

Critical Third Parties: The Next Wave of UK Financial Sector Regulation to Plug the Systemic Risk Gap

by Toju Dediare, GDFM Consulting, Head of Resilience and Risk

Background

Financial services firms are increasingly turning to third-party service providers to augment their operating models and leverage the benefits of specialisation whilst supporting digital transformation and innovation. However, the rise of these service providers poses an increase in systemic risks for individual financial services firms and financial market infrastructures. While the UK supervisory framework provides limited tools for managing these risks, policymakers have concluded that additional legislative measures are needed to address this gap.

Designated critical third parties - PRA Discussion Paper 3/22 and FCA Discussion Paper 22/3 were issued by the Financial Conduct Authority and Prudential Regulation Authority on 20 July 2022, followed by the FSM Bill. By setting up a statutory framework, the bill aims to manage systemic risks posed by third parties designated by HM Treasury as 'critical third parties' (CTPs).

Proposed Requirements

The proposed framework outlined in the DP targets third parties, focusing on those who provide services to one or more financial services firms (firms) or financial market infrastructures (FMI). The proposed rules will apply to those third parties that HM Treasury has designated as CTPs.

The Discussion Paper outlines how the supervisory authorities could use their proposed powers in the FSB bill to reduce CTP systemic and concentration risks.

Measures

This discussion paper outlines three measures to consider the risks of regulatory fragmentation by setting out potential ways to improve international and cross-sectoral coordination and plugging the gap where the existing UK Op Res requirements do not cover this area. The measures do not aim to complement or replace firms' and FMIs' responsibility concerning operational resilience.

1. A framework for the supervisory authorities to identify potential CTPs where HMT will formally call these designated CTPs.
2. Tools for testing the resilience of material services that CTPs provide to firms and FMIs.
3. Minimum standards (for designated CTPs to abide by in respect of material services they provide to financial services firms and FMIs).

Supervisory Powers

The UK financial regulators will have the power to:

- Make rules relating to the provision of these material services, gather relevant information from critical third parties, and take formal action, including enforcement, where needed.
- Require third-party suppliers providing services to the financial sector to adhere to minimum resilience standards.
- Request information directly from CTPs and third parties to commission an independent skilled person to report on providers' services.
- Require critical third parties to participate in various targeted forms of resilience testing.
- Appoint an investigator to review any potential breaches.
- Enter the CTP's premises under warrant and interview CTP representatives.
- Publicise any failings from reviews or breaches.
- Prohibit critical third parties from providing future services or continuing to provide services to regulated firms and FMIs.

Uncertainties To Be Ironed Out

- Clarity is still required on what constitutes 'critical'; earlier commentary from the UK regulators suggests that designation will focus on third parties that can potentially be a source of systemic risk to the UK's financial stability.
- Specifics on how the UK proposals will interact with similar recommendations in other jurisdictions and their steps to have similar oversight regimes (such as EU DORA). The same group of companies will likely be subject to overlapping regulations.
- Clarification on how the framework will deal with unregulated entities operating with a global presence and complicated group structures.
- A substantial number of entities intended to be captured by this regime will undoubtedly be headquartered outside the UK.
- Communication channel for the supervisory authorities to cascade information back to firms and FMIs that rely on designated CTPs.
- The robustness of giving the powers and responsibilities to the FCA, HMT and PRA in the face of a live disruption to a CTP needs to be revised and may prove ineffective.

The FSM Bill's Impact on Businesses

The identification of designated CTPS will have the benefit of helping regulated firms in their dealings and negotiations with such third parties – particularly when it comes to outsourcing agreements. Additionally, it could drive up the standards even for non-designated CTPS. Some third-party groups will potentially be categorised as designated CTPs.



Cloud Providers



Core Banking
Platforms



Data & AI Machine
Learning Models



Cash & Distribution
Platforms



ICT Third Parties

The FSM Bill will impact the designated CTPS, firms, and FMIs.

Designated CTPs

Implementation of stipulated resilience standards

- Review and, where applicable, refine the services provided to firms and FMIs that meet the criteria stipulated in the DP.
- Develop or enhance existing internal processes/frameworks that:
 - a. Identifies, escalates, manages, and promptly reports incidents and threats that have a potential or actual systemic impact or concentration risk.
 - b. Capture measures to mitigate the potential systematic impact that could arise from its failure or severe disruption to its material services.
 - c. Provides a tailored communication plan for stakeholders of the disruption that includes lessons learned from any disruptions experienced by the designated CTP.
 - d. Ensures that the new requirements are filtered down through their supply chain where applicable.
- Identify and document:
 - a. Material services provided to firms and FMIs (including resources, processes, and technology).
 - b. Risks and controls to mitigate the risks to its material services across the supply chain.

- c. Periodic scenario testing continued internal resilience testing and tests convened by the relevant supervisory authority.
- d. Incidents or threats that may have a systemic impact. These must be promptly disclosed to the relevant supervisory body.

Firms and FMIs

- Assure that designated CTPs are subject to appropriate resilience standards
 - Helps firms and FMIs with their risk assessments on outsourcing to CTPs.
- Have the potential of increasing 'CTPs' costs which they may seek to pass on to service users or cause some service providers to consider the extent to which they provide services in the UK
- The DP acknowledges that the regime is limited to addressing the provision of services by CTPs to UK firms and FMIs.
 - Variations in the substance and scope from the UK's proposed approach to that of other regimes may create complications for CTPs and those firms and FMIs that operate cross-border.
- Regulated firms and FMIs may be asked to participate in the resilience testing programmes for CTPs.
 - They may need to adapt their contingency plans to address the risk of regulatory action prohibiting or restricting the provision of services by CTPs.

Next Steps

- Feedback to the DP must be submitted by 23rd December 2022.
- It is difficult to predict with certainty, but the new regime will likely be implemented in late 2023
 - A second reading of the FSM Bill is expected in September 2023 to pass the Bill after that, though the timeline may change depending on other pressing Parliamentary priorities.
- Call to action in your firm to discuss and consider:

Firms & FMIs

- Undertake a TPRM framework health check to ensure compliance with existing regulatory requirements
- Define a response mechanism if a designated CTP is exited
- Design a detailed exit strategy to mitigate any circumstance where a designated CTP needs to be exited
- Recalibrate your firm's Business Continuity playbook, ensuring an aggregated plan for a CTP disruption
- Consider the revision of contractual agreements to be more outcome based
- Assess the substitutability of third parties that provide services to your firm's critical operations and other viable alternatives
- Verify the capability of designated CTPs in monitoring their critical vendors

Designated CTPs

- Undertake a preliminary impact assessment on the regulation of your firm
- Undertake a health check of your end-to-end third-party risk management framework to ensure it is compliant with existing regulatory requirement
- Review of the firm's resilience standards and testing regime
- Design and implementation of designated CTP reporting framework and Target Operating Model
- Define a strategy for the financial services sector business continuity playbooks
- Enhance the incidence management framework to address concentration and systemic risks
- Define a tailored communication plan in place for firms and FMIs for any disruptions
- Design, implement and embed a change programme to incorporate the new regulatory requirements



Knowing about all the critical vendors your third party relies on by verifying your third-party vendors' capability in monitoring their critical vendors.

How GDFM Can Help Your Firm Optimise and Refresh TPRM

GDFM can help your firm to understand its challenges and develop suitable measures to identify and mitigate the risks associated with third-party service providers. We have over a decade of experience assisting financial institutions in developing adequate controls for identifying, managing, and monitoring third-party vendors; we tailor a robust set of solutions that addresses your challenges explicitly.

Firms & FMIs

- End-to-end TPRM framework health check ensuring compliance with existing regulatory requirements
- Define a designated CTP exit response mechanism
- Advisory / Design an exit strategy for a designated CTP
- Contractual agreement reviews and remediation to ensure all are more outcome-based
- End-to-end TPRM framework health check ensuring compliance with existing regulatory requirements
- TPRM Managed Services

Designated CTPs

- Preliminary impact assessment on the regulations of your firm
- Review of the firm's resilience standards and testing regime
- Design and implementation of designated CTP reporting framework and Target Operating Model
- Strategy definition of the financial services sector business continuity playbooks that incorporate the new requirements
- End-to-end TPRM framework health check ensuring compliance with existing regulatory requirements

