

The Bank of England's approach to the supervision of financial market infrastructures

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BANK OF ENGLAND



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Introduction

Responsibility for the supervision of securities settlement systems and central counterparties will transfer to the Bank of England (the Bank) from the Financial Services Authority (FSA) following the enactment of the Financial Services Bill. The transfer of responsibility is currently expected to take effect on 1 April 2013. This document sets out the Bank's intended approach to the supervision of these financial market infrastructures. It aims to enable the operators of and participants in infrastructures that will be subject to the Bank's supervision to consider, respond to, and prepare for the Bank's supervisory approach.

Financial market infrastructures — FMIs — including securities settlement systems and central counterparties, as well as the recognised payment systems already overseen by the Bank, can, through their design and their rules, reduce risk in financial markets. Market functioning, and therefore financial stability, can also be dependent on the continuity and orderly operation of services provided by FMIs. In many cases, market participants have few, if any, practicable alternatives to using these infrastructures. Poor FMI design can mean that unnecessary exposures arise between market participants. Disorderly insolvency of an FMI, or operational failure, could lead to severe systemic disruption. Supervision of FMIs is therefore closely linked to preserving financial stability. Consistent with that, the Bank will undertake its supervision of FMIs with a view to protecting and enhancing the stability of the financial system.

If FMIs are operated only in the private interests of their managers, owners, or even their members, they may under-invest in the mitigation of risks to the wider system. The Bank's role as supervisor is to ensure that the infrastructures are managed in a manner that is consistent with the public interest including reducing systemic risk.

The Bank will exercise its supervision of FMIs within the framework of a UK legal regime that will, for central counterparties and securities settlement systems, itself sit within directly applicable EU regulations and accompanying binding technical standards. These UK and EU regulations and standards in turn follow global standards drawn up by central banks and securities market regulators working together through the Committee on Payment and Settlement Systems (CPSS) and the International Organization of Securities Commissions (IOSCO). The *Principles for Financial Market Infrastructures* published by CPSS-IOSCO in April 2012⁽¹⁾ form a key foundation stone for the Bank's supervisory approach, as the previous CPSS-IOSCO *Recommendations*⁽²⁾ have been for FSA supervision. The UK regulatory framework, and requirements and rules set within it, will be consistent with the minimum standards in the *Principles*. They will go beyond the

minimum standards if the Bank judges this necessary to address systemic risk.

Section 1 of the paper gives an overview of the critical role of FMIs and how that relates to the Bank's supervision and its financial stability objective. Section 2 provides a high-level description of the regulatory regime and the legal instruments available to the Bank. Section 3 sets out some supervisory priorities for the Bank, and Section 4 describes how Bank supervisors will engage with supervised institutions in practice. Sections 5 to 8 give an overview of policy making, enforcement, fees, and accountability, transparency and complaints. Section 9 sets out next steps. Annex 1 sets out how these changes will affect payment systems already overseen by the Bank. Other Annexes provide reference material.

1 The Bank's objective and the critical role of financial market infrastructures

FMIs can enhance the stability of markets and promote wider financial stability. It is for this reason that the Bank and other authorities have encouraged use of FMIs, and developed the *Principles* and regulations by which they should operate. It is also why, in 2009, G20 leaders agreed that all standardised OTC derivative contracts should be cleared through central counterparties by the end of 2012.⁽³⁾

FMIs are different from banks. Banks create risks, for example, through the loans they make using the deposits they receive. In general, FMIs do not themselves create risk, but can reduce risks that arise as part of the transaction process, and enable the better management of risk, including, in some cases, by redistributing or mutualising risk. FMIs are, in essence, sets of rules, contracts, processes and operational arrangements for managing, reducing and allocating risk arising from transactions between market participants.

Securities settlement systems, for example, can reduce credit risk in securities purchases by ensuring that securities are delivered only when payment is received with finality (delivery versus payment). Central counterparties (CCPs) and payment systems can reduce credit and liquidity risk by enabling the multilateral netting of payment or financial exposures. CCPs also simplify and bring transparency to otherwise complex

(1) The full set of 24 *Principles* can be found at <http://www.bis.org/publ/cpss101a.pdf>. They cover management of credit, liquidity, business, legal and operational risk as well as governance, default management, and transparency. They are addressed to five types of FMI: payment systems, securities settlement systems and central securities depositories (CSDs), central counterparties and trade repositories. The term FMI can also sometimes be used to refer to exchanges. In this document, however, the term is used to refer to operators of recognised payment systems, securities settlement systems, CSDs and central counterparties only. Trade repositories based in the EU will be supervised by ESMA rather than by national authorities, and are not discussed in this publication.

(2) <http://www.bis.org/publ/cpss61.pdf> and <http://www.bis.org/publ/cpss46.htm>.

(3) http://ec.europa.eu/commission_2010-2014/president/pdf/statement_20090826_en_2.pdf

networks of bilateral exposures, and seek to mitigate credit risk by collecting margin from all counterparties. All these types of FMI can serve to reduce operational risks through the standardised processes they introduce.

Monitoring, managing and mitigating risk, including systemic risk, is, then, a primary responsibility for the operators of financial market infrastructures. In turn, a large part of the role of FMI supervisors is to ensure that the FMI's rules and policies are designed, and applied, in ways that genuinely reduce these risks. It is this combination of roles that informs the Bank's supervisory priorities and practical approach to supervision set out in more detail in Sections 3 and 4 below.

Because of their critical systemic role, FMI rules must be designed to minimise the extent to which difficulties experienced by one participant can spread to others as a result of the transactions processed by the FMI, and also to minimise their own vulnerability to failure. The *Principles* and regulations that apply to FMIs are intended in large part to achieve this. One key set of rules in this regard determines what happens when a participant in an FMI defaults, and how the impact of that default on other participants and the FMI itself is managed. Whether the FMI is itself a counterparty to the transactions it processes and therefore takes principal risk related to those transactions is, however, an important difference between FMIs in relation to participant default. CCPs in particular, by design, take principal risk. A particularly important element of the design and rules of CCPs is, therefore, how they calculate and maintain their own loss-absorbing resources and the discretion available to management within those rules. This will, therefore, be one key area of focus of Bank supervision, as described in Section 3.3.

No matter how strict the *Principles* and regulations, or how good an FMI's risk management, the possibility of the FMI's own financial distress, or failure, cannot be entirely excluded. Another key part of the rule set is, therefore, the actions the FMI would take in the event of its own distress, how the FMI will recover if and when risks do crystallise, and how its rules facilitate resolution by the authorities if recovery is not feasible. What happens when things go wrong is a useful starting point for assessing the risk for market participants in using an FMI.

The G20 objective in relation to central clearing is expected to increase the scale and importance of CCPs for the functioning of the financial system. It is important that the Bank's and other authorities' encouragement for the development and use of financial market infrastructure to meet this objective, does not create a new class of too-important-to-fail institutions. In assessing FMIs' risk management, recovery and resolution plans, the Bank will therefore seek to ensure that FMI management planning takes proper account of protecting

the system as a whole, and, to that end, that sufficient priority is given to continuity of key services, without systemic disruption and without recourse to public funds. Work is underway in the UK, in Europe, among G20 standard-setters and at the Financial Stability Board (FSB) to set out how FMIs can and should recover from losses that might otherwise threaten their viability, as well as the key features of resolution regimes should these recovery plans prove inadequate.⁽¹⁾ Section 3.4 considers the central importance of recovery and resolution planning to FMIs.

Responsibility for each FMI's design and operation sits firstly with the board and the management of the firm that manages the FMI. Section 4 explains how the Bank's supervisory approach, and the practical application of its supervision, will therefore be centred on an expectation that the board and managers of FMIs take full responsibility for managing the infrastructure in a manner that protects the stability of the FMI and with regard to the financial system as a whole. The Bank's aim is to establish a framework that creates incentives for the operators of FMIs to manage and mitigate systemic risk.

The Bank, as supervisor, will assess how well the senior executives and boards of FMIs perform against this responsibility. It will look for evidence that institutions' management decisions reflect the importance to the wider system of the infrastructures that they run, and the cost that the disruption or failure of the infrastructures would impose on external stakeholders. This will be particularly important where FMI operators also have commercial incentives that may weigh in a different direction.

This focus on protecting financial stability will guide the Bank's priorities in relation to FMI design, operation, recovery and resolution plans, the Bank's expectations in respect of the FMI's governance and the Bank's practical supervision.

Consistent with FMIs' role in enhancing and safeguarding financial stability, and the focus on financial stability in the Bank's supervisory approach, the Financial Policy Committee (FPC) may, as part of its responsibility for reducing risks to the UK financial system, make recommendations within the Bank in relation to supervision of clearing houses, settlement systems or payment systems.

The Bank is committed to effective information sharing, consultation and co-operation with other central banks and supervisory authorities in its supervision of UK-based FMIs. Many FMIs are international in nature, often operating in multiple currencies and involving participants from multiple jurisdictions. Foreign authorities therefore have a legitimate

(1) see, for example http://www.hm-treasury.gov.uk/consult_financial_sector_resolution_broadening_regime.htm.
http://ec.europa.eu/internal_market/consultations/2012/nonbanks_en.htm.
<http://www.bis.org/publ/cpss103.htm>.

interest in the robustness of UK FMI supervised by the Bank. The Bank will take Responsibility E of the CPSS-IOSCO *Principles* — on co-operation between authorities — as a minimum standard which it will seek to exceed. Making co-operative oversight and supervision effective will be a supervisory priority for the Bank. This is explored further in section 4.3.

2 The regulatory regime

For all the FMIs supervised by the Bank, the regulatory regime will be framed by the new CPSS-IOSCO *Principles*. Within that overall framework, there are different legal obligations for securities settlement systems, CCPs and recognised payment systems.

Both securities settlement systems and CCPs are regulated under Part 18 of the Financial Services and Markets Act 2000 (FSMA) and are subject to the UK “recognition requirements” as Recognised Clearing Houses (RCHs). Securities settlement systems are also regulated under the Uncertificated Securities Regulations 2001. For these two types of system, the legal obligations they have to satisfy are, or will be, defined in large part in European law. The EU has introduced a Regulation covering the activities of CCPs: the European Regulation on OTC derivatives, central counterparties and trade repositories of 4 July 2012, commonly known as the European Market Infrastructure Regulation, EMIR. The EU Council, Parliament and Commission are also working on a Regulation covering central securities depositories (CSDs), a class of institution that will include securities settlement systems. As directly applicable Regulations, these EU regimes establish key parts of the content of the UK regime. Where required or appropriate, they will be supported by changes to UK implementing legislation. Recognised payment systems are regulated under Part 5 of the Banking Act 2009.

Sections 2.1 to 2.2 below summarise the key changes for securities settlement systems and CCPs. Section 2.3 and Annex 1 flag changes for recognised payment systems, and Annex 3 compares the recognised clearing house (RCH) and recognised payment system regimes. Table A, below, gives an overview of the future regulatory regime.

2.1 Securities settlement systems

UK-incorporated securities settlement systems, currently only Euroclear UK and Ireland, which operates the CREST system, are regulated under the Uncertificated Securities Regulations 2001 (USRs) and, as an RCH, must satisfy the recognition requirements in regulations made under Part 18 of the Financial Services and Markets Act 2000 (FSMA).

The Financial Services Bill will amend the FSMA RCH provisions and also the Companies Act 2006 under which the USRs are made. To coincide with the transfer of supervisory responsibility to the Bank, the Treasury is also preparing complementary amendments to the USRs.

The legal regime for securities settlement systems is expected to change more significantly when the Central Securities Depository Regulation (CSDR), currently being discussed comes into force.

In the interim period prior to the adoption of the CSDR, the Bank's supervisory expectations will be guided by the updated CPSS-IOSCO *Principles*, the substance of which the Bank anticipates will be reflected in the CSDR and associated technical standards. Given the update to the *Principles*, and consistent with moving to a judgement-based approach to supervision, FSA Handbook Guidance will no longer apply from the point of transition, with the exception of the guidance on minimum financial resources,⁽¹⁾ which requires RCHs to hold a buffer of financial resources above the minimum standards required in the *Principles*.

Table A Overview of future regulatory regime

	Central counterparties	Securities settlement systems	Recognised payment systems
Global requirements	CPSS-IOSCO <i>Principles for financial market infrastructures</i>		
European requirements	EMIR and associated binding technical standards	EU CSD Regulation under discussion	None for system operators
Domestic requirements	HMT 'recognition requirements' (updated and largely superseded by EMIR once CCP authorised under EMIR) and FSMA RCH provisions, as amended in line with EMIR (Current FSA Guidance and Handbook falls away upon transition except that related to financial resources requirements)	HMT 'recognition requirements' and FSMA RCH provisions as amended Uncertificated Securities Regulations as amended (Current FSA Guidance and Handbook falls away upon transition, except that related to financial resources requirements)	The Bank has adopted the CPSS-IOSCO <i>Principles</i> as the Bank's <i>Principles</i> to which recognised payment systems must have regard under the Banking Act 2009 (These replace the Bank's previous 14 <i>Principles</i>)

(1) PS12/13: Financial resources requirements for recognised bodies, <http://www.fsa.gov.uk/static/pubs/policy/ps12-13.pdf>.
FSA Handbook REC 2.3 Financial Resources:
<http://fsahandbook.info/FSA/html/handbook/REC/2/3>.

2.2 Central counterparties

EMIR came into force in August 2012. The associated technical standards to support it have been prepared by the European Securities and Markets Authority (ESMA) and European Banking Authority (EBA), and are currently being reviewed by the Commission. Once adopted, EMIR and the technical standards will be directly applicable in the United Kingdom. UK-incorporated CCPs will therefore need to satisfy the provisions of the Regulation and standards, together with any additional domestic requirements, in order to achieve and maintain authorisation under EMIR.

UK-incorporated CCPs⁽¹⁾ may be in the process of seeking authorisation under EMIR at the time that supervisory responsibility transfers to the Bank. Authorisation requests must be submitted to the home competent authority within six months of certain technical standards to support EMIR entering into force. Currently, these Standards are expected to come into force in early 2013. The relevant home competent authority — which for UK-incorporated CCPs will be the FSA until the amendments to FSMA made by the Financial Services Bill comes into force, and the Bank after that — will then have 30 working days to decide if the application is complete and, once complete, a further four months to make a recommendation on authorisation to a supervisory college. A supervisory college will be formed for each CCP and will include other relevant EU authorities under the chairmanship of the home competent authority.⁽²⁾ The college has a further 30 calendar days to consider the recommendation. In certain circumstances, the home competent authority's recommendation to authorise can be rejected by the rest of the college or is subject to mediation by ESMA.

The FSA and Bank will provide further information on the authorisation process and requirements to CCPs in early 2013. CCPs will need to demonstrate that they satisfy or in the future will satisfy EMIR's provisions, the technical standard requirements and any additional UK requirements. The FSA and Bank will work together to ensure that the application and recommendation process works smoothly, notwithstanding the transfer in supervisory responsibility.

During the interim period until a decision on their authorisation under EMIR, UK-incorporated CCPs will remain subject to the existing RCH regime and the "recognition requirements". During this interim period, Bank supervision will, however, be guided by the requirements of EMIR and the CPSS-IOSCO *Principles*. FSA explanatory Guidance will largely fall away, replaced by the *Principles*, and, in due course by EMIR and associated technical standards.

The Treasury is currently preparing the necessary amendments to UK legislation to ensure EMIR is implemented in full in the United Kingdom. Because EMIR is directly applicable in all EU member states, the purpose of the statutory instrument that

the Treasury is preparing is to ensure that the UK regime is compatible with EMIR, and provides the competent UK authorities, including the Bank as supervisor of CCPs, the necessary powers to enforce EMIR. Two changes are envisaged to achieve that: the recognition requirement regulations will be amended to define a CCP authorised in the UK under EMIR as an RCH; and the recognition requirement regulations for RCHs authorised as CCPs in this way will be amended to refer to EMIR, rather than the current recognition requirements (other than in areas which EMIR does not cover, or where supplementary UK provisions are required).

From the point at which a CCP is authorised under EMIR, the current recognition requirements will, therefore, no longer apply, except for the retained recognition requirements, for example, on monitoring and mitigating financial crime and market abuse; new requirements in relation to facilitating the porting of client positions and, subject to appropriate conclusion of the consultation process, a requirement on loss allocation rules. This last area, loss allocation rules, is one where EMIR does not, for the time being, cover the minimum requirements set out in the *Principles*, and on which CPSS-IOSCO is expected to publish further guidance in 2013. This gap may be addressed in due course by separate EU legislative proposals related to recovery and resolution.⁽³⁾ In the meantime, given the importance of recovery rules, the Treasury is preparing to consult on a change to UK recognition requirements that will require CCPs to have rules for allocating losses in excess of their financial resources, and with a view to ensuring continuity of services should these rules need to be implemented.

A number of CCPs incorporated in jurisdictions other than the UK currently operate in the UK as recognised overseas clearing houses (ROCHs).⁽⁴⁾ The ROCH regime will continue for these CCPs until a decision on their authorisation under EMIR is taken. That authorisation process will be led by the relevant home competent authority for EU-incorporated CCPs, and by ESMA for CCPs incorporated outside the EU. In the meantime, the Bank will continue the existing model of close co-operation with the home supervisor, together with annual reporting to the Bank by the ROCH in question.

(1) Annex 2 lists CCPs that currently have RCH status.

(2) The composition of the college is set out in EMIR. It will include: the CCP's competent authority; ESMA; the competent authorities responsible for the supervision of the clearing members of the CCP that are established in the three Member States with the largest contributions to the default fund of the CCP; competent authorities responsible for the supervision of trading venues served by the CCP; competent authorities supervising CCPs with which interoperability arrangements have been established; competent authorities supervising central securities depositories to which the CCP is linked; relevant members of the ESCB responsible for the oversight of the CCP and other CCPs with which interoperability arrangements have been established; and the central banks of issue of the most relevant EU currencies in which financial instruments are cleared.

(3) The European Commission issued a consultation paper on non-bank resolution that covers CCPs (and CSDs) in October 2012 http://ec.europa.eu/internal_market/consultations/2012/nonbanks/consultation-document_en.pdf.

(4) Annex 2 identifies CCPs that currently have ROCH status.

2.3 Recognised payment systems

The Bank set out its approach to payment systems oversight in its 2009 publication on *Oversight of Interbank Payment Systems under the Banking Act 2009*.⁽¹⁾ The Financial Services Bill introduces some small changes to the legal regime for payment systems oversight, including, for example, the power for the Bank to request information for financial stability purposes, and the power for the Bank to apply for injunctions to enforce compliance with directions, requirements or Codes of Practice. There will be broad alignment between the practical and policy approach to oversight of recognised payment systems and that proposed here for securities settlement systems and CCPs. This document therefore updates and supersedes the 2009 publication.

Where recognised payment systems are 'embedded' within an RCH, these payment systems will continue to have to satisfy relevant *Principles* and any other requirements that might be imposed, in future, under the Banking Act 2009. Particular issues pertaining to changes to payment system oversight are discussed more fully in Annex 1.

2.4 Settlement Finality Directive

Where payment systems are embedded within an RCH, responsibility for designating these systems under the Settlement Finality Directive currently lies with the FSA in consultation with the Bank. The Treasury will be amending the Settlement Finality Regulations⁽²⁾ to reflect the transfer of supervisory responsibilities.

The Bank's decision to designate a payment system for settlement finality purposes is independent of the Bank's role in providing information to the Treasury about the suitability of a payment system for recognition under the Banking Act 2009. A system can seek designation for settlement finality purposes, and benefit from the advantages of designation (helping to protect system rules on the irrevocability of payments and protect the finality of settlement from challenge by insolvency practitioners), even if not recognised under the Banking Act 2009.

Supervised institutions that operate a recognised or designated payment system will be able to use the same Bank point of contact for their notification obligations under the Settlement Finality Directive as for supervisory matters.

3 Key supervisory pillars

While all supervised FMIs will have to meet the full set of minimum standards established in the *Principles* and applicable legal requirements, the Bank will prioritise its supervisory effort based on its assessment of where risks to financial stability are greatest.

Table B provides an overview of key elements on which the Bank will focus in its assessment. The Bank considers these areas and the standards within them to represent the most important and fundamental requirements for FMIs, in much the same way as threshold conditions for other regulated financial institutions. Supervision will cover both the design of FMI rules and the use of management discretion in the application of the rules. The paragraphs below set out some specific areas where the Bank will seek evidence that the FMI meets adequate standards.

While the Bank will at a practical level take a broadly similar approach to its engagement with all three types of market infrastructure, specific requirements will be tailored to the risks within the different entities. For example, the Bank will place a greater emphasis on counterparty credit risk management for CCPs because of the principal risk they take. However, the systemic risk management role is common to all FMIs, as are the *Principles* relating to governance, managing operational risk, ensuring continuity of service, and managing participant default.

3.1 Governance: the centrality of systemic risk management to culture and decision-making

Within the framework of applicable *Principles* and legal requirements, FMIs will have considerable scope and discretion to influence how risk is managed. FMIs should demonstrate

Table B High-level overview of the Bank's supervisory risk assessment model

Risk			Mitigating factors							
Potential systemic impact	Risk context		Operational mitigants				Financial mitigants			Structural mitigation
	External risks (eg member default or business risk)	Internal risks (eg IT failure)	Promotion and maintenance of standards	Management and governance	Risk management and controls	Disaster recovery plans	Collateral/ Margin and Default Fund	Liquid resources	Capital	Recovery and resolvability

(1) <http://www.bankofengland.co.uk/publications/Pages/other/financialstability/oips/default.aspx>.

(2) The Financial Markets and Insolvency (Settlement Finality) Regulations 1999 (S.I. 1999/2979).

that their governance and decision-making processes reflect the risk management purpose of the institution — and give adequate regard to the interests of system participants and the financial system as a whole.

Risk management will therefore need to include, but go beyond, the management of micro-prudential risks to the institution itself and also consider systemic risks. A strong user representation in the FMI's governance, and the inclusion of directors independent of any firm with a significant business relationship with the FMI, on both the board and the risk committee can help to ensure this broad focus. Strong user representation can also help to ensure that stakeholders from multiple jurisdictions are represented. Mutual or member ownership structures are one way of encouraging the alignment of owner, executive and participant interests. Where there is a different ownership model, the FMI's corporate governance structure and arrangements will need to demonstrate that systemic risk management is not sacrificed in the pursuit of the commercial interests of particular stakeholders. For supervised FMIs that form part of wider groups, the Bank will want assurance that other group priorities are not directly or indirectly imposed on supervised institutions at the expense of the FMI's responsibility for managing risk, and, in particular, systemic risk.

FMIs should demonstrate that incentives and reward policies, and practices, for senior executives do not create pressure to prioritise revenues, market share and profit over systemic risk management objectives. FMIs will need to show that risk-management functions are adequately resourced, sufficiently independent from commercial pressures and have a key role in the decision-making process. Senior executives and the board as a whole should have risk management as a primary objective. Given the special role of FMIs, risk-management should be central to resourcing and corporate culture.

For example, there may be incentives for a CCP to allow margin requirements to fall to low levels when prices are relatively stable in order to reduce collateral costs for participants and thereby to win business. Conversely, at times of stress there may be incentives to increase margin requirements sharply and pro-cyclically to protect the CCP, but draining liquidity from market participants just when it is most scarce. A better solution for the system is for margins to remain at higher levels in good times even if this may be above the minimum level required by regulation. In accordance with its macro-prudential responsibilities, the Bank will therefore want FMIs to demonstrate that they are managing risks through the cycle without introducing excessive pro-cyclicality. Indeed, the Bank, in conjunction with overseas counterparts, may sometimes ask RCHs to act counter-cyclically, or less pro-cyclically.

3.2 Promotion and maintenance of standards: FMIs' own role in promoting risk management in the markets they serve

FMIs impose standards and disciplines on individual participants or members which can improve the robustness of the FMI, and the system more widely. FMIs can play a role in leading industry thinking, enhancing standards, and co-ordinating across stakeholder groups, as well as facilitating industry initiatives.

For example, the FMI's rules will generally place requirements on the resilience of FMI members' operations and may include criteria on how direct participants manage their risks arising from relationships with customers that are indirect participants, such as how credit and liquidity exposures are stress-tested and controlled. Effective management of risk will require that an FMI performs some monitoring of the positions of its members and the customers of its members. For example, to understand the potential impact of participant failure, a securities settlement system is likely to need to maintain an understanding of which indirect participants rely on which direct participants, and where indirect participants are large relative to the direct participant. Similarly, CCPs need to satisfy themselves that their clearing members are adequately managing the risks arising from the cleared position of their clients.

3.3 Financial risk mitigants: loss absorbency

The Bank will take a close interest in how supervised FMIs assess the adequacy of their loss-absorbing resources.

For CCPs, which must protect themselves against counterparty credit risk, loss-absorbing resources typically comprise margin, pre-paid default funds and supplementary commitments to replenish them, and CCP equity capital. Given that competitive incentives may result in pressure to lower margin requirements, the Bank will carefully supervise where and how discretion is used in the modelling and assessment of risks, and in choices on how to mitigate that risk. This will include using specialist resource and potentially commissioning external reviews of CCPs' modelling methodology. Margin and default fund cover will have to meet or exceed minimum standards set out in CPSS-IOSCO *Principles* and EMIR. But the modelling assumptions and stress tests employed by the CCP play a key role in determining whether these default resources genuinely provide the degree of protection desired by the *Principles*. The Bank will carefully consider the suitability of these models. Where it identifies deficiencies, it will, in consultation with the college established under EMIR, withhold its approval, or require enhancements.

The Bank will give particular scrutiny to exposures that may not be well covered by the usual CCP risk mitigants. These include exposures arising from interoperability 'links' between CCPs, where CCPs not only receive initial margin as they would

for a clearing member, but also post margin, which they would not do in their counterparty relationships with clearing members. Similarly, some types of cross-margining arrangements between CCPs can weaken the CCP's usual protections if margin is held not by the CCP itself but by another CCP on which it has an unsecured claim. CCPs will have to demonstrate clearly that such arrangements do not result in a lower degree of protection than would be the case were all counterparties using the same CCP.

In addition to minimum standards in relation to credit risk, FMIs are also required to meet minimum standards in relation to liquidity risk. The Bank will require FMIs to demonstrate that they hold at least the minimum levels of liquid resources required by EMIR and the *Principles* to withstand extreme but plausible stresses, and that they have rules and procedures for allocating any liquidity shortfalls among their participants should these resources prove insufficient.

3.4 Recovery and resolvability

Given that many markets rely on the services of FMIs, the Bank will attach a high priority to FMIs' demonstrating that they have plans to ensure the continuity of critical services should risks to the FMI crystallise. This will in part hinge on the clarity, credibility and comprehensiveness of plans to distribute any uncovered credit losses among FMI participants in a way that means service closure can be avoided.

The CPSS-IOSCO *Principles* require explicit rules and procedures on how any losses in excess of loss-absorbing resources would be allocated,⁽¹⁾ and CPSS-IOSCO has also issued a follow-up consultation on recovery and resolution for FMIs.⁽²⁾ Further CPSS-IOSCO guidance on important features of recovery plans is expected to be published over the coming months. FMIs will have to demonstrate that their recovery plans meet the objectives and required features set out in this guidance.

If recovery plans do not prove comprehensive, or are not implemented effectively, the Bank will want to ensure that the authorities are able, to the fullest extent practicable, to step in to resolve the FMI in a way that prevents or limits systemic disruption without calling on public funds. The Financial Services Bill makes provision for a resolution regime for CCPs in the UK, as part of which the Bank would become resolution authority for CCPs.

3.5 Transparency and disclosure

FMIs' plans for managing risk must be suitably transparent to those who rely on the FMIs' services, including members, indirect participants, the authorities, and the general public. Transparency is important to enable these participants and other stakeholders in the stability of the system to assess risk exposures. The Bank will be placing greater emphasis on public disclosure by FMIs, in order to allow market discipline to

reinforce internal and regulatory incentives for effective risk management.

Increased transparency is likely to lead to better risk management decisions as features and flaws of rules and risk models can be challenged, and trade-offs — for example the balance between lowering collateral costs and protecting against risk — can be properly understood. Appropriate disclosure is all the more important where FMIs operate in multiple jurisdictions. Disclosure and transparency for FMIs in all jurisdictions will help to enable peer-to-peer comparison of FMIs, and encourage the wider adoption of good practices. The Bank will therefore attach importance to FMIs' satisfying disclosure objectives in letter and spirit. CPSS-IOSCO is currently working on a disclosure framework for FMIs, including key quantitative information to be provided by FMIs⁽³⁾. This is intended to enable all stakeholders to evaluate the systemic importance of FMIs in the markets they serve, as well as the risks they might bring to these markets and the risks associated with being, or becoming a participant.

4 Supervision in practice

The focus of Bank supervision will go beyond assessing compliance with rules and requirements. The Bank will seek to reach forward-looking judgements on whether an FMI's governance, operational design, policies or actions pose unacceptable risks to financial stability objectives. Where the Bank judges such risks unacceptably high, it will expect the FMI to take action to reduce them. The Bank's test of materiality for requiring action will, however, be high and supervisory interventions will be clearly and directly linked to reducing risks to the stability of the system.

4.1 Meeting regulatory requirements and satisfying minimum standards

Supervised institutions themselves will have full and primary responsibility for satisfying the minimum standards in the CPSS-IOSCO *Principles*, and the various regulatory requirements in EMIR, the prospective CSDR, associated binding technical standards and UK recognition requirements.

Consistent with that, the Bank will expect FMIs to complete their own self-assessments against the *Principles*, and provide these to the Bank. FMIs will be expected to review their self-assessment at least annually, and alert the Bank to any

(1) Principle 4, Key Consideration 7, "An FMI should establish explicit rules and procedures that address fully any credit losses it may face as a result of any individual or combined default among its participants with respect to any of their obligations to the FMI. These rules and procedures should address how potentially uncovered credit losses would be allocated, including the repayment of any funds an FMI may borrow from liquidity providers. These rules and procedures should also indicate the FMI's process to replenish any financial resources that the FMI may employ during a stress event, so that the FMI can continue to operate in a safe and sound manner".

(2) <http://www.bis.org/publ/cpss103.pdf>.

(3) <http://www.bis.org/publ/cpss106.htm>.

material changes that occur between such reviews. This self-assessment will be an important test of FMI's ability and willingness to demonstrate their understanding of, and commitment to, risk objectives. For example, a self-assessment which paints an overly optimistic picture of an FMI against risk standards, or takes too narrow a view, may indicate that inadequate priority is being given to those standards, weaknesses in risk management, or the management and board's misunderstanding of the standards. Self-assessment does not, however, mean self-regulation. The FMI's self-assessment will not replace the Bank's own judgement, but will be used as one input to the Bank's assessment. It will be viewed as indicative of the FMI's own risk tolerance and risk management capability.

4.2 Supervisory assessment and intervention

The Bank's assessment will start from an analysis of the main risks presented to the stability of the financial system by the FMI's design or by interruption to the services it provides. This risk assessment will be regularly reviewed including a full review at least annually.⁽¹⁾ Following the Bank's annual assessment, or such other interim examinations and assessments as the Bank judges necessary, the Bank will set expectations for mitigating actions by the FMI. While the intensity of supervision will vary in proportion to the Bank's assessment of risk, all supervised FMIs will be assessed.

The Bank intends to perform spot checks on particular aspects of an FMI's rules or operations, either directly, or via external experts, and either by requesting evidence or by on-site examination, pre-announced or otherwise. These spot checks will be viewed as an important test of the FMI's risk management capabilities and of the institution's willingness and ability to internalise systemic risk objectives in its management and governance. They will also help incentivise senior management to prioritise risk management.

The Bank expects there to be a relatively small number of prioritised issues on which supervisors will seek action from the institution, leaving responsibility for provision-by-provision compliance with regulations and rules to the institution itself. Where the Bank does identify material risk, it will seek to intervene early and pre-emptively. When doing so, or considering doing so, the Bank will consult actively with supervised institutions, and potentially also with their members and participants (either through the FMI, or directly). When it sets expectations for actions, the Bank will engage directly with the Chief Executive Officer (CEO), and, typically, also with the board of the institution.

The Bank's internal processes will be designed to ensure that supervisory team experts have the advice and guidance of senior Bank officials, including from other areas of the Bank, such as Markets and Banking Services areas, the Special Resolution Unit, and the Prudential Regulation Authority

(PRA). Senior Bank officials will have regular contact with the FMI's CEO, and also with board chairpersons, and will periodically meet with other non-executive directors, including in relation to assessment of the CEO's own performance. The Bank will expect its supervisory expectations to be shared with the board, and will engage directly with boards to assess progress against these expectations, consistent with the board having ultimate responsibility for risk management and for the completion of actions required by the Bank.

4.3 Co-operation with overseas authorities

Some FMIs operate across borders. This may, for example, reflect a desire amongst users to reduce risk through multilateral netting of exposures across counterparties in different jurisdictions. There are also important efficiencies to be gained from a single FMI operating across multiple jurisdictions and currencies. Conversely, fragmentation of business across multiple FMIs is likely to result in greater costs and greater liquidity demands for market participants.

Given these cross-jurisdiction operations, effective FMI supervision and oversight involves co-operation between authorities in different jurisdictions. For UK-based FMIs that serve global markets, the Bank accepts particular responsibility for ensuring effective co-operative oversight. That is also consistent with Responsibility E of the *Principles*. For example, where FMIs settle material amounts of business in multiple currencies, the Bank will want to involve relevant central banks of issue. In other cases, FMIs may support markets in other jurisdictions, have key participants from other jurisdictions, or be linked to systemically important FMIs in other jurisdictions. Relevant overseas authorities from those jurisdictions, including relevant central banks, market and prudential supervisors, will be important stakeholders in oversight and supervision, reflecting their responsibilities for these currencies, markets and firms.

The Bank is convinced of the benefits of working with relevant interested international authorities and will actively seek their input, going beyond the minimum levels of co-operation set out in the *Principles*. This will, in the Bank's view, contribute to the effectiveness of supervision of UK FMIs by enriching the picture of risks, and providing for other authorities to contribute insights, challenge assumptions, and influence outcomes in ways that reduce risks. The Bank will also stand ready to contribute to co-operative arrangements established by other authorities for FMIs in their jurisdictions.

(1) During any interim period following formal transfer of supervisory authority to the Bank but before the completion of an assessment by the Bank, and subject to the Bank amending, supplementing or confirming it is satisfied with steps taken by the RCH in accordance the RCH's most recent FSA ARROW Risk Mitigation Programme (RMP), RCHs should continue to work towards completing actions in their ARROW RMP. For CCPs, for example, there may be such an interim period until the authorisation decision under EMIR, during which the Bank will focus on any shortfalls against EMIR requirements.

The Bank will share information with and consult with these authorities as part of its supervisory process. This will include not just sharing annual assessments, but also more routine sharing of relevant information from the FMI, seeking input to those assessments, and offering invitations to be involved in joint work.

As well as ensuring that the regulatory colleges required under EMIR for CCPs yield all intended benefits, the Bank will also involve authorities from beyond the EU in co-operative oversight of relevant CCPs. To assess whether the objectives of co-operative oversight have been achieved, the Bank will invite other authorities involved in co-operative oversight of UK-based securities settlement systems and CCPs to assess the effectiveness of the arrangements against a set of simple criteria including whether information sharing is sufficient and timely, whether collective decision making mechanisms are effective, and whether co-operation is genuine.

Effective international co-operative oversight of CCPs is one of “four safeguards” identified by the FSB as key to establishing a resilient and efficient global framework within which the G20 commitment on central clearing of standardised OTC derivatives can be met.⁽¹⁾ The others are: fair and open access to CCPs for market participants, based on transparent and objective criteria; recovery and resolution regimes that ensure the core functions of CCPs are maintained during times of crisis and that consider the interests of all jurisdictions where the CCP is systemically important; and appropriate liquidity arrangements for CCPs in the currencies in which they clear.

The Bank will work in consultation and co-operation with other authorities to ensure that UK-based CCPs, and the supervision of UK CCPs, satisfy all four safeguards. Access and participation requirements form part of the *Principles*. Recovery and resolvability are discussed in section 3.4 above, and liquid resources requirements in section 3.3. In respect of liquidity, the Bank will, without committing to lend, seek to ensure that there are no technical obstacles to timely provision of central bank liquidity where the CCP is solvent and such provision will help safeguard financial stability.

4.4 Groups

Some securities settlement systems and CCPs supervised by the Bank will form part of groups that include other FMIs, other regulated financial institutions or indeed non-regulated firms. These groups may be entirely UK-incorporated, or may contain firms in other jurisdictions. In contrast to the model for banking, EU and international requirements for FMIs do not currently require consolidated group supervision. The FMI regulatory regime is based on whether an individual FMI entity satisfies the standards and regulations applicable to its particular function.

The Bank will, however, want to understand how the institutions that it supervises relate to the rest of any group of which they form part, how group objectives affect the Bank-supervised institutions, the risks the rest of the group might bring to the Bank-supervised institution, and vice versa. In particular the Bank will want to consider inter-dependencies between group entities in relation to finances, operations, risks, risk management and governance. The Bank’s aim will be to ensure that critical UK FMI services are not at risk of contagion from risks in other parts of the group and can meet all applicable regulatory requirements on a standalone basis.

The Bank will, therefore, look to establish effective dialogue with the supervisors of other parts of groups of which UK-incorporated FMIs form part. In some cases there are already formal arrangements for liaising with relevant supervisors. For some CCPs, this may potentially be achieved through the college established under EMIR, or through co-operative arrangements with authorities from beyond the EU. The Bank will also aim to continue the current FSA practice of contact with overseas parent companies’ senior executives to ensure a clear understanding of risks to UK entities from other parts of a group, and vice versa.

A number of existing UK CCPs form part of a group which also includes a Recognised Investment Exchange that will in future be supervised by the Financial Conduct Authority (FCA). In respect of such groups, the Bank will co-operate closely with the FCA under a Memorandum of Understanding (MoU) which has been published alongside this document.⁽²⁾

In some cases, the Bank may have some supervisory powers over the holding companies of RCHs supervised by the Bank (see Section 6.2).

4.5 Approach to approving appointments to critical roles

The Bank will require notification, prior to appointment, of some appointments to an FMI’s board and to some senior executive positions. The Bank will agree with each system which roles fall in scope but would ordinarily expect to be notified in relation to appointments to the roles of Chair, CEO, Chief Risk Officer, Chief Financial Officer, chair of the risk committee, senior independent non-executive director, head of internal audit, chair of audit committee, and chair of remuneration committee. The Bank should also be notified of group appointments that could materially affect the Bank-supervised institution. The Bank will review those proposed appointments for competence and suitability. The Bank expects to interview nominated candidates for only the

(1) <http://www.imf.org/External/spring/2012/imfc/statement/eng/fsb.pdf> and http://www.financialstabilityboard.org/publications/r_120619a.pdf

(2) <http://www.bankofengland.co.uk/financialstability/Pages/supervision.aspx>.

most significant of these roles, but reserves the right to interview others depending on the circumstances.

4.6 Data collection and reporting requirements

The Bank will require data from the FMIs it supervises to inform its supervisory and systemic risk analysis. It will generally collect data from RCHs under new powers in the Financial Services Bill to collect information by notice.⁽¹⁾

The Bank will discuss its data needs, and the appropriate mechanism to collect those data with individual FMIs. FMIs should expect the volume of data required from them to increase. Over time, the Bank may look to automate some of the data collection from FMIs so that a greater range of data can be collected without imposing material burden on the FMIs.

There will also be some areas where supervised institutions will be required to provide information in accordance with a regulatory rule rather than by notice. One such area is that of changes to RCHs' own rules, where there will be, as now, a requirement under FSMA⁽²⁾ for RCHs to inform their supervisor, in future the Bank, of any proposed changes to their rules that are not required by law or in pursuit of a regulatory objective and where such changes could be considered disproportionate to their intended purpose. The Bank will in practice expect all supervised FMIs to consult with their Bank supervisors before making material changes to rules and other aspects of system design.

Other areas where FMIs are required by regulation to provide prior notice to the Bank of changes include amendments to default rules by FMIs designated under the Settlement Finality Directive, significant changes to margin risk models, default fund contributions and other risk controls by RCHs authorised as CCPs⁽³⁾ and key staff appointments at RCHs.

4.7 "Embedded" payment systems

The Bank will continue to oversee embedded payment systems within securities settlement systems and CCPs, where these payment systems are recognised by the Treasury under the Banking Act 2009. For supervised RCHs that operate such recognised embedded systems, the Bank's existing expectations as payment system overseer will remain in place until completed, withdrawn or superseded by a subsequent expectation. While payment arrangements should and will remain a distinct area of focus, and the separate Banking Act 2009 legal regime (as amended by the Financial Services Bill) will apply, the oversight of embedded payment arrangements will be dovetailed with wider supervisory work so that FMIs benefit from a single point of contact with the Bank. This will also, in future, mean a single set of supervisory expectations.

4.8 Expert reports

The Bank will establish and maintain in-house expertise in relation to the main risks managed by FMIs, for example the

counterparty credit risk faced by CCPs. It will supplement this with specialist expertise from elsewhere in the Bank, notably from the PRA. The Financial Services Bill also amends FSMA to provide for the Bank to commission reports from external experts, either directly or via the supervised institution. For RCHs, as for recognised payment systems, the Bank will commission expert reports where it judges them necessary or useful — for example to diagnose risks. The Bank will decide on a case-by-case basis whether to commission a report itself or to direct the RCH to do so. Relevant factors would include the urgency of the review, the use to which it will be put, and the Bank's assessment of the RCH's ability properly to brief and manage the expert report provider. The Bank envisages that reports from external experts will be commissioned on an occasional basis, in response to specific needs as they arise. The Bank will be separately publishing a proposed rule that will allow it to recover from RCHs the costs of any expert reports that the Bank commissions directly.

4.9 External auditors

The Financial Services Bill provides new powers to protect RCH auditors who share information with supervisors. The Bank will meet regularly with FMIs' external auditors to gain insights into risks and how risks are managed. In managing its relationship with external auditors, the Bank will be guided by the Code of Practice developed jointly by the Bank of England and FSA.⁽⁴⁾

4.10 Internal audit, risk and compliance functions

Bank staff will also meet with FMIs' internal audit, risk, compliance and finance departments where the Bank judges it necessary and consistent with the differing role that each of those functions plays in delivering and monitoring progress towards mitigating risks identified in FMIs' own assessments, as well as those identified by the Bank as supervisor.

4.11 FMI provision of non-core services

Where an FMI provides non-core services, the Bank will want to see convincing evidence that this is not exposing the core infrastructure to risk, nor materially distracting the FMI's board or management from its core service and risk-management objectives.

5 Policy

In considering its approach to supervisory policy for FMIs, the Bank will, wherever practicable, consult with the FMIs affected, their participants and other relevant experts.⁽⁵⁾ It will also

(1) For payment systems data collection will remain under the existing notice power s204, of the Banking Act 2009.

(2) FSMA s300B and FSA rule REC 3.26.4.R. More detail on the proposed practical operation of these FSMA notification requirements may be found in the forthcoming consultation paper on rules.

(3) EMIR, Article 49.

(4) http://www.fsa.gov.uk/pubs/guidance/fg11_09.pdf.

(5) Unless such consultation might be prejudicial to financial stability. The Bank does not, however, expect to need to make policy without consultation in other than exceptional circumstances.

consult and co-ordinate with the Treasury, the PRA, the FCA and international counterparts as appropriate. Policies will be defined within the framework of directly applicable European Regulations and the CPSS-IOSCO *Principles*. In practice, a significant part of supervisory policy-making in relation to CCPs and securities settlement systems will be done at European and global level, including in CPSS-IOSCO, and in the European Supervisory Authorities, in particular ESMA. The Bank will be an active participant in these fora.

In accordance with the MoU between the Bank, the PRA, and the FCA, which holds the UK seat at ESMA, the Bank will, where possible and practicable, engage directly in relevant ESMA Supervisory Board meetings, committees and groups when subjects relevant to supervision of CCPs and securities settlement systems are being discussed. The FCA and Bank will consult each other to agree positions on the relevant subjects that reflect the views, objectives and responsibilities of both authorities.

Arrangements for co-operation between the Treasury, the Bank, the PRA and FCA on international policy matters are set out in a separate MoU.⁽¹⁾ The Bank, FCA and PRA will cooperate closely with respect to areas of common interest across all relevant international fora (including CPSS, IOSCO and the European Supervisory Authorities), sharing agendas and information relating to areas of common interest.

In any cases where rules for CCPs are introduced nationally and cost-benefit analysis has not therefore been undertaken at a European level, the Bank will analyse the costs and benefits of proposed rules as a part of the policy development process, if these costs are material, and if their measurement is practicable. Quantitative estimates of costs and benefits will not be used where they are not meaningful or practicable.

6 Enforcement

6.1 The Bank's supervisory powers in relation to recognised clearing houses

The Financial Services Bill will confer on the Bank a set of powers to ensure it can deliver on its RCH supervisory responsibilities. The proposed powers include both tools for intervention and for sanctions in the event that supervised RCHs fail to satisfy supervisory requirements. This provides a more graduated 'sliding scale' of options to enforce supervisory requirements than has previously been available to the FSA. This more flexible set of tools will be important in supporting effective supervisory interventions. The powers fall into four main areas.

- *Information gathering* — The Bank will have powers to gather information from RCHs, to support both its supervision and its financial stability work more generally.

- *Imposing requirements and rules* — Responsibility for making recognition requirements regulations for RCHs will remain with the Treasury. The power to make recognition requirements regulations is also being amended so that it will be possible for the Treasury to give the Bank the power to elaborate those requirements in rules where the Treasury judges it appropriate to do so.
- *Powers of direction* — Where an institution is not complying with FSMA requirements, the Bank may direct the RCH to take actions that bring it back into compliance. In certain circumstances, the Bank may also direct a UK clearing house to take, or refrain from taking, other specified action if the Bank is satisfied that it is necessary, for example to protect financial stability.
- *Sanctions, warning notices and appeals* — The Bank will also have more flexible powers to enforce supervisory requirements including public censure, penalties and, ultimately, revoking recognition.

6.2 The Bank's supervisory powers in relation to RCH holding companies

As noted in section 4.4, the Bank will pay close attention to how group structures affect the management of risk. The Financial Services Bill provides certain powers over some parent companies of RCHs. The Bank will be empowered to gather information from these qualifying parent undertakings and will have a power to direct them in defined circumstances.

The Bank is required to consult on how it will use these powers, and will set out its plans in a separate paper.

6.3 The Bank's approach to use of powers

The Bank will, where practicable, want to supervise with the support of FMIs and their participants, having clearly explained the risk rationale for its supervisory priorities and actions. The Bank's supervision will, however, be conducted in the shadow of the powers granted by Parliament, and these powers will be used where necessary to effect change.

The Bank hopes that it will not need to make regular use of powers to direct, and that it will not face cases where an institution fails to act in accordance with a direction. Should this occur, however, public censure, financial penalties and injunctions may be applied to supervised FMIs, or, in certain circumstances, action may be taken against individuals employed by the supervised FMIs. Where the Bank imposes a financial penalty, proceeds will be transferred by the Bank to the Treasury so that it can benefit the taxpaying public.⁽²⁾ ⁽³⁾

(1) http://www.hm-treasury.gov.uk/d/fin_fs_bill_mou_international_organisations_jan2012.pdf.

(2) In some cases a part of the penalty may be used to meet costs incurred by the Bank in enforcement.

(3) www.hm-treasury.gov.uk/press_90_12.htm.

The Bank will publish a separate statement on penalties, and sanction processes in due course.

7 Fees

The Bank will be able to charge fees to FMIs to cover the costs of its supervision. The Bank's other policy work, including policy in relation to financial stability and its existing oversight of recognised payment systems, is, however, funded from Cash Ratio Deposit income. Consistent with this model, the Bank does not currently plan to charge fees to supervised FMIs. The costs of its FMI supervision will, however, ultimately be borne by the customers or shareholders of banks paying the Cash Ratio Deposit, and the Bank will attach importance to cost-efficiency and effectiveness in performance of its supervisory responsibilities.

As noted in section 4.8, supervised institutions will normally be required to cover the cost of any reports that the Bank considers it necessary to commission from external experts, either directly or by refunding costs incurred by the Bank. The Bank may also seek to recover some other exceptional costs, for example if it were necessary to appoint a specialist inspector under s193 of the Banking Act 2009 in relation to a recognised payment system.

8 Accountability, transparency and complaints

The Bank's responsibilities, objectives and powers in relation to supervision of FMIs are conferred by Parliament on behalf of the public. The Bank is committed to being transparent and accountable to Parliament and the public for performance of these responsibilities and use of these powers. It will publish an annual report specifically in relation to its supervisory priorities and activities in respect of FMIs.

The Bank, in respect of its supervision of FMIs, will be part of a common complaints scheme also covering FCA and PRA supervisory activities. The arrangements will include, as currently for the FSA, an independent complaints commissioner. The FCA and Bank, including the PRA, published a consultation paper on the details of the complaints scheme in November 2012.⁽¹⁾

8.1 Bank of England provision of operational services to FMIs

The Bank will in some cases have an operational relationship as well as a supervisory relationship with a supervised CCP or securities settlement system (as is already the case with a number of the recognised payment systems). For example, in accordance with the risk-reduction objectives of the CPSS-IOSCO *Principles*, some supervised institutions settle in central bank money in order to avoid unnecessary commercial

bank credit exposures. Others that do not yet settle in central bank money may be encouraged to do so. The Bank may also provide some other services to operators of infrastructure, for example some settlement and custody services. Whether as supervisor, settlement agent or provider of other services, the Bank's decisions will be motivated by protecting and enhancing financial stability, and, consistent with that, prudent management of risks to the Bank itself.

8.2 Information flow between parts of the Bank

Information in relation to supervised FMIs provided to or collected by one part of the Bank will be shared, consistent with legal requirements, across other parts of the Bank, including the PRA, where sharing would be useful in light of the Bank's responsibilities. For example, FMI supervisors, PRA supervisors of financial institutions, staff supporting the FPC, Bank operational staff, those engaged in collecting market intelligence to support financial stability analysis and staff in the Special Resolution Unit will share information in relation to supervised FMIs and their major participants, where useful, and permitted to do so. All parts of the Bank will protect the confidentiality of commercially sensitive or supervisory information in accordance with legislative requirements and relevant agreements with third-parties. This will inform what controls are applied if and when relevant information is shared between parts of the Bank.

9 Next steps

The Bank will refine its supervisory approach over coming months. It would welcome comments on this proposed approach from FMIs, market participants and other stakeholders. These should be sent to FMIFeedback@bankofengland.co.uk.

The Bank will be publishing further information on:

- processes for issuing warning and decision notices;
- penalties;
- powers in relation to holding companies;
- rules that the Bank will introduce, including in relation to use of the power to commission expert reports under Section 166 of FSMA, notification of system rule changes, and appointment of key individuals.

(1) <http://www.bankofengland.co.uk/financialstability/Documents/consultationoncomplaints.pdf>.

Annex 1: Recognised payment system oversight

The Bank set out its approach to payment system oversight in its 2009 publication on *Oversight of Interbank Payment Systems under the Banking Act*⁽¹⁾. Some changes will be introduced to payment system oversight when the Bank assumes responsibility for supervision of securities settlement systems and CCPs. As a result this document supersedes and updates the 2009 publication.

For recognised payment systems⁽²⁾, as for CCPs and securities settlement systems, the CPSS-IOSCO *Principles* will form the basis for oversight and supervision. In the case of payment systems, the updated CPSS-IOSCO *Principles*, as applicable to payment systems, replace the 14 Principles previously published by the Bank and become the 'Principles' to which recognised payment systems must have regard under the terms of the Banking Act 2009.

The key elements of the Bank's practical approach to supervision of CCPs and securities settlements will also apply to payment systems overseen by the Bank. This will not represent a fundamental change for recognised payment systems, but in some areas there will be a difference. For example all recognised payment systems will be expected to provide an annual self-assessment against the CPSS-IOSCO *Principles*. The approach to approval of the appointment of critical persons will also be common across all FMIs.

The Financial Services Bill also introduces some new tools for payment system oversight. These include the power for the Bank to request information for financial stability purposes, and the power to apply for injunctions. The Bank's powers over recognised payment systems are summarised in Annex 3. The Bank is not proposing any significant change in its use of those powers — for example it is not currently proposing to issue any Codes of Practice.

Some of the recognised payment systems are "embedded" within RCHs that will be supervised as CCPs and securities settlement systems. The Bank will continue to oversee these embedded payment systems under the Banking Act 2009. Payment arrangements are fundamental to risk management within securities settlement systems, and also within CCPs — where they can re-introduce credit risks that other prudential standards such as collateral and margin requirements seek to reduce or eliminate. Without the distinct supervisory focus on payment arrangements that the Bank will maintain, the risks in these payment arrangements can be neglected. Supervision of securities settlement system and CCP payment system risks will, however, be dovetailed with wider supervisory priorities so that supervised institutions benefit from a single point of contact with the Bank as supervisor.

The Bank will also maintain its existing horizon-scanning role to advise the Treasury as to whether any further payment systems merit recognition. That may include payment systems embedded within other CCPs or securities settlement systems supervised by the Bank. The Treasury is responsible for deciding which payment system are recognised.⁽³⁾

It is not uncommon for the 'scheme companies' that manage a number of the recognised payment systems to outsource day-to-day functions and the development of hardware and software facilities to one or more technical infrastructure providers. The CPSS-IOSCO *Principles* cover such outsourcing risks, and the Treasury can, by Order, apply the recognition regime to service providers to recognised payment systems. This power has not, to date, been exercised.

The Oversight regime does not give rise to any responsibility for relationships between members of payment systems and individual users or consumers. Consumers may have rights under, for example, the Payment Services Regulations 2009 which implement the EU Payment Services Directive (PSD). The FSA, currently, and, in future, the FCA will be the main competent authority in respect of the PSD.

(1) <http://www.bankofengland.co.uk/publications/Documents/other/financialstability/oips/oips090928.pdf>.

(2) The responsibilities for managing and operating existing UK payment systems typically lie with a 'scheme company'.

(3) Recognition does not of itself confer any special privileges on a payment system, and nor does it imply that the authorities have identified any specific weakness in the system. Recognition is based solely on the criteria in s185(1) of the Banking Act 2009. HMT guidance on recognition may be found at www.hm-treasury.gov.uk/d/bankingact_guidancenote_040809.pdf.

Annex 2: Financial market infrastructures to be supervised by the Bank

Recognised Clearing Houses (RCH)

The following firms currently have RCH status in the UK or have publicly stated their intent to apply to become RCHs and would therefore be subject to Bank of England supervision.

- CME Clearing Europe Limited, which clears OTC commodity derivatives.
- Euroclear UK & Ireland Limited, which settles securities including gilts, UK and Irish equities and money market instruments.
- European Central Counterparty Limited, which clears mainly equities.
- ICE Clear Europe Limited, which clears mainly energy contracts and OTC CDS transactions.
- LCH.Clearnet Limited, which clears, among other products, OTC interest rate swaps, repo, equities, and commodities.
- LIFFE Administration and Management, which clears mainly exchange-traded interest rate products, currently through an outsourcing agreement with LCH.Clearnet Limited under its RIE status, and has made public its intention to launch its own clearing house.
- The London Metal Exchange Limited has also made public its intention to establish a UK CCP.

Recognised Overseas Clearing Houses (ROCH)

The following firms currently have ROCH status in the UK. Relevant aspects of their operations will therefore be subject to Bank of England supervision, in co-operation with home supervisors, until an authorisation decision is made under EMIR.

- Cassa di Compensazione e Garanzia SpA
- Eurex Clearing AG
- European Multilateral Clearing Facility NV
- ICE Clear U.S. Inc.
- LCH.Clearnet SA
- SIX x-Clear Ltd
- The Chicago Mercantile Exchange

Recognised payment systems

The Treasury has to date recognised seven systems under the Banking Act 2009. These are:

- Bacs
- CHAPS
- CLS
- Faster Payments Service

And the 'embedded' payment systems within:

- Euroclear UK & Ireland Limited
- ICE Clear Europe Limited
- LCH.Clearnet Limited

In securities settlement systems, embedded payments systems serve to effect payment against the settlement of other assets such as equities or bonds. In CCPs, embedded payment systems are used for the collection and payment of margin and to effect cash settlement of contracts.

Approved operator of a securities settlement system

The following firm currently has approved operator status under the Uncertificated Securities Regulations 2001.

- Euroclear UK & Ireland Limited.

Annex 3: Summary of recognised payment system and RCH legal regimes

Bank powers	Recognised payment systems	RCHs
Requirement setting	<p>The Bank can issue Codes of Practice; can issue directions regarding standards, or issue principles (which systems must have 'regard to').</p> <p>The Bank can direct to take a specific action; or require it to establish or change the system's own rules.</p>	<p>HMT sets recognition requirements in regulations, with potential for HMT to give the Bank power to elaborate the recognition requirements through rules where appropriate.</p> <p>The Bank can direct to come back into compliance with requirements in or under FSMA. In certain circumstances, the Bank may also direct a UK clearing house to take, or refrain from taking, specified action if the Bank is satisfied that it is necessary, for example to protect financial stability.</p>
Available sanctions		
Fines	Yes	Yes
Publication of details of compliance failures and fines	Yes	Yes
Closure of a system	Yes	Yes — by revoking recognition
Disqualification of management	Yes	EMIR provides for removal from Board
Enforcement via injunction	Yes	Yes
Ownership		
Controls over ownership of FMI	No	Yes — EMIR provides for terms on which purchasers are assessed
Information gathering		
Information requests	Yes	Yes
Right to request an independent report	Yes	Yes
Right to 'inspect' a system	Yes	Yes
Relationship with Auditors	—	Auditors protected when they share information with the regulator