

The Bank of England's oversight of interbank payment systems under the Banking Act 2009

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BANK OF ENGLAND

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Introduction

Central banks' involvement in the oversight of payment systems arises from their core role as the systems' settlement bank, providing the ultimate settlement asset, central bank money. This gives central banks a very direct interest in any potential systemic risks inherent in such systems. More broadly, payment systems are crucial to the functioning of the UK banking system and thus the wider financial system and economy, and it is therefore important that they operate in a way that contains risks to the system as a whole to an acceptable level. If payment systems are operated only in the narrow self-interest of their member participants, they may tend to underinvest in the mitigation of those risks. This can be countered by ensuring a broader risk perspective through central bank oversight.

This was recognised in the framework set out in the Memorandum of Understanding (MoU) with HM Treasury and the Financial Services Authority (FSA) in 1997.⁽¹⁾ The Banking Act 2009⁽²⁾ ('the Act') puts the Bank's oversight of payment systems onto a statutory footing.

This paper provides a brief overview of the relevant provisions of the Act and describes how the Bank intends to reflect these provisions in its approach to oversight. It also invites comments in relation to the draft Principles the Bank is intending to apply to recognised payment systems once the new framework is in place.

Objectives of oversight

The Banking Act 2009 puts the Bank's Financial Stability Objective into statute. The Act specifies this as being 'to contribute to protecting and enhancing the stability of the financial systems of the United Kingdom'. Part 5 of the Act gives the Bank a set of statutory tools that will assist it in pursuing its objectives in respect of payment systems. The Bank's approach to its statutory oversight responsibilities will be applied in the light of this overarching financial stability objective.

The oversight regime does not give rise to any responsibility for relationships between the 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's Payments Services Directive, but this is not the Bank's area of responsibility. The FSA will be the main competent authority in this area.⁽³⁾

Overview of Part 5 of the Banking Act 2009

Part 5 of the Act deals with the oversight of recognised interbank payment systems. It allows HM Treasury to recognise systems that are 'arrangements designed to facilitate or control the transfer of money between financial institutions who participate in the arrangements', if those systems meet the criteria set out in the Act (s182–187).⁽⁴⁾

Section 185 of the Act establishes two criteria for identifying interbank payment systems that are of systemic significance to the United Kingdom. These criteria form the basis for decisions by HM Treasury to make recognition orders, bringing them within the Bank's statutory oversight regime. Recognition orders 'must specify in as much detail as is reasonably practicable the arrangements which constitute the inter-bank payment system' (s184(2)).

The first criterion identifies systems that would have the potential 'to threaten the stability of, or confidence in, the UK financial system' if there were any deficiencies in their design or if their operation were disrupted. Such a threat to the financial system could be expected to manifest itself through the system acting as a channel for contagion between its users, or through disruption to core financial markets.

The second criterion identifies systems where any deficiency in design or disruption to their operation could lead to 'serious consequences for business or other interests throughout the United Kingdom'. Such consequences could include the

(1) The Memorandum of Understanding was updated in 2006 and the current version can be found at www.bankofengland.co.uk/financialstability/mou.pdf. Under the proposals outlined in the Government's white paper *Reforming financial markets* (July 2009) the Memorandum would be replaced by the Terms of Reference of a new Council for Financial Stability.

(2) www.opsi.gov.uk/acts/acts2009/pdf/ukpga_20090001_en.pdf.

(3) The Office of Fair Trading (OFT), HM Revenue and Customs, and the Financial Ombudsman Service also have specific roles under the Regulations.

(4) Under the Act, 'financial institutions' means banks and building societies.

disruption of a payment system used widely in the real economy for which there was no practicable substitute.

Payment systems may be divided into two types. First, those that could be called 'pure' payment systems, where the system controls a transfer of money but does not facilitate the settlement of any other contracts. Second, so-called 'embedded' payment systems, where the payment is generally linked to the settlement of some other obligation within the same system. Embedded systems are most commonly found within securities settlement systems (SSSs) and central counterparty clearing houses (CCPs). In SSSs, they exist to effect payment against the settlement of other assets such as equities. In CCPs, embedded payment systems are used for the collection and payment of margin and to effect cash settlement of derivatives contracts. In the United Kingdom, operators of SSSs and CCPs must be regulated by the FSA under the Financial Services and Markets Act 2000 (FSMA), usually as Recognised Bodies.⁽¹⁾

The process for considering whether systems meet the criteria set out in the Act is explained in HM Treasury's guidance note, 'Guidance on the recognition process for inter-bank payment systems'.⁽²⁾ 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 Act.

The majority of the Bank's oversight powers under the Act apply to the operators of these recognised systems. Section 183(a) of the Act defines operators as 'any person with responsibility under the system for managing or operating it'.

The responsibilities for managing and operating existing UK payment systems typically lie with a 'scheme company', which determines the rules of the system, manages membership, sets standards and specifies how the system will operate. Currently, it is not uncommon for scheme companies to outsource day-to-day functions, and the development of hardware and software facilities, to one or more technical infrastructure providers.

The Act includes requirements for the operators of recognised systems to have regard to Principles published by the Bank, and to comply with any Codes of Practice that are published by the Bank (s188–189). The Act also gives the Bank a power to require operators to establish or change system rules in a specified way (s190) and a general power to give directions (s191).

The Bank is also given various powers to help it gather information and assess payment systems. These comprise the power to require the provision of information (s204), the

power to inspect premises (s193) and the power to require independent reports (s195).

Failure to comply with certain requirements can lead to formal sanctions such as public censure, financial penalties, disqualification of specific individuals from positions of responsibility, or closure of the system (s196–200). The Act provides for the Bank to give warnings about the imposition of such sanctions in most cases (s201) and for appeals (s202).

In its miscellaneous provisions, Part 5 of the Act permits the Bank to charge fees for its oversight (s203) and makes it an offence for the operator of a non-recognised system to pretend the system is recognised by HM Treasury (s205).

General approach to Oversight

Principles

Section 188 of the Act provides that the Bank may publish Principles, to which operators of recognised payment systems must have regard. System operators will be expected to take appropriate action in respect of matters described in the Principles in a way that is appropriate to their system's particular characteristics and the risks they pose to the UK financial system or to business and other interests. Appropriate observance of the Principles may involve a judgement, balancing the cost of implementing changes against the risk reduction benefits — including to the wider financial system.

The Bank's approach, which is subject to this consultation, will be based on the ten CPSS Core Principles for Systemically Important Payment Systems.⁽³⁾ The Bank will also pursue other areas that are not directly covered by the existing CPSS Principles, but which it considers to be of sufficient importance to financial stability to merit the status of Principles in the new UK regime. These four additional draft Principles are described below, and the full list of fourteen proposed Principles that would result is set out in Box 1.

Draft Principle XI relates to the mitigation of **business risk**. In the United Kingdom, payment systems are typically managed and operated by private companies, mainly owned by their members, and often depend on sole providers for key services. Although many such systems take no credit or market risk in the course of their business, schemes — or their technical infrastructure providers — could nonetheless get into financial difficulties in some circumstances. This could lead them to underinvest in risk mitigation, or in severe cases become insolvent and, in doing so, disrupt the operation of the

(1) Recognised Clearing Houses, Recognised Overseas Clearing Houses, Recognised Investment Exchanges or Recognised Overseas Investment Exchanges.

(2) www.hm-treasury.gov.uk/d/bankingact_guidancenote_040809.pdf.

(3) Committee on Payment and Settlement Systems (January 2001), available at www.bis.org/publ/cpss43.htm.

system. Having regard to Principle XI would require system operators to take steps to minimise the probability and consequences of such disruption, and take a sound strategic approach to their business generally. Risk-reducing measures could include maintaining certain levels of capital and liquidity; contractual step-in rights for a scheme or members in the event of insolvency of a technical infrastructure provider; and pre-planned sources of funding to ensure that day-to-day operations can continue until a new provider can be found.

Draft Principle XII concerns **interdependencies** between payment systems. A recent CPSS report, *The interdependencies of payment and settlement systems*,⁽¹⁾ identified a number of ways in which interdependencies could propagate problems through the financial system and give rise to contagion risks between systems. Having regard to Principle XII would require individual system operators to review the risk their system poses to, and faces from, other entities. Such interdependencies could arise through direct links (for example, so-called liquidity bridges, which allow participants to transfer liquidity from one system to be used in another); through institutions that are members of multiple systems; or because of some shared element of infrastructure. Where operators identify risks to their own systems, they would be required to implement appropriate monitoring and controls to manage these risks. Each operator should also ensure that procedures are in place to communicate promptly and effectively with interdependent systems and co-ordinate actions in a crisis.

Draft Principle XIII aims to focus on issues arising from **payment system participants' relationships with indirect participants**. In many UK payment systems, a small set of direct members provide services to a much larger group of 'indirect users', some of whom will be significant financial institutions themselves. In some circumstances, these indirect users can add to risks in the system — particularly where their transactions can enter the system outside the control of the sponsoring member, or where the indirect user accounts for a significant proportion of the risks arising in the system. In having regard to Principle XIII, systems should understand the extent and nature of these risks, including by considering the terms on which members provide access to significant indirect participants, and should seek to ensure that they are adequately protected from those risks. This could include setting rules in relation to how direct members accommodate the activities of indirect members, and taking account of indirect members' business flows when devising and calibrating the system's default arrangements and rules more generally.

Finally, **draft Principle XIV** deals with **outsourcing**. Currently, in the majority of UK payment systems, a scheme company outsources the technical operation of the system to a third

party. The extent of such outsourcing has increased significantly in recent years, to an extent that was not anticipated in the CPSS Core Principles. This new Principle aims to ensure that the relationships between scheme companies and technical infrastructure providers are managed prudently, for example by ensuring that the roles and responsibilities of the respective parties are set out in contract and sensibly assigned; that necessary changes to the technical operation of the system can be implemented promptly; and that compliance with the Bank's oversight requirements is not frustrated by contractual issues or the separation of functional roles.

Comments on the draft Principles are invited by 30 October 2009, and should be sent to the address at the end of this document.

Principles and embedded payment systems

The Bank's Principles will apply to recognised interbank payment systems embedded within SSSs and CCPs.

International committees of central banks (the Committee on Payment and Settlement Systems (CPSS)) and securities regulators (the International Organization of Securities Commissions (IOSCO)) have jointly developed Recommendations for the safe and efficient design and operation of SSSs (in 2001) and CCPs (in 2004).⁽²⁾ These Recommendations were updated⁽³⁾ by a joint group of the ESCB (the European System of Central Banks) and CESR (the Committee of European Securities Regulators) in 2009, in which the Bank participated. Observance of the Bank's Principles, with respect to the 'embedded' payment arrangements, will provide a foundation for SSSs and CCPs to meet the relevant Recommendations.⁽⁴⁾

Application of Principles

These Principles are high-level descriptions of important issues that prudent payment system operators should consider, in ensuring that their system is appropriately robust. Responsibility for having proper regard to them lies with the operator of the system.

Failure to observe a Principle is not itself a compliance failure within the meaning of section 196 of the Act. For some systems it may not be necessary to meet all the elements of each Principle. But for others, even fully observing the Principles might not be sufficient: those systems might be expected to take further action to reduce risks, commensurate

(1) CPSS (June 2008), available at www.bis.org/publ/cpss84.htm.

(2) CPSS-IOSCO (2001), *Recommendations for securities settlement systems* and CPSS-IOSCO (2004), *Recommendations for central counterparties*.

(3) ESCB-CESR (May 2009), *Recommendations for securities settlement systems and recommendations for central counterparties in the European Union*, available at www.ecb.int/pub/pdf/other/pr090623_escb-cesr_recommendationsen.pdf.

(4) For example, the 2004 *Payments Systems Oversight Report* set out the results of the Bank's mapping exercise of the Core Principles to the CPSS-IOSCO Recommendations.

Box 1 Proposed Bank of England Principles for recognised payment systems

1. The system should have a well founded legal basis under all relevant jurisdictions.
2. The system's rules and procedures should enable participants to have a clear understanding of the system's impact on each of the financial risks they incur through participation in it.
3. The system should have clearly defined procedures for the management of credit risks and liquidity risks, which specify the respective responsibilities of the system operator and the participants and which provide appropriate incentives to manage and contain those risks.
4. The system should provide prompt final settlement on the day of value, preferably during the day and at a minimum at the end of the day.
5. A system in which multilateral netting takes place should, at a minimum, be capable of ensuring the timely completion of daily settlements in the event of an inability to settle by the participant with the largest single settlement obligation.
6. Assets used for settlement should preferably be a claim on the central bank; where other assets are used, they should carry little or no credit risk and little or no liquidity risk.
7. The system should ensure a high degree of security and operational reliability and should have contingency arrangements for timely completion of daily processing.
8. The system should provide a means of making payments which is practical for its users and efficient for the economy.
9. The system should have objective and publicly disclosed criteria for participation, which permit fair and open access.
10. The system's governance arrangements should be effective, accountable and transparent.
11. The system should manage its business risks so that its users can rely on continuity of its services.
12. The system should regularly review the risks it bears from, and poses to, other infrastructures as a result of interdependencies, and should implement controls adequate to manage those risks.
13. The system should understand and manage risks that are brought to the system as a result of participants' relationships with indirect participants.
14. The system should manage its outsourced relationships prudently, ensuring that contractual and risk management arrangements are clear, appropriate and robust.

with their importance to the financial system and the real economy. The Bank will make its own assessment of the appropriate level of observance of the Principles for each recognised system, and communicate this to the system operator.

Where the Bank considers that an operator is not having adequate regard to a Principle, it will in the first instance discuss this with the operator. It may then seek commitments from the system operator via an Expectations Letter (see below) to work towards the Bank's desired level of observance, and will monitor progress via regular meetings. Failure by a system to make such commitments, or to implement an agreed plan of improvements, could, where appropriate, lead to exercise of the Bank's formal powers under the Act.

Codes of Practice

The Act allows the Bank to publish Codes of Practice about the operation of recognised payment systems. Codes of Practice are binding on recognised payment systems, and failure to comply with a Code of Practice is sufficient grounds for the Bank to impose sanctions under the Act. The Bank may issue Codes of Practice that apply to some or all recognised payment systems.

The Bank is not currently proposing to issue any Codes of Practice that would take effect when the new regime comes

into force. It may, however, do so in future. It would expect to consult about proposed Codes and to give a reasonable notice period before issuing them.

Risk assessment framework

The Bank makes an assessment of the risks to financial stability posed by a particular system and aims to calibrate the intensity of its oversight accordingly. When overseeing a particular system, the Bank also seeks to prioritise among the risks the system faces.

The Bank uses an Oversight Risk Framework (ORF) as one key tool for informing such decisions.⁽¹⁾ The ORF assigns risks to three broad headings: settlement risk, business risk and operational risk. It also includes a 'register' of possible risks and assigns probabilities and impacts to each, with impacts quantified in monetary terms on the basis of estimates of the full economic cost. Taken together, this helps to rank the relative importance of particular risks within a system.

The simplifying assumptions built into the ORF, together with the inherent difficulty of estimating probabilities and likely impacts of the relevant risks, mean that it cannot provide a definitive prioritisation of actions for overseers. So its output

⁽¹⁾ The Bank has published a separate paper describing the Oversight Risk Framework, *Financial Stability Paper no. 6*, 'A risk-based methodology for payment systems oversight'.

is taken alongside information available to the Bank from other sources – for example, intelligence obtained from users of or participants in the system; incident reports; and qualitative information about the robustness of the system’s rules, processes, policies and procedures. The Bank’s overall risk assessment, based on all the sources outlined above, will determine the intensity of its oversight of a particular system and the nature of the risk mitigation actions proposed. However, primary responsibility for identifying and managing risk remains with the system operator.

The oversight process

The Bank’s oversight processes will be based around an annual cycle.

The Bank expects, as a matter of routine, to meet senior representatives of the operators of recognised interbank payment systems four times each year to gather information and review progress in mitigating risks, to carry out risk assessments and to communicate its expectations as to improvements. The number of meetings each year may vary, depending on the Bank’s assessment of a particular system’s risk profile, and the Bank or the system’s operator may suggest *ad-hoc* meetings to deal with specific topics.

The outcome of each meeting will be communicated in a letter from the Bank of England to the Chief Executive of the operator, who will be expected to share the letter with the system operator’s Board. Once a year (or more often if appropriate), this will take the form of an ‘Expectations Letter’ as described below.

As a matter of routine, the Bank will follow a programme of risk reviews for each system. The review will include analysis of:

- qualitative information about the features of the system and its operations;
- quantitative information and statistics in relation to the system’s flows, and the resulting risks;
- target areas for further risk mitigation; and
- where the system’s current level of observance of the Bank’s Principles or of any Codes of Practice lies relative to the Bank’s assessment of the appropriate level.

Major incidents, other evidence of material weaknesses, or substantial changes in the rules or operation of a system may warrant additional review. And the Bank will in any case maintain and update its analysis and conclusions as to the specific actions it wishes recognised payment system operators to prioritise.

The outcome of such risk reviews will usually be formalised in Expectations Letters to each system operator, which will set out the Bank’s expectations for issues to be dealt with and actions to be taken by the operator. In each case, it will specify a timescale by which the Bank expects them to be completed.

Expectations Letters will not carry statutory force — they will not, for example, constitute Directions under s191 of the Act — but they should nonetheless be taken as a statement of risk-mitigating actions the Bank believes are necessary to protect and enhance financial stability. If a recognised payment system fails to have sufficient regard to actions recommended by the Bank in an Expectations Letter, the Bank will, where necessary, consider using its statutory powers. The Bank retains the discretion to use its powers without first issuing an Expectations Letter, if it considers it necessary.

The Bank’s relationship with other UK bodies with interests in payment systems

Several other UK bodies have interests in payment systems: notably the FSA, HM Treasury, the Payments Council and the Office of Fair Trading.

Relationship with the FSA

The FSA takes an interest in payment systems for a number of reasons and under several of its statutory objectives.

In particular, it is the regulator with responsibility under FSMA 2000 for the regulation of Recognised Bodies, which may have payment systems embedded within them. It is also the regulator for many participants in recognised interbank payment systems, including UK banks and the UK subsidiaries of foreign banks, and is therefore responsible for the regulation of credit, liquidity and operational risks they may incur by using such systems.

The Bank and FSA co-operate in their oversight of recognised payment systems that are operated by entities regulated by the FSA. A Memorandum of Understanding (MoU) will set out their respective roles and responsibilities in relation to payment and settlement systems, and how they intend to fulfil these roles without unnecessary duplication of each other’s work.⁽¹⁾

Separately, the FSA has a statutory objective to secure an appropriate degree of protection for consumers in their use of payment products, and is the authority responsible for enforcing the majority of the provisions of Payment Services Regulations 2009.

(1) Section 192 of the Banking Act 2009 deals with the interaction of the statutory powers of the Bank and the FSA.

Relationship with HM Treasury

As indicated earlier in this document, HM Treasury has responsibility under the 2009 Act for recognising interbank payment systems (and for revoking their recognition, where appropriate).

Relationship with the Payments Council

The Payments Council is a voluntary membership organisation that sets strategy for UK payments. Its three objectives are: to have a strategic vision for payments and lead the future development of co-operative payment services in the United Kingdom; to ensure payment systems are open, accountable and transparent; and to ensure the operational efficiency, effectiveness and integrity of payment services in the United Kingdom.

The area of the Payments Council's work most relevant to the Bank's oversight is its role in ensuring the integrity of payment systems, under which it focuses mostly on issues that are pertinent to more than one scheme, or those that would affect the overall reputation of the UK payments industry.

The Bank liaises regularly with the Payments Council at a senior level and the Bank's Executive Director for Banking Services is an observer on the Payments Council's Board.

The Office of Fair Trading

The Office of Fair Trading is the competent authority for issues of competition policy in relation to interbank payment systems. It also has a specific role under the Payment Services Regulations 2009, being the authority responsible for compliance with Part 8 in relation to access to payment systems.

Delivery of oversight for international systems

Payment systems are, in general, overseen by their home central bank. But other central banks may also have an interest in the oversight of systems that have a cross-border or multi-currency aspect. Principles for managing these relationships were set out most recently in the CPSS's 2005 report, *Central bank oversight of payment and settlement systems*.⁽¹⁾

In particular, home central banks are expected to notify all other central banks with potential interests (normally at least those whose currencies are settled within the system). Co-operative oversight arrangements based on those Principles involve the appointment of a lead overseer — normally the home central bank — and the participation of other interested central banks.

Where a recognised interbank payment system is subject to co-operative oversight, and the lead overseer is a foreign

central bank, the Bank will consider how it can best deliver its statutory objectives. Normally, the Bank expects that this will be through its participation in those arrangements — particularly where the direct use of its own statutory powers in relation to that system is likely to be difficult or counterproductive.

Information gathering to support other financial stability related work

The Act does not in any way prevent the Bank from having dealings with payment systems that have not been recognised by HM Treasury ('non-recognised systems').

Horizon-scanning

Monitoring the wider payments landscape is important both to understand the potential risks to (and created by) recognised systems themselves and to help identify any systems that have become (or seem likely to become) sufficiently important to merit recognition under the Act.

Where the Bank believes that it has identified a system that might meet the criteria for recognition, it will inform HM Treasury accordingly. If necessary, the Bank will use its power under s204(1)(a) of the Act to obtain any information it requires for that purpose.

Market intelligence

Even where HM Treasury has determined that a payment system does not currently meet the recognition criteria, the Bank may still have an interest in the implications for financial stability of a particular system or other entity that, for example, provides services to payment systems.

The Bank will therefore maintain a dialogue with these entities, including through informal meetings and by reviewing information received from them.

Exercise of the Bank's powers under the Act

Overview

The Bank's powers can be divided broadly into three categories: information-gathering powers; powers imposing requirements; and sanctions. The Bank aims to follow a fair, reasonable and transparent process in the exercise of its powers, taking account of all relevant considerations.

Information gathering

Section 204 of the Act gives the Bank wide powers to request information that it needs for the purpose of advising HM Treasury about recognition or that it otherwise requires under Part 5. This power is not limited to the operators of

(1) CPSS (May 2005), available at www.bis.org/publ/cpss68.htm.

recognised payment systems: requirements may, for example, be placed on technical service providers, other stakeholders in systems or potential operators of new systems. The Act also allows the Bank to require recognised systems to notify it when particular events occur.⁽¹⁾ Information gathered under s204 may be disclosed to certain other authorities and may also be published, subject to regulations made by HM Treasury. The Bank will make clear when an information request is made under its s204 power. A requirement under s204 will be in writing and will normally state how long the relevant person has to respond.

The Bank also has powers under s193–194 to appoint an inspector to enter premises on, or from which, any part of a recognised payment system is operated. This would include the premises of any outsourced technical services providers. The power will generally only be used where the Bank has been unable to obtain information from the operator of a recognised payment system or where it thinks the information received may not be correct. The inspector would be a member of the Bank's staff or an expert appointed by the Bank for the purpose.

Section 195 of the Act allows the Bank to require an operator of a recognised system to commission an independent report from an expert in a particular field. The Act allows the Bank to impose requirements about the nature of the expert to be appointed, the timing and scope of the report, and the subsequent treatment of the report in terms of disclosure or publication. The Bank will need to be satisfied that the selected expert is sufficiently competent and independent.

The Bank may use this power in connection with the performance of any of its functions under this Part of the Act, but it would normally be used in order to assess whether a system is having sufficient regard to the Bank's Principles and/or complying with its Codes of Practice. Examples might be the commissioning of an auditor to report on a system's operational risk controls, or an IT security consultant to assess the system's resistance to electronic attack. The report would be prepared at the operator's expense.

Powers imposing requirements

Alongside the Bank's powers to publish Principles and Codes of Practice, it also has powers to impose more specific requirements on systems. The Bank will normally seek first to discuss improvements with operators of recognised interbank payment systems and would consider whether to exercise its powers only if such action fails.

Section 190 of the Act gives the Bank a power to instruct an operator to take particular actions in respect of the system's rules. The Bank can secure important improvements by requiring an operator to establish or change system rules under s190(1)(b), since many of the most important aspects of

payment system operations are encapsulated in the rules that the system and its members agree to follow. For example, the Bank may require a system's rules to be changed to improve the handling of a participant default or to ensure that members are required to use adequately resilient communications networks.

Many recognised systems will also be designated systems under the Financial Markets and Insolvency (Settlement Finality) Regulations 1999 ('the Settlement Finality Regulations'), and therefore already under an obligation to notify the Bank of changes to their rules (and to do so in advance where the change would affect default arrangements). Where the Bank thinks it is important to receive advance notice of all rule changes, it will use its power under s190(1)(c).

The Bank does not currently intend to introduce a general requirement for changes to system rules to be pre-approved under s190(1)(d), except in cases where — for example — a system has previously changed its rules in such a way that they fail to have regard to the Bank's Principles.

Section 191 of the Act gives the Bank a general power to issue directions to the operators of recognised payment systems. As described in the section on the oversight process, this power could be used where specific risk mitigating actions have been identified by the Bank and where the system operator has not implemented them.

Sanctions, warnings and appeals

In the event of a compliance failure (as defined in s196 of the Act), and in certain other circumstances, the Bank may choose to impose one or more of the sanctions set out in s197–200.

In those rare circumstances where the Bank is satisfied that it is necessary to close a system or disqualify a person without notice, it can use its power under s201(3) to impose that sanction immediately.

In all other cases, the Bank will write to the operator (or other person who may be subject to the sanctions) giving notice of its intention to impose a sanction and setting out why it is minded to take this step. Under s201(1)(b), the Bank will state a deadline for representations to be made, which will be at least 21 calendar days from the date of the notice.

The Bank will then consider any representations received before reaching its final decision.

Where a sanction is imposed, the affected operator or person may still appeal against the sanction to the Financial Services

(1) Recognised systems may already be subject to certain notification requirements if they are designated under the Financial Markets and Insolvency (Settlement Finality) Regulations 1999 — see below.

and Markets Tribunal. It may also appeal to the Tribunal retrospectively in cases where the Bank has used its power in s201(3) to impose a sanction without notice.

Other issues in relation to the interpretation of the Act

Section 192 of the Act deals with the interaction of the statutory powers of the Bank and the FSA. It states that that Bank shall have regard to any action that the FSA has taken or could take, and sets out a procedure for the Bank to follow before taking action against an operator of a recognised system that is also regulated by the FSA as a Recognised Body or under Part 4 of FSMA.

Under s203 of the Act, the Bank can impose fees on recognised systems within a scale approved by HM Treasury. At present the Bank does not intend to impose fees routinely: its oversight function is funded in the same way as its other policy functions. However, the Bank might seek to recover exceptional costs (for example, due to the need to appoint a specialist inspector under s193).

Under s198 of the Act, the Bank can impose financial penalties on a system. The Act requires the Bank to publish a statement about its approach to penalties and send a copy to HM Treasury. The Bank aims to publish this statement by the time of the commencement of the sections of the Act dealing with its oversight.

The Bank's wider role in payment systems

In several cases the Bank has other relationships with recognised payment systems. This includes relationships as part of wider policy work in support of the Financial Stability Objective.

The Bank's provision of central banking services

The Bank's oversight role relates closely to its operational role as provider of final settlement services for sterling payment systems, including real-time settlement for the major wholesale systems, and of reserve accounts in central bank money for their participants. The Bank operates the real-time gross settlement (RTGS) system for sterling central bank money. This provides final and irrevocable settlement for CHAPS and CREST transactions, and transfers to and from reserve accounts, in real time. It also provides final multilateral net settlement facilities to Bacs, Faster Payments, LINK and the Cheque and Credit Clearings. As a CHAPS member, CLS Bank International has a settlement account within the Bank's RTGS system.

The Bank also uses a range of payment systems for the settlement of its official business — in the course of the management of its balance sheet and implementation of monetary policy — and for various public bodies and other central banks. The Bank participates in CHAPS, CREST, Bacs, and the Cheque and Credit Clearings as a direct or settlement member. As a consequence of direct membership, the Bank nominates directors to sit on the Boards of these systems, alongside those nominated by other members.

The Bank may provide other services to operators of recognised payment systems. The Bank provides banking, custody and securities settlement services to LCH.Clearnet Ltd.

Settlement Finality Designation

Under the Settlement Finality Regulations, the Bank is also given a role in designating payment systems. The Regulations allow payment and settlement systems to apply for certain protections against the operation of normal insolvency law, generally in order to ensure that transactions that have been settled in the system are final and irrevocable, and to ensure the enforceability of collateral security. In order to receive these protections, systems must meet the criteria set out in the Settlement Finality Regulations and be designated by the relevant authority.⁽¹⁾ The Bank analyses applications for designation and decides whether to designate a system on the basis of whether it meets the requirements set out in the Settlement Finality Regulations.

The Bank's decision to designate a system for settlement finality purposes is independent of its role in providing information to HM Treasury about the suitability of a system for recognition under the Banking Act criteria. A system can seek designation for settlement finality purposes even where it is not recognised under the Act. However, the Bank will have regard to systemic risks when taking designation decisions.

Wider financial stability work

The Bank engages with payment systems in the context of other financial stability work, for example in relation to the effect of liquidity regulation on payments business and in the pursuit of infrastructure research. This wider role also includes analysis of the design of payment systems and other infrastructures in the context of reducing risks and improving efficiency; this informs the Bank's oversight work and feeds more generally into national and international policy discussion.

(1) The Bank is the relevant authority for systems processing only payment transfer orders. The FSA is the relevant authority for securities settlement systems, but consults the Bank when it receives an application for designation of a system that processes both securities transfer orders and payment transfer orders.

Consultation responses

Responses to the Bank's consultation on its proposed Principles for payment systems oversight should be sent by 30 October 2009 to:

Payment Systems Oversight Team
Payments and Infrastructure Division (HO-3)
Bank of England
Threadneedle Street
London EC2R 8AH

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