

David Bailey: Operational resilience - next steps on the Prudential Regulation Authority's supervisory roadmap

Speech (virtual) by Mr David Bailey, Executive Director for International Banks Supervision of the Bank of England, at the UK Finance Webinar "Operational Resilience: Beyond", 28 April 2022.

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Introduction

Good morning everyone and I'd like to thank my colleagues at UK Finance for inviting me to speak today, the first opportunity I have had to speak at a UK Finance event since I took up my post as Executive Director for UK Deposit Takers Supervision at the Prudential Regulation Authority (PRA) last September.

Given that, I'm going to focus on one of our highest supervisory priorities at the moment, Operational Resilience (Op Res). It is a particularly timely moment to be discussing the topic as it has been just over 12 months since our Op Res policy was published. Since then firms have been on a journey towards the end of March deadline that recently passed to identify their Important Business Services (IBS), set impact tolerances, and start mapping and testing to ensure they can remain within those impact tolerances.

From our initial Discussion Paper in July 2018, through the follow up to our Consultation Paper in December 2019¹, and the close and collaborative work on implementation last year, I'd like to thank UK Finance and its members for their open engagement on this policy. At the PRA we have found this two way dialogue valuable in guiding the development of the Op Res policy, and in that spirit, my remarks today aim to keep you informed on the next steps on our Op Res roadmap.

The need to focus on this topic has never been more pressing. Since our original Discussion Paper: the Covid pandemic; the ongoing shift of services to the Cloud; and, more recently, the terrible events in Ukraine have all brought fresh challenges to the overall operational resilience of the sector. This has included the need to shift to remote working at short notice, address the risk posed by dependencies on services and third party providers (including those located in highly disrupted areas of the world), and highlighted an increasing need to focus on cyber resilience.

The good news is that the sector has, to date, shown itself to be resilient in the face of these challenges. However, while clear progress has been made, there is still distance to travel to a point where firms across the sector reach the level of operational resilience we expect to see. This has been highlighted by a variety of operational outages still occurring frequently, such as payment outages, app and website failures, and incidents at third party providers. These incidents often attract significant attention from both customers and the media, emphasising the need for demonstrable resilience to underpin broader confidence in the financial sector.

Today, there are a few areas I would like to focus on:

- ♦ First, I will very briefly recap our Op Res policy, including our expectations of firms and the links to other key policy areas such as outsourcing and Critical Third Parties (CTPs);
- ♦ Second, I will share with you some initial assessments of firms' progress based on our supervisory work on UK banks and building societies so far; and
- ♦ Finally, I will cover what is coming up next in our Op Res roadmap; this includes our expectations around what firms should be doing, and the supervisory steps the PRA will be taking.

1. The PRA's operational resilience policy

Starting with the first of those points, I will provide a short recap of our expectations of firms in the Op Res policy. I will keep this brief as I am aware that many of you will already be very familiar with our expectations.

In particular, there are three particular policy expectations that I will draw out.

i) Important Business Services

The first is the requirement for firms to identify their IBS. Here we expect firms to take a holistic approach and consider all parts of their business in order to identify the full suite of services they offer, and then which of those should be deemed “important”. The definition of “importance” should be based on a service being provided to an external end user and having the potential to threaten regulatory objectives in the event of a disruption.

ii) Impact Tolerances

The second is the requirement for firms to set impact tolerances for their IBS. Here, we expect firms to assume that disruption to IBS will occur and then set clearly defined time-based metrics, and well defined thresholds, at which the disruption would threaten regulatory objectives.

iii) Mapping and Testing

The third area is, following the identification of IBS and setting impact tolerances, we expect firms to perform mapping and testing so they are able to demonstrate their ability to stay within their impact tolerances. Firms’ testing strategies should incorporate the risks and vulnerabilities they will face in severe but plausible scenarios and then demonstrate how they will remediate any disruption in a timely manner. The experience gained from this testing can then inform how firms monitor risks to their operational resilience and increase the maturity of their overall processes.

Policy interactions

For the recent March 2022 deadline, firms had to meet the first two of these elements, namely identifying the IBS and setting impact tolerances. Looking ahead to the next key deadline, which is in 2025, firms will have to prove that they are able to remain within the impact tolerances that they have set out, and this is where the assurance gained from high quality testing will be key.

I would also like to highlight the interaction of these expectations with the PRA’s outsourcing and third party risk management policy², which was published at the same time as the policy on Op Res. My former colleague Lyndon Nelson gave a speech last year³ setting out how the approaches in the two policies complement each other. In his remarks he very clearly stressed that whilst firms can outsource services, their boards and senior management cannot outsource their ultimate accountability and responsibility for their resilience.

Our Op Res policy further emphasises this point. The identification of IBS, determining the maximum tolerable level of disruption to those services and taking measures so that firms can remain within those tolerances under severe but plausible scenarios, means firms and their boards need to assess in detail the dependencies that they have on other parties.

2. Our initial supervisory assessment of firms’ progress

Having provided a brief summary of the policy, I wanted to share some initial feedback on the progress that UK banks and building societies (firms) have made in meeting our expectations. We are still at a relatively early stage in our analysis and engagement with firms, with it being less than a month since we have received the initial responses from firms. So I want to emphasise that this initial feedback will be preliminary, and we won’t at this stage be able to say what “best in class” looks like for each aspect of the policy. However, there are some important

themes that are already emerging from our review of the board-approved lists of IBS and impact tolerances which we received.

Findings on Important Business Services identification

On IBS, our current view is that firms have generally made positive progress against our expectations for identifying these services. This is good to see and reflects well on the sector as a whole. We also know that firms have taken a wide variety of approaches to the granularity with which they have identified their IBS.

To illustrate this I will use a couple of examples of different approaches we have seen. These represent only a small subset of the IBS that firms' submitted but I think illustrate the point. So, taking payment services as one example, we saw that some firms have identified all types of payments as a single business service, whilst others have split out different types of payment (for example payments made via individual systems including BACS, CHAPS and Faster Payments). Others have gone in a different direction, for example differentiating services for credit card payments versus debit card transactions.

We have seen similar themes in other areas, such as services to do with lending. Here some firms have taken a granular approach – for example listing services such as “obtaining a loan” and separating different types of loan – while other firms have kept their IBS at a higher level or gone in different directions by identifying different types of products and/or the split between pre- and post-trade execution.

Guidelines for identification of Important Business Services

Given this divergence in approach, you might reasonably ask me whether these differences are justified, what the ‘right’ answer is, and why the regulators do not just specify what it is? In response, I think it’s important to recognise that we have deliberately built some flexibility into the policy to allow firms to identify IBS in a way that best suits their specific business models. So a degree of difference is absolutely expected.

As we continue our supervisory work we will be asking firms to clarify how they have incorporated the key points of the policy that make clear that IBS should:

- ♦ deliver a specific outcome or service to an identifiable external user. This means if it’s more than one outcome, or the user cannot be identified, then the granularity is too high;
- ♦ be granular enough that they are distinguished from business lines which are a collection of services;
- ♦ be at a level where one impact tolerance per regulatory objective can be set;
- ♦ not be at the level of internal services (where the granularity would be too low); and
- ♦ be at a level where boards can make prioritisation and investment decisions.

We expect these guidelines for setting IBS to inform firms thinking and that differences in approach will narrow over time. Bodies such as UK Finance also have an important role to play in facilitating and encouraging information sharing across firms, which in turn is likely to help increase consistency where appropriate. And ultimately, where we identify that firms have taken an approach which is not consistent with the aims of the policy, then we will certainly let those firms know.

Findings on impact tolerances

On impact tolerances it’s clear from our work that, whilst progress has again been made, firms have found this more challenging than identifying IBS. This is in part due to the complexity of defining tolerances for the different regulatory objectives of customer harm or market integrity

versus safety and soundness, and – for the largest firms – financial stability.

For example, we have seen that several of the IBS that have been submitted by firms were accompanied by an impact tolerance for customer harm or market integrity but did not include one for safety & soundness, and an even higher number did not include one for financial stability. These are gaps which we expect firms to fill as a matter of priority.

We also noted that the granularity with which firms defined their IBS impacted the tolerances they then defined. Picking up the payments example I used earlier, again as one example of a broader trend, we saw that:

- ♦ Where firms separated out BACS payments from other payment types, the impact tolerances they defined for customer harm or market integrity as well as safety & soundness were all within one working day;
- ♦ The firms that listed CHAPS and Faster Payments as separate IBS typically set 24 hours as the impact tolerance for customer harm or market integrity, but with a range of impact tolerances for safety & soundness that spread from two days to two weeks;
- ♦ For international payments, the impact tolerances we saw ranged from 24 to 48 hours for customer harm or market integrity, and from 24 hours to two weeks for safety & soundness; and
- ♦ Where firms identified IBS more broadly than relating to individual payment systems, the tolerances they set were necessarily more generic.

As a supervisor for many years, I have experienced a variety of operational incidents and seen the effects they have had on customers, market confidence, safety & soundness and ultimately financial stability. Based on this, my initial impression is that the range of impact tolerances that have been submitted for payments-related IBS seems surprisingly wide.

Therefore, as we go about our supervisory reviews in the coming year, our teams will be pushing firms to justify their judgements and we will undertake more detailed comparisons across peer groups. This is certainly an area where I think dialogue amongst the industry would be beneficial to share information on the various approaches taken to modelling and setting impact tolerances. This will help individual firms understand where they are outliers and to consider if that is appropriate and justifiable. Getting this right over time will be key in supporting robust scenario analysis and ultimately, firms' resilience.

Findings on mapping and testing

Our policy also set the expectation that, by the end of March this year, firms would have done enough mapping and testing to identify IBS and set impact tolerances, but we did not expect mapping and testing frameworks to be fully developed. From our conversations on this topic so far, it appears that firms have typically leveraged existing frameworks and tools at this stage.⁴ It is also clear that the maturity of firms' thinking in these areas varies significantly. This may be understandable, as firms still have time before the final deadline in March 2025, but it indicates that significant further work is required in the next three years for firms to embed fully coherent mapping and testing frameworks.

Summary of initial supervisory review

So, to summarise, our view based on our initial supervisory work is that meaningful progress was made by firms in developing their Op Res capabilities ahead of the first deadline in March 2022. However, further analysis and development is needed to reach the standards we expect of a fully matured Op Res framework, where firms know what their impact tolerances are for all of their IBS, and know that they can remain within them in a severe but plausible scenario.

3. So what comes next?

Looking forward to what comes next on the supervisory roadmap, I hope firms can incorporate some of this feedback into the ongoing development of their Op Res capabilities.

And, as we look further ahead to the full implementation of all aspects of the policy no later than the end of March 2025, we expect firms to proactively develop and progress their approaches to mapping and testing. In line with this, firms will also need to take forward the investment necessary to remediate the vulnerabilities they identify through their testing to ensure they can remain within their impact tolerances.

Supervisory engagement

Our supervisory approach to firm engagement during this time will be determined as we look in more detail at the submissions we have already received, as well as those to come, from firms. It will include firm-specific engagement through our usual schedule of meetings with firms and relevant stakeholders as well as industry-wide roundtables or seminars, like this one, to discuss issues on a cross-firm basis. This builds on the two-way dialogue we have enjoyed to date, and industry bodies like UK Finance also have the opportunity to play a key part in facilitating information sharing and the building of expertise across the sector.

In taking forward this work, we will continue to build on the close and collaborative approach we have taken to date with our fellow regulators; both domestically with the Financial Conduct Authority (FCA), and also internationally through standard setting bodies like the Basel Committee, supervisory colleges and the bilateral engagement we have with other supervisors. We recognise the importance firms attach to a coordinated approach on this topic.

Implications from other relevant upcoming policies

Finally, I would also like to highlight some other areas of ongoing work that have implications for Op Res. In particular, the Bank of England's (Bank) Cyber Stress Test⁵ and the work the Bank, FCA and PRA are undertaking with HM Treasury on potential ways to address the risks posed by Critical Third Parties (CTPs).

We published information on the first of these, the Cyber Stress Test, in the FPC's March 2022 record⁶. Whilst it is a distinct exercise to the topics I have outlined today, we expect the findings will prove valuable in informing thinking about operational resilience more broadly.

And on the second topic, CTPs, this a complex topic and to make sure our thinking is fully informed by industry perspectives the FCA, Bank and PRA are planning to publish a joint Discussion Paper on CTPs in 2022. This will be a key development in our thinking about Op Res (including third party risk management) as a whole. It will also inform the evolving cross-sectoral and international debate on the topic.

4. Conclusion

As I outlined at the start of my remarks, firms are on a journey to achieve the level of operational resilience set out in the policy we published as final just over a year ago.

A positive start has been made on this journey, and I want to thank you all again for the open and direct engagement we have enjoyed along the way. It will be important to build on this as firms tackle the next legs of the journey. In line with my remarks today, there are clear developments needed before the deadline for meeting the policy outcomes by end March 2025 at the latest.

You can expect the PRA to continue to work with firms along the way both directly through firm specific supervisory dialogue but also through industry wide events like this. We will also be

continuing to evolve our own supervisory and policy approach to ensure it supports this industry-wide effort.

I would like to thank you for your time today and I look forward to ongoing engagement with you all, including through the discussion to come, as we collectively move this work forward.

I would like to thank Helen Stone and Harry Grantham-Hill for their invaluable help in preparing these remarks.

¹ [PS6/21 | CP29/19 | DP1/18 Operational Resilience: Impact tolerances for important business services](#)

² [SS2/21 Outsourcing and third party risk management](#)

³ [Operational resilience – outcomes in practice - speech by Lyndon Nelson | Bank of England](#)

⁴ Examples of frameworks and tools include but are not limited to: • OCIR catalogues (); • Operational Risk Management Framework (ORMF) assessment triggers; • ICAAPs (); • Firms' incident management; and • Risk and Control Self-Assessments (RCSAs).

⁵ [Prudential Regulation Authority statement on the 2022 cyber stress test: Retail payment system](#)

⁶ [Financial Policy Summary and Record of the Financial Policy Committee meetings on 9 and 18 March 2022](#)[Opens in a new window](#) (bankofengland.co.uk)