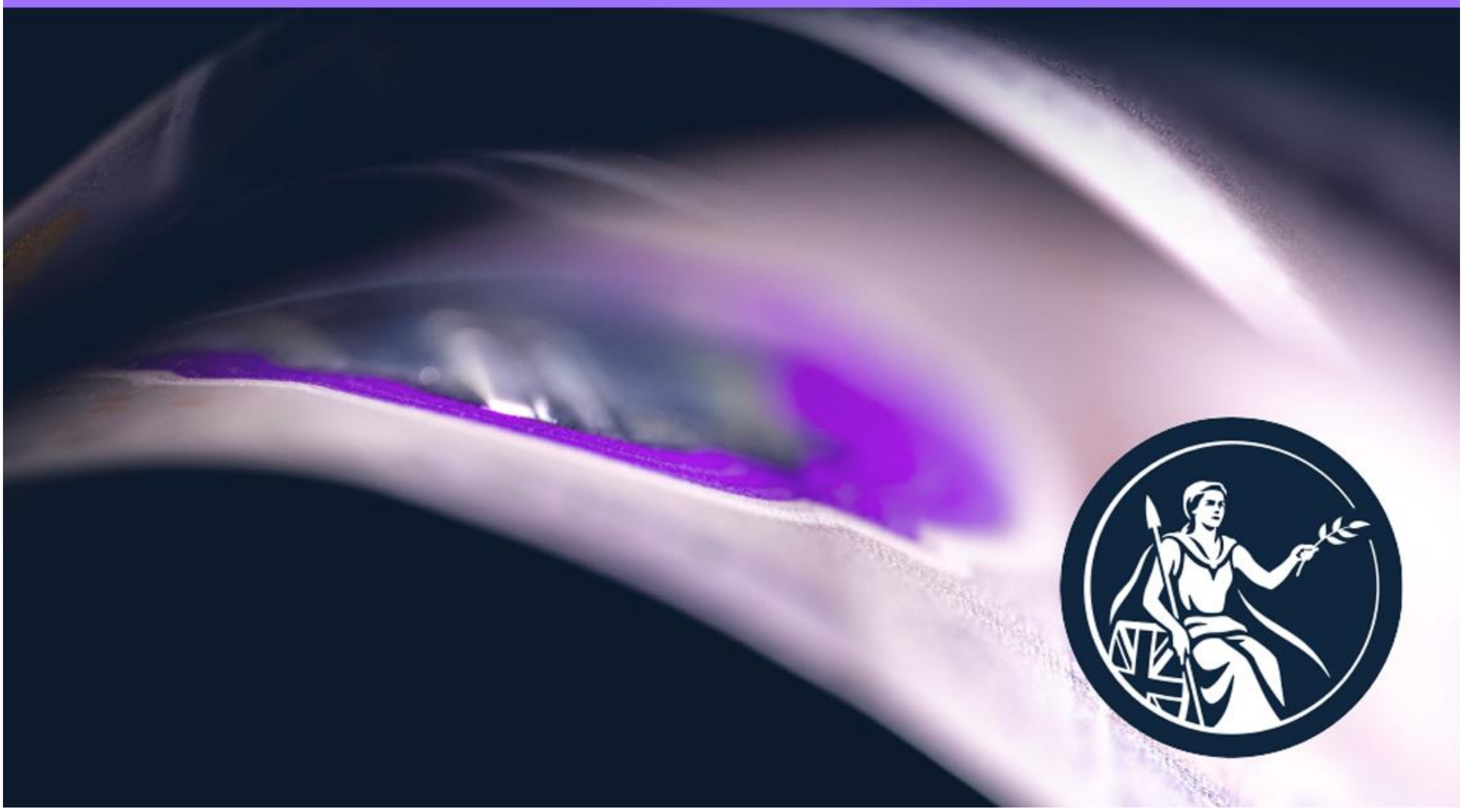
Bank of England PRA

FCA FINANCIAL CONDUCT AUTHORITY

Appendix 6 – Cost benefit analysis

Consultation paper | CP26/23

December 2023



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Prudential Regulation Authority | 20 Moorgate | London EC2R 6DA

Introduction

1. The Financial Services and Markets Act 2000 (FSMA), as amended, requires the FCA and the PRA to publish a cost benefit analysis (CBA) of proposed rules. Specifically, sections 138I and 138J require the FCA and the PRA to publish a CBA of proposed rules, defined as 'an analysis of the costs, together with an analysis of the benefits that will arise if the proposed rules are made', and to consult each other prior to publishing a CBA of proposed rules.

2. The same requirement applies to the Bank of England ("the Bank") as part of rulemaking powers set out under FSMA 2000 Schedule 17A, as amended.

3. FSMA 2000 requires regulators to provide an estimate of the costs and benefits of the proposals, unless, if in the opinion of the regulators, the costs and benefits cannot reasonably be estimated or it is not reasonably practicable to do so. Where estimates cannot be ascribed a monetary value, other estimates of outcomes are provided.

4. The analysis has been conducted with regard to the PRA and FCA's primary objectives, the PRA's secondary competition objective, the PRA and FCA's secondary competitiveness and growth objective, and the FCA's duty on competition. The analysis has also been conducted with regard to the Bank's financial stability objective and the Bank's secondary innovation objective.

Case for regulatory intervention

5. The full case for regulatory intervention is set out in Chapter 1 of this consultation paper, and also as discussed in Chapter 2 of Discussion Paper 3/22 'Operational resilience: Critical third parties to the UK financial sector'.

6. Financial services firms (firms) and Financial Market Infrastructure (FMIs) increasingly rely upon third-party services to support the delivery of functions and services that are vital to the stability of, or confidence in, the UK financial system. Cloud service providers (CSPs) are a frequently cited example of these third parties. However, there are other examples, including but not limited to other providers of information and communications technology (ICT) services, and data analytics.

7. In its Q2 2021 **Financial Policy Summary and Record**, the FPC concluded, that 'the increasing reliance on a small number of CSPs and other CTPs for vital services could increase financial stability risks in the absence of greater direct regulatory oversight of the resilience of the services they provide'.

8. Likewise, in the December 2023 **Final report on enhancing third-party risk management and oversight – a toolkit for financial institutions and financial authorities**, the Financial Stability Board noted that "market concentration in the provision of services to financial institutions is not a new phenomenon nor does it automatically pose systemic risks by itself. In some instances, it can strengthen the operational resilience (including cyber-resilience) of financial institutions and, by extension, financial stability. However, relying on a single or small number of service providers will likely increase the impact to the financial sector if these service providers or their services to financial institutions (in particular, critical services) are disrupted or fail. Concentration combined with other criteria, such as the financial and operational resilience of the service provider, and the substitutability of its services, can be relevant considerations when identifying systemic third-party dependencies and potential systemic risks".

9. The current financial regulatory framework requires each firm and FMI to manage risks to their individual operational resilience, including those posed by third parties. The measures proposed in this consultation paper do not alter this. Firms and FMIs would continue to be held responsible for their operational resilience, regardless of whether they rely upon third parties to support the delivery of their important business services.

10. However, firms and FMIs cannot manage systemic risks that may arise because multiple firms and FMIs outside their group have independently decided to rely on a common third party for certain services. Several respondents to **PRA CP30/19 'Outsourcing and third party risk management** highlighted this limitation and also noted an imbalance in negotiating power between firms and certain third party service providers. **PRA Policy Statement (PS) 7/21 summarises this feedback.** Likewise, respondents to DP3/22 noted challenges firms face in establishing meaningful dialogue about resilience with some service providers and that further information on testing or other assurances would inform and strengthen their resilience.

11. The FPC Q2 2021 **Financial Policy Summary and Record** acknowledged that current financial regulatory and supervisory framework has very limited tools to manage the systemic risks to the regulators' objectives posed by third parties. It acknowledged these systemic risks could arise if the failure or disruption of certain third parties simultaneously impacted the provision of services to (a) one or more systemically significant firms or FMIs, or (b) multiple firms and FMIs.

12. Given this backdrop, the FPC Q2 2021, concluded that 'the increasing reliance on a small number of CSPs and other CTPs for vital services could increase financial stability risks in the absence of greater direct regulatory oversight of the resilience of the services they

provide'.

13. In keeping with responses to the DP, the regulators have designed the proposals to allow them to monitor and manage the operational resilience risks posed by CTPs to their objectives in an effective but proportionate manner. The proposals primarily seek to manage the systemic risk by introducing requirements designed to deliver minimum resilience standards for CTPs and the material services they provide to firms and FMIs.

Causal chain

14. Poor operational resilience at CTPs would represent a collective threat to the regulators' objectives, in addition to their shared goal of maintaining financial stability.

15. Figure 1 sets out the proposed interventions and the mechanisms through which benefits are expected to materialise. The expected costs of the interventions and the benefits are discussed in the following sections.

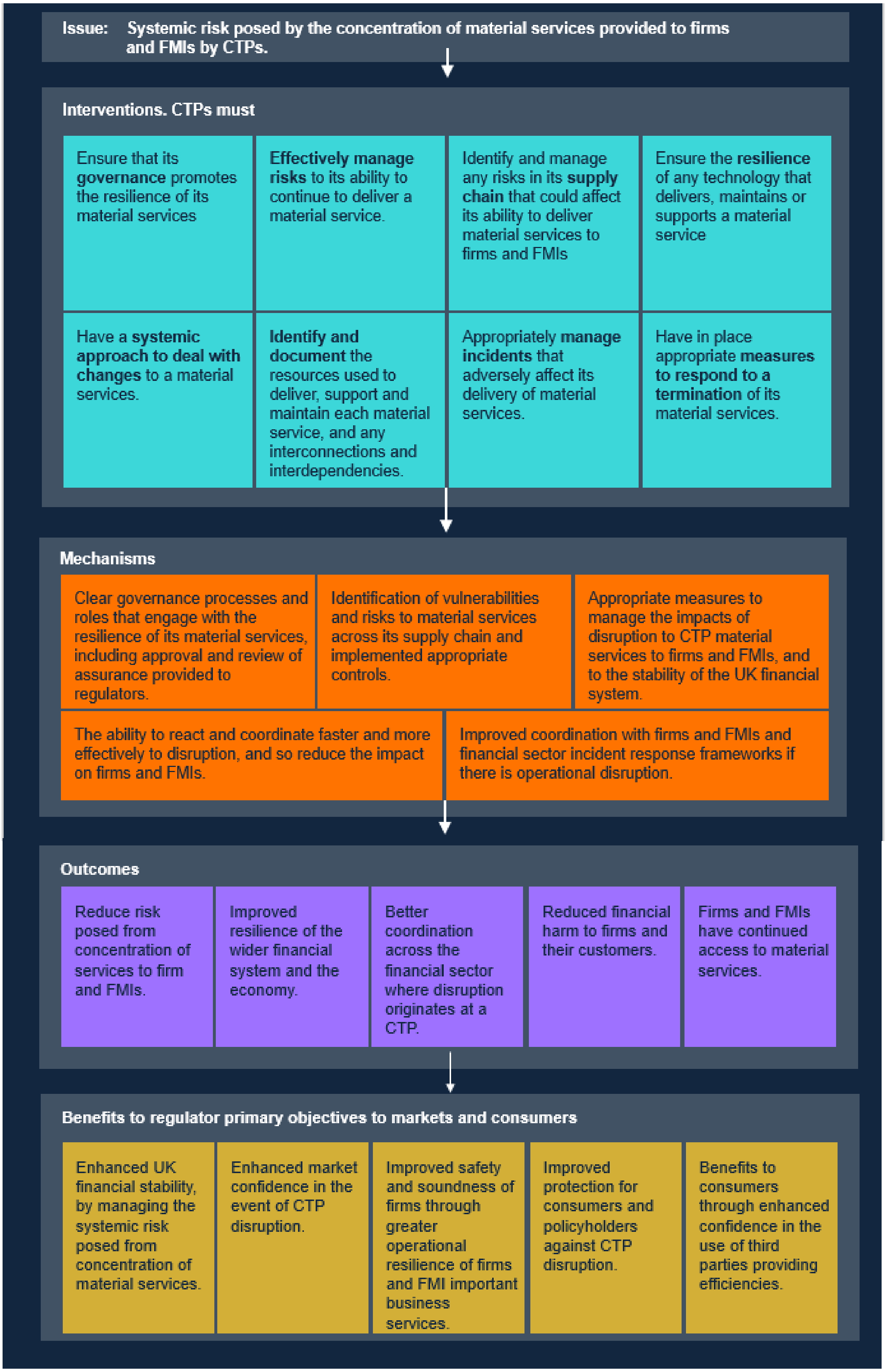

Figure 1 Causal chain

Summary of benefits and costs

16. The sections below assess the one-off and ongoing (annual) costs and benefits arising from the proposed framework. Based on the analysis of the costs and benefits of the proposals that are set out below, the regulators expect that the proposals would bring net benefits to the UK financial sector.

17. The costs include compliance costs to CTPs directly arising from the proposals, reflecting the incremental changes that CTPs would not have undertaken in the absence of the regulation.

18. Table 1 summarises the estimated average (mean) costs to CTPs. It is likely that many CTPs may already meet some of the requirements, due to the nature of their businesses, or due to preparations to meet international standards. Therefore, costs to CTPs may be lower than those presented.

Table 1: Estimated average one-off and ongoing (annual) costs per CTP, by cost type

Cost	One-off costs (£)	Ongoing costs (£, annual)
Familiarisation and gap analysis	20,000	N/A
Fundamental rules and operational risk and resilience requirements	640,000 – 910,000	c.500,000
Total	660,000 – 930,000	c.500,000

Table notes:

1. The figures are rounded to the nearest £10,000; therefore, cost estimates may not sum exactly to totals in the table.

2. The ranges are based on estimated costs from two sources:

   i) a cost survey by the PRA/FCA completed by third parties; and

   ii) estimated costs from the CBA of FCA and PRA's Operational Resilience requirements for regulated firms.[1]

[1] See Cost benefit analysis in **CP19/32: Building operational resilience: impact tolerances for important business services.**

19. For the purposes of this CBA, it is assumed there would be 20 CTPs as assumed in HMT's Impact Assessment.[2] The total costs of the proposals are summarised to an estimated number of 20 CTPs in table 2 below.

Table 2: Estimated average one-off and ongoing (annual) aggregate costs to 20 CTPs, by cost type

Aggregate cost across 20 CTPs	One-off costs (£)	Ongoing costs (£, annual)
Familiarisation and gap analysis	0.4 million	N/A
Fundamental rules and operational risk and resilience requirements	12.8 – 18.2 million	c.10 million
Total costs	13.2 – 18.6 million	c.10 million

20. In addition to the one-off and ongoings costs, CTPs could also incur costs for the proposed skilled persons reviews, under Sections 166 and 166A of FSMA, if the regulators request a review. Regulators have occasionally used these powers to review technology and infrastructure at firms and FMIs. The current reviews of firms and FMIs have been used to estimate a potential additional cost of £1.1 million to the CTP for a skilled person review when requested by regulators.

21. The benefits from the proposals are expected to arise through improved operational resilience at CTPs resulting in a reduction in the likelihood of disruption at CTPs posing a risk to financial stability, and an improved ability for the financial sector to work collaboratively with CTPs to manage these disruptions and the risks the pose. The benefit of enhanced operational resilience at a CTP would be amplified where multiple firms and FMIs use a CTPs material service. This is particularly important in mitigating the impacts of major incidents at CTPs that, while potentially less frequent, pose a systemic risk. The proposals may also have indirect benefits including promoting innovation and resilience in financial services, and efficiencies to the services provided to consumers, and promote consumer trust and engagement in the financial sector.

22. To assess whether the proposals are likely to be net beneficial, this analysis compares the expected costs of the proposals to the potential direct cost savings to firms and FMIs brought about through enhanced operational resilience of CTPs. Using conservative estimates of the potential benefits of the proposals gives annual net benefits to the UK of between £5 million and £62 million.

[2] Financial Services and Markets Act 2023, UK Parliament (see Impact Assessment).

23. Regulators have concluded that the proposals are likely to bring net benefits to the financial sector due to the important role that critical third parties are likely to play in affecting the system-wide resilience of the financial sector.

Affected population

24. The proposed requirements would apply to third parties that are designated as 'critical' by HMT under the Financial Services and Markets Act 2023, following finalisation of the regulators' rules. As the regulators do not know which third parties HMT would designate, for the purposes of this CBA, the analysis adopts the assumption in HMT's impact assessment that there would be 20. As per HMT's Impact Assessment, the analysis assumes that 20 CTPs would be designated in the first year of the rules come into force, and no further third parties are designated in later years. In reality, additional third parties may be designated in later years, and some designated entities may lose their designation status.

Costs

Costs to critical third parties

25. The proposals apply a new oversight regime to CTPs in respect of the services that they provide to the financial sector.

26. Regulators expect that there would be one-off costs to CTPs to familiarise themselves with the regime, assess current practices against new requirements and set up compliance processes. There would also be ongoing annual costs to CTPs to comply with the requirements such as reporting to regulators, incident management, risk management processes, and testing.

27. The data sources used to estimate these costs are set out below, followed by the analysis of the estimated costs of the proposals to CTPs.

Data

28. A range of sources are used to estimate the likely costs to CTPs from the proposals. The assessments of costs to CTPs are informed by the FCA's Standard Cost Model, the FCA's and PRA's cost survey to third parties, the estimated cost of the FCA Operational Resilience requirements for regulated firms,[3] and information from discussions with third

[3] See Cost benefit analysis in **CP19/32: Building operational resilience: impact tolerances for important business services.**

parties. These sources are described in more detail below, followed by a summary of the key assumptions.

FCA's standard cost model

29. The regulators have used the FCA's Standard Cost Model (SCM). [4] This is a framework for estimating common types of compliance costs. The framework is based on the FCA's understanding of how certain compliance costs are structured, drawing on a 'core' set of assumptions[5]. Costs can then be estimated in a bottom-up manner by supplying some variables specific to the intervention, principally relating to how many hours of time a certain activity requires of different types of firms.

30. The SCM classifies firms as small, medium, or large based on FCA fee block data and uses assumptions about firm size to estimate costs. Based on the criteria for being 'critical' third parties, the regulators expect CTPs are most likely to be equivalent in size to a large financial services firm.

Regulators' cost survey to third parties

31. To assess the costs of the proposals to potential CTPs, regulators published a survey questionnaire on the websites in April 2022 and sent the questionnaire to third parties providing a range of services to financial services industry. There were 19 responses to this survey from third parties providing a mix of ICT and non-ICT services to the UK financial sector and non-financial sector clients.

32. Following removing seven responses with no information on costs (blank responses) the resulting sample used for cost estimations was made up of 12 third parties. This sample had the following characteristics:
    - All respondents, except one, provide services to the UK financial sector.
    - Three provide ICT services, four provide non-ICT services and four provide a mix of ICT and non-ICT services. One respondent did not provide this information.

33. Additional sources of evidence have been used to assess the costs to CTPs given the small sample size and due to concerns around whether the sample population is representative of the population of CTPs expected. The estimated cost of the FCA's operational resilience regime to firms is used to present a range of estimated average costs to CTPs.

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[4] **How we analyse the costs and benefits of our polices, FCA (2018).**

[5] In early 2023, the underlying salary and firm size data in the SCM were updated. The underlying assumptions remain the same as in Annex 1 of FCA's CBA framework.

FCA's CBA of Operational Resilience regime for regulated firms

34. To build on the evidence base, information on costs is also drawn from the FCA's CBA of the Operational Resilience regime, which required firms to meet similar resilience standards. The cost estimates in the CBA make use of the estimated compliance costs of this regime submitted by 45 large regulated firms (as classified in the FCA's SCM) in response to the FCA's survey of a randomised sample of 110 large firms. The PRA's CBA of the Operational Resilience regime draws on the same survey but estimates costs using data submitted by dual-regulated firms only[6]. The regulators use the estimates from the FCA's CBA as they are based on a larger sample size and allow the regulators to breakdown the costs of the regime to compare the proposals in this CP.

35. The Operational Resilience regime is considered to include a comparable set of requirements and therefore represent a reasonable evidence base to assess the costs of the proposals upon. For example, the proposed mapping and testing requirements under the CTPs regime have been developed by drawing on the mapping and scenario testing requirements set out for firms under the Operational Resilience regime.

36. Although there are some differences between the two regimes, the overall burden is considered to be similar and therefore the costs to similar sized entities to be comparable. The average costs to firms for the Operational Resilience regime are estimated for three sizes of firms. There is a focus on the estimated costs to large firms as regulators believe it is likely that CTPs are likely to be larger based on the threshold of providing 'critical' services to the UK financial sector.

Engagement with third parties

37. To inform the policy development and following the cost survey, regulators discussed the potential costs of the proposals with some third parties. This information is used to inform the assessment of the likely costs to CTPs.

Familiarisation and gap analysis costs

38. CTPs would incur one-off costs to familiarise themselves with the proposals and conduct gap analysis of the new requirements against current practices to understand the changes they would need to implement to meet the requirements.

39. The FCA's SCM is used to estimate the cost to CTPs to familiarise themselves with the proposals and complete gap analysis.

[6] See cost benefit analysis in **CP29/19 'Operational resilience: Impact tolerances for important business services' (bankofengland.co.uk).**

Table 3: Estimated familiarisation and gap analysis costs to CTP

Costs	One-off cost (£)	Assumptions
Familiarisation	12,000	As per the SCM: • The regulators assume it would take approximately 1.5 working days to read the policy documentation. • 20 compliance staff at large firms who need to read the policy documentation. • The hourly compliance staff salary is assumed to be £62 at large firms, including 30% overheads. Regulators believe that 20 compliance staff is likely to be at the higher end based on two third parties' expectations that two and 10 staff would manage compliance with the CTP regime.
Gap analysis	8,000	• There are around 15 pages of legal instrument and as per the SCM, legal and gap analysis review would involve four staff at the largest firms. • As per the SCM, each legal staff member can review 50 pages of legal text per day and the hourly legal staff salary is set at £74 at large firms, including 30% overheads.
Total costs per CTP	20,000	
Total costs to CTPs	400,000	For the purposes of this CBA, it is assumed there are 20 CTPs.

Table notes: Figures are rounded to the nearest £1000 and cost estimates may not sum exactly to the totals.

Costs of Fundamental Rules and Operational Risk and Resilience requirements

40. The estimated costs to CTPs meeting the Operational Risk and Resilience requirements (excluding governance requirements) are based on the estimated costs provided by third parties in response to the survey and the estimated costs to firms of the FCA's and the PRA's Operational Resilience regime. A range of average estimated costs is presented based on these two sources to mitigate against issues around the representativeness of

the sample population for estimates based on the survey to third parties (see 'analytical approach' above). A summary of the estimates from the two sources is presented in table 4.

Table 4: Estimated average one-off and ongoing (annual) costs of Operational Risk and Resilience requirements (excluding governance requirements) per entity, by cost type and source

Costs	Source	One-off costs (£)	Ongoing costs (£, annual)
Operating and overseeing	Third Party survey	197,000	189,000
	Operational Resilience CBA	411,000	255,000
IT	Third Party survey	263,000	244,000
	Operational Resilience CBA	400,000	169,000
Training	Third Party survey	159,000	70,000
	Operational Resilience CBA	80,000	49,000
Total	Third Party survey	619,000	504,000
	Operational Resilience CBA	891,000	473,000

Table notes:

1. Costs from the Operational Resilience CBA (2019 prices) have been adjusted to 2023 values using HMT's GDP deflators[7].
2. The costs for operating and overseeing the Operational Risk and Resilience regime are assumed to represent comparable costs to the implementation costs including ongoing governance estimated in the Operational Resilience CBA.

[7] GDP deflators at market prices, and money GDP June 2023.

3. Costs relating to governance requirements are estimated separately (see paragraphs 41-42 below), as third parties were not asked to estimate these costs as part of the survey and these requirements do not map to costs in the Operational Resilience CBA.
4. The costs for operating and overseeing the Operational Risk and Resilience regime are assumed to map to the implementation costs including ongoing governance estimated in the Operational Resilience CBA.

41. CTPs would also incur costs to comply with the proposed Fundamental Rules, although it is expected that costs would be minimal as CTPs are likely to already comply with these high-level principles. Similarly, regulators expect CTPs are likely to already be complying with many of the proposed governance requirements as part of the Operational Risk and Resilience requirements. However, regulators expect CTPs to incur costs for demonstrating compliance with the proposed rules for both sets of requirements. These change and governance costs to CTPs have been estimated using the FCA's SCM. It has been assumed that the project would be very small and would require the following as per the SCM:
    - 45 total person days shared between the project team and manager,
    - 0.4 person days required for board review, and
    - 0.6 person day reviews for executive Committee review

42. Based on this, the estimated average one-off cost for a change and governance project at a CTP is approximately £20,000, and the total one-off costs to 20 CTPs is £400,000.

43. It is likely that costs incurred by CTPs would vary based on the scale of changes required to their existing systems and processes. For some CTPs, these costs would likely represent an upper estimate. This could be the case where cyber resilience is critical to their business, for example, Cloud Service Providers, where it likely that CTPs already fully comply with the proposed requirements. This is evidenced by responses to the survey in which five third parties submitted zero additional costs.

44. Some third parties may already be preparing to comply with similar requirements for the European Union's Digital Operational Resilience Act (DORA) and so may only incur small additional costs to meet the proposed requirements, for example, interacting with additional regulators on an ongoing basis. On discussion with two third parties following the survey, they noted the more regimes are aligned, the more efficient the resourcing and implementation at the CTP.

45. The regime is being consulted on jointly by the PRA, Bank and FCA. Some proposals may require CTPs to submit information and notifications separately to each of the regulators. This could result in additional one-off and ongoing reporting costs that has not been included in the cost analysis of the proposed policy. When developing the oversight

approach to CTPs, the regulators would consider the impact of reporting requirements to ensure the potential costs on CTPs are proportionate.

Cost of information gathering (expert review) on critical third parties

46. The regulators propose to commission skilled persons' reviews of CTPs under Sections 166 and 166A of FSMA. These reviews would be used for any purposes, including for resilience testing, and the CTP would bear the costs in addition to the costs set out above. The average cost to firms and FMIs for skilled persons reviews relating to data and IT infrastructure, and technology and information management is £1.1 million.[8] Currently, skilled person reviews are used infrequently by regulators on firms and FMIs. Regulators would ensure that the potential costs from requesting expert reviews on CTPs are proportionate to the risk being posed.

Costs to regulators

47. The proposals will impose some costs on the PRA, the FCA, and Bank of England. These costs would arise from the additional resources required by the regulators to carry out new oversight activities on an ongoing basis. The regulators' future, annual consultations on fees will consider how to incorporate the costs they may incur due to the CTP regime.

48. As noted in Chapter 1, in parallel to developing and consulting on the proposals in this CP, the regulators are developing an oversight approach for CTPs. The regulators will publish an Approach Document and MoU in due course setting out how they will coordinate their engagement with and oversight of CTPs in practice.

49. The eventual resourcing model and costs to regulators may vary significantly depending on a number of factors that are yet to be determined, including but not necessarily limited to:

- any changes to the regulators' proposed requirements and expectations for CTPs made as a result of feedback to this consultation;
- the eventual number of CTPs that are designated;
- the regulators' oversight approach to CTPs i.e. the frequency and intensity of their engagement with each CTP;
- how the regulators coordinate their engagement with and oversight of CTPs
- the extent of the regulators' coordination with non-UK financial regulatory, oversight or supervisory authorities, and UK regulators and other public authorities outside the financial services sector.

[8] Internal data and calculations.

50. Based on the regulators' preliminary estimates, the costs are not expected to exceed £10 million and are likely to be lower. These estimates are based on 20 CTPs being designated and seek to provide an initial basis for discussion. The estimates could vary based on the factors referred to above. The regulators will update their estimates when they publish their final policy, at which point they should have greater clarity on their oversight approach.

Costs to firms and FMIs

51. As customers of CTPs services, firms and FMIs may incur costs to familiarise themselves with the proposals in order to understand what information they can expect from CTPs that could help them to manage their operational resilience risks.

52. CTPs may also seek to pass on the costs of complying with this regime to firms and FMIs through higher charges for their services. Firms and FMIs may decide to pass on these increased charges, and additional fees from the regulators to oversee this regime, to consumers. However, the extent costs are passed through to market participants depends on the supply and demand elasticities.

Benefits

53. The supervisory authorities expect that several benefits would emerge as a result of the proposed rules and requirements for CTPs, as set out in the causal chain (Figure 2). While some of these estimated benefits are specific to the implementation of particular rules, most are expected to arise from the policy package as a whole. The key mechanisms through which benefits are expected to materialise are through improved operational resilience at CTPs, firms and FMIs. This will generate benefits, broadly in the following groups: (i) benefits to UK financial stability and market confidence; (ii) benefits to behaviour and innovation in the market; and (iii) benefits to consumers of financial services.

54. Where possible, benefits are assessed on a quantitative basis but where there are data limitations, qualitative analysis has been used. The net benefits of the proposals are assessed in the following section, based on weighing up the costs of the proposals to the estimated costs of operational resilience incidents and disruptions to firms and FMIs that could be avoided.

Improved operational resilience of CTPs, firms and FMIs

55. The benefits to the market and consumers are expected to materialise as a result of improved operational resilience of CTPs, firms and FMIs. The mechanisms through which the proposals may drive improvements in operational resilience are set out below.

56. The proposals would enhance the operational resilience to the material services that CTPs provide to firms and FMIs. The proposals aim to deliver specific outcomes that collectively aim to reduce the systemic risk posed by CTPs and bring about benefits to the regulators' objectives that are summarised in Figure 2.

57. The proposals could also bring indirect benefits to the safety and soundness of individual firms and FMIs by enabling improvements to their own operational resilience. Overall, this could be achieved if the proposals improve individual firms and FMIs' understanding of the key risks stemming from the CTP services they rely on to provide their own services.

58. Examples of proposals in the regime that could facilitate this include the proposed incident management requirements on CTPs (Requirement 7). This could improve incident management at firms and FMIs that rely on the material services provided by a CTP. The proposed requirement could improve communications from CTPs and, in the most severe cases, facilitate sector wide responses by UK regulators. The proposed testing of the financial sector incident management playbooks that include firms and FMIs could further embed understanding of the communication process during an incident reducing the risk of uninformed decision making.

59. Firms and FMIs risk management of CTPs could be improved by the proposed expectation on CTPs to be transparent about the key components of the supply chain (Requirement 3). This could improve firm and FMIs assessments of supply chain dependencies, enhancing firms' ability to meet outsourcing expectations.[9]

60. The proposed requirement for CTPs to ensure appropriate transitional continuity of its material services in the event of unexpected termination of its operations (Requirement 8) could mitigate the risk of financial services being unavailable for a sustained period. Firms and FMIs remain responsible for compliance with existing operational resilience and third-party risk managements requirements, including those around stressed exits. However, due to systemic nature of CTPs, it is essential there are arrangements in place that support these requirements on firms and FMIs.

[9] Paragraph 5.24 SS2/21 – **Outsourcing and third party risk management**.

61. The proposed requirements and expectations on CTPs to share assurance and testing information with firms and FMIs that use the material service would help the FS sector's understanding of potential risks to the delivery of their important business services. This would help enable firms and FMIs to actively put in place processes and procedures in place to mitigate the risks rather than reactively managing the consequences if risks materialise.

Benefits to UK financial stability and market confidence

62. The regulators have a shared objective to protect and enhance the stability of the financial system of the UK. The concentration in the provision of material services by CTPs to multiple firms and FMIs is regarded as a potential risk to this objective.

63. The proposed rules and requirements on CTPs aim to reduce the likelihood that such a disruption will occur by ensuring that important and relevant risks are identified and effectively managed. When disruption does occur, the proposals aim to reduce the threat to financial stability and market confidence through improved communication and coordination with regulators, firms and FMIs.

64. The regulatory focus on ensuring operational resilience of material services provided by CTPs should reduce the risk of financial sector dysfunction when disruption at a CTP does occur. The proposed requirements aim to ensure CTPs have a plan and procedures in place when incidents that result in disruption to or a failure in material services occur. This would enable CTPs and firms and FMIs that rely on the material service, to act in a rationale and prudent manner to manage the risks from a disruption. In particular, regulators propose that CTPs would be expected to maintain a 'financial sector incident management playbook', documenting how it will coordinate with the regulators and its firms and FMI customers (collectively and individually) during those incidents. This reduces the risk of disruptions triggering wider disruption or distress in the financial sector and UK economy.

Benefits to behaviour and innovation

65. The proposals aim to provide greater confidence in the stability of the financial sector. In turn, this may give firms and FMIs further confidence to utilise the innovation and resilience benefits of third-party services. A greater use of innovative technology would bring benefits to firms and FMIs, the wider financial sector, and the real economy.

66. The proposals would not place any requirements on firms and FMIs themselves around the use of CTPs for provision of services. Moreover, the regime does not discriminate on the basis of particular technologies, the policy is intended to be technology-neutral and focuses on regulatory outcomes. Regulators consider that this technology-neutral

approach helps create a regulatory environment where firms and FMIs can pursue innovation.

Benefits to consumers

67. A reduction in disruption to firms and FMIs important businesses services would benefit consumers by ensuring that they have continued access to financial services, promoting the FCA's primary objective. Better information on operational risks at CTPs would allow firms and FMIs to react faster and more effectively when their important business services are disrupted, thereby reducing the number of consumers affected and lessening the impact on those that are affected.

68. A reduction in the likelihood of major disruption to financial services may also promote consumer trust and engagement in the financial services sector.

69. Regulators do not consider that the costs or benefits would disproportionately impact particular groups of financial services firms or consumers. However, depending on the type of services CTPs provide, it is possible that the impacts affect particular financial services and customers of these particular services.

70. Based on the analysis of the benefits against the overall costs of the regime, the regulators expect that the proposed rules and requirements for CTPs would bring net benefits to the UK financial sector.

Assessment of the net benefits of proposals

71. The expected costs of CTP disruption to firms and FMIs and the wider UK financial sector are considered to determine the extent of the regime's potential benefits on financial stability and the financial sector. The likelihood that the proposals reduce the chance of such disruptions occurring are then estimated to determine the benefits and assess whether the regime is likely to be net beneficial.

72. Regulators uses four scenarios for estimating the expected cost of CTP disruption to firms and FMIs and the wider UK financial sector. These include the cost of:

- frequent but minor disruption and operational incidents at CTPs that impact multiple firms;
- major disruption at CTPs to individual firms;
- major disruption at CTPs to individual FMIs; and
- major disruptions at CTPs that impact multiple firms and FMIs.

Reducing the costs of frequent but minor disruption and operational incidents at critical third parties

73. Less severe operational incidents occur more frequently than major incidents.[10] Although less severe, they may still pose a threat to UK financial stability where multiple firms rely on the same provider to support the delivery of an important business function. These incidents still have the potential to impact regulators' objectives at an individual firm basis; impacting the safety and soundness of firms and disruption to important business services that firms and FMIs provide to consumers or policyholders. To determine the potential benefits of the proposed CTP regime in these cases, regulators have estimated the potential cost savings to firms and FMIs of enhanced operational resilience at CTPs if the regime reduces the likelihood of frequent less severe disruptions.

74. The cost benefit analysis in CP19/32 – Building operational resilience[11] calculates the average cost per incident at firms as £685,000.[12] CP19/32 also notes there were 852 technology and cyber incidents reported by firms to the FCA in financial year 2018/19, making these incidents frequent occurrences. The cost of these incidents ranged from hundreds of thousands to tens of millions of pounds and do not include the costs of the most major incidents. For disruption that originates at a CTP where multiple firms rely on the same provider, the costs from the incident could be five times higher per incident.[13] As such, the cost of an incident to a firm's important business services is multiplied by five to estimate the cost of CTP disruption be £3,400,000.

Reducing costs of major disruption to individual firms

75. The proposals seek to mitigate the significant risk to the financial sector that a major disruption at a CTP could pose. The regulators are not aware of any systemic incidents of this type to illustrate the potential financial impact of a CTP disruption. Instead, technology incidents at firms and FMIs are used as a proxy to illustrate the potential financial impact of a major disruption at a CTP.

76. Three relevant incidents are a technology failure incident at the Royal Bank of Scotland in 2012, a major cyber incident and Tesco Personal Finance PLC in 2016, and a major incident at TSB Banking Group PLC in 2018. These incidents are estimated to have cost

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10 FCA CP19/32 – **Building operational resilience**, paragraph 12.
11 CP19/32 – **Building operational resilience.**
12 Shown in 2023 values.
13 Based on the PRA's 2021 Outsourcing Register data. Regulators calculate, up to five firms outsource services to the same third party supplier for the same type of important business services.

£158,000,000,[14] £22,700,000,[15] and £387,500,000.[16] The incidents separately involved severe disruption to each firm's critical functions, ultimately impacting customers' ability to access accounts and make payments.

77. The incidents described above were not caused by disruption at an external third party. However, as firms and FMI's reliance on third parties grows, they are considered useful comparators. Taking the average of these incidents, the estimated potential cost to a single firm or FMI of a major CTP disruption that had a significant impact on a firm's important business services be £189,400,000.

Reducing costs of major disruption to individual FMIs

78. CTPs could also impact the services FMIs offer either directly, where services or components of services are outsourced to third parties, or indirectly, where participants in FMIs outsource functions to connect to FMI services.

79. Disruption at a CTP providing services directly to an FMI has the potential to impact UK financial stability due to the systemic nature of each FMI's role. As above, no systemic incidents impacting FMIs have occurred for us to use as evidence for this CBA. Instead, operational incidents at FMIs are used as a proxy to illustrate the potential disruption a CTP could create where services are outsourced.

80. Two potentially relevant proxy incidents are the partial service disruption at Visa Europe in 2018 and Euroclear UK & International Limited's[17] (EUI) settlement system disruption in 2020. The Visa Europe incident impacted 5.2 million debit and credit card transactions over a 10 hour period. At its peak, 35% of transactions failed for UK Visa cardholders during a 50-minute period.[18] This incident impacted retail transactions, meaning it directly affected the consumers and merchants. Incidents like this can impact trust in the UK financial sector causing wider implications to firms and FMIs and the wider UK economy.

81. EUI, the UK Central Securities Depository (CSD), suffered a system outage to its settlement system for securities transactions which caused notable market disruption.[19]

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14 **RBS reaches IT Incident settlement.**

15 **FCA fines Tesco Bank £16.4m for failures in 2016 cyber attack | FCA**.

16 **TSB announces 2018 full year results.**

17 Previously known as 'Euroclear UK & Ireland Limited' before September 2021.

18 **Letter from Visa regarding service disruption, 15 June 2018.**

19 **Bank of England announces supervisory action over Euroclear UK and Ireland September 2020 operational settlement outage.**

This disruption was due to an issue with messaging software component of the CSD's operations.

82. These examples highlight that disruptions to services at FMIs can have a systemic impact on the financial system. While these examples are not cited as examples of disruptions caused by issues at an external third party, as FMI reliance on third parties grows, they are considered useful examples to cite.

Reducing costs of major disruption to multiple firms and FMIs

83. Disruptions at certain CTPs have the potential to simultaneously impact the provision of important business services at multiple firms and FMIs. In a worst-case scenario, such a disruption could result in an incident comparable to multiple TSB Banking Group PLC disruptions (see paragraph 47) at the same time, which could have a major impact on financial stability.

84. Where five large firms rely on the same provider to support the delivery of an important business service, such a catastrophic disruption could cost five times higher than the cost of disruption to a single firm.[20] As such, the average major incidents at firms is multiplied by five to estimate the potential financial disruption from CTP disruption to be £947,000,000.

85. This figure is likely to be an underestimate of the true cost of a CTP disruption. In addition to the direct costs to firms and FMIs being unable to deliver financial services to customers, in the event of significant disruptions there would also likely be market dysfunction. Such a market dysfunction would be amplified by imperfect information on cause, remediation steps, and plans to mitigate the impact.

86. Due to the types of important business services that CTP disruption could impact, there could be impacts in the real economy. An example of this is firms' provision of payment services to customers being impacted that could limit or prevent critical payments such as wages, loan and mortgages repayments, bills, and universal credit payments being made. These secondary impacts are difficult to quantify but should be considered as part of the wider assessment of benefits.

Conclusion of net benefits assessment

87. Assuming there are no further benefits of the proposals beyond these direct costs avoided by firms, the potential net benefits of the proposals can be calculated. Using the

[20] Using 2021 outsourcing survey data collected from 30 firms regulators calculate for the same selected important business service type up to 5 firms outsource services to the same third party supplier

estimate of the potential cost of CTP disruption to the financial sector of £947,000,000, the proposals would be net beneficial if they led to the avoidance of one major disruption every 27 years. Separately, looking at less severe operational incidents, the proposals would be net beneficial if it led to the avoidance of six CTP incidents per year.[21]

88. It would not be possible for the policy proposals to completely mitigate the possibility of major incidents at a CTP. However, the likelihood and impact of disruption at CTPs on the financial sector is expected to decrease as a result of the policy proposals. This decrease could be limited where CTPs are already required to comply with regulations in other jurisdictions that seek to drive similar benefits, for example DORA. Regulators have determined the net benefits in two scenarios using the assumed impact of similar regimes from previous publications.

89. In a scenario where the benefits of the regime are more conservative, the net benefit is calculated using the estimate of the potential cost of CTP disruption to the financial sector of £947,000,000, and then apply the assumption previously used by HMT.[22] This assumes the proposals would reduce the probability of major disruption by three percentage points. In this scenario, the proposals would have an average annual net benefit of £5 million.[23] An EU impact assessment of similar proposals assumed a 10% fall in the likelihood of major disruption.[24] Using this less conservative assumption, the proposals would have an average annual net benefit of £62 million.[25]

Competition impacts

Impact on third party markets

90. Where a third party provides services in a market that is already highly concentrated, e.g., cloud services[26], the proposals could further entrench the market power of third parties designated as CTPs. Firms could view the regime as a 'kitemark' of regulatory approval and choose to contract with a CTP in the belief that they are more resilient than providers outside the regime, or that the regulators will view them favourably for doing so. This could lead to a negative impact on competition between third parties in that market. This

21 Based on average annual cost of proposals over initial 10 year period.

22 Assumption used in HM Treasury Financial Services and Markets Bill Impact Assessment **Financial Services and Markets Bill publications - Parliamentary Bills - UK Parliament.**

23 Based on average annual cost of proposals over initial 10 year period.

24 Assumption used in European Commission Staff Working Document **Impact Assessment Report accompanying Proposal for a Regulation of the European Parliament and of the Council on digital operational resilience for the financial sector.**

25 Based on average annual cost of proposals over initial 10 year period.

26 **Cloud service market study**, Ofcom (2023).

can be referred to as a ‘halo effect’. As some third party markets are already highly concentrated, there may be limited scope to increase concentration. However, even if it did not *increase* concentration, a halo effect could lock in existing concentrated market structures. To address this, the regulators have proposed mitigations (see chapter 8):

- clarifying that a CTP’s designated status will not necessarily mean that it is inherently more resilient, safer, or more suitable to provide a given service to a given firm or FMI than non-designated third parties providing the same or similar services; and
- rules to prevent CTPs using designation or oversight as a mark of regulatory approval or endorsement, or that this confers any advantage to anyone using its services.

91. It is possible that aspects of the CTP regime may offset any potential for this effect to emerge. The regime gives the regulators enforcement powers, including the ability to publicly censure a CTP that has contravened a relevant requirement or prohibit both the CTP and firms from entering further arrangements. The risk of such regulatory sanction may disincentivise firms from choosing a CTP as a third-party provider.

92. Non-designated third parties may seek to counter the impact of the halo effect by demonstrating to financial services customers that they meet the Operational Risk and Resilience Requirements of designated third parties, in order to compete with CTPs. In doing so non-designated third parties could incur additional costs. Although it is unclear if and how many third parties may respond in this way, this is considered to be an indirect cost of the regime.

93. It is possible, if compliance costs were prohibitive, that the CTP regime could raise barriers to entry and expansion to firms providing third party services. This could potentially discourage new third parties from entering the market for supply of FS firms (‘deterred entry risk’), or prevent current third parties from expanding beyond a certain point if they felt this could lead to their designation as CTPs, in order to avoid regulatory oversight (‘cliff-edge risk’). It could lead to current third parties exiting the supply to FS firms (‘firm exit risk’). These effects could lead to less intense competition between third party service providers to FS firms. As a result, there could be reduced innovation in the CTP market.

94. However, as many potential CTPs may already be preparing to comply with international regimes and since the costs are likely to be small relative to the types of providers that may be designated as CTPs, the regulators consider the risk of such impacts arising to be very small.

Impact on financial services markets

95. Another possible competition impact could occur if CTPs pass on the costs of compliance to their firm or FMI customers through higher charges for their services. This could have a small competition impact within financial services, as smaller firms may find it relatively more costly to use CTPs than larger firms. The extent to which costs are passed through to firms will depend on supply and demand elasticities. Such an impact might disproportionately impact small firms, which would be less able to absorb costs. If this impact arose, it could have the potential to result in firms passing on costs to their customers.

96. Many potential CTPs may already be preparing to comply with international regimes and since the costs are likely to be small relative to the types of providers that may be designated as CTPs. The regulators believe the proposals are proportionate and that they are unlikely to result in an increase in costs that will significantly impact the structure of a third party market or result in a significant transfer to firms. Therefore, the regulators consider the potential for negative impacts on competition to be low.

97. Overall, the regulators consider that the benefits of the regime, including managing the systemic risks posed by CTPs, exceed the costs and the proposals will advance the regulators' respective objectives having taken into account the potential impacts on competition.

Impact on international competitiveness and medium-term growth of the economy

98. While the proposals do impose more regulatory burden on the UK financial system, regulators do not expect they will do so to an extent that will negatively impact competitiveness or growth.

99. There are emerging and established standards for the oversight of CTPs in other jurisdictions – most notably, the European Union's Digital Operational Resilience Act (DORA) and the United States' Bank Service Company Act (BSCA). The regulators are closely involved in the work of the Financial Stability Board (FSB), which has led global discussions on potential systemic risks posed by CTPs. There is close alignment between the recently published FSB toolkit and the UK's CTP oversight regime.

100. The proposals are compatible with DORA and BSCA. Where they differ, they do not do so in a way that could reasonably be expected to detrimentally impact UK

competitiveness and growth. For example, the BSCA and the UK regime have a shared focus on services, while DORA will provide for oversight of the whole CTP, not just its service to financial services firms. There are similarities between DORA and the UK's CTP regime in respect of the criteria that will be used to identify providers for designation.

101. The regulators consider that the proposals will contribute to making the UK an attractive environment for firms and FMIs by enhancing the resilience of the CTP services on which firms depend and supporting financial stability. Enhanced operational resilience should contribute to enhanced financial stability, thereby contributing to maintaining the UK as an attractive place for firms to base operations and therefore contributing to UK competitiveness and growth.

102. As noted in chapter 10, the regulators therefore consider that the proposals in this CP will advance the FCA and PRA's secondary competitiveness and growth objective.