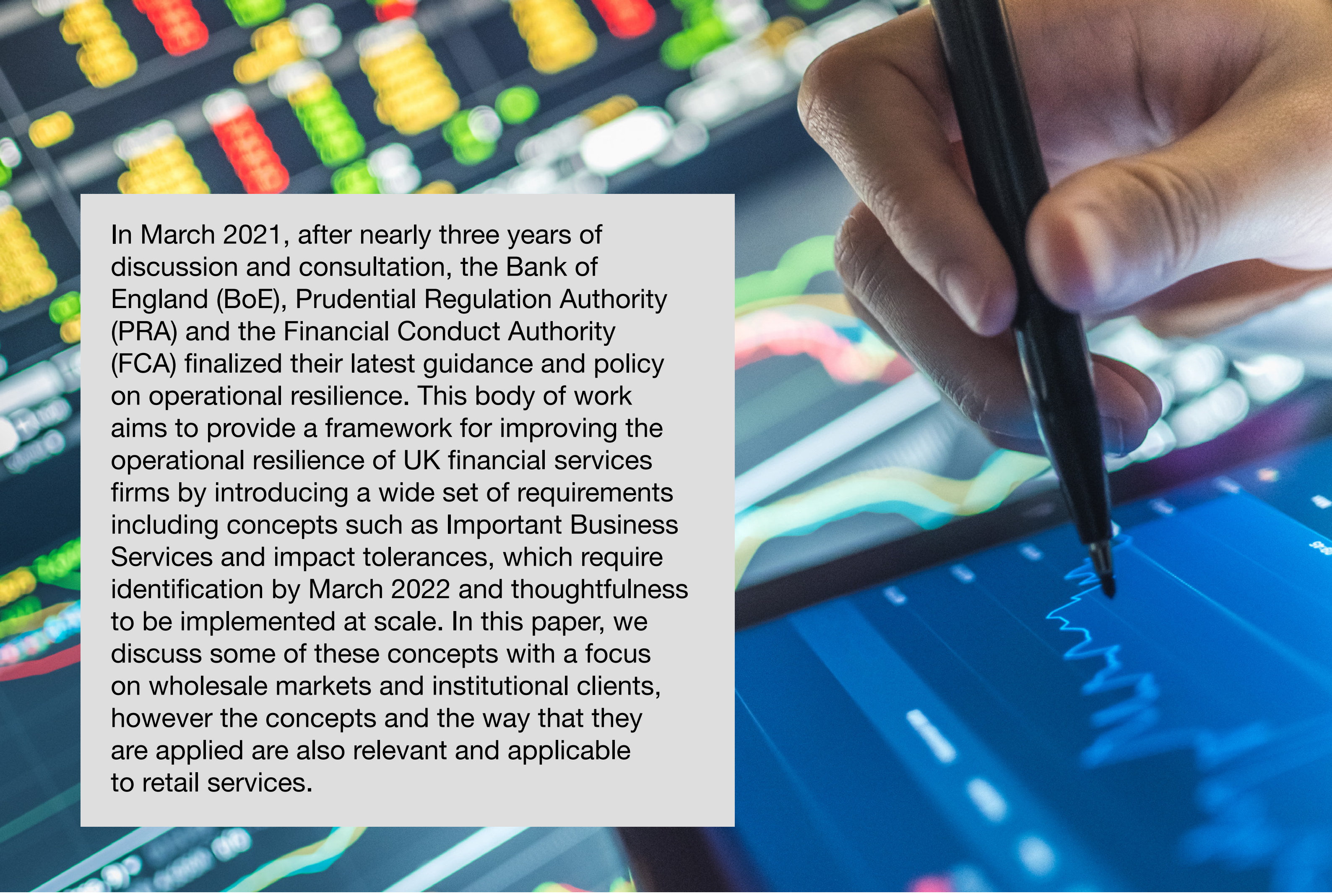
Impact Tolerances—A Perspective on Wholesale Markets for Institutional Clients



In March 2021, after nearly three years of discussion and consultation, the Bank of England (BoE), Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA) finalized their latest guidance and policy on operational resilience. This body of work aims to provide a framework for improving the operational resilience of UK financial services firms by introducing a wide set of requirements including concepts such as Important Business Services and impact tolerances, which require identification by March 2022 and thoughtfulness to be implemented at scale. In this paper, we discuss some of these concepts with a focus on wholesale markets and institutional clients, however the concepts and the way that they are applied are also relevant and applicable to retail services.

1. Defining impact tolerances and identifying Important Business Services

It is important to clarify that impact tolerances are **not** the same as Recovery Time Objectives (RTOs). Whereas RTOs are specific to recovery of a specific business process, impact tolerances are a measure of the maximum tolerable level of disruption to an Important Business Service. Should the business service be disrupted, the impact(s) could cause intolerable levels of harm to clients, threaten the stability of the UK financial system or the orderly operation of markets, or pose a risk to the firm's safety and soundness.

Fundamental to the existence of impact tolerances is the assumption that disruptions will occur. Preventing disruptions is an important part of operational resilience, inherited from traditional business continuity practices, but over-indexing on prevention can come at the expense of building the muscle memory to respond. Impact tolerances are a planning tool, meant to help firms understand their resilience and identify vulnerabilities. This supports investment decision-making that prioritizes building resilience in the form of mitigating recovery and response capabilities for the most important external-facing services to avoid intolerable harm.

By 31 March 2022, firms must identify their Important Business Services (IBS), set impact tolerances and identify vulnerabilities in their operational resilience by mapping their Important Business Services and beginning a program of scenario testing. By 31 March 2025, firms are also required to create and begin executing a strategy to avoid breaching impact tolerances, even in severe but plausible scenarios.

2. Interpreting impact tolerance statements

The initial July 2018 Discussion Paper by the UK regulatory authorities introduced the impact tolerance concept[1] and included a sample impact tolerance statement with respect to the Bank of England's operation of CHAPS: All payments (volume) should be settled by the end of the operating day (time) in all, even extreme, circumstances. It is expected that firms are likely to follow a similar syntax in developing impact tolerance statements for their Important Business Services. That is, each firm is likely to have one or more statements that read as follows, where "X" is the key accomplishment:

The [Important Business Service] will do/complete [X] within [time], even in severe but plausible scenarios.

CHAPS settlement is, of course, fundamental to the UK financial system and firms may decide not to calibrate tolerance thresholds for their Important Business Services to as high a threshold as that for CHAPS.

Firms are at different stages of maturity in the development of their resilience capabilities and impact tolerances are a key facet in the development of operational resilience as they help firms prioritize activities to enhance resilience. While some firms have progressed securing tolerance approvals from their boards, March 2022 is a foundational point for many organizations.

With the UK regulators requiring firms to be clear as to how they derive impact tolerances, being capable of showing your work is important. A 'right' answer will require sufficient reasoning, demonstrating the thought process and rationale for decision-making which is driven by internal criteria and also influenced by discussions and collaboration across the industry. However, considering the sensitive nature of the content and its specificity to each institution, it remains to be seen what level of disclosure will be appropriate.

[1] https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/discussion-paper/2018/dp118.pdf

Impact tolerance considerations

There are a myriad of factors that influence the setting of an impact tolerance, not least firms' size, customer and client volumes and demographics, but also a firm's market share and even their own corporate purpose. As a result, how should market participants and regulators best interpret impact tolerances?

For regulators, it is not just about the point at which tolerances are set in comparison with others, but firms' own analyses of their impacts in disruption; how will the impacts be felt, by whom and how quickly? This will give the UK regulators a good guide to the unique impacts created by a firm, and, by piecing this together across the industry, also a systemic view of the impacts of disruption.

For peer firms, the general comparison of impact tolerance thresholds is of most interest. Firms can use their industry contacts to develop a 'mosaic view' by looking across the market to understand common practices. This can help establish the general guide rails around impact tolerances, and to understand outliers. The challenge in this case is how comparable and relatable the tolerances are; are we really talking apples being compared with apples?

For the other market participants who provide or receive services from the firm, the impact tolerance is a headline but non-contractually binding standard the firm has set. We say 'has set', as we are still within the regulatory implementation cycle. The regulator has provided a 'reasonable time' or three year period ending March 2025 for firms to demonstrate they are operating within impact tolerances. Service recipients should rely on their own due diligence for more stringent metrics such as Service Level Agreements (SLAs) and RTOs.

It is also worth emphasizing that impact tolerances are most relevant when talking about 'severe but plausible' events, but it is recognized by regulators that there may be some occasions where it might be more understandable for firms to breach their tolerances, such as if resuming a service could risk spreading a computer virus. Impact tolerances don't solve for all disruptions but are expected to be applicable to most of them. Firms should identify scenarios in which they would be unable to remain within impact tolerances and senior management should determine if a breach is acceptable in those situations.

3. Impact tolerance disclosure: key challenges

As challenging as it is for firms to implement the requirements of the UK impact tolerance rules, it can be nearly as challenging for them to formulate an effective approach to communicating these impact tolerances to clients or others to whom they provide a service. This is due to a number of factors, the most important of which is limited empirical evidence that would more clearly indicate the changing impact of disruptions to different types of constituents over sustained periods of time. Without this, impact tolerances must be based on what scant experience exists, together with careful thought and consideration of subject matter experts. Further, testing a firm's capability to operate within an impact tolerance is equally challenging, considering the difficulty of simulating the sustained disruption period contemplated by impact tolerances for each IBS.

Setting impact tolerances leverages subject matter expertise

As noted previously, impact tolerances are not a business-as-usual metric like RTOs. Calibration of tolerance thresholds is, by necessity, based on assumptions and estimates—including impact on a firm's clients, market participants, market infrastructure, and even risk to the stability of the financial system. Fortunately (albeit not for this exercise), most firms have limited real life examples of disruptions that have persisted long enough to create the severity of impact envisioned by the regulators' requirements. Banks and other firms are having to find their way through creating and implementing methodologies by nature of these new concepts and will naturally feel uncomfortable disclosing much detail until further validation or guidance is provided by the regulators.

Anticipating future revisions

While periodic discussions are taking place between the regulatory authorities and the firms implementing these requirements, there is no guarantee that they will accept the impact tolerance thresholds determined by firms. In all likelihood, regulatory authorities will review the required self-assessments shortly after they are due in March 2022 and may challenge the calibrations and approaches for setting impact tolerances. Firms are currently in the early stages of validation of Important Business Services and scenario testing so anything determined today may be subject to significant revision and improvement over time.

Lack of a statistical baseline

There have been few disruptions that have persisted long enough to rattle financial markets or cause intolerable harm to clients that could not be addressed through compensation. Without a statistical baseline, firms will need to determine how to test for these severe but plausible scenarios. Firms won't actually be able to disrupt services for days as part of a test and will need to consider what testing methods they can employ to simulate a disruption. Firms will be pushed to go beyond workshop or tabletop exercises but avoid impacts to daily operations in their testing. Furthermore, firms may consider testing not only internally but also with third party service providers, service receivers, and financial market infrastructures to simulate a disruption through the value chain of the industry as a whole.

4. Benefits to service receivers

The increased focus on impact tolerance requirements should result in firms not only gaining a deeper understanding of their and their clients' operational vulnerabilities, but it will also serve to strengthen their capabilities to resolve disruptions that may occur, regardless of the cause. Although firms have been performing business impact analysis (BIA) for years, these have historically been focused on the potential effect on the firm itself. Operational resilience is seeking to introduce more stress and challenge to drive increased resilience and business understanding. As firms' operational disruptions rarely result in a significant impact to the firm's capital and liquidity and thus rarely challenge a firm's safety and soundness, BIAs have generally not forced large scale meaningful change. The implementation of impact tolerance rules requires firms to shift their thinking to the possible impacts of their potential inability to deliver services on third parties—specifically financial markets and clients.

By March 2025, firms must be able to demonstrate that they are able to avoid breaching their tolerance thresholds in severe but plausible scenarios. We believe that through the required scenario testing and self-assessments, many firms will discover that enhancements to their capabilities are either necessary or, at the very least, recommended. As firms continue to invest in knowledge and capabilities to improve their resilience, the benefits will accrue not only to the firms themselves but also to service receivers. Indeed, arguably financial markets will benefit as well from the reduction of risk.

5. Considerations for service receivers subject to impact tolerance requirements

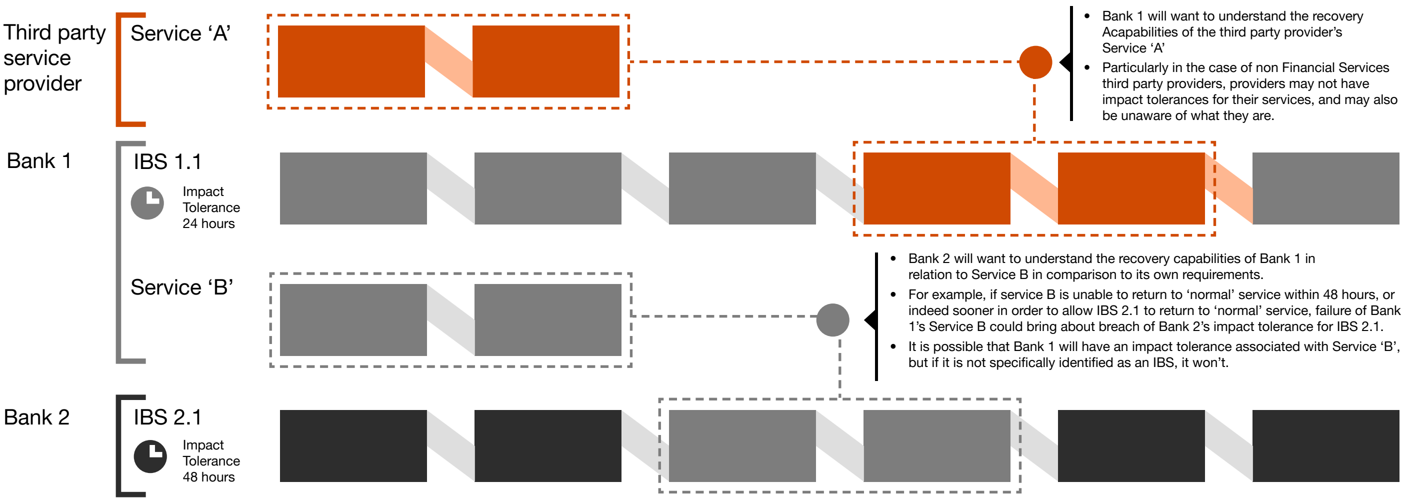
If your firm receives services from a bank and is itself also subject to impact tolerance requirements, you may find that you need to take into account some additional factors as you think about your firm's own implementation. First, it is clear that the authorities intend service receivers to consider the resiliency and impact tolerance of their third-party providers (in this case, the banks) because each firm is ultimately responsible for meeting the requirements, even if some activities are outsourced to third parties. To underscore this relationship, the authorities released new outsourcing and third-party risk management rules contemporaneously with the operational resilience rules.

Impact tolerances are meant to be set (or calibrated) without regard for mitigating capabilities or actions, so a third-party provider does not need to be consulted in the setting of an impact tolerance. However, third parties' capabilities are an important consideration in firms' evidence that they can remain within tolerances. This does not necessarily mean that the service received is an Important Business Service or that it is already the subject of the service provider's impact tolerance threshold. If a service provider can provide strong evidence of capability to enable continuity of service even in severe but plausible scenarios (drawing on, for example, evidence of business continuity and disaster recovery testing), that may be sufficient for service recipients to demonstrate that they can remain within their tolerances.

That said, there is benefit to service provider and recipient discussing perspectives on Important Business Services and impact tolerances. At a minimum, this should drive up mutual understanding of mitigating procedures and should support identification of any vulnerabilities. While tolerances are likely to differ between service provider and recipient, even in respect of the same business service, the rationale for differences should be understood. If you sense that the service provider has a much longer tolerance for the service than your firm, it is worth giving additional consideration to possible mitigating actions to offset potentially longer recovery of your third-party provider, assuming both provider and receiver are subject to the same severe stress.

The implication of this, however, could be that even in the event that impact tolerances are not shared, providers are likely to be squeezed by the market to provide increased levels of service based on the impact tolerances they may have set for their services. This could lead to firms having to provide services to the 'highest common denominator', or more simply to the levels necessary to retain their most important clients.

Example Impact Tolerance



6. What's next?

After the UK policy goes into effect in March 2022, and as the UK regulators start to request the self-assessment documentation from the firms they oversee, we may see more disclosure about how firms have determined their Important Business Services and impact tolerances. Indeed, the regulators have stated they anticipate that "best practice will emerge over time."[2] Impact tolerances might reasonably be expected to evolve similarly to practices around Recovery and Resolution Planning, where regulatory confidence grew in time as leading strategies and tools emerged.

Firms will not only be required to evidence they can remain within their impact tolerances by the end of March 2025, but also how they've matured their approach. Today, firms are at different levels of maturity when it comes to testing different disruption scenarios. Firms may be more experienced with disruptions to technology and facilities or have proven their ability to withstand a global pandemic, and as a result we expect to see an increase in scenario testing with third party service providers, both through tabletops and simulations, during the transition period.

The resiliency, safety and soundness of financial firms and the stability of the financial system is a focus for regulators worldwide and operational resilience has also been a recent area of focus for regulatory regimes outside of the UK. The Basel Committee for Banking Supervision published Principles for Operational Resilience in March 2021, and US agencies released Sound Practices for Operational Resilience in late 2020 followed by an update to the FFIEC Examination Handbook emphasizing resilience as a part of IT Operations in June 2021. With this in mind, standards should continue to be defined and implemented consistently across regions with different regulatory regimes.

In the immediate future, UK regulated firms will need to remain focused on the March 2022 deadline and the following transition period, while monitoring the evolution of impact tolerances and being prepared to mature their approach in response.

[2] https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/publication/2021/building-operational-resilience-impact-toleranc-es-for-important-business-services.pdf

Additional information

For more information on the contents of this brief, please contact:

BNY Mellon

Americas

Amy Shanle
amy.x.shanle@bnymellon.com

Daniel Smith
dan.smith@bnymellon.com

Sharon Haas
sharon.haas@bnymellon.com

EMEA

Mohit Sarvaiya
mohit.sarvaiya@bnymellon.com

Edward Rhodes
edward.rhodes@bnymellon.com

PwC

Americas

Julien Furioli
julien.furioli@pwc.com

Corey Booth
corey.booth@pwc.com

EMEA

Duncan Scott
duncan.j.scott@pwc.com

Contributing authors:

Ken Quinlan
Merrill Roth