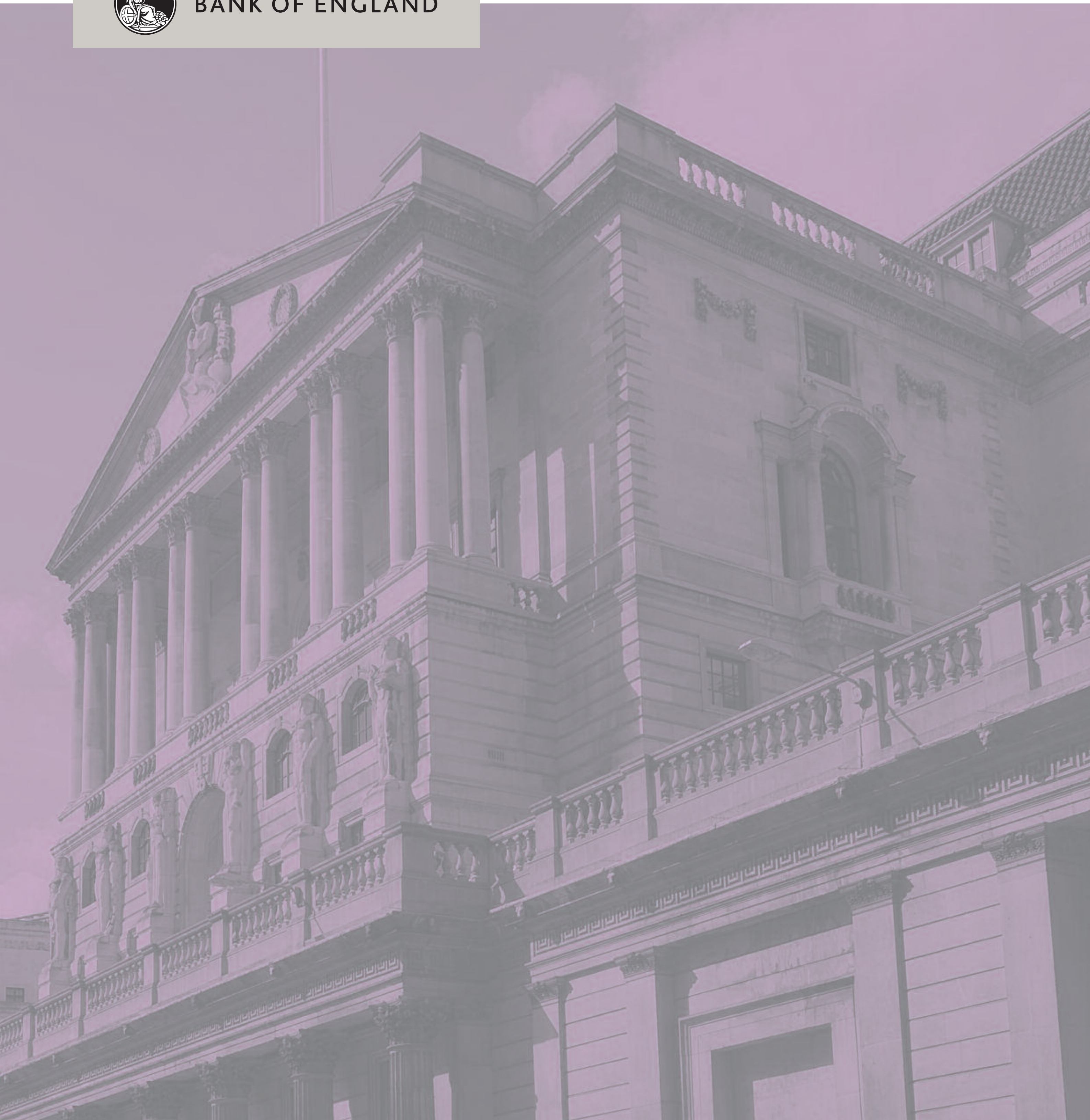
Consultation Paper

Draft Code of Practice and Supervisory Statement relating to governance in recognised payment system operators

September 2016

BANK OF ENGLAND



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Responses are requested by Friday 2 December 2016.

Please address any comments or enquiries to:
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Purpose

The purpose of this consultation paper (CP) is to seek views on the Bank of England's ('the Bank') proposal to introduce a code of practice ('the code') and supervisory statement (SS) on the governance of recognised operators of payment systems (RPSO), being those payment systems specified by Order as recognised systems under section 184 of the Banking Act 2009 ('the Act'). Good governance is vital to the successful management of risks in payment systems. The draft code is set out in Annex 1. The draft supervisory statement is set out in Annex 2. These together will set out the Bank's minimum requirements and expectations for governance in relation to the RPSOs to which they apply.

This CP is relevant for operators of all RPSOs, their shareholders, members, users and other stakeholders in their wider eco-systems. It may also be of interest to operators of payment systems that have not been recognised. The Bank is proposing, however, that the code will not apply to a recognised payment system that is operated by a recognised clearing house or central securities depository (CSD), given they are or will be subject to other requirements (eg EMIR and CSDR).

Introduction

The Bank has decided to develop a code for payment system operators that have been recognised by HM Treasury under the Act. The code will provide transparency on the minimum requirements that all RPSOs to which the code applies must meet. The code will be issued under s.189 of the Act; this means that it will be binding on RPSOs to which it applies. If a RPSO fails to comply with its requirements, the Bank may take enforcement action against the RPSO. The Bank's enforcement powers are set out in the sections 196-202A of the Act.

The Bank has also decided to introduce an SS to complement the code. The SS will set out in more detail how the Bank expects RPSOs to which the code applies to comply with the provisions in the code. Unlike the code, the provisions in the SS will not in themselves be binding although they will provide RPSOs with guidance as to how the Bank will assess compliance with the code.

This CP invites comments on Part 1 of the code and associated SS which concerns governance and related issues only. These will provide transparency on the minimum requirements that all RPSOs to which the code applies must meet when designing and operating their governance frameworks. It will also provide clarity for RPSOs undertaking or planning governance changes as to the Bank's expectations. We anticipate setting an implementation date of twelve months after the publication of the final code.

The Bank currently intends to consult on further parts of the code and further supervisory statement(s) in the future to set out requirements and expectations in other areas.

Approach

This CP focuses on governance and related issues. Good governance is critical to successfully managing risk and controls in payment systems and RPSOs need effective governance structures in place to provide leadership and drive change in pursuit of their objectives.

The Committee on Payment and Settlement Systems(1) and the International Organization of Securities Commissions *Principles for financial market infrastructures* (PFMI)(2) form the basis for the code. The Bank has also taken into account the UK Corporate Governance Code,(3) Prudential Regulation Authority (PRA) governance requirements, EU requirements on other FMIs and lessons learned from the Bank's own supervisory assessment of governance in some RPSOs. As a result, in some areas, and in line with many other jurisdictions, the Bank intends to set more specific requirements or provide more detailed guidance to RPSOs than is contained within the PFMIs. This extra detail is predominantly contained within the SS.

The Bank adopted the PFMIs as a published set of principles in 2012 to which recognised payment systems operators are to have regard, as set out in s188 in the Act, and these will continue to apply.

Once the code is implemented, the Bank will no longer expect independent non-executive directors (INEDs) to have an explicit veto for public interest reasons, given that the composition of the board should ensure independence and the board in its entirety would be expected to perform the function of systemic risk manager.

Proposed requirements and expectations

Systemic risk manager

The code sets out that a RPSO to which the code applies must be a systemic risk manager. The PFMIs are clear that an RPSO's governance arrangements should promote the safety and efficiency of the payment system and support the stability of the broader financial system.(4) The SS sets out in more detail what the Bank expects a systemic risk manager to deliver. This includes considering how RPSOs' actions may impact financial stability and the management of the end-to-end risks, including operational risk and financial risk.

(1) Renamed the Committee for Payments and Market Infrastructure (CPMI) in September 2014
(2) http://www.bis.org/publ/cpss101.htm.
(3) https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Corporate-Governance-Code-April-2016.pdf.
(4) Principle 2 of the PFMIs.

The code also sets out that a RPSO to which the code applies must have objectives that support financial stability and the board must establish and approve the risk management framework.

Governance arrangements

The code sets out expectations for what a RPSO's governance arrangements should include. The SS provides further clarity on these expectations, particularly with regard to board responsibilities and committees. This includes that the board is the ultimate decision making body and, while it can delegate decisions, it remains accountable for them.

Composition of the board

The code sets out the Bank's expectations on the composition of the board, including that the board will be independent and appropriately balanced. The supervisory statement clarifies what the Bank considers to be a sufficiently balanced and independent board, including currently proposing, at a minimum, that a third of the RPSO's board comprise independent non-executive directors, and that the board contains a minimum of one executive director and two independent non-executive directors.

Alternatively the Bank is considering whether the SS should set expectations that a half of the RPSO's board be independent, which is in line with PRA's expectations. The Bank would welcome respondents' views on which approach would be most appropriate.

The Executive

The code sets out that the executive must have appropriate skills and experience and act appropriately.

Conflict of interest

The code sets out that the board must have a procedure to identify and manage conflicts of interest. The supervisory statement sets out examples on the types of conflict that can arise.

Performance management

The code sets out that the board must review its performance annually, in addition to seeking regular independent performance assessments, and there must be procedures for managing the performance of the executives.

Records

The code requires that governance policies and procedures should be documented and kept up to date.

Firms subject to supervision by multiple regulators

It is proposed that this code and SS will apply to all RPSOs (excluding those operated by a recognised clearing house or a CSD). This will include some RPSOs regulated by multiple entities.

The Bank has worked closely with the Payment Systems Regulator (PSR) in preparing this code and SS. The Bank would expect RPSOs to consider, and be able to demonstrate, if required, how their governance arrangements take into account, not only the requirements of the code and SS, but also the objectives and requirements of the PSR, in the case of RPSOs that are also designated under the Financial Services (Banking Reform) Act 2013.

Where RPSOs are supervised by authorities in other jurisdictions, for financial stability purposes the Bank would expect the RPSO to abide by the code and discuss with us the applicability of the SS to their situation.

UK payments landscape

The Bank notes that the Payment Strategy Forum (PSF) issued a consultation on 13 July 2016 which sets out proposals for the future structure of various recognised operators of UK retail payment systems. The Bank expects that HM Treasury would maintain the current approach to supervision by recognising any new consolidated UK retail payment system and therefore expects that any new such operator would fall within the scope of these requirements and expectations. The timeframe for implementation of this code will take into account the outcome of the PSF consultation.

Transitional period for compliance

The Bank is consulting on this code and will publish a final version in due course. This will allow the Bank to take into account any consultation responses as well as any further changes in the UK payments landscape. The Bank plans to allow a long lead in period (around twelve months) from the publication date before bringing the governance part of the code into effect so that RPSOs have sufficient time to achieve compliance.

The Bank recommends that RPSOs begin to consider a transition plan for code compliance and discuss with their supervisors, based on the proposed content of this CP and developments in the UK landscape as discussed above. RPSOs are also encouraged to have regard to the proposed content in this CP should they be considering any changes to their governance in the interim.

An RPSO that is recognised after the code comes into force would have twelve months from the date of recognition to comply with the requirements of this part of the code.

Other matters

Having had regard to the public sector equality duty under the Equality Act 2010, the Bank does not consider this package to have any implications for equality matters. This consultation is based on best practice drawn from international principles and commonly used UK standards. It is compatible with the Bank's financial stability objective in that it facilitates robust governance which prioritises systemic risk management. The expectation that RPSOs have at least a third or a half of their board comprising independent non-executive directors is the only expectation with potentially a material cost, depending on a RPSO's current board composition. That said, independence of the board is essential to good governance. Therefore, the Bank believes that either option would be a reasonable and proportionate requirement and is seeking views on this as part of this consultation. These requirements are consistent with requirements in EMIR and CSDR that apply to those RPSOs which are excluded from the scope of these requirements.

Feedback to this consultation

This consultation closes on 2 December 2016.

Please send comments to FMIFeedback@bankofengland.co.uk by this date.

The Bank will consider the feedback received and publish the finalised code of practice and supervisory statement at a later date.

Annex 1

DRAFT CODE OF PRACTICE ABOUT THE OPERATION OF RECOGNISED PAYMENT SYSTEMS [2017]

Powers exercised

A. This code of practice is published under section 189 of the Banking Act 2009. The operator of a recognised payment system must comply with this code.

B. A failure to comply with this code will constitute a “compliance failure” under s.196 of the Banking Act 2009, which can result in the imposition of a sanction under s.198 to 200 of the Banking Act 2009 (financial penalty, management disqualification, and in certain specified circumstances, a closure order). It can also involve publication of the details of the compliance failure and any sanction imposed (s.197).

Commencement

C. This code of practice comes into force on [**DATE in 2017**].

Citation

D. This code of practice may be cited as the Bank of England Recognised Payment Systems Code of Practice.

[DATE]

PART 1: GOVERNANCE

1 APPLICATION AND DEFINITIONS

1 .1 This code of practice applies to a *RPSO* that is not operated by a recognised clearing house or a central securities depository.

1.2 The following definitions shall apply:

board

means a *RPSO*’s *body or bodies* which are appointed in accordance with national law, which are empowered to set a *RPSO*’s strategy, objectives and overall direction, and which oversee and monitor executive decision-making, and include the persons who effectively direct the business of a *RPSO*. The board includes any board committees.

executive

means the senior management of a *RPSO* who are responsible for and accountable to the *board* for the day-to-day management of the *RPSO.*

RPSO

means a recognised payment system operator that is the operator of a payment system specified by order as a recognised payment system under section184 of the Banking Act 2009.

2 SYSTEMIC RISK MANAGER

2.1 A *RPSO* must perform the function of a systemic risk manager.

2.2 A *RPSO* must have objectives that place a high priority on the safety and efficiency of the payment system and support financial stability.

2.3 A *RPSO* must establish and maintain a clear internal control and risk management framework that:

(1) includes the *RPSO's* risk-tolerance policy;

(2) assigns responsibilities and accountability for risk decisions; and

(3) addresses decision making in crises and emergencies.

2.4 In relation to a *RPSO's* function and obligations in this chapter, the *board* must:

(1) ensure that it receives appropriate information;

(2) have sufficient oversight as to how a *RPSO* performs this function; and

(3) approve and periodically review the risk management framework to ensure that it is fit for purpose.

3 GOVERNANCE ARRANGEMENTS

3.1 A *RPSO* must have governance arrangements that:

(1) are clear and transparent; and

(2) promote the safety and efficiency of the payment system.

3.2 In relation to a *RPSO* the governance arrangements must include:

(1) a description of:

(a) the roles, responsibilities and lines of accountability of the *board* and *executive;*

(b) the functioning of the *board*;

(c) the ownership structure; and

(d) the strategy of the *RPSO*;

(2) the mechanisms for regular review of its efficiency and effectiveness;

(3) the design of risk management, internal control and audit functions, including a description of how these functions have adequate authority, independence, resources and access to the *board;*

(4) the procedures for:

(a) the appointment of *board* members and the *executive*; and

(b) the recruitment, induction and training arrangements for the *board;* and

(5) the policy regarding the term of appointment for the *board.*

4 COMPOSITION OF THE BOARD

4.1 A *RPSO* shall ensure that the members of the *board*:

(1) are of sufficiently good repute;

(2) possess sufficient knowledge, skills and experience to perform the role for which they are appointed;

(3) act with honesty and integrity; and

(4) commit sufficient time to perform their functions in the *RPSO.*

4.2 The composition of the *board* must be appropriately balanced in order to facilitate the *board* carrying out its duties in an independent manner and must:

(1) collectively possess:

(a) adequate knowledge and skills; and

(b) a broad range of experiences

to understand the payment system, including the main risks and controls; and

(2) have an appropriate combination of executive and non-executive directors including a substantial and effective number of independent non-executive directors.

5 THE EXECUTIVE

5.1 The *board* must ensure that the members of the *executive* of a *RPSO*:

(1) possess appropriate skills and experience necessary to discharge their responsibilities for the operation and risk management of the payment system;

(2) act with honesty, integrity and due skill care and diligence; and

(3) are provided with the appropriate information and support to discharge their responsibilities.

6 CONFLICT OF INTEREST

6.1 The *board* must have in place a policy and procedure to identify, address and manage conflicts of interest.

7 PERFORMANCE MANAGEMENT

7.1 The *board* must review its overall performance, and the performance of its individual board members at least annually.

7.2 A *RPSO* must:

(1) ensure that the effectiveness of the *board* is assessed independently on a regular basis; and

(2) have procedures for ensuring and assessing the performance management of the *executive.*

8 RECORDS

8.1 A *RPSO* shall ensure that the objectives, risk management framework, governance arrangements, policies and procedures in chapters 2, 3, 6, and 7 are:

(1) documented in writing;

(2) approved by the *board*; and

(3) reconsidered from time to time by the *board* to ensure they remain fit for purpose.

9 TRANSITIONAL PROVISIONS

9.1 This code of practice shall not apply for the first twelve months after a payment system becomes a *RPSO.*

Annex 2
Draft supervisory statement for operators of recognised payment systems: governance

1 This supervisory statement applies to recognised payment systems operators (RPSOs) to which the corresponding Code of Practice (Bank of England Recognised Payment Systems Code of Practice) applies.

2 This supervisory statement should be read alongside the Code of Practice and does not replace it. It provides additional guidance on how the Bank of England ('the Bank') expects RPSOs to comply with some elements of Code of Practice Part 1: Governance.

Systemic Risk Manager

3 The Bank in Article (2.1) of the code requires a RPSO to function as a systemic risk manager.

4 In order to comply with this Article the Bank of England expects that a RPSO shall, as a minimum:

- assess and mitigate the impact of the RPSO's own requirements and actions on UK financial stability. This might include , but would not necessarily be limited to:
  - considering in the design and implementation of its requirements and actions, the potential impact on the financial position of participants[(1)] and/or the ability of participants to maintain access to the relevant payment system;
  - considering the risks that the RPSO may pose to other payment systems and other financial market infrastructures.
- assess and mitigate financial risks that may build-up in the payment system between participants (eg tiering risk), and between participants and the RPSO.
- assess and mitigate operational risks to the end-to-end flow of payments across the relevant payment system. This might involve, but would not necessarily be limited to:
  - setting rules, standards, service level agreements or similar for participants of, and critical service providers to, the payment system; assessing appropriate delivery against such rules, standards or service level agreements; and taking appropriate action in the event of any non-compliance;
  - identifying and managing any incidents or issues that could cause, or are causing, widespread disruption to the smooth flow of payments across the payment system and/or reputational risk to the payment system, whether caused by one or more participants or critical service providers, and assessing lessons learned from such incidents and reflecting these in rules, standards, service legal agreements or similar, as appropriate;
  - undertaking end-to-end testing of the payment system, including simulating the operation of the system under extreme scenarios; and
  - putting in place and maintaining business continuity plans that include consideration of risks to the end-to-end system.

5 The RPSO should consider the above aspects in the context of its risk appetite and in the design of its risk metrics.

Governance Arrangements

6 The Bank requires in Article (3.2 (1)(a)) that the governance arrangements should describe the roles, responsibilities and lines of accountability of the board. The Bank expects these arrangements to be disclosed to owners, relevant authorities, participants, and, at a more general level, the public. In describing the responsibilities and lines of accountability, a RPSO should take into account the following:

- The board of a RPSO is ultimately responsible for the decisions and actions of the RPSO. It can delegate decisions and responsibilities, but it remains accountable.

- The board of the RPSO should be aware of the environment in which it is operating and of all its regulatory responsibilities. This should include any responsibilities imposed by other regulators where an RPSO is regulated by multiple regulators.

- The board of a RPSO should ensure that the payment system's design, rules, overall strategy, and major decisions reflect appropriately the legitimate interests of its participants and other relevant stakeholders. Major decisions should be clearly disclosed to relevant stakeholders and, where relevant, the public.

7 The governance arrangements referred to in Article (3.2) should include:

- a clear articulation of the RPSO's board and committee structure which appropriately differentiates between board committees and other committees (eg participant or executive committees).

- clear terms of reference for the board and its committees which set out the purpose, membership, responsibilities, delegated authorities and reporting lines.

(1) In this document, references to 'participants' should be taken to refer to direct participants and, where relevant, indirect participants.

- a clear articulation of the responsibilities of committee members and the capacity in which they sit on a committee. Only board directors should have voting rights on board committees. A board director who is a member of a non-board committee should understand that they are not acting as a board director in that context.

Composition of the board

8 The Bank requires that the board be appropriately balanced and collectively possess adequate knowledge and skills (Article 4.2(1)).

- In order to ensure an appropriate balance of skills and knowledge, the Bank would expect the board to identify the skills and experience that it requires. This should include, but not necessarily be limited to:
  - understanding of fiduciary duties;
  - relevant experience (eg of payment systems, board membership, wider financial system);
  - interpersonal skills;
  - strategic awareness;
  - understanding of risks and internal controls and management; and
  - relevant technical knowledge.

9 The chair should assess the skills of the board against its requirements periodically and identify any gaps. There should be an appropriate programme to ensure that the board and individual directors have the necessary skills and knowledge to fulfil their responsibilities, including understanding their fiduciary duties. This should include, but not necessarily be limited to:

- a comprehensive induction programme;
- individual development plans;
- board training/development programmes; and
- periodic updates on external and internal developments.

10 The Bank requires (Article 4.2) that a RPSO board be appropriately balanced to facilitate the board's carrying out its duties in an independent manner, and comprise an appropriate combination of executive and non-executive directors including a substantial and effective number of independent non-executive directors ('INEDs'). To be independent and appropriately balanced, no single group should be able to dominate the board. In addition, in order to meet these requirements, the Bank expects that:

- The board will contain at least one member of the executive.

- The board will have a minimum of two INEDs.

- A minimum of a third of the board will comprise INEDs.(1) The independent non-executive directors individually and collectively should have the competence and capability to ensure a balanced board and that the risks arising from the conflicts of interest (as set out below) can be managed.

- The chair of the board will be an INED.

- A second INED will be appointed as a senior INED. A key responsibility of the senior INED is to hold the chair to account, eg lead consideration of the chair's appointment/reappointment, remuneration and performance management.

Conflict of interest

11 The Bank requires (Article 6.1) that a RPSO board must have a process for identifying, addressing and managing conflicts of interest. Examples of potential conflicts that would need to be managed include, but are not limited to the following:

- where a director is an employee of a participant, a conflict arises as the board is responsible for setting, assessing and enforcing rules that apply to that participant;

- where a director is an employee of a participant, a conflict arises as the board is likely to decide upon issues that could impose costs on that participant;

- where a director is an employee of a parent company that owns the RPSO, a conflict can arise where a director sits as a representative of the parent on the subsidiary;

- where a director represents an organisation which has ownership of a critical service provider conflicts can arise, eg when discussing contract terms, or possible contract termination.

12 These conflicts do not mean such people cannot serve on a RPSO's board. Indeed, conflicts could be managed through a variety of methods, including recusal, ringfencing of information and separation of roles. In addition, the INEDs would have a key role in ensuring that the board collectively mitigates the risk arising from conflicts of interest faced by individual directors (as indicated above).

Transitional arrangements

13 The Code of Practice contains a transitional provision stating that the code does not apply for the first twelve months after a payment system is recognised as a RPSO. The Bank expects, however, that a newly recognised payment system will make all reasonable effort to work towards full compliance as soon as practicable in its first year, and in any event will be fully compliant by the end of the twelve month period.

(1) The consultation paper seeks views on whether the proportion of the board that should be INEDs should be one third or one half.