ICS INSURANCE COMPLIANCE SERVICES LTD

Hot topICS

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Financial resilience and resilience reporting – why, what, and what next?

Financial resilience is the ability of an organisation to withstand events that affect its capital structure, liquidity, revenue and assets, and is a measure of how robust a financial plan is to shocks. Without it, operational and reputational resilience cannot be maintained.

As the FCA moves its periodic financial resilience survey to RegData from January 2024, it is a useful opportunity to revisit the topic of financial resilience and what firms should be considering.

Background

Financial resilience planning is important because it allows customers and firms to prepare for downturns and to use that planning to achieve better financial management during turbulent times. The global coronavirus pandemic was a recent example of 'turbulent times', so it is perhaps not surprising that it was the pandemic that gave rise to the FCA's financial resilience reporting requirements – the latest version of which will be the FIN073 baseline financial resilience regulatory return.

- Financial resilience as a requirement for authorised firms is not new – the Principles for Businesses and the Threshold Conditions were introduced in 2001.
- Principle 4 sets a fundamental duty for firms to 'maintain adequate financial resources'.
- Similarly, Threshold Condition 4 ('TC4') requires that firms must retain financial and non-financial resources of 'sufficient quality, quantity and availability' to meet their current and anticipated commitments arising from regulated activities.
- In addition to Principle 4 and TC4, the FCA's Prudential sourcebook for Mortgage and Home Finance Firms, and Insurance Intermediaries (MIPRU) sets specific minimum financial resource requirements for general solvency, capital resources and professional indemnity insurance.

Unlike TC4 and Principle 4, the MIPRU prudential requirements are based on historic income data which takes little or no account of matters such as asset quality, changing asset values, contingent liabilities (e.g., unresolved legal action) and intercompany loans. This is why the MIPRU rules effectively set a 'minimum' requirement.

Regulatory guidance

In February 2010, the Financial Services Authority (FSA) wrote to 300 large general insurance intermediaries, reminding them of their obligation to retain adequate financial resources, and also posted a copy of a 'Dear CEO' letter on the 'small firms' section of its website.

In its letter the FSA stated that it expected to see a firm's current and up to date TC4 assessment if they asked for it.

The requirement to provide a copy of a TC4 assessment when asked is still applicable under FCA regulation.

The letter contained a useful list at Appendix A of things to consider in meeting TC4, set out as common examples of where firms were paying insufficient attention, including:

- sufficient analysis of a firm's cash generation capabilities and retention needs;
- changes to funding requirements that may be needed in order to manage liquidity or liabilities owed to third parties;
- adequacy of controls over client money and other client asset arrangements;
- adequacy of a firm's risk assessment of the size and probability of potential causes of significant stress to its business models, including the effect of multiple events;
- the quality of other relevant systems and controls, such as risk transfer arrangements, including terms of business agreements;
- the quality and adequacy of a firm's professional indemnity insurance in relation to its exposures;
- the implications of a firm's business model and operational structure; and
- various aspects of a firm's financial statements, in particular the quality of assets, working capital requirements and the robustness of cash flow forecasts.

The letter also set out, at Appendix B, the FSA's minimum expectation that:

- all UK regulated insurance intermediaries were able to demonstrate that they met MIPRU requirements; and
- they had sufficient resources within their direct control to deliver their business plan in a compliant manner.

This minimum expectation still resonates as a regulatory requirement today.

In our July 2020 Hot TopICS we explained that, following a consultation in 2019 (highlighted in our July 2019 Hot TopICS), the FCA had published finalised guidance FG20/1 setting out its expectations on how firms determine that they have adequate financial resources.

Although the guidance did not place specific additional requirements on firms, the FCA pointed out that the Covid-19 pandemic underlined the need for all firms to have adequate resources in place and to assess how those needs may change over time.

In setting out the purpose of adequate financial resources and the FCA's approach, the FCA set out that adequacy of financial resources is designed to:

- enable firms to remain financially viable in order to provide services through the economic cycle; and
- enable an orderly wind-down without causing undue economic harm to consumers or to the integrity of the UK financial system.

The FCA expressed its view that poor financial management can lead to poor conduct (such as prioritising short-term revenue generation over consumers' interests). The FCA set out what it looks for from all firms, and its expectations of firms to reduce potential to cause harm, including commentary on:

- financial resources;
- systems and controls;
- governance and culture;
- identifying and assessing the impact of harm;
- risks that can lead to harm or impair the ability to compensate for harm done;
- the viability and sustainability of the business model and strategy; and
- wind-down planning.

Resilience and wind-down planning

The failure of any resilience within a business can ultimately lead to the failure of a business itself. Recognising this, particularly in light of the commercial challenges faced by many firms during the pandemic, the FCA increased its focus on how firms should go about managing the closure (or the 'winding down') of a business.

There is a general requirement in the FCA Handbook at SYSC 4.1.1 R for firms to have overarching systems and controls and robust governance arrangements. There is Guidance in the Handbook at SUP 6 Annex 4: Additional guidance for a firm winding down (running off) its business, but the Handbook also contains a Wind Down Planning Guide chapter as part of the Regulatory Guides section of the Handbook. This provides extensive guidance on wind-down planning.

Wind-down planning is a process that allows firms to build a framework that achieves two things:

1) to put in place assessments and measures (MI) that will enable a management team to foresee a winding-down event (allowing a firm to identify the steps and resources it needs to wind down its business, especially in a situation where resources are limited); and

2) a documented and thought-through process that the firm will follow to achieve an orderly wind-down, following an evaluation of the risks and impact of a wind-down and consideration of how to mitigate those risks.

What is a wind-down plan, and what is the link to resilience?

The objective of wind-down planning is to help to reduce the risk of negative effects on customers and other firms if a firm's regulated business becomes unviable or when it makes a strategic decision to withdraw from the market. A wind-down plan can also help a firm to assess if it would have adequate resources (e.g., capital, liquidity, knowledge and manpower) to wind down in an orderly manner, especially under challenging circumstances.

An effective wind-down plan typically includes the scenarios that could lead to a firm no longer being viable, adequate governance processes, management information, monitoring and other control processes to support timely wind-down decision making. This is a key element of a firm's financial resilience considerations – the points at which resilience is looking weak.

The aim is to create a documented wind-down plan that is approved at the firm's most senior level, with a nominated person ensuring it is periodically reviewed as to its adequacy. It should remain current and relevant to the firm's operations.

Once a firm has identified that a wind-down event has occurred, or that the firm has got to a point where the winding down of the business is inevitable or it is deemed to be appropriate, this is the point at which a wind-down plan would be put into action. The end point of the wind-down period is when the FCA cancels the firm's authorisation (i.e., its Part 4A Permissions).

While the FCA's guidance does not impose any formal obligation on insurance intermediaries to create a wind-down plan, there is an increasing expectation from the Regulator for firms to maintain financial resilience and to be prepared for adverse scenarios; firms should, therefore, be prepared for the Regulator to request to see such a document.

In conjunction with this bulletin, we have taken the opportunity to refresh our Wind-down planning template CRK16.

Financial resilience information gathering – FCA financial resilience surveys

In June 2020 the FCA started issuing financial resilience surveys, initially seeking an accurate view of the effects and impact of Covid-19 on the finances of firms. The surveys consisted of ten or eleven main questions covering topics including liquidity resources, cash needs, recent profits and/or losses, recent income, business model impact and the levels of any client money held.

The surveys were repeated numerous times, but in October 2022 the FCA issued Consultation Paper CP22/9 outlining its proposals to replace the sporadic financial resilience surveys with a quarterly baseline financial resilience regulatory return – FIN073. The FCA acknowledged that the approach of collecting the data through ad hoc surveys placed a significant administrative burden on firms.

The new FIN073 return

In its Consultation and subsequent Policy Statement PS23/3, the FCA set out its view that high quality baseline financial resilience data is essential in helping it to understand the risk of firm failure and risks across the financial services sector. The more focussed and consistent data will allow the FCA to improve its ability to protect consumers, to ensure market integrity and, ultimately, to help to reduce harm from firm failure.

The FCA is rationalising and standardising this data collection by replacing the previous surveys with a formal return that will appear in firms' RegData schedules, aligned to their year-end date ('accounting reference date'). Firms must submit the FIN073 Baseline Financial Resilience Report quarterly, within 20 business days after their:

1) accounting reference date;
2) accounting reference date plus 3 months;
3) accounting reference date plus 6 months; and
4) accounting reference date plus 9 months.

The information in the Baseline Financial Resilience Report must show the position at the end of the relevant quarter.

Following a further Consultation in relation to the scope of the new reporting, insurance intermediaries and all 'Full Permission' consumer credit firms will be included in the types of firms which will have to complete the return.

In-scope firms will need to be prepared to submit the returns when due, from January 2024. **Firms will receive an automated reminder via RegData when the return is available for submission**.

The financial resilience question set will be rationalised to five questions, which will ask for:

- the total amount of liquid assets that you control or have unrestricted access to;
- the firm's average monthly cash needs arising from fixed costs;
- the firm's net profit OR loss in the last quarter;
- the firm's revenue for the financial year to date;
- the firm's net asset or liability position at the end of the relevant reporting period (financial quarter).

Until then firms must continue to respond to the FCA's periodic requests.

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Actions for firms

When considering financial resilience, firms should consider:

- if they have a risk management framework which includes a clear risk appetite;
- if they appropriately and adequately identify the risks to which they are exposed;
- the materiality of each risk;
- the adequacy of the systems and controls they have in place;
- whether adequate use has been made of stress testing in the risk assessments;
- whether the risk assessment process meets the 'use test' (i.e., is it used day-to-day and for decision making; and
- whether they have adequate financial resources based on the risks to which they are exposed.

In relation to wind-down planning, firms should:

- review the FCA's Guidance and its Wind-down Planning Guide;
- consider the financial/market/operational triggers that might indicate a potential wind-down requirement;
- create a documented Wind-down Plan to assist the firm to manage the business in run-off.

In relation to the FIN073 return, we recommend that firms:

- add this return to their Compliance Monitoring Plans to ensure that the returns are not missed;
- note the five required data items listed above;
- read the Guidance in relation to the completion of the data items (which can be found in the last few pages of the Policy Statement, and which will ultimately appear as a new SUP16 Annex 54G in the FCA Handbook); and
- start to create the appropriate MI now to enable them to be able to complete the new returns when due.

If you would like any help or Information in relation to this update or any FCA-related compliance issues or ICS Services, please contact your usual ICS representative or Head Office on 01892 539600 or admin@insurancecompliance.co.uk and we will be happy to discuss further.

The above information is a summary of certain matters which will affect the majority of firms conducting Insurance Distribution and reflects ICS's views at the date of publication. Each firms' requirements are individual, and rules are regularly changing; it is therefore important that you always seek specific advice from ICS before acting on anything contained in this publication.

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