Plan, Conserve, Maintain, Assess, Update

REGULATORY CAPITAL IS IT ADEQUATE FOR THE TIMES AHEAD?

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The financial services sector, like most industries worldwide, are in the midst of assessing the impact of COVID-19 on their business and future strategies.

In addition to the operational challenges triggered by the outbreak, the need to re-budget inevitably impacts on regulatory capital requirements. It is arguably more important than ever to not lose focus on the pillars that were established for regulated businesses to cope with times of crisis.

The Regulator's expectations remain the same; that firms must have adequate financial resources to protect their businesses, and more importantly, customers. This means taking necessary steps to preserve capital in the light of potential demands on liquidity.

On 17 April the FCA provided an update on financial resilience for FCA solo-regulated firms, with a clear message that it expects all firms to plan ahead, conserve capital, maintain capital adequacy, assess liquidity and update ICAAP and wind-down plans:

- Plan – Firms should plan ahead and assess their position for the foreseeable future
- Conserve – Firms need to consider setting aside regulatory capital
- Maintain – Ensure that capital adequacy is maintained and identify possible deficit situations going forward
- Assess – Firms must assess their liquid resources available and ensure that they have sufficient working capital to meet their obligations
- Update – Firms should revisit and update their ICAAPs and wind-down plans to ensure that these assessments are relevant to the current market conditions.

What does this mean at a practical level?

Adequacy of financial resources, capital and liquidity is reported through the regulatory returns submitted to the FCA on a periodic basis. In addition to this, the FCA expects firms to conduct, at very least on an annual basis, an 'internal capital adequacy assessment process' or 'ICAAP' to further analyse and quantify the risks that a business faces.

Within the requirements and in addition to the above, however, is the rule within GENPRU 1.2.26 – Requirement to have adequate financial resources which states:

A firm must at all times maintain overall financial resources, including capital resources and liquidity resources, which are adequate, both as to amount and quality, to ensure that there is no significant risk that its liabilities cannot be met as they fall due.

This puts an ongoing responsibility on firms to monitor their position and have measures in place to ensure that no breaches occur on the capital adequacy and liquidity adequacy fronts.

What should firms be doing now?

Identify and Assess

It is more important than ever before to identify and assess their risks from an operational and financial perspective and ensure that they have the appropriate documentation in place in order to demonstrate continuity of their business going forward.

"Adequacy of financial resources is designed to:
• enable firms to remain financially viable and to provide services through the economic cycle
• enable an orderly wind-down without causing undue economic harm to consumers or to the integrity of the UK financial system "

Ref: FCA's CP19/20 – Assessing Adequate Financial Resources

In particular firms should focus on the critical revenue drivers and business lines such as management/advisory fee arrangements and how these may be affected in the current environment and certain stress scenarios, including business areas subject to the greatest risks, e.g. if a sudden large volatility in the currency market will lead to unexpected losses; business areas subject to the greatest risks.

From an operational perspective, firms should examine their current infrastructure, resources or third parties upon which they heavily depend. It is essential that the firm's agreed (qualitative and quantitative) risk appetite and risk thresholds are reviewed, and that the relevant compliance monitoring and reporting processes are in place.

Firms need to ensure that these assessments are documented sufficiently, and that their governance arrangements include clearly defined responsibilities amongst their identified Senior Managers.

Actions

To assess the above factors, firms should, if they haven't already done so, implement the following actions as soon as possible:

• Prepare realistic financial projections for 2020 as granularly as possible and compare them with actual results on a month by month basis. Use the projections for a detailed estimate of capital adequacy so that all potential breaches can we avoided. Liquidity requirement as explained further needs specific monitoring as well.

• Incorporate stress testing within the monitoring process which is representative of the real scenarios faced by the firm.

• Construct a Risk Register or matrix which clearly articulates the likelihood of occurrence of all types of operational and business risks, specific controls that can be allocated to those risks, identify senior managers with ultimate responsibility towards the monitoring of those risks and quantification of capital required to address the risks. This drives the Pillar 2 capital framework and the FCA expect firms to have documented this diligently.

• Prepare or update wind-down plans as per the FCA's guidance. This is discussed in detail later on in this article.

For most managers, the above components should already be included within the ICAAP, Firms should consider updating the ICAAP as soon as possible so that it is current, real-time and complete.

The FCA's view

In the event that the FCA decides to review a firm's current operational effectiveness, the FCA will consider if a firm has:

• taken reasonable steps to identify and measure its risks.

• taken a forward-looking approach to risks and how these develop through the economic cycle.

• appropriate systems and controls and human resources to measure risks prudently at all times.

• accessed adequate capital to support the business, and that client money and custody assets are not placed at risk.
• resources which are commensurate with the likely risks it faces.

In theory, your ICAAP should discuss a scenario that is catastrophic at a performance and operational level. It is important to include a detailed discussion about a pandemic so disastrous to the business continuity of the firm and the actions that the firm would take in such a situation.

Meaningful and robust stress testing needs to be part of your ICAAP. An event like this can trigger not just a significant drop in revenues and assets, but may also test the operational resilience that firms should articulate within their ICAAPs and business continuity plans.

Cash is king but cash is not capital

There is often confusion in the difference between the capital in the business and the liquid assets available. In order for capital to be eligible Tier one capital must have all the following characteristics:

• it is able to absorb losses.
• it is permanent or available when required.
• it ranks for repayment upon winding up, administration or similar procedure after all other debts and liabilities.
• it has no fixed costs, that is, there is no inescapable obligation to pay dividends or interest.

> "Firms should consider 'what if' scenarios and estimate the potential impact. This is to determine the amount and type of financial resources needed to put things right when they go wrong."
>
> Ref: FCA's CP19/20 Assessing Adequate Financial Resources

The most common forms of eligible tier 1 capital are ordinary share capital and share premium, members' capital (for LLPs) and audited retained earnings. However while capital may be put into a business to meet its working capital and regulatory capital requirements, it can often be tied up in illiquid assets such as fixed assets and deposits and also get eroded if there are continuous losses.

Liquid assets are cash and cash equivalents but cannot be considered as capital until specifically designated as 'regulatory capital'. In addition, not all current assets can be treated as liquid assets; the general norm under MiFID being that assets that can be converted into cash within 90 days are considered 'liquid'.

Firms authorised under AIFMD also have a requirement of ensuring that their 'Funds under Management' requirement can be met through liquid assets. There is an additional challenge for such firms in that liquid assets under AIFMD are those that are cash convertible within 30 days.

It is therefore essential that firms assess their balance sheets, in particular given the current situation, to ensure that the regulatory capital of the business is backed up by sufficient liquid and recoverable assets.

Hope for the best but plan for the worst

The FCA Handbook includes detailed guidance under **Regulatory guides - WDPG** which sets out its expectations from firms to document the process they intend to follow for an orderly wind-down.

Guidance states that besides having a clear-headed and prompt decision-making ability, it is important to articulate a wind-down plan at an operational level.

The starting point of the wind-down timeline is the decision and the end point is the successful cancellation of the regulatory permissions but the 'planning' is all about the numerous tasks and challenges in between.

The key questions that the plan should address are as follows:

• What is the estimated length of the wind-down period
• What resources (both financial and non-financial) would be needed to implement it?
• Who needs to be available to assist the firm in winding-down?
• How would the firm deal with redundancies and, conversely, which employees need to be retained with special financial arrangements?
• What systems (e.g. IT systems) need to be available to the firm during the winding-down?
• Will the firm need to engage professional advisors to wind-down?
• Has the firm considered the implications for any overseas offices and branches?

To conclude, it is essential to have a robust wind-down plan which gives a clear picture on governance process, operational analysis, estimated revenue/ costs schedule and resource assessment.

If you need to discuss capital adequacy planning or update your ICAAP documentation and wind-down plans, please get in touch at enquiries@buzzacott.co.uk