3 The same Recognition Requirement applies to a Recognised Clearing House. We have adopted guidance[1], which elaborates upon this requirement, by setting out the principles we will take into account when determining whether the Recognition Requirement has

1 See Chapter 2.3 of REC.

been satisfied. REC establishes the principle that the holding of financial resources equal to six months operating costs will ordinarily be deemed sufficient to meet the Recognition Requirements (known as the 'standard approach'). The standard approach is discussed further in Chapter 3.

1.4 In the context of RIEs, the Recognition Requirement serves to implement Article 39(f) of the Markets in Financial Instruments Directive (MiFID), under which the UK must require a Regulated Market[2]: 'to have available, at the time of authorisation and on an ongoing basis, sufficient financial resources to facilitate its orderly functioning, having regard to the nature and extent of the transactions concluded on the market and the range and degree of the risks to which it is exposed'.

1.5 These requirements began in 2001, with the implementation of the Financial Services and Markets Act 2000. Since then, we have developed further supervisory practices to support the objectives of REC. In particular, we have made supervisory arrangements with the Recognised Bodies intended to ensure that we can monitor the headroom provided by the actual financial resources of a Recognised Body, relative to the financial resources requirement (known as the 'liquidity buffer'). The liquidity buffer is discussed further in Chapter 4.

The purpose of the review

1.6 When we introduced REC 2.3, we noted that: '…in view of the special position of recognised bodies in the Act, their systemic importance as providers of market infrastructure and the regulatory objectives (as set out in section 2 of the Act), it is appropriate that the financial standards recognised bodies have to meet should be set conservatively. The FSA would expect to review the position in the light of the conclusion of international work on the capital and other standards for financial institutions currently being conducted under the auspices of the Basel Committee on Banking Supervision'.[3]

1.7 The evolution of the market landscape since 2001 underlines the need for this review. Since REC was introduced, the regulatory and competitive environment in which Recognised Bodies operate has changed considerably. Market infrastructure providers have, largely, transformed from mutual organisations into fully commercial enterprises that, alongside new categories of service provider such as multilateral trading facilities (MTFs), compete in global financial markets to develop their businesses.

1.8 In conjunction with these market developments, and guided by experience of the global financial crisis, considerable further work has been undertaken under the auspices of Basel, IOSCO and the EU in relation to the prudential regulation of financial institutions and infrastructures. In the EU context, the prudential obligations of UK MTFs, as authorised firms, are set according to the appropriate classification under FSA rules giving effect to the

2 As defined by Article 4(14) of MiFID.
3 Policy Statement 39, April 2001.

Capital Requirements Directive (typically as a limited activity or a limited licence firm under BIPRU). In addition, RCHs which fall within the definition of a central counterparty (CCP) will, in due course, be subject to detailed and maximum harmonising organisational, prudential and conduct requirements under a proposed European Regulation on OTC derivatives, central counterparties and trade repositories (EMIR).[4] Further, RCHs which are central securities depositories are expected to fall within the scope of European CSD legislation, in due course.

1.9 In the international context, it is noted that CPSS-IOSCO has consulted on a comprehensive set of revised principles for the regulation of Financial Market Infrastructures, capturing payment systems, central securities depositories, securities settlement systems, central counterparties and trade repositories (the FMI principles). The FMI principles include proposed minimum requirements with respect to the own financial resources of an FMI. In addition, US regulators have consulted on rule-makings under the Wall Street Reform and Consumer Protection Act[5] (the 'Dodd-Frank Act') regarding, among other things, the financial resources requirements that apply to Designated Contract Markets (DCMs) and Derivatives Clearing Organisations (DCOs). They have elaborated on Core Principles applying to those market infrastructures under the Dodd-Frank Act.

1.10 So, in light of the market and regulatory developments described above, we have reviewed REC 2.3 to ensure that it remains appropriate to give full effect to the Recognition Requirements and, in the case of a UK RIE, that it continues to reflect the obligations of a Regulated Market under MiFID. In addition, we believe there is an opportunity to consider enhancing to REC to help CCPs prepare for their future obligations under EMIR.

1.11 While the financial crisis did not expose any critical weaknesses in the current regime, we consider that REC needs to be modernised in response to the significant developments in the market infrastructure landscape since its creation. This conclusion is underlined by the contrast between REC and the other prudential regimes discussed in this paper. In our review, we have also considered the market benefits of increased competition, and the associated willingness to take risks (within an appropriate control environment) to drive innovation, as well as the need to ensure that the financial resources requirement does not stifle competition by establishing undue barriers to entry.

Summary of proposals

1.12 We have identified some amendments to REC 2.3 to meet the objectives outlined above. In summary, we propose to:

4 According to a proposal published by the European Commission on 15 September 2010, 2010/0250 (COD). References to EMIR in this document are references to the text consulted on by the Commission.

5 Pub.L. 111-203

a) make it clearer what regulatory capital is for;

b) strengthen the 'standard approach' as an objective proxy for the cost of orderly closure by standardising the meaning of 'operating expenses';

c) set the 'standard approach' as a floor to the financial resources requirement, by not allowing alternative bespoke arrangements;

d) replace existing supervisory practices in relation to the use of a 'liquidity buffer' with specific risk-based processes, designed to ensure that a Recognised Body is adequately protected against business losses likely to arise in stressed but plausible market conditions; and

e) introduce guidance on measuring group risk as a component of the financial resources calculation.

1.13 The proposals set out in this Consultation Paper will principally be of interest to RIEs and RCHs. They are intended to address the own capital requirements of a Recognised Body arising from its position as a business enterprise. They are not intended to address the risks that arise as a result of the role of a RCH as a counterparty to transactions, and which involve the holding of participant capital.

Next steps

1.14 In light of consultation responses, and subject to FSA Board approval, we expect to finalise the proposals in this CP by making guidance in the first half of 2012. We will publish a Policy Statement, including feedback on the responses to the consultation.

2

The function of capital

2.1 The principle that should guide the detailed design of financial resources requirements is an understanding of the function that regulatory capital is intended to perform.

2.2 Our proposals that led to the introduction of REC 2.3 (CP39, January 2000) recognised that regulatory capital should play a dual role in the context of Recognised Bodies. CP39 stated that: 'These standards are designed respectively to ensure sufficient finance to cover a prudent estimate of the time required to wind up a recognised body or to transfer its business to another institution and to reduce the likelihood of failure by UK recognised bodies'. This dual role is reflected in our guidance on operational risk (in REC 2.3.6), which states that the purposes of capital include:

> …
>
> (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.

2.3 Consequently, the financial resources of a Recognised Body are intended both to mitigate risks to its position as a going concern (and support its ability to carry on properly the regulated activities involved in the provision of its services to market participants) and to enable the Recognised Body to resolve its business in an orderly manner, thereby minimising disruption to market participants (often referred to as the 'gone concern' function).

2.4 These objectives continue to be appropriate, in light of the level of systemic importance of each category of Recognised Body in today's financial markets.

2.5 The view that Recognised Bodies are, to a degree, systemically important is reflected in the regulatory permissioning architecture of FSMA. Recognised Bodies possess a distinct regulatory status, under Part 18 of FSMA, and (unlike their members) are exempt from the requirement to be authorised in relation to the regulatory activities they perform. The government has confirmed that the recognition regime through which exempt person status is conferred will be preserved as part of the UK's program of regulatory reform.

2.6 This position is also underlined by the centrality of the role that Recognised Bodies play in UK markets, both where they act as a central counterparty to market transactions and as a provider of exchange services, including access by issuers to global capital markets. The role of central counterparties and organised trading venues, such as RIEs, is set to increase under commitments by G20 leaders to impose a clearing obligation upon market participants for certain derivatives products (to be implemented through EMIR), and to promote greater use of organised platforms for the trading of standardised derivatives where appropriate, by means of the MiFID review.

2.7 It is also notable that both the FMI Principles, and the current form of EMIR, envisage that regulatory capital should fulfil a going concern objective, in the context of CCPs. Principle 15 of the FMI principles, with regard to measures to address the business risks of an FMI, specifies that it should: '…hold sufficiently liquid net assets funded by equity to cover potential general business losses so that it can continue providing services as a going concern'. This is reinforced by Article 12 of EMIR, as currently drafted, which specifies that a CCP should hold sufficient regulatory capital to ensure that it '…is adequately protected against operational and residual risks'.

2.8 However, particularly in the case of RIEs (whose services are arguably more easily substitutable given the emergence of other types of trading platform following the implementation of MiFID), it is not thought that these institutions are too big to fail, or that orderly resolution over an appropriate period would not be achievable. While, accordingly, capital requirements might be designed to embed financial resilience in market infrastructure, it would be inappropriate to aspire to the outright prevention of any business failure.

2.9 So, our proposals are designed to ensure that the detailed arrangements embedded in REC 2.3 continue to be sufficient to fulfil the dual functions discussed in this section, reflecting the benefits of Recognised Bodies continuing to operate as sustainable businesses. At the same time, the arrangements must continue to recognise that REC does not represent a zero-failure regime – and therefore make provision to ensure a Recognised Body is able to achieve an orderly wind-down if necessary.

Q1: Do you agree with this assessment of the function of capital in the context of Recognised Bodies?

3 The standard approach to operational risk

3.1 Here, we consider whether the detailed arrangements embedded in REC 2.3, as they have been applied in practice, are sufficient to give full effect to the dual objectives of capital discussed in the previous chapter – to provide a sound basis for orderly wind-down while seeking to reduce the likelihood of business failure.

3.2 In that context, REC 2.3.7 sets out a 'standard approach', which serves as a proxy for the measurement of operational and other risks. The standard approach is widely adopted among the community of Recognised Bodies as the minimum financial resources requirement, and specifies that:

> 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.

3.3 Adopting a proxy to calibrate a financial resources requirement is common to a number of existing and emerging prudential regimes for market infrastructure, as illustrated by the table below:

Table A: The use of proxies in financial resources requirements

Type of infrastructure	Business/operational risk proxy	Source of requirement
Payment systems, central securities depositories, securities settlement systems, central counterparties and trade repositories	At a minimum, an FMI should hold equity capital at normal times equal to [six, nine, or twelve] months of expenses	CPSS-IOSCO draft principles for Financial Market Infrastructures
Multilateral trading facilities (limited licence or limited activity BIPRU firm)	The 'fixed overheads requirement' (one quarter of the firm's relevant fixed expenditure), subject to €730,000 base	GENPRU 2.1.45
Designated Contract Markets, Derivatives Clearing Organisations (US)	The DCM/DCO must maintain sufficient financial resources to cover its operating costs for at least one year, calculated on a rolling basis	CFTC draft rule-makings under Dodd-Frank

3.4 In principle, the standard approach appears to have served as an effective proxy for operational and other risks. Conceptually, as a measure linked to a pre-determined proportion of operating costs reflecting a given period of trading, it also appears to be in line with international practices in relation to other types of market infrastructure. Further, six months appears to be a reasonable timeframe to achieve an orderly wind-down in most cases. While the six-month period is more conservative than the equivalent period applicable to an MTF operator classified as a limited licence/limited activity firm, the activity of operating a Regulated Market could be more complex (for example, typically involving a primary market function with a different user set). Also, this approach positions REC within (though at the lower end of) the scale proposed by CPSS-IOSCO, in relation to the minimum prudential obligations of FMIs. So, in the context of the proposal to strengthen the definition of operating costs, as discussed below, we propose to retain the six-month period for the standard approach.

Q2: Do you agree that it is appropriate to retain a standard approach based on six months of operating costs?

3.5 REC elaborates upon the rationale for the standard approach through guidance that: '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)'. Currently, therefore, the focus of the standard approach is upon a gone concern objective.

3.6 This focus is reflected in guidance offered by REC on how operating costs may be calculated. REC specifies that: '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'. This basis of calculation recognises that variable costs incurred in the ordinary course of business may be eliminated or reduced during an orderly wind-down. In practice, many Recognised Bodies using the standard approach apply a discount (which in some cases represents a material proportion of operating expenses) reflecting the likely adjustment to the cost base that would be possible in a gone concern context (e.g. excluding travel or marketing costs).

3.7 The ability to exclude variable costs linked to the exempt activities of a Recognised Body is seen to raise a number of difficulties. In practice, Recognised Bodies have taken different views in relation to the nature and extent of the savings that could be made during an orderly wind-down. Such inconsistencies have arguably eroded the value of the standard approach as a firm and objective proxy. In addition, it is likely that reductions in discretionary costs would be offset, at least to some extent, by exceptional costs that would be necessary to properly administer an orderly wind-down process (for example, those relating to professional services, staff severance/retention or run-off of contractual commitments). However, REC currently makes no provision for this.

3.8 In addition, the ability of a Recognised Body to fund the expenses it expects to incur as a going concern for the next six months would help to ensure the sustainability its services. Accordingly, a standard test of the capital requirement which reflects the needs of a Recognised Body as an ongoing business would be consistent with the objective of reducing the probability of business failure. The FMI principles do not envisage permitting deductions from operating expenses.

3.9 So we propose amending the basis for calculating operating costs so it includes both fixed costs and variable costs incurred while performing exempt activities. However, the deduction of non-cash costs, such as depreciation, would still be permitted under the new approach.

> **Q3:** Do you agree that variable costs incurred in the course of performing exempt activities should be included in the calculation of operating costs?

3.10 Currently, Recognised Bodies are not obliged to apply the standard approach when calculating the financial resources requirement. In clarifying that we are prepared to consider alternative approaches, REC states that: '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'. In practice, a limited number of Recognised Bodies have adopted bespoke arrangements under this provision, based on individually agreed methodologies.

3.11 Accordingly, the standard approach does not currently serve as a 'floor' to the financial resources requirement and it is possible for a Recognised Body to hold less than six months of operating expenses as regulatory capital (where this is supported by a bespoke methodology). This position contrasts with the comparable regulatory frameworks described above, where it is common for the proxy to act as a minimum requirement. Multilateral trading facilities, financial market infrastructures and DCMs and DCOs could not meet minimum standards under the applicable prudential regime unless they held the financial resources specified by the proxy for operational/business risk.

3.12 A minimum requirement linked to operating expenses is seen to retain flexibility, since the requirement will be sensitive to the size and stage of development of the business in question, and adjust over time according to business growth or increased operational efficiency. So on this basis, we propose to make it clear that we regard the standard approach as a reflection of the minimum capital necessary to meet the Recognition Requirement, and to remove REC 2.3.9 with respect to the possibility of alternative approaches.

Q4: Do you agree that REC 2.3.9 should be removed?

4 A risk-based approach

4.1 In principle, the calibration of the financial resources requirement should take into account the particular risks to which the business of a Recognised Body is exposed. This is reflected, for example, in the requirements for Regulated Markets under MiFID, which explicitly specify that reference should be made to the 'degree of the risks to which [the Regulated Market] is exposed'. In the FSA's view, the particular risk profile of a Recognised Body could justify the holding of capital above its cost of orderly closure, where otherwise funds allocated to orderly closure would be placed at risk as a result of the possibility that the Recognised Body could suffer financial stress. A risk-based approach would help to achieve the objectives of the regulatory capital regime by embedding an appropriate degree of financial resilience in the UK's market infrastructure, such that capital adequacy was maintained in both normal and stressed market conditions.

4.2 As discussed above, since REC was introduced, we have developed supervisory practices that allow us to monitor the level of headroom provided by the actual financial resources of a Recognised Body, relative to its financial resources requirement under the standard approach. This is usually in the form of a 'liquidity buffer', where we would expect to more intensively supervise a Recognised Body if its financial resources provided less than 1½ times cover of its financial resources requirement. This gives us the ability to intervene at an early stage, where we identify a downward trajectory in the financial position of a Recognised Body that might jeopardise future compliance with the standard approach. In addition, the headroom represented by the liquidity buffer reinforces the ability of a Recognised Body to absorb shocks encountered in the course of its business without prejudicing its ability to undertake an orderly wind-down.

4.3 Other prudential regimes take a different, and more precisely calibrated, approach to determining the appropriate final level of regulatory capital. The FMI principles specify that, regardless of the level of the minimum requirement, 'an FMI may also need to hold additional equity capital, taking into account its general business risk profile'. In that context, the FMI principles envisage that an FMI will need to develop an internal process to identify, measure and monitor its business risks, so it is in a position to assess whether additional financial resources might be necessary. The FMI principles state that:

> …An FMI should assess and thoroughly understand its business risk and the potential effect that this risk could have on its cash flow, liquidity, and capital positions. Although it is difficult to specify or quantify, an FMI should also consider the likelihood of potential adverse effects on its revenue or expenses and the impact of those potential effects.
>
> …In identifying and assessing business risk, an FMI should consider a combination of tools, such as risk management and internal control assessments, scenario analysis, and sensitivity analysis. Internal control assessments should identify key risks and controls, and assess the impact and probability of the various risks and the effectiveness of controls.

4.4 Further, under capital requirements for authorised firms, multilateral trading facilities are required to perform individual risk assessments. Known as the overall pillar two rule, an MTF must: 'have in place sound, effective and complete processes, strategies and systems… to assess and maintain on an ongoing basis the amounts, types and distribution of financial resources, capital resources and internal capital that it considers adequate to cover…the nature and level of the risks to which it is or might be exposed…'. The pillar two assessment needs to consider a range of categories of risk specified by GENPRU, including (most notably in the context of an MTF) operational, business and group risk.

4.5 It is also noted that, while the CFTC rules do not require an additional risk assessment when calculating the financial resources requirement, the relatively conservative one-year period is seen to dovetail with accounting principles in relation to the going concern status of a business. The draft CFTC rules state that: 'the one-year period also is consistent with established accounting standards, under which an entity's ability to continue as a going concern comes into question if there is evidence that the entity may be unable to continue to meet its obligations in the next 12 months without substantial disposition of assets outside the ordinary course of business, restructuring of debt, externally forced revisions of its operations, or similar actions'.

4.6 It appears, in this context, that our guidance in REC should provide for the possibility that the nature of the risks to which a particular Recognised Body is exposed could justify a financial resources requirement above the cost of orderly closure.

4.7 Two options appear to be available to meet this objective:

Option A: financial risk assessments

Under this approach, Recognised Bodies would develop and apply financial risk assessments, as a way of quantifying an appropriate amount of capital to cover financial stress. Such assessments would measure the specific financial exposures of a Recognised Body in stressed but plausible market conditions, which could justify the holding of

regulatory capital over and above the cost of orderly closure. This would be conceptually similar to the processes envisaged by CPSS-IOSCO and embedded in the overall pillar two rule, and be based on stress and scenario testing.

Under such an approach, a Recognised Body would need to consider the risks to which it was exposed that involve a financial impact (i.e. an increase in cost or reduction of revenue against expectations), so that in certain market conditions costs could exceed revenues requiring a loss to be charged against capital (a 'business loss'). The Recognised Body would satisfy the financial resources requirement if it held enough financial resources to absorb the potential business losses specifically attributable to the risks it incurs and accepts as a going concern, in addition to those necessary to cover the cost of orderly closure.

Option B: formalise the liquidity buffer

As an alternative to financial risk assessments, a Recognised Body could be expected to hold financial resources representing a pre-determined level of cover of its financial resources requirement indicated by the standard approach. This would provide a Recognised Body with the capability to absorb shocks arising from adverse events or circumstances experienced in the ordinary course of business, without prejudicing its ability to conduct an orderly wind-down. In line with current supervisory practices, the specified headroom relative to the standard approach could be set at 50%, as a level of cover that has appeared to be effective previously. In addition, such a liquidity buffer could be positioned as either a core component of the financial resources requirement (in effect, modifying the proportion of operating costs representing the minimum requirement to nine months). Or it could be a separate arrangement that the Recognised Body could access where necessary, as long as there was close engagement between us and it, to understand the reasons for the action and the steps proposed to restore the buffer to the specified level. These possibilities are discussed further below.

Financial risk assessments

Method of calculation

4.8 To support this regime, we would introduce specific guidance to REC, intended to give Recognised Bodies a framework for developing financial risk assessments that are proportionate and effective. We expect the key elements of this framework to be consistent, in principle, with the approach under BIPRU 2.2, with respect to the internal capital adequacy standards of a BIPRU firm. This would include:

- An assessment of the material financial risks the Recognised Body is exposed to in light of the nature, scale and complexity of its operations. It could use its existing

risk-management tools under REC 2.5.6[6] as opposed to any separate categorisation of risk in REC. This would incorporate any new risks, or changes to the impacts/probabilities of existing risks, arising from its current business development plans (such action should be enshrined in the current risk-management process of a Recognised Body).

- The development of a stress and scenario testing plan, covering a forward-looking period of at least one year, designed to provide a reasonable estimate of the likely business losses (if any) if the risks identified in the assessment were to materialise (in the form of pre-defined stress events with a given severity and duration, allowing for realistic management actions to resolve such events). There is further discussion of the anticipated structure and format of a stress and scenario testing plan in **Annex 1**.
- A decision on the amount of capital it would be appropriate for the Recognised Body to hold to cover such potential business losses, to give it the necessary shock absorbance capabilities in stressed but plausible market conditions.
- A proposal for the amount of financial resources assessed to be equal to the Recognised Body's financial resources requirement under the risk-based approach. Such proposals would comprise:

  I. the capital assessed to be necessary to absorb the potential business losses attributable to financial shocks, as quantified through stress and scenario testing; and

  II. the Recognised Body's cost of orderly closure.[7] In this context, we propose that a Recognised Body either adopts the standard approach as a proxy for the cost of orderly closure, or provides an individual calculation of such costs based on a tailored scenario plan. We think this is appropriate given that the standard approach, as amended, may be regarded as too inflexible a measure of the cost of orderly closure. However, we would expect to closely scrutinise a bespoke estimate of the cost of orderly closure which was below the figure produced by the standard approach, to ensure that the Recognised Body had made a rigorous and prudent assessment of the full range of costs associated with such a process.[8]

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6 Under REC 2.5, a Recognised Body must already operate systems and controls for assessing and managing risk, in line with the below guidance:

In assessing a UK recognised body's systems and controls for assessing and managing risk, the FSA may also have regard to the extent to which these systems and controls enable the UK recognised body to:

(1) identify all the general, operational, legal and market risks wherever they arise in its activities;

(2) measure and control the different types of risk;

(3) allocate responsibility for risk management to persons with appropriate knowledge and expertise; and

(4) provide sufficient, reliable information to key individuals and, where relevant, the governing body of the UK recognised body.

7 We are not proposing to permit a Recognised Body to 'double count' eligible capital against the business loss element of the risk-based approach and its cost of orderly closure. If double counting were to be permitted, the effect of a financial shock could be to leave a Recognised Body with insufficient funds to undertake an orderly wind-down, which is not considered to be in line with the objectives of the Recognition Requirements.

8 It is unlikely to be acceptable for a Recognised Body to use the figure currently produced by the standard approach, before the modifications proposed by this CP, as a bespoke estimate of the cost of orderly closure. As discussed elsewhere in this CP, such an approach would not include the specific costs necessary to properly administer an orderly wind-down that are not incurred in the ordinary course of business.

4.9 Under this regime, the standard approach would represent a floor to the financial resources requirement. Accordingly, the final requirement would be the higher of the amount produced by the standard approach, and that produced by adding the two components of the financial risk assessment. We have given an overview of how the final financial resources requirement would be calculated under the new regime in Annex 2.

Reporting and supervision

4.10 We propose that Recognised Bodies should carry out the financial risk assessment at least once a year, and report it to us in line with an agreed timetable that would dovetail with its financial reporting calendar. We also propose that, where necessary, a financial risk assessment may be reviewed more frequently, e.g. to respond promptly to a fundamental change to the business of a Recognised Body, or to its operational environment, which suggested its financial resources requirement no longer adequately reflected its business risks.

4.11 We would consider and challenge the outcomes generated by financial risk assessments, and their underlying methodologies.[9] As part of this process, we would expect to issue individual capital guidance (ICG) to each Recognised Body, with respect to its view of the amount and quality of capital resources that it should hold at all times.[10] Where our view of the financial resources necessary to satisfy the Recognition Requirements was different to the proposal made by a Recognised Body, we would seek to discuss the reasons for such differences with the entity concerned.[11]

4.12 We expect to oversee compliance with the new regime in line with the existing framework of close and continuous, risk-based supervision outlined in REC 4.[12] We recognise that circumstances may arise where a business risk anticipated by the financial risk assessment of a Recognised Body materialises, which temporarily reduces the eligible capital of a Recognised Body below the level we specified in its ICG. In our view, where such reduction was commensurate with the amount of capital allocated to the relevant risk by the Recognised Body (such that it's eligible capital continued to exceed the standard approach, assuring it's continued ability to conduct an orderly wind-down), this would be an example of the prudential regime functioning efficiently, in line with the intended uses of regulatory capital. Accordingly, our supervisory actions in this scenario would focus on ensuring that the Recognised Body concerned had a plan to restore the amount of its regulatory capital to the level required by its ICG in a reasonable timeframe. In all cases, our supervisory approach will be guided by the ongoing ability of a Recognised Body to fully satisfy the objectives of the prudential regime and the nature of any risks to market confidence. We believe it unlikely that those objectives could be met unless a Recognised Body always held, as eligible capital, the amount indicated by the standard approach.

9 To be set out in REC. This could be conceptually similar to the SREP process described in BIPRU 2.2.9
10 This would be similar to individual capital guidance issued to a firm under BIPRU 2.2.12.
11 We could take a different view for several reasons, including identified weaknesses in the design or application of the risk assessment suggesting it may not be a rigorous evaluation of potential business losses in stressed but plausible market conditions.
12 Under which, among other things: 'The FSA expects to have an open, cooperative and constructive relationship with UK recognised bodies to enable it to have a broad picture of the UK recognised body's activities and its ability to meet the recognition requirements'.

Discussion

4.13 An individually tailored financial risk assessment offers several advantages. It would, arguably, allow financial resources requirements to be calibrated with greater degree of precision, reflecting the actual risk profile of each Recognised Body and giving appropriate credit for systems, processes and controls designed to mitigate or transfer business risks. It would also build upon risk-management processes deployed by a Recognised Body to meet its obligations under REC 2.5.6, to create an appropriate control environment for the performance of its activities.

4.14 We recognise that developing models allowing sufficiently precise quantification of financial exposures arising from the diverse sources of business risk may be challenging.[13] In addition, the first line of defence for a Recognised Body against the particular risks to which its businesses is exposed will most frequently (and appropriately) be a robust system of processes and controls (for example, in the form of business continuity plans). However, the prudential regime can fulfil a critical supporting role in ensuring that a Recognised Body also considers whether capital is an appropriate component of its overall approach to risk mitigation, as an ongoing business.

4.15 Consistent with the existing prudential regime for both MTFs operated by investment firms, and the expected future regime for CCPs, we consider that regulatory capital requirements should be calibrated according to the specific risks posed to the ongoing viability of a Recognised Body. Consequently, we strongly prefer Option A. The risk of imprecise quantification of business risk under this option would be mitigated by the parallel calculation of the standard approach, which would serve as a floor to the financial resources requirement.

A formal liquidity buffer

4.16 A formal liquidity buffer to supplement the standard approach would have the advantage of ensuring a greater degree of consistency across the population of Recognised Bodies, and it would not be necessary for financial risk assessment methodologies to be developed. However, a formulaic approach would lack the precision of Option A and is not as well aligned with international principles for financial market infrastructures.

4.17 The possibility of a formal liquidity buffer raises the additional question of whether this should be treated as a core element of the financial resources requirement (a change to current supervisory practices), or alternatively as something akin to the capital planning buffer under BIPRU 2.2.12A. The capital planning buffer, known as the Pillar 2B rule, operates separately from the minimum financial resources requirement (and can

13 Business risk is defined by GENPRU as follows: 'in a narrow sense, business risk is the risk to a firm that it suffers losses because its income falls or is volatile relative to its fixed cost base. However, in a broader sense, it is exposure to a wide range of macro-economic, geopolitical, industry, regulatory and other external risks that might deflect a firm from its desired strategy and business plan'.

accordingly be accessed where necessary without breaching FSA rules). In our Policy Statement PS10/14, we noted that:

> '…Pillar 2B represents the CPB, which is not part of the regulatory capital requirement. The CPB is identified now so it can be used to absorb losses and/or to cover increasing capital requirements in adverse circumstances that are outside the firm's normal and direct control… By articulating the CPB separately from the ICG, we intend firms to understand that it is not part of the regulatory capital to be held at all times. Instead, the CPB is designed to be used in a period of stress and, therefore, using the CPB does not necessarily result in the firm not meeting GENPRU 1.2.26R'.

4.18 Accordingly, it would be possible for a Recognised Body to access the liquidity buffer where a particular need arose without breaching REC. However, we would expect to discuss the reasons for such action with the Recognised Body, and consider its proposals for restoring the liquidity buffer to the prescribed level in a reasonable timeframe.

4.19 An approach which treated a REC liquidity buffer in a manner consistent with the Pillar 2B rule would offer greater flexibility, in that the financial resources held to meet the buffer would be available for use by the Recognised Body. However, articulating the liquidity buffer as an arrangement separate from the financial resources requirement could lead to the risk that a Recognised Body would hold an insufficient amount of loss absorbing capital over and above its cost of orderly closure. It is noted that, under UK and international accounting principles, in assessing whether to adopt the going concern basis of preparation for its financial statements, a company would typically be expected to consider its ability to continue in business for a forward-looking period of 12 months. Positioning the liquidity buffer as a core component of the financial resources calculation would more fully align the minimum regulatory capital of a Recognised Body with this principle.

Q5: Do you consider that the risk-based approach (Option A) or the use of a formulaic capital buffer (Option B) would be preferable to determine the final level of financial resources necessary to satisfy REC?

Q6: If Option B is preferred, do you agree that calibrating the buffer at 50% (i.e. 1½ cover of the standard approach) would provide the appropriate shock absorbance capabilities?

Q7: Do you consider that a capital buffer should be a core element of the FRR, or be treated as a separate arrangement that could be accessed by a Recognised Body without breaching REC?

Group risk

4.20 As discussed earlier in this paper, since the implementation of MiFID, we must – under the Recognition Requirements – 'take into account all the circumstances, including the exchange's connection with any person…', with respect to an RIE. Under REC 2.3.3, we will accordingly have regard to the Recognised Body's connection with: 'any undertaking in the same group as the UK recognised body'. However, there is currently no further amplification of how, in practical terms, the position of a Recognised Body as an element of a group structure is expected to affect the financial resources requirement (if at all). In practice, specific ad hoc arrangements have been agreed with individual Recognised Bodies designed to take account of group relationships.

4.21 Clearly, the market structure landscape is currently experiencing a high level of corporate activity, with a number of transactions at varying stages of development that could lead to the combination of a number of exchange businesses. While we already have a clear legal foundation through the Recognition Requirements to consider the adequacy of the arrangements made by a Recognised Body to address group risks, the changing industry landscape has underlined the need for clearer mechanisms. These will ensure that Recognised Bodies understand our expectations, and reflect them in a consistent fashion in their financial resources calculations.

4.22 The relatively light touch position under REC, as currently drafted, also contrasts with the obligations owed by an authorised firm regulated, for prudential purposes, under measures implementing the recast Capital Requirements Directive[14] (the CRD).

4.23 Recital 27 of the CRD specifies that: 'in order to ensure adequate solvency of institutions within a group, it is essential that the minimum capital requirements apply on the basis of the consolidated financial situation of the group'. The CRD, in part, gives effect to the Basel framework on the international convergence of capital measurement and capital requirements.[15] The Basel framework specifies that: 'to the greatest extent possible, all banking and other relevant financial activities (both regulated and unregulated) conducted within a group containing an internationally active bank will be captured through consolidation'.

4.24 Consequently, a trading platform regulated as a MiFID investment firm (an MTF) is required to comply with group consolidation requirements. BIPRU 8 introduces the concept of a 'UK consolidation group', which is defined according to a series of rules designed to identify the scope of the group. BIPRU specifies that:

14 Directive 2006/49/EC

15 Basel Committee on Banking Supervision, International Convergence of Capital Measurement and Capital Standards: a Revised Framework, June 2004.

> A firm that is a member of a UK consolidation group must comply, to the extent and in the manner prescribed in BIPRU 8.5, with the obligations laid down in GENPRU 1.2 (Adequacy of financial resources), the main BIPRU firm Pillar 1 rules (but not the base capital resources requirement) and BIPRU 10 (Large exposures requirements) on the basis of the consolidated financial position of:
>
> (1) where either Test 1A or Test 1B in BIPRU 8 Annex 1 R (Decision tree identifying a UK consolidation group) apply, the parent institution in a Member State in the UK consolidation group; or
>
> (2) where either Test 1C or Test 1D in BIPRU 8 Annex 1 R apply, the parent financial holding company in a Member State.

4.25 The BIPRU consolidation rules accordingly extend aspects of the pillar one and pillar two capital requirements to the wider group of which a BIPRU firm is part. This gives effect to the requirements of the CRD.

4.26 The BIPRU approach is different to the approach expected to be taken by the prudential regimes applicable to other types of market infrastructure. For example, EMIR is not currently expected to apply a group consolidation requirement to a CCP. Instead, it is expected to deal with the group risk question through requirements for capital resources to be ring-fenced within a CCP, such that their exposure to external risks is minimised.

4.27 Further, prudential regulators of exchanges elsewhere in the EEA do not currently appear to interpret the financial resources requirements of MiFID, as they relate to Regulated Markets, as requiring the application of a group consolidation regime to achieve the objectives of Article 39.[16] It does not appear that, to date, there has been much consideration, in a European context, of the extent to which these objectives justify the application of measures similar to those prescribed by the CRD.

4.28 The question arises as to how (if at all) REC should deal with recent market developments and the possibility of significant consolidation of market structures through additional guidance on group risk. Three options appear to be available to expand upon the guidance currently provided by REC, as set out below. In each case, the guidance would reflect that the FSA would consider the Recognition Requirements to be satisfied where the arrangements specified by the option were in place.

16 To have available, at the time of authorisation and on an ongoing basis, sufficient financial resources to facilitate its orderly functioning, having regard to the nature and extent of the transactions concluded on the market and the range and degree of the risks to which it is exposed.

Option 1 – Ring-fencing

A Recognised Body should hold financial resources equal to (or greater than) its financial resources requirement at a solo level, free of any encumbrances under any intra-group arrangements (e.g. cross company guarantees or other contingent liabilities).

Option 2 – Solo assessment of group risk

A Recognised Body should make a quantitative solo assessment of its financial exposures arising from its membership of a group, particularly in the context of stress events affecting other group entities, and hold an appropriate amount of capital against such potential exposures. In this context, group risk could be broadly described as 'the risk that the financial position of [the Recognised Body] 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, for example reputational contagion' consistent with the guidance provided by GENPRU. It is expected that such an approach would include (but not necessarily be limited to) consideration of: intra-group transactions (such as loans, guarantees or provision of security) other intra-group arrangements (such as re-charge for shared services), reliance on infrastructure provided by other group entities (such as technology), relationships with holding companies and expected management response to stress events (such as the provision of financial support by one entity to another). It would also include an assessment of the possibility of reputational contagion across a group.

Option 3 – Group consolidation

As noted above, the CRD, in giving effect to the recommendations of the Basel committee, places emphasis on the importance of group consolidation in achieving effective prudential oversight of the firms to which it applies. In the UK context, group consolidation requirements are applied to investment firms, including operators of MTFs, through BIPRU 8. One way of enabling us to fulfil our mandate to take account of group risk, with respect to Recognised Bodies, would be to apply a group consolidation regime similar in its intentions to BIPRU 8. In so doing, the FSA would achieve further alignment between RIEs (which are able to operate an MTF as a market embedded in the RIE), and investment firms undertaking functionally similar businesses.

It is not considered that a customised group consolidation regime would be a viable option for Recognised Clearing Houses, in light of the implications of EMIR. In its current form, Article 12 of EMIR (as elaborated by any implementing measures) will prescribe prudential obligations for CCPs, representing a maximum harmonising regime beyond which it will not be possible to impose super-equivalent requirements. Accordingly, it would not appear to be appropriate to consider introducing group consolidation arrangements for RCHs where this does not appear consistent with the direction of travel of EMIR.

Guidance on a group consolidation regime, customised to apply to RIEs, would comprise the following elements:

- provisions defining the scope of a UK consolidation group, that would be expected to include the ultimate UK parent undertaking of a RIE, where the main activity of that parent undertaking was the holding of financial institutions (in other words, the RIE itself, or other entities performing MiFID investment services, such as the operation of an MTF);
- provisions describing the consolidated financial resources calculation, to be applied to the consolidated accounts of any relevant parent undertaking. We would expect the calculation to be based on the solo financial resources calculation, and hence envisage that the financial resources available to the UK consolidation group should be equal to the standard approach measured on a consolidated basis.

Arrangements would be necessary to cater for the international character of many group structures (for example, it would be necessary to recognise capital resources held by group entities for the purpose of meeting comparable financial resources requirements under the law or regulation of a different jurisdiction, to avoid duplicative regulation).

Discussion

4.29 We believe Option 1 would underpin existing supervisory practices and helpfully clarify our expectation that the financial assets of a Recognised Body eligible to meet FRR should be ring-fenced against risks posed to other members of the financial group.

4.30 In addition, the current form of EMIR would place certain limits on the investment policies of CCPs, in order to minimise exposure to external risks. In particular, Article 44(3) states that: ‘a CCP shall not invest its capital…in its own securities or those of its parent or subsidiary undertaking’. The objective of Option 1 would be to ring-fence the capital of a Recognised Body such that it is adequately protected against external risks. Consequently, in the context of the future EMIR requirements, views are sought on the appropriateness at this stage of an equivalent limit on the investment policy of a Recognised Body to achieve the desired outcomes.

4.31 We believe that the arrangements envisaged by Option 2 would usefully supplement Option 1 by ensuring that a specific assessment was made of any risks posed to the costs/revenues of a Recognised Body as a result of its relationships, interactions and association with other group entities. This approach would dovetail with the proposals set out earlier in this chapter, with respect to the use of stress and scenario testing tools to determine an appropriate amount of capital to cover potential business losses, and become an element of the financial risk assessment made by a Recognised Body. Further, it would provide a degree of alignment with the general pillar two rule applicable to MTFs, as trading platforms whose secondary market services are comparable to those of an RIE.

4.32 The group consolidation approach applied to investment firms, which Option 3 would intend to largely mirror, is founded on the view that the contagion risks posed to a firm are such that effective regulation of the firm justifies the extension of prudential requirements to the wider financial group headed by its parent company (including both regulated and unregulated activities). Consequently, where an RIE was a member of a group that undertook unregulated activities (for example, technology services), Option 3 would lead to specific additional costs in the form of the capital charge applied to those activities. However, in circumstances where a RIE was already expected to ring-fence its assets against external risk (Option 1), it is not clear that this additional capital would be an effective mitigant of any residual contagion risk, taking account of the specific nature of the risks posed by (and to) RIEs. For example, if operational risks were to materialise as a catastrophic or sustained failure of the trading system of another market operator within a RIE's group, it appears unlikely that additional financial resources would be useful in reducing any contagion to the RIE.[17] Accordingly, the incremental benefits of consolidated supervision (over and above the other options discussed in this section) do not appear to be justified when weighed against the costs of bringing all activities of a UK consolidation group within the direct scope of prudential supervision.

4.33 More broadly, as noted above, Competent Authorities elsewhere in Europe do not appear to have considered it necessary to apply group consolidation rules to Regulated Markets in order to achieve the objectives of Article 39 of MiFID, when implementing those provisions. Under our current statutory responsibilities, we are required to 'have regard' to the international character of financial services and markets.[18] If we unilaterally introduced a group consolidation regime we could risk imposing materially greater burdens on UK RIEs than those facing operators of Regulated Markets elsewhere in Europe, and potentially introduce opportunities for regulatory arbitrage.

4.34 It is possible that, at a European level, further consideration might be given to the benefits of measures elaborating upon the outcomes that MiFID is intended to produce, with respect to Regulated Markets. Pending any such consideration, we believe we should align our approach to the prudential regulation of RIEs and RCHs. Consequently, we would prefer to introduce guidance specifying that we will consider the Recognition Requirements to be met where the arrangements described in Option 1 and Option 2 are in place. These steps would move REC closer towards the requirements currently applicable to MTFs operated by investment firms, and represent a stepping stone towards the future regime for central counterparties under EMIR.

4.35 We think it would be helpful for the data submitted to us as part of a financial risk assessment to include information regarding the consolidated financial position of a Recognised Body's group (at the level of its ultimate parent company within the EEA). Such information would comprise the consolidated balance sheet of the relevant parent

17 A knock-on effect upon the RIE could be conceivable if, for example, trading platforms within a RIE's group operated on the same technology platform.

18 Section 2 of the Financial Services and Markets Act 2000 specifies that: "In discharging its general functions the Authority must have regard to… the international character of financial services and markets and the desirability of maintaining the competitive position of the United Kingdom'.

undertaking for the last completed financial period (such as to give us an understanding of the consolidated assets and liabilities of the group, including such matters as the degree of leverage within the group and the amount of its tangible equity, after discounting intangible assets such as goodwill. Such information would not be used for any consolidated capital adequacy calculation. But we think it could provide useful context to our evaluation of whether a financial risk assessment makes adequate provision for contagion risks posed specifically to the business of the Recognised Body on a solo basis, as a result of its positioning within the group.

Q8: Which of Options 1, 2 or 3 (or combination of those options) would be most effective in elaborating upon the responsibility of the FSA to take account of group risk?

Q9: Do you agree with the FSA's preliminary view that Options 1 and 2, applied in combination, would be the most effective approach to elaborating upon the FSA's expectations with regard to the mitigation of group risk?

Q10: In relation to Option 1, do you consider that a limit on the investment policy of a Recognised Body comparable to Article 44(3) of EMIR would be appropriate at this stage to achieve the ring-fencing objective?

Q11: Do you agree that a Recognised Body should be required to notify the FSA of the consolidated financial position of its ultimate EEA parent company, to support the FSA's review of its financial risk assessment (and the provision it makes for group risk)?

5

The characteristics of eligible capital

5.1 Currently, in order to meet its financial resources obligations, a Recognised Body is expected to meet two conditions. It must hold:

- financial resources equal to its financial resources requirement in liquid form; and
- an equivalent amount in net capital.

5.2 In elaborating upon this provision, REC specifies that 'the FSA would normally expect the capital equal to the amount of liquid financial assets to be in the form of equity'.

The net capital characteristic

5.3 The expectation that the net capital of a Recognised Body be in the form of equity is consistent with the emphasis placed by other prudential regimes on high quality capital. Under BIPRU, different forms of capital are allocated to tiers according to their perceived quality. Tier 1 capital, representing the highest quality capital, consists of capital possessing the attributes necessary to respond effectively to business losses. These are:

(1) it is able to absorb losses;

(2) it is permanent or (in the case of a BIPRU firm) available when required;

(3) it ranks for repayment upon winding up, administration or similar procedure after all other debts and liabilities; and

(4) it has no fixed costs, that is, there is no inescapable obligation to pay dividends or interest.

5.4 The forms of capital allocated to Tier 1 include share capital, retained earnings and the share premium account. BIPRU allows the use of other forms of capital (allocated to lower tiers) in specified cases and subject to defined gearing rules.

5.5 The current approach under REC is also broadly consistent with the FMI principles, in relation to the composition of a FMI's capital. They state:

> …An FMI should hold sufficient equity or equity capital, in the form of shareholders' funds (such as common stock, disclosed reserves, or retained earnings), to cover potential general business losses, so that it can continue providing services as a going concern.

5.6 However, the draft CFTC rules on DCMs and DCOs do not specify that financial resources must be in the form of equity to qualify as acceptable capital. Instead, the relevant rule-making envisages that: 'A DCO would be able to request an informal interpretation from CFTC staff on whether or not a particular financial resource may be acceptable to the Commission'.

5.7 One option would be to create flexibility within REC allowing a Recognised Body to discuss the mix of its regulatory capital with us. Under such an approach, it would be possible to recognise that forms of capital other than equity would be effective in an orderly wind-down scenario and so may be an appropriate component of an overall capital structure that included a sufficient proportion of equity capital (possibly subject to specific gearing rules customised for REC). However, this would represent a dilution of current standards and be inconsistent with emerging international policy applicable to RCHs (as FMIs under CPSS-IOSCO principles). Consequently, recognising that equity capital possesses the characteristics of high-quality loss absorbing capital, we propose to continue expecting that the net capital of a Recognised Body equal to its financial resources requirement be in the form of equity.

5.8 To elaborate upon current guidance, recognising the commercial position of Recognised Bodies which operate profitable businesses, it is proposed to clarify that interim earnings which have been subject to external verification (by the entity's auditor) should be capable of treatment as eligible financial resources.

Q12: Do you agree that the financial resources applied to meet the financial resources requirement should be funded by equity capital? Do you agree that externally verified interim earnings should be recognised as eligible capital?

The liquidity characteristic

5.9 Currently, we expect the financial resources of a Recognised Body be held in a sufficiently liquid form ensures that such bodies can access funds when needed (with minimal loss of value) and hence respond effectively to different market situations. The application of a liquidity condition is common to other prudential regimes: for example, the FMI principles specify that:

> …In addition to capital adequacy, an FMI's equity capital should reflect a strong cash, cash-equivalent, or securities position to allow the FMI to meet its current and projected operating expenses under a range of scenarios; cash equivalents and securities should consist of high-quality and sufficiently liquid assets that can easily be converted into cash at little or no loss of value, even in adverse market conditions.

5.10 In addition, the draft CFTC rules would require DCMs and DCOs to maintain unencumbered liquid financial assets in the form of cash or highly liquid securities, equal to six months' operating costs. The current form of EMIR, with regards to CCPs, envisages that a CCP would be required to invest its financial resources in cash or highly liquid financial instruments with minimal market and credit risk and that are capable of being liquidated rapidly with minimal adverse price effect.

5.11 Currently, REC does not seek to define the term 'liquid'. It would be possible to construct a more detailed definition of liquidity,[19] potentially drawing on relevant accounting principles. However, our preliminary view is that further guidance on the meaning of 'liquid' is unnecessary. The current approach creates a degree of flexibility for Recognised Bodies to discuss with us the arrangements we propose to ensure that its financial resources are sufficiently liquid to be available when needed (both as a continuing business and as would be the case in the course of an orderly wind-down), and hence deliver the outcome that the requirement intends. So we are not proposing any changes on this.

19 For example, based on the definition of 'cash' and 'cash equivalent' set out in international accounting standards. Under these standards, cash equivalents are: '…short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value.' Typically, a maturity period of three months or less is permitted.

6 Scope and implementation

Scope

6.1 As we noted earlier, forthcoming European legislation will have a significant impact upon the way that some Recognised Bodies are regulated, and is likely to take a form (whether as Regulations or as ESMA binding technical standards) that is of direct effect in the UK. For example, EMIR (and its delegated measures) are expected to represent a comprehensive regime for the regulation of CCPs (including with respect to capital adequacy) and to supersede REC 2.3 for that purpose.

6.2 In addition, the European Commission (the Commission) will publish a formal proposal later this year in relation to the reform of MiFID. However, it is not currently expected that the Commission will propose any measures modifying or elaborating the prudential responsibilities of a EU Regulated Market under Article 39 of MiFID. Accordingly, the detailed arrangements put in place by operators of Regulated Markets to achieve the objectives of Article 39 will remain dependent on the national regimes applied in each member state. Consequently, applying the modifications proposed by this CP to RIEs should complement and reinforce the modernisation of the MiFID framework proposed by the Commission.

6.3 In this context, we have considered the optimum approach to implementing the proposals set out in this paper, and has identified two options:

- apply any amendments only to RIEs, and maintain REC in its current form as an interim prudential sourcebook for RCHs pending the implementation of EMIR and its accompanying binding technical standards; or
- apply any amendments to all categories of Recognised Body during the period between finalisation of the amendments and the coming into force of EMIR, and then make appropriate further changes in relation to RCHs as part of the implementation of EMIR.

6.4 The full application of EMIR to CCPs depends on several steps being completed, including the finalisation of binding technical standards and the preparation and approval of applications for authorisation as a CCP. Consequently, the timeframes within which

UK CCPs will need to begin complying with prudential standards under EMIR are fluid, and it is possible that such Recognised Bodies will continue to operate under the guidance provided by REC 2.3 for some time. So we believe that there would be benefits in applying any modifications to REC 2.3 to CCPs, as a stepping stone to EMIR. However, we recognise that applying new guidance to CCPs at this stage would require such entities to respond to two sets of changes to their financial resources requirements, potentially in a relatively short space of time.[20]

6.5 Our current preference is to apply any amendments resulting from this consultation to all categories of Recognised Body, on the proviso that once the final form of the amendments is known, it is clear that they are consistent in principle with the future obligations of CCPs under EMIR. In this context, it is noted that the proposals set out in this paper are closely aligned with the FMI principles set out in the consultative report of CPSS-IOSCO, which are expected to inform the requirements of binding technical standards under EMIR. Provided that there is sufficient congruity between the final changes to REC 2.3 and EMIR, their application to CCPs should represent a positive step in allowing CCPs to prepare for their future responsibilities under the European requirements.

Q13: Do you agree that it is appropriate to apply any amended guidance under REC 2.3 to both RIEs and RCHs, provided it is consistent in principle with EMIR? If you consider that changes should apply to RIEs only, please give reasons for this view.

Implementation

6.6 It is noted that, if adopted, the proposals set out in this paper would require a Recognised Body to develop new processes, in particular for financial risk assessments, and to consider whether or not its financial resources requirement might change as a result of those processes.

6.7 In order to achieve a smooth transition to the amended regime, it is proposed that a Recognised Body's financial resources requirement would be maintained at its current level for a specified transitional period following the implementation of any amendments to REC. We consider that a period of between three and six months would be enough to enable Recognised Bodies to prepare for the new regime. The FSA would also be willing to discuss, through existing supervisory channels, particular circumstances where the proposed transitional period might not be practicable to achieve compliance with the new regime, such as where new funding might be required.

20 It is noted, for example, that the proposal to continue to adopt 6 months as the appropriate period for which a CCP should be able to fund its operating expenses is without prejudice to the possibility that FMI Principles adopted by CPSS-IOSCO could adopt a different period.

Q14: What would be an appropriate transitional period between implementation of the consultation proposals, and their application to Recognised Bodies?

Annex 1

Stress and scenario testing

1. Under the proposed modifications to REC 2.3, stress and scenario testing would form a core element of the calculation of the financial resources requirement, in line with a risk-based approach. Under this approach, it is necessary for each Recognised Body to develop, and keep under review, a stress and scenario testing plan that provides a reasonable basis for the assessment of its potential business losses in stressed but plausible market conditions.

2. When deciding on the structure and format of a stress and scenario testing plan, we expect Recognised Bodies to consider how they might build on management information tools already used for capital planning and risk management purposes. Recognised Bodies will need to adapt their internal processes in a way that is broadly consistent with the systems and procedures applied by investment firms to meet the stress and scenario testing requirements of GENPRU. In line with the responsibilities of investment firms, the stress and scenario testing plan should represent functional management information that would form part of a Recognised Body's risk management culture. The relevant provisions of GENPRU[1] state that:

> '…In carrying out the stress tests and scenario analyses…a firm must identify an appropriate range of adverse circumstances of varying nature, severity and duration relevant to its business and risk profile and consider the exposure of the firm to those circumstances, including:
>
> (a) circumstances and events occurring over a protracted period of time;
>
> (b) sudden and severe events, such as market shocks or other similar events; and
>
> (c) some combination of the circumstances and events described in (a) and (b), which may include a sudden and severe market event followed by an economic recession.
>
> (3) In carrying out the stress tests and scenario analyses in (1), the firm must estimate the financial resources that it would need in order to continue to meet the overall financial adequacy rule and the CRR in the adverse circumstances being considered.

1 GENPRU 1.2.45

(4) In carrying out the stress tests and scenario analyses in (1), the firm must assess how risks aggregate across business lines or units, any material non-linear or contingent risks and how risk correlations may increase in stressed conditions.

…….'

3. In light of the differences in the activities and business model of each of the Recognised Bodies, it would be a matter for the senior management of each Recognised Body to determine the nature and scope of the suite of stress events that should be included in its particular assessment. It is expected that these judgements would be based on both historic events and future business risks, taking particular account of a Recognised Body's strategy and business plans. It should be noted, however, that in light of the focus of this process on the own capital of a Recognised Body, it would not be necessary for a central counterparty to include within its range of stress events the potential default of a participant or other entity (such as another CCP).[2]

4. Under our proposed guidance, as a minimum, the plan should encompass those events and sets of circumstances that could reasonably be foreseen in stressed but plausible market conditions. This will not necessarily include every adverse scenario that could conceivably affect a Recognised Body's business, as in some cases it may be reasonable to conclude that a particular scenario is too improbable to be treated as plausible (for example, allowing for the quality of the systems/controls in place to prevent the scenario from arising). In developing it's plan, a Recognised Body should be guided by any risk-scoring methodology used to evaluate the impact/probability of its business risks, in the context of its wider risk-management responsibilities under REC. As part of our review, we will consider whether a stress-testing plan provides for an appropriate range of adverse scenarios that adequately reflects the Recognised Body's exposure to financial shocks, given its over-arching risk profile. It will also be necessary for such plans to consider the relationships between different stress events and the potential for a primary stress event to have broader ripple effects. In many cases, there will be a clear link between this review and our wider oversight of the systems and controls operated by a Recognised Body to mitigate its business risks.

5. Following the determination of an appropriate set of adverse scenarios (of a defined severity and duration), it would be necessary for each Recognised Body to develop a financial model designed to simulate the financial impacts of those scenarios. It is intended that this should be a practical exercise that considered, among other things, the actions that senior management would take in response.[3] In this context, we will consider carefully the range of assumptions underlying each model (for example, the assumed loss of market share resulting from increased competition or poor execution of business strategy), and the sensitivity of a Recognised Body's financial position to changes in those assumptions.

2 The stress-testing process would not be intended, in any way, to overlap with or duplicate processes operated by a central counterparty for the purpose of counterparty credit risk management (for example, as envisaged by Principle 4 of the FMI Principles).

3 In this regard, it is noted that a realistic management response to certain risks may be to initiate an orderly wind-down (for which provision is made separately in the calculation of FRR).

In addition, we will consider the ability of the Recognised Body to reliably project its financial performance.

6. For each Recognised Body, the objective of the assessment is to quantify the likely increase in cost or reduction of revenue, relative to its expected financial performance, resulting from the particular stress event (or several correlated stress events) being tested. The consequent losses (if any) that would need to be absorbed by capital would then form an element of the Recognised Body's calculation of its financial resources requirement under the risk-based approach.[4] Where the potential loss is such that the senior management would not try to recover, but would instead initiate an orderly-wind down, this would be a legitimate consideration in determining whether or not it would be appropriate to hold capital against that stress event (and if so, how much).

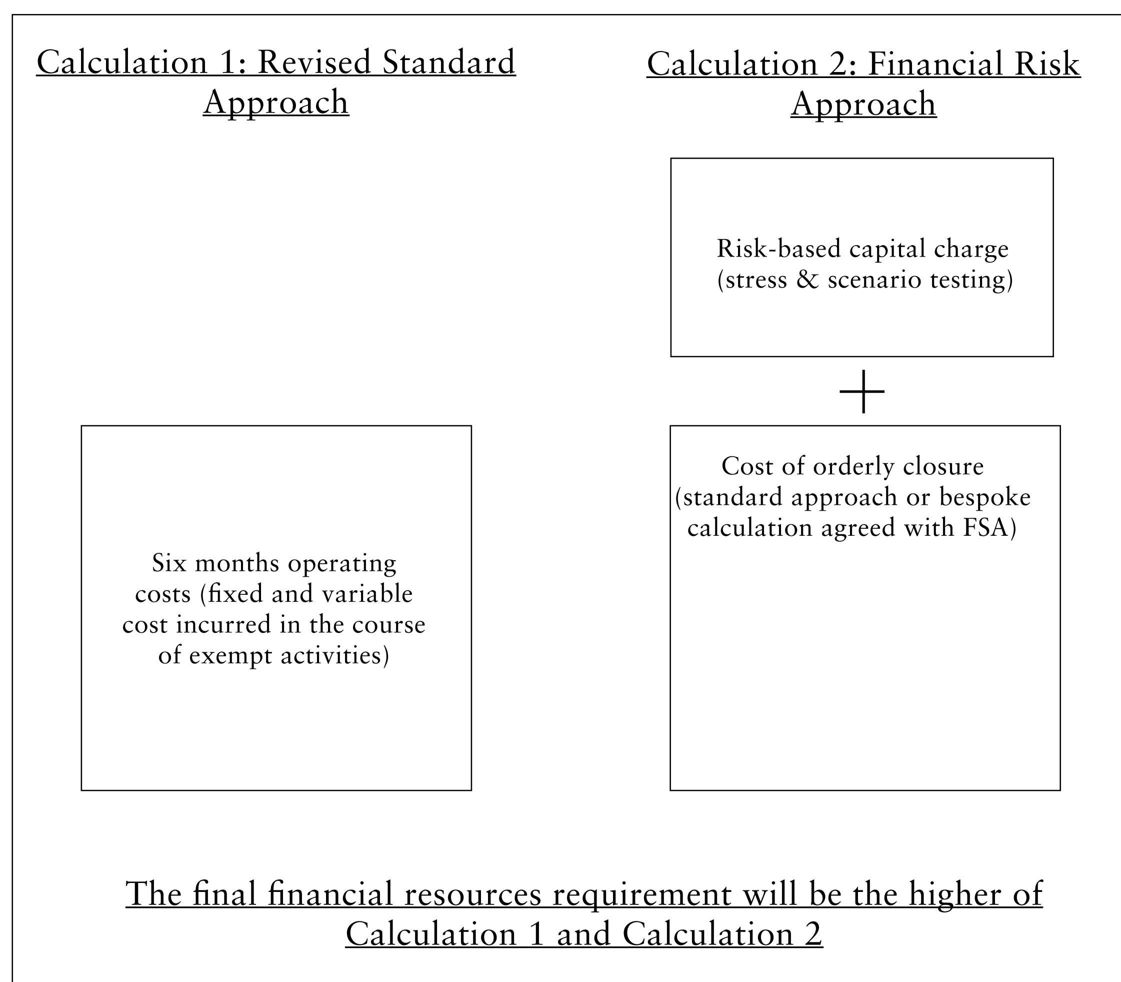
7. For a Recognised Body that expects to be loss-making during the period covered by the financial risk assessment, the losses it anticipates in normal market conditions would not need to be included when quantifying its business risk. The purpose of the stress-testing exercise is to quantify the incremental losses attributable to a specific set of stress events in a plausible worst case scenario, that cause costs to increase or revenues to reduce relative to the expected performance in normal market conditions.

8. During the period between finalising any modifications to REC 2.3, and the coming into force of any amended guidance, we aim to work constructively with Recognised Bodies to assist them with the necessary adaptations to their internal systems and reporting processes.

4 The second element of the risk-based approach would be an amount assessed to be equal to the Recognised Body's cost of orderly closure, measured either by the standard approach or by a bespoke methodology agreed with the FSA.

Annex 2

Overview of final FRR calculation



Annex 3
Cost-benefit analysis

1. We are not obliged by FSMA to carry out a cost benefit analysis (CBA) when issuing guidance. However, we have publicly committed to consider undertaking and consulting upon CBA where guidance is likely to result in firms or consumers incurring significant costs that were not formally considered when we consulted on the rule to which the guidance relates. Given that our view is that firms will have to change their conduct with regards to capital requirements for operational and other risks and this leads to some costs for them, we include a CBA for this guidance paper.

Scope

2. Our proposals will affect the 10 Recognised Bodies currently operating in the UK. Among these there are five Recognised Investment Exchanges (RIEs) and five Recognised Clearing Houses (RCHs) offering exchange, clearing and settlement services across a range of markets.

Changes in the capital requirements

3. Under modifications to our sourcebook on RIEs and RCHs (REC), the guidance provided to Recognised Bodies in relation to the level of capital necessary to satisfy the Recognition Requirements will change. Under the new approach, the final level of capital that we will consider to be adequate to meet these requirements will now be equal to the value of the highest of two indicators.

- The first indicator will be a revised version of the 'the standard approach', based on an amount equal to six months operating expenses computed to include both the fixed costs and variable costs incurred by a Recognised Body in the course of performing exempt activities.
- The second indicator will be a new risk-based approach, based on the total of two amounts: firstly, an amount assessed to be appropriate to absorb any losses that would be consequential to financial stress scenarios, and secondly, an amount equal to a Recognised Body's cost of orderly closure.

4. As a result, the impact of the proposed modifications to REC, and the extent of any increase to the minimum level of capital deemed necessary to satisfy the Recognition Requirements, will differ according to the Recognised Bodies in question.

5. In this chapter, we will examine separately how the minimum capital requirement will be affected by each separate indicator before summarising the overall impact of the changes in the CP on capital requirements for Recognised Bodies.

1. Changes in the definition of the operating expenses for the standard approach

6. We are proposing to retain the key premise of the 'standard approach': namely that orderly wind-down would be achievable over a period of six months, but change the way in which operating expenses are computed under this measure. In particular, we propose to disallow the practice of deducting variable costs incurred by a Recognised Bodies as an ongoing business that could be reduced or eliminated during the process of orderly wind-down. Consequently, the basis of calculating operating costs will be amended to include both fixed costs and variable costs incurred in the course of performing exempt activities. It will still be permissible to deduct non-cash costs such as depreciation and amortization from operating expenses.

Costs

7. We have estimated how much the minimum capital requirements under the standard approach would increase under the new guidance we are consulting on. We found that for each Recognised Body the increase of the minimum level of capital will be on average of £5.7m (the median of the increase for a Recognised Body is around 22%). The total cost for the industry will be £57m (corresponding to an increase of 22%).

8. We believe that most Recognised Bodies hold financial resources in excess of the minimum capital requirement under the standard approach, as it is proposed to be amended. For this reason, we consider that the change in computing operating expenses will present no additional costs for Recognised Bodies in relation to a need to raise further capital. The real cost of this change will be the reduction of the current amount of capital held by Recognised Bodies that they can use freely, or invest in assets that do not meet the criteria to be treated as sufficiently liquid financial resources.

Benefits

9. We expect this proposal to strengthen the standard approach as an objective proxy for the operational and other risks of a Recognised Body and ensure that Recognised Bodies hold an appropriate level of capital that allows:

- a better prospect of orderly resolution that minimises disruption to users of a Recognised Body, as the new basis of computing operating costs recognises that the

process of orderly wind-down is likely to trigger special costs that do not arise in the ordinary course of business; and

- a reduction of the probability of failure, as the standard approach would ensure the ability of a Recognised Body to fund the costs associated with operating its business as a going concern for the next six months.

10. We believe that – based on enquiries of the current financial position of Recognised Bodies as close to the publication of the CP as was practicable – Recognised Bodies hold capital in excess of the new minimum level. For this reason, the principal benefit of the change will be to ensure that the capital held to meet the increase in the minimum level is available at all times, in a sufficiently liquid and safe form to be treated as eligible capital, so that it can be accessed when needed.

2. Removal of the bespoke approach

11. Under the CP proposals, the outcome generated by the 'standard approach' would serve as a 'floor' to the minimum capital we would expect a Recognised Body to hold, by disallowing the use of alternative arrangements under which a Recognised Body applies a bespoke methodology to calculate its financial resources requirement.

Costs

12. Under this proposal, a Recognised Body will lose the possibility of using a bespoke approach. We are aware that some Recognised Bodies have used this option in the past and held lower capital buffers than those prescribed by the standard approach. However, no Recognised Body is currently using this option, so we believe that removing the possibility of a bespoke approach will have minimal costs for the industry.

Benefits

13. We believe that setting an objective floor to the minimum capital requirement will have benefits, and align REC with the approach taken by other prudential regimes. In particular, this change will overcome the risk that particular bespoke approaches which generate less rigorous outcomes do not adequately equip a Recognised Body to implement an orderly resolution, or are not adequately responsive to changes in the size or complexity of a Recognised Body's operations. In addition, we consider that a measure of minimum capital adequacy linked to operating costs retains flexibility, since the outcome will be sensitive to changes in the size, stage of development and operational efficiency of a Recognised Body over time.

3. Introduction of a risk-based approach for the assessment of capital adequacy

Cost in capital

14. Under the CP proposals, in parallel with the computation of the standard approach, a Recognised Body would need to calculate the level of financial resources necessary to meet a new risk based approach. The calculation would be based on the sum of two elements:

- an amount equal to the business losses that would need to be charged against the capital of a Recognised Body, as a consequence of financial stress scenarios modelled by a Recognised Body in light of the ongoing risks to its business; and
- an amount equal to the Recognised Body's cost of orderly closure, the computation of which might adopt the outcome of the standard approach or use a tailored methodology accepted by the FSA.

15. We have attempted to estimate an upper limit for the potential increase in the minimum level of capital for the industry under the risk-based approach. As the final outcome produced by the risk-based approach is intended to take account of the specificities of each firm (particularly its exposure to business risk given the nature and scale of its operations), we have limited our enquiries to a high-level analysis. We have used for our assessment the typical relationship between the fixed element (pillar one) and the risk-based element (pillar two) of the current capital requirements for investment firms that operate Multilateral Trading Facilities (MTFs), whose businesses share some of the same characteristics as RIEs. So we are able to assess, in broad terms, to what extent applying risk-based requirements to an MTF leads to an uplift to its minimum capital, relative to the fixed requirements.

16. Taking into account the evidence from the MTF community, we do not expect the introduction of the risk-based approach to lead to a material increase in the minimum capital requirement of a Recognised Body, as it would be computed under the revised standard approach. As a proviso to this conclusion, it is recognised that Recognised Bodies undertake different activities and operate additional business lines (such as primary markets) that may expose them to a different or wider set of business risks. We also consider that it is likely that Recognised Bodies currently hold financial resources in excess of any increase to the minimum capital requirement and for this reason Recognised Bodies will not have to raise additional capital.

17. In our assessment of the costs of the risk-based approach, it is also recognised that the stress and scenario testing process that would underpin the calculation of a Recognised Body's potential business losses has been designed to be proportionate. In particular:

- the range of financial stress scenarios required to be measured are those assessed to be plausible in stressed market conditions[1];
- the assessment of the capital necessary to cover potential business losses is expected to take account of realistic management actions, such that the calculation is sensitive to the risk appetite of the Recognised Body's senior management; and

1 And excludes any financial stress scenario linked to participant default.

- the assessment is not expected to have a disproportionate effect on smaller or loss-making Recognised Bodies, since capital provision for the risk-based approach is not expected to include losses projected in normal market conditions that are not attributable to identified financial stress scenarios.

Compliance costs

18. Requiring Recognised Bodies to calculate their capital requirements based on the use of financial risk assessments will lead to incremental compliance costs for the Recognised Bodies. These costs may be incurred initially, when the new systems are set up, as well as on an ongoing basis.

19. Recognised Bodies are currently required to have processes in place to identify, monitor and mitigate their risks. We expect Recognised Bodies to consider how they can adapt these existing systems, and foresee that the added costs will be manageable. We believe that the initial and ongoing compliance costs, although not significant, will differ depending on the size, complexity and activity of the organisation and the quality of its existing risk management and capital planning infrastructure.

20. In determining the cost estimate for the implementation and periodic review of financial risk assessments, we have considered the resources that would be necessary to carry out the steps described in Table 1:

Table 1: Incremental compliance costs estimates per peer group

Processes	Resources	Days*	Implementation
1. Assessment of the guidance set in the FSA handbook	Team of 5 1-2 days	5-10	One-off
2. Stress/scenario models – development			
a. Compliance input	Team of 1/2 2-5 days	2-10	One-off
b. Risk input	Team of 1/2 2-5 days	2-10	One-off
c. Finance input	Team of 1/2 2-5 days	2-10	One-off
d. Sales input	Team of 1/2 2-5 days	2-10	One-off
3. Stress/scenario models – review and documentation	Team of 5 2-5 days	10-25	Ongoing
4. Senior management/board review	10 days	10	Ongoing
5. Agreement of model with FSA	5-10 days	5-10	Ongoing
Total		**38-95**	

*Compliance officer person-days

Table 2: Summary of compliance costs

Costs	£000s
One-off costs(*)	34.2 – 85.5
Ongoing costs(*)	22.5 – 40.5

*Based on the daily average wage for a UK recognised body manager or specialist

21. Based on these responses, we estimate the total one-off compliance cost to the Recognised Bodies affected would be up to £85,500. We estimate the corresponding ongoing cost to be up to £40,500 per annum.

22. At the level of the industry this would represent a total one-off cost of £855,000 and an ongoing cost of £405,000 per year. Because some firms may for instance have already implemented the processes necessary to conduct a risk assessment of their capital adequacy or because this assessment may actually be less resource intensive, these estimates are upper-bound and do not take into account the fact that, in practice, some firms will have a smaller increase in their compliance costs. Additionally, these estimates do not include any external consulting services that some firms may need to engage to develop the risk assessment model.

Benefits

23. The risk-based approach would replace currently supervisory arrangements applied by the FSA, based on the monitoring of the actual financial resources of a Recognised Body against a benchmark of 150% of FRR (the liquidity buffer). We believe that the risk-based approach, calibrated in accordance with the actual risk profile of a Recognised Body, will provide a better way of ensuring that Recognised Bodies maintain an appropriate capital buffer than the headroom represented by the liquidity buffer. We believe that this change is consistent with our financial stability and market confidence objectives, and will ensure that Recognised Bodies are able to absorb the losses they may suffer as a result of financial shocks, thereby making them more resilient during periods of stress, without placing at risk the funds otherwise considered to be necessary to achieve an orderly resolution.

Annex 4
Compatibility statement

1. This section sets out our assessment of the compatibility of the proposals outlined in this Consultation Paper (CP) with our general duties under Section 2 of FSMA and our regulatory objectives.

Compatibility with our regulatory objectives of market confidence and financial stability

2. The modifications to the REC sourcebook on which we are consulting, aim to take account of our regulatory objectives of market confidence and financial stability.

3. The guidance set out in Chapter 2.3 of REC has applied in its current form since the implementation of FSMA in 2001. In the context of the significant changes in the market infrastructure landscape since its introduction, we believe that our guidance on recognition requirements is in need of modernisation. We consider that this modernisation will provide a better prospect of orderly resolution of Recognised Bodies, while enhancing their financial resilience during periods of market stress, thereby promoting market confidence in the UK financial system, as well as contributing to financial stability.

Compatibility with our other regulatory objectives

4. The guidance is not directly related to the objectives of securing the appropriate degree of protection for consumers (even if our proposal could contribute to it indirectly, by increasing the probability of an orderly resolution), or reduction of financial crime, but we do not believe that the proposals are incompatible with those objectives.

Principles of good regulation

5. 5.4 Section 2(3) of FSMA requires that, in carrying out our general functions, we have regard to specific matters. Those matters that are relevant to this CP are set out below.

The principle that a burden or restriction which is imposed on a person, or on the carrying on of an activity, should be proportionate to the benefits, considered in general terms, which are expected to result from the imposition of that burden or restriction.

6. The proposed amendments to REC seek to deliver a proportionate, risk-based approach to the prudential regulation of Recognised Bodies. The proposals aim to minimise burdens on Recognised Bodies by aligning capital requirements with the specific risks posed to their businesses, and providing a process for calibration which builds on systems, controls and procedures already in place for the purpose of meeting existing risk management responsibilities. The costs associated with a move to a risk-based regime are considered to be proportionate to the benefits, in relation to strengthening the confidence of market participants in the stability of UK financial markets and exchanges (and activities connected with them). The proposals also aim to fit with emerging international principles for the prudential regulation of Financial Market Infrastructures and provide a stepping stone to future European regulation.

The international character of financial services and markets and the desirability of maintaining the competitive position of the UK.

7. In developing the consultation proposals, we have benchmarked our approach against comparable regimes applied (or proposed to be applied) to different forms of market infrastructures, including CPSS-IOSCO Principles for Financial Market Infrastructures (2011). We believe that the arrangements envisaged by the new guidance are consistent with the aim of maintaining the UK's competitive position in international markets, in light of the approach taken by prudential regulators in other jurisdictions and the framework of standards proposed at the international level.

The need to use our resources in the most efficient and economic way.

8. Recognised Bodies are currently required to operate systems, controls and processes in relation to risk management, which will provide the basis for compliance with our consultation proposals. We will supervise the arrangements made by Recognised Bodies to meet our proposals, building on these systems, as part of our existing oversight of the risk management frameworks and capital adequacy of regulated entities, which we believe will result in an economic and efficient use of our resources.

Equality and diversity.

9. We have assessed the equality and diversity impact of our proposals. We believe that there are no equality and diversity implications. However, we would welcome any comments that respondents to the consultation may have.

Annex 5

List of questions

Q1: Do you agree with this assessment of the function of capital in the context of Recognised Bodies?

Q2: Do you agree that it is appropriate to retain a standard approach based on 6 months operating costs?

Q3: Do you agree that variable costs incurred in the course of performing exempt activities should be included in the calculation of operating costs?

Q4: Do you agree that REC 2.3.9 should be removed?

Q5: Do you consider that the risk-based approach (Option A) or the use of a formulaic capital buffer (Option B) would be preferable to determine the final level of financial resources necessary to satisfy REC?

Q6: If Option B is preferred, do you agree that calibrating the buffer at 50% (i.e. 1½ cover of the standard approach) would provide the appropriate shock absorbance capabilities?

Q7: Do you consider that a capital buffer should be a core element of the FRR, or be treated as a separate arrangement that could be accessed by a Recognised Body without breaching REC?

Q8: Which of Options 1, 2 or 3 (or combination of those options) would be most effective in elaborating upon the responsibility of the FSA to take account of group risk?

Q9: Do you agree with the FSA's preliminary view that Options 1 and 2, applied in combination, would be the most effective approach to elaborating upon the FSA's expectations with regard to the mitigation of group risk?

Q10: In relation to Option 1, do you consider that a limit on the investment policy of a Recognised Body comparable to Article 44(3) of EMIR would be appropriate at this stage to achieve the ring-fencing objective?

Q11: Do you agree that a Recognised Body should be required to notify the FSA of the consolidated financial position of its ultimate EEA parent company, to support the FSA's review of its financial risk assessment (and the provision it makes for group risk)?

Q12: Do you agree that the financial resources applied to meet the financial resources requirement should be funded by equity capital? Do you agree that externally verified interim earnings should be recognised as eligible capital?

Q13: Do you agree that it is appropriate to apply any amended guidance under REC 2.3 to both RIEs and RCHs, provided it is consistent in principle with EMIR? If you consider that changes should apply to RIEs only, please give reasons for this view.

Q14: What would be an appropriate transitional period between implementation of the consultation proposals, and their application to Recognised Bodies?

Appendix 1

Draft handbook text

RECOGNISED INVESTMENT EXCHANGES AND RECOGNISED CLEARING HOUSES SOURCEBOOK (FINANCIAL RESOURCES REQUIREMENTS) INSTRUMENT 2011

Powers exercised

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

Commencement

B. This instrument comes into force on [*date*].

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 2011.

By order of the Board
[*date*]

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

…

2.3 Financial resources

…

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 eligible financial resources in an amount which is the higher of that needed to meet:

(1) ~~liquid financial assets amounting to at least six months' operating costs~~ the standard approach; and

(2) ~~net capital of at least this amount~~ the risk-based approach;

and, in addition, holds net capital of at least that amount, will, at that time, have sufficient financial resources to meet the *recognition requirements* unless there are special circumstances indicating otherwise.

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* will provide a *UK recognised body* with individual *guidance* on the amount of eligible financial resources which it considers the *UK recognised body* should hold in order to satisfy the *recognition requirements*. In determining the *guidance* the *FSA* will ordinarily apply the approach described in *REC* 2.3.7G.

(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.~~ [deleted]

~~Operational and other risks: alternative approaches~~

2.3.9 G ~~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.~~ For the purposes of *REC* 2.3, eligible financial resources 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.

2.3.10 G For the purposes of *REC* 2.3, the net capital equal to a *UK recognised body's* eligible financial resources should be in the form of equity. This may include interim earnings that have been independently verified by its auditor in its calculation of net capital.

2.3.11 G The *FSA* considers that a *UK recognised body* will not satisfy the *recognition requirements* where its investment policy permits it to invest its eligible financial resources in its own securities or those of its parent or *subsidiary undertakings.*

The standard approach

2.3.12 G (1) Under the standard approach the *UK recognised body* will have eligible financial resources amounting to at least six *months* 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*). In addition, the *FSA* considers that capital in an amount equal to the ongoing operating expenses of a *UK recognised body* for the next six *months* will provide a minimum level of protection against the risk of business failure during periods of market stress.

(3) For the purposes of the standard approach the calculation of operating costs should include fixed costs and variable costs incurred by the *UK recognised body* in the course of performing *exempt activities*. The calculation may exclude non-cash costs (costs that do not involve an outflow of funds).

The risk-based approach

2.3.13 G Under the risk-based approach the *UK recognised body* should have eligible financial resources sufficient to enable it to absorb the potential business losses that a business of its nature, scale and complexity might incur in stressed but plausible market conditions. Such amount should be sufficient to ensure that, after allowing for any reduction of capital resulting from such business losses, a *UK recognised body* would continue to be capable of effecting an orderly transfer or wind-down of its *exempt activities*. In this context, a business loss arises where there is an increase in cost or reduction of revenue relative to a *UK recognised body's* expectation of its financial performance, such that a loss needs to be charged against its capital.

The risk-based approach: assessment for a UK recognised body

2.3.14 G In order to demonstrate that it meets the requirements of the risk-based approach the *FSA* would normally expect the *UK recognised body* to complete and provide to the *FSA* an annual financial risk assessment that identifies the risks to its business. Given that a financial risk assessment is likely to form an integral part of the *UK recognised body's* management process and decision-making culture it is expected that it would be approved by the *UK recognised body's governing body*.

2.3.15 G The financial risk assessment would be used by the *FSA* in the course of preparing individual *guidance* on the eligible financial resources that a *UK recognised body* should hold in order to satisfy the *recognition requirements*. In particular, the *FSA* would use the financial risk assessment to determine the amount of eligible financial resources that should be held by the *UK recognised body* under the risk-based approach.

2.3.16 G The financial risk assessment should be based on a methodology which provides a reasonable estimate of the potential business losses of a *UK recognised body* in stressed but plausible market conditions and would be carried out at least once in every twelve-*month* period, or more frequently if there are changes in the nature, scale or complexity of its operations or its business plans that suggest such financial risk assessment no longer provides a reasonable estimate of the potential business losses. The *FSA* considers that it would be reasonable for the financial risk assessment to be structured in the following way:

(1) Step 1: the *UK recognised body* would identify, in writing, the risks which the business of the *UK recognised body* is exposed to that could have a materially adverse effect on its financial position, in 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 recognised body* in order to meet its responsibilities under *REC* 2.5. Such description would identify which risks are indemnified or transferred by the *UK recognised body* and which are retained and accepted.

(2) Step 2: the *UK recognised body* 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 recognised body* 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* expects that a *UK recognised body* would be guided by any risk-scoring methodology that it deploys for general risk-management purposes and that is intended to evaluate the probability and impact of its risks.

The *FSA* would not expect a *UK recognised body* 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 recognised body* 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 recognised body* to absorb the financial shocks attributable to the business risks it incurs and accepts.

In carrying out this assessment, it would be reasonable for a *UK recognised body* to consider the action which its senior management would take in response to a given stress event. In particular, if the risk appetite of a *UK recognised body* is such that it would not pursue recovery from a given stress event (and would instead initiate

an orderly wind-down), the *UK recognised body* is entitled to take this into account when determining the eligible financial resources that it is appropriate to hold against the business losses related to such an event.

Where a *UK recognised body* 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, such losses would not need to be included in the financial risk assessment.

(4) Step 4: the *UK recognised body* 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 in accordance with *REC* 2.3.16G(3); and

(b) an amount assessed to be equal to the *UK recognised body's* cost of orderly closure. For the purpose of this assessment, the *FSA* considers that it would be reasonable for a *UK recognised body* to adopt the amount needed under the standard approach as its cost of orderly closure or, alternatively, to use its own method of calculation based on a scenario plan which comprehensively documents the costs that a *UK recognised body* in its position might incur in order to fully implement an orderly wind-down.

2.3.17 G When the *UK recognised body* provides the *FSA* with a financial risk assessment it should also include its underlying methodology and the proposal made in accordance with *REC* 2.3.16G(4). It should, at the same time, provide the *FSA* with a copy of the consolidated balance sheet:

(1) of any *group* in which the *UK recognised body* is a *subsidiary undertaking*; or

(2) (if the *UK recognised body* is not a *subsidiary undertaking* in any *group*) of any *group* of which the *UK recognised body* is a *parent undertaking*.

2.3.18 G The *FSA* will consider the financial risk assessment and consolidated balance sheet in determining its *guidance* on the amount of eligible financial resources it considers to be necessary for the *UK recognised body* to meet the *recognition requirements*. In making such a determination 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 recognised body* 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 recognised body* (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 recognised body* 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 recognised body*.

PUB REF: 002774

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