

# 142 *newsletter*

Financial Services Authority

# Operational risk systems and controls

July 2002

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This newsletter provides a summary of FSA Consultation Paper 142 – Operational risk systems and controls

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## Executive Summary

Our initial proposals for rules and guidance on operational risk were outlined in *Consultation Paper 97: Integrated Prudential Sourcebook* (CP97) issued in June 2001. However, in this Consultation Paper (CP) we are reconsulting on the material about operational risk systems and controls and outsourcing as we have materially revised the draft text we consulted on in CP97. So, this CP seeks comments on this proposed new *Handbook* text, all of which is guidance, which we expect to take effect in 2004.

For insurers, the proposed *Handbook text* in this CP will take forward and complement the proposed guidance on risk management systems and controls, as presented in CP140 (*The Interim Prudential Sourcebooks for Insurers and Friendly Societies and the Lloyd's Sourcebook: Guidance on Systems and Controls*).

### How these proposals affect retail consumers

**This CP will be of some interest to retail consumers because its proposals promote our consumer protection objective, by ensuring that firms manage their operational risks adequately. We intend our general systems and controls requirements and specific guidance on operational risk to help ensure that firms have adequate systems and controls to comply with our Conduct of Business and Client Money rules. But, this CP does not propose changes to how our COBS and Client Money rules operate. So, our guidance should help to reduce direct losses to consumers arising from operational failures at firms. In addition, our guidance should help to reduce the frequency and impact of operational losses that may deplete a firm's financial resources, ensuring that firms remain able to meet their liabilities when they are due. Our statement on our policy's compatibility with our objectives and general duties under the Financial Services and Markets Act 2000 (in Chapter 5 of this CP) sets out in more detail how we achieve our consumer protection objective.**

### Changes to the proposals in CP97

One significant change from our earlier consultation on this topic is that it is now proposed that some of our guidance on operational risk management systems and controls, including that on outsourcing, should be located in **SYSC** (*Senior Management Arrangements, Systems and Controls*). This change has stemmed from our view that placing all our guidance on operational risk in the *Integrated Prudential Sourcebook (PSB)* would not highlight sufficiently the effects that operational risk management failures may have on our consumer protection and financial crime objectives. The **SYSC** guidance on operational risk systems and controls will apply to almost all regulated firms, as set out in **SYSC 1** (see Annex B).

The guidance on operational risk identification, assessment, monitoring and control, and the content of a firm's operational risk policy that will be in the **PSB**, is designed to be complementary to **SYSC**. This guidance will apply to fewer firms. It will broadly affect deposit-takers, insurance firms, investment firms that take principal positions, and investment firms and Lloyd's agents that hold client money.

We do not expect that the overall impact of this policy on firms will be adverse. We have framed our proposed *Handbook* text on operational risk as guidance on the application of high level requirements for adequate systems and controls in **SYSC 3** (*Systems and controls*) and **PRAG 6** (*Prudential systems and controls*) of the PSB. As such, there is flexibility for firms to make cost-effective arrangements that are appropriate to their particular business and proportionate to their risks, and that help them manage their business.

We consider that our guidance reflects common practices at prudently managed firms and that many firms already meet it. So, we believe that the benefits of this policy will be more than proportionate to the costs.

### This CP contains:

Chapter 2 – outlines the purpose of this CP and our guidance on operational risk, including the background to the development of our policy, our timetable for implementing the policy and its context in the current international discussions on operational risk.

Chapter 3 – outlines the structure and content of our guidance on operational risk management systems and controls, and briefly considers the definition and scope of operational risk.

Chapter 4 – provides feedback on the comments we received on **PROR 1** and **2** as part of the CP97 consultation process and our responses to these comments.

Chapter 5 – sets out the statement of compatibility with our statutory objectives.

Chapter 6 – contains our cost benefit analysis.

Annexe A lists the questions in this CP.

Annexes B and C contain the draft *Handbook* text.

We are still considering our policy on professional indemnity insurance and will be carrying out further work on this. Our feedback statement on the responses to CP97 and CP115 offers further discussion of this topic.

### Next steps

We will consider the comments received in response to this CP (the deadline for comments is 31 October 2002) when we develop our operational risk policy. We expect to publish a Policy Statement outlining our conclusions on operational risk systems and controls, including final *Handbook* text, in 2003. As we stated in CP115, we expect the policy will then take effect in 2004, as part of the first phase of the implementation of the PSB.

The Financial Services Authority invites comments on this Consultation Paper. Comments should reach us no later than 31 October 2002, although earlier responses would be welcomed, particularly if they involve substantial comments. Throughout the Consultation Paper we have highlighted questions on which we would particularly welcome your views.

Comments may be sent by electronic submission using the form on the FSA's website (at [www.fsa.gov.uk/pubs/cp/cp142\\_response.html](http://www.fsa.gov.uk/pubs/cp/cp142_response.html)).

Alternatively, please send comments in writing to:

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