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

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BANK OF ENGLAND

Contents

Introduction

This document sets out the Bank of England's (the Bank's) approach to the supervision of securities settlement systems, central counterparties and recognised payment systems (financial market infrastructures). It aims to enable the public, Parliament, the operators of and participants in infrastructures, and the wider financial system to understand the Bank's supervisory approach.

Financial market infrastructures (FMIs) can, through their design, their rules, procedures and operation reduce risk in financial markets. Conversely, poor FMI design, rules, procedures or operation can mean that unnecessary exposures arise amongst market participants. 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. 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 undertakes 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 exercises its supervision of FMIs within the framework of a UK legal regime that, for central counterparties and in due course for securities settlement systems, itself sits within directly applicable European Union (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. 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. The FPC may also make recommendations within the Bank in relation to the supervision of clearing houses, settlement systems or payment systems as part of its role in reducing risks to the UK financial system.

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. 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 over the counter (OTC) derivative contracts should be cleared through central counterparties.[2]

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 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

(1) The full set of 24 *Principles* can be found at 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 depositaries (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) See http://ec.europa.eu/commission_2010-2014/president/pdf/statement_20090826_en_2.pdf.

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 is, therefore, a 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 increases 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 therefore seeks 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 United Kingdom, 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, is therefore 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, assesses how well the senior executives and boards of FMIs perform against this responsibility, looking 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 is particularly important where FMI operators also have commercial incentives that may weigh in a different direction.

This focus on protecting financial stability guides 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 interest in the robustness of UK FMIs supervised by the Bank. The Bank takes Responsibility E of the CPSS-IOSCO *Principles* — on co-operation between authorities — as a minimum standard which it seeks to exceed. Making co-operative oversight and supervision effective is a supervisory priority for the Bank. This is explored further in Section 4.3.

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

2 The regulatory regime

For all the FMIs supervised by the Bank, the regulatory regime is framed by the 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 — supported where necessary or appropriate by changes to UK implementing legislation. Recognised payment systems are regulated under Part 5 of the Banking Act 2009.

Sections 2.1 to 2.3 below summarise the key legal provisions of the current regulatory regime for securities settlements systems, CCPs and recognised payment systems. Annex 2 provides a high-level overview of how the regimes compare. **Table A**, gives an overview of the three regulatory regimes.

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).(1)

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 expects will be reflected in the CSDR and associated technical standards. There is supplementary material on minimum financial resources,(2) which, for example, requires RCHs to hold a buffer of financial resources above the minimum standards required in the *Principles*.(3)

2.2 Central counterparties

EMIR came into force in August 2012 and the key associated technical standards to support it came into force on 15 March 2013. EMIR and the technical standards are 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.

Requests for authorisation under EMIR must be submitted to the home competent authority within the EMIR transitional period for those CCPs wishing to retain their regulatory status. The relevant home competent authority — which for UK-incorporated CCPs is the Bank — 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.(4) 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.

In addition to satisfying the EMIR requirements, there are additional UK requirements on monitoring and mitigating financial crime and market abuse; the porting of positions and, subject to appropriate conclusion of the consultation process, there will be a requirement to have rules on the allocation of losses that exceed standard default resources. 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 of non-banks.(5) In the meantime, given the importance of recovery rules, the Treasury has consulted on a change to UK recognition requirements which would require CCPs to have rules for allocating losses in excess of their

(1) Euroclear UK & Ireland is also a recognised payment system under the Banking Act 2009.
(2) As set out in previous FSA guidance, see www.bankofengland.co.uk/financialstability/Pages/role/risk_reduction/srr/RCH-Requirements.aspx.
(3) Other FSA guidance material falls away as of 1 April 2013.
(4) 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.
(5) The European Commission issued a consultation paper on non-bank resolution that covers CCPs (and CSDs) in October 2012.

Table A Overview of future regulatory regime

	Central counterparties	Securities settlement systems	Recognised payment systems
Global requirements	CPSS-IOSCO *Principles for financial market infrastructures*		
European requirements	EMIR and associated binding technical standards	EU CSD Regulation under development	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	HMT 'recognition requirements' and FSMA RCH provisions as amended Uncertificated Securities Regulations as amended	The Bank has adopted the CPSS-IOSCO *Principles* as the Bank's Principles to which recognised payment systems must have regard under the Banking Act 2009

financial resources, with a view to ensuring continuity of services should these rules need to be implemented.

During the interim period until a decision on their application for 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*.(1)

A number of CCPs incorporated in jurisdictions other than the United Kingdom currently operate in the United Kingdom as Recognised Overseas Clearing Houses (ROCHs).(2) The ROCH regime will continue for these CCPs until a decision on their application for 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.

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*. This document updates and supersedes the 2009 publication.

For recognised payment systems,(3) as for CCPs and securities settlement systems, the CPSS-IOSCO *Principles* form the basis for oversight and supervision.(4) The Bank's powers over recognised payment systems are summarised in Annex 2. The Bank is not proposing significant change in its use of those powers, for example, it is not currently proposing to issue any Codes of Practice.

Where recognised payment systems are 'embedded' within an RCH, those 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. Supervision of payment system risks are, however, dovetailed with wider supervisory priorities so that supervised institutions benefit from a single point of contact with the Bank as supervisor, while respecting the different statutory procedures.

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 Bank will review the integrity of such outsourcing arrangements. 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 Bank maintains a horizon-scanning role to advise the Treasury whether any further payment systems should be recognised under the Banking Act 2009. These may include payment systems embedded within CCPs or securities settlement systems supervised by the Bank. The Treasury is responsible for deciding which payment systems are recognised.(5)

The Bank's 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 Financial Conduct Authority (FCA) is the main competent authority in respect of the PSD.

2.4 Settlement Finality Directive

The Bank is responsible for designating systems(6) for the purposes of the Settlement Finality Regulations.(7)

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

(1) FSA guidance falls away bar that relating to financial resources, see www.bankofengland.co.uk/financialstability/Pages/role/risk_reduction/srr/RCH-Requirements.aspx.
(2) Annex 1 identifies CCPs that currently have ROCH status.
(3) The responsibilities for managing and operating existing UK payment systems typically lie with a 'scheme company'.
(4) These replace the Bank's previous fourteen principles.
(5) 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.
(6) Except recognised investment exchanges.
(7) The Financial Markets and Insolvency (Settlement Finality) Regulations 1999 (S.I. 1999/2979).

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. EMIR requires that CCPs are designated under the SFD. Supervised institutions that operate a recognised or designated payment system may use the same Bank point of contact for their notification obligations under the Settlement Finality Directive as for supervisory matters.

3 Key supervisory pillars

The Bank prioritises 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 focuses 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 do for other regulated financial institutions. Supervision covers 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 at a practical level takes a broadly similar approach to its engagement with all three types of market infrastructure, specific requirements are tailored to the risks within the different entities. For example, the Bank places 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 have considerable scope and discretion to influence how risk is managed. FMIs should demonstrate 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 therefore needs to include, but go beyond, the management of microprudential 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 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 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

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	

requirements sharply and procyclically 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 macroprudential responsibilities, the Bank therefore wants FMIs to demonstrate that they are managing risks through the cycle without introducing excessive procyclicality. Indeed, the Bank, in conjunction with overseas counterparts, may sometimes ask RCHs to act counter-cyclically, or less procyclically.

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 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 requires 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 takes 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 carefully supervises where and how discretion is used in the modelling and assessment of risks, and in choices on how to mitigate that risk. This includes 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 the 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 carefully considers 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 gives 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 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 requires 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

CCPs (and other FMI) have an important role to play in managing the default of a participant to minimise disruption to the system itself or the markets they serve. They should have effective and clearly defined rules and procedures to manage a participant default, as well as adequate financial resources to contain losses or liquidity pressures that might arise. Under EMIR, CCPs must offer appropriate arrangements to enable the segregation and portability of the positions and assets of a member's clients. CCPs should also liaise with the resolution authority where a failing participant is being resolved.

The Bank pays close attention to these aspects of FMIs' arrangements in line with the detailed requirements in EMIR and the CPSS-IOSCO *Principles* on default management. But whilst CCPs must hold a prudent level of prefunded resources to manage these risks, it remains possible these will be insufficient, threatening the viability of the CCP itself.

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. This applies to all FMI but is particularly important for CCPs given the counterparty credit risk to which they are exposed.

The CPSS-IOSCO *Principles* require explicit rules and procedures on how any losses in excess of loss-absorbing resources would be allocated,(1) and the Treasury has consulted on a change to the UK recognition requirements that will require CCPs to have such loss-allocation rules. 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.

In assessing the suitability of CCPs' loss-allocation rules to deal with the default of a clearing member, the Bank has regard to several principles. First, loss-allocation rules should provide a full and comprehensive description of the way in which losses would be allocated; and they should be clear, transparent and capable of being implemented quickly.

The second principle is that contractual procedures for the tear-up of contracts should bite only as a last resort. Some loss-allocation rules include provision for outstanding contracts ultimately to be cancelled — in the jargon 'torn-up' — as a means of capping the loss incurred by the CCP following a member default. Tear-up could expose market participants to risks as hedging positions are lost, and might lead to market participants attempting to replace positions in a short space of time during stressed market conditions. That may in turn exacerbate market stress.

Third, for similar reasons, where tear-up is used, it should as far as possible be isolated to the affected clearing services so that the CCP's other services can in principle be maintained.

Fourth, the design of loss-allocation rules should be sensitive to the incentives that they provide to participants. For example, loss-allocation rules should endeavour to incentivise participants to participate competitively in auctions, and should not incentivise participants to resign their membership if that is likely to destabilise the CCP.

Fifth, the existence of loss-allocation rules should not disincentivise effective risk management by CCPs. This suggests that loss-allocation rules should not be structured in such a way that losses fall only on participants whilst shareholders are unaffected.

Finally, loss-allocation rules intended to maintain the continuity of clearing services should not compromise the CCP's risk management of open positions. For example, if initial margin on open positions is subject to a haircut, the CCP must be able to ensure that that initial margin is replaced so that the CCP is protected against further member defaults.

Besides the default of a clearing member, the viability of a CCP may also be threatened by a loss that directly reduces its capital resources. In particular, CCPs that invest as principal margin or default fund they receive from participants are at risk of suffering investment losses. It is important to ensure that CCPs are not vulnerable to such losses. This may be achieved by loss allocation arrangements that ensure participants bear the risk and return on this investment activity.

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 Act amends the Banking Act 2009 to establish a resolution regime for CCPs in the United Kingdom, as part of which the Bank is the resolution authority for CCPs. Following the consultation 'Financial sector resolution: broadening the regime' in August 2012, the authorities have been giving further consideration to the need for resolution powers, or similar powers, for critical FMI. HMT will be consulting shortly on a proposal for payment and settlement systems.

The Bank will undertake resolvability assessments and prepare resolution plans for UK CCPs in accordance with the FSB's Key Attributes for Effective Resolution Regimes. This will require the co-operation of CCPs, for example in the provision of information.

In many areas the rules and practices of CCPs will have implications for the resolution options available to authorities, and for the practicability of implementing preferred resolution strategies. One example is the establishment of distinct segregated default funds for different products within a single CCP. This could help facilitate resolution strategies that aim to isolate the impact of a default to a particular product line, allowing the clearing of other products to continue. But default fund segregation may not be sufficient, for example if operational processes such as the investment of margin are not separate.

Another example is the legal basis on which CCPs take margin collateral from their participants. Full title-transfer could

(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) See www.bis.org/publ/cpss103.pdf.

provide the CCP with the maximum degree of flexibility, for example in liquidity management, and if margin is not bankruptcy-remote it could be subject to write-down in resolution, consistent with the no-creditor worse-off safeguard, which would provide for a wider set of potential resolution strategies. But to the extent that CCPs incur investment risk on their margin holdings, putting their own capital at risk, this may reduce the robustness of CCPs. The individual segregation of clients' positions and margin at the CCP, which EMIR requires CCPs to offer, may facilitate resolution, both of a clearing member and if necessary of the CCP itself, by ensuring that the CCP, and the resolution authority, have full visibility of client positions.

The Bank will engage with CCPs on their rules and practices in these and other areas with a view to establishing effective resolution strategies for CCPs.

Authorities also need to take action themselves in certain cases to facilitate the recovery and resolution of CCPs. In the EU, the Financial Collateral Arrangements Directive currently inhibits resolution authorities from writing down initial margin held by, or variation margin payments due from a CCP. And EMIR prohibits CCPs from establishing rules that would allow members' initial margin to be used in a loss-allocation rule to address extreme losses, even if the CCP's participants were prepared to enter into such a rule. The Bank will promote amendment of these provisions.

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 places strong 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 any 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 therefore attaches 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.(1) 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 goes beyond assessing compliance with rules and requirements. The Bank seeks 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 expects the FMI to take action to reduce them. The Bank's test of materiality for requiring action is, however, 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 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 expects FMIs to complete their own self-assessments against the *Principles*, and provide these to the Bank. FMIs are expected to review their self-assessment at least annually, and alert the Bank to any material changes that occur between such reviews. This self-assessment is an important test of FMIs' 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 does not replace the Bank's own judgement, but is one input to the Bank's assessment. It is viewed as indicative of the FMI's own risk tolerance and risk management capability.

4.2 Supervisory assessment and intervention

The Bank's assessment starts 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 is regularly reviewed including a full review at least annually.(2) Following the Bank's annual assessment, or such

(1) See www.bis.org/publ/cpss106.htm.

(2) 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.

other interim examinations and assessments as the Bank judges necessary, the Bank sets 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 are assessed.

The Bank performs 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 are 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 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 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 engages directly with the Chief Executive Officer (CEO), and, typically, also with the board of the institution.

The Bank's internal processes are designed to ensure that supervisory team experts have the advice and guidance of senior Bank officials, including from other areas of the Bank. Senior Bank officials have regular contact with the FMI's CEO, and also with board chairpersons, and periodically meet with other non-executive directors, including in relation to assessment of the CEO's own performance. The Bank expects its supervisory expectations to be shared with the board, and engages 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 among 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, are 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 actively seeks their input, going beyond the minimum levels of co-operation set out in the *Principles*. This, in the Bank's view, contributes 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 also stands ready to contribute to co-operative arrangements established by other authorities for FMIs in their jurisdictions.

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

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

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 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 consider interdependencies between group entities in relation to finances, operations, risks, risk management and governance. The Bank's aim is 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 maintains 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 supervised by the Financial Conduct Authority (FCA). In respect of such groups, the Bank co-operates closely with the FCA under a Memorandum of Understanding (MoU) which has been published alongside this document.(1)

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 requires 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, and may accordingly modify the application of the relevant RCH rule or waive it, but the Bank 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 most significant of these roles, but may interview others depending on the circumstances.

4.6 Data collection and reporting requirements

The Bank requires data from the FMIs it supervises to inform its supervisory and systemic risk analysis. It generally collects data from RCHs under powers in FSMA to collect information by notice.(2)

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 is a continuing requirement under FSMA for RCHs to inform 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 in practice expects all supervised FMIs to consult with their Bank supervisors before making material changes to rules and other aspects of system design.

(1) See www.bankofengland.co.uk/about/Documents/mous/moumarket.pdf.
(2) For payment systems data collection will remain under the existing notice power s204, of the Banking Act 2009.

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[1] and key staff appointments at RCHs.

4.7 'Embedded' payment systems

The Bank continues to oversee payment systems embedded 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 Act) 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 maintains an in-house expertise in relation to the main risks managed by FMIs, for example the counterparty credit risk faced by CCPs. It supplements this with specialist expertise from elsewhere in the Bank, notably from the Prudential Regulation Authority (PRA). The Financial Services Act 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 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. Where the Bank commissions a report itself, it will provide the RCH with an indication of the expected cost before commencing the work.

4.9 External auditors

FSMA provides powers to protect RCH auditors who share certain 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 is guided by the Code of Practice developed jointly by the Bank of England and FSA.[2]

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.[3] It will also consult and co-ordinate with the Treasury, the PRA, the FCA and international counterparts as appropriate. Policies are defined within the framework of directly applicable European Regulations and the CPSS-IOSCO *Principles*. In practice, a significant part of supervisory policymaking 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 is 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.[4] 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.

(1) EMIR, Article 49.
(2) See www.fsa.gov.uk/pubs/guidance/fg11_09.pdf.
(3) 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.
(4) www.bankofengland.co.uk/about/Documents/mous/mouintorg.pdf.

6 Enforcement

6.1 The Bank's supervisory powers in relation to Recognised Clearing Houses

The Bank's powers include both tools for intervention and for sanctions in the event that supervised RCHs fail to satisfy supervisory requirements. This provides a graduated 'sliding scale' of options to enforce supervisory requirements. The powers fall into four main areas:

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

- I**mposing 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 CCP 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 has 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 pays close attention to how group structures affect the management of risk. FSMA provides certain powers over some parent companies of RCHs. The Bank is empowered to gather information from these qualifying parent undertakings and has a power to direct them in defined circumstances.

The Bank's policy on use of these powers sets out the conditions under which these powers may be used. In particular, the policy notes the Bank's intention to apply this policy to the appropriate parent or parents within the group. The policy sets out a non-exhaustive list of possible scenarios in which the Bank may consider exercising the power of direction to a parent company. They include, for example, scenarios where action at the level of a parent company is required to improve the resolvability of an RCH or where the allocation of risks and financial resources do not meet the standards expected by the Bank. In addition, the policy contains a list of non-exhaustive possible directions the Bank may consider giving to the parent. They include a restriction on dividend payments or other payments in respect to capital instruments in order to keep capital in the group; to move funds or assets around the group to address risks; and to raise new capital. The Bank does not intend to use the power of direction to create an unlimited liability for a parent company of an RCH, though it would expect any parent to act as a source of financial strength and support for any regulated subsidiary.

6.3 The Bank's approach to use of powers

The Bank, where practicable, seeks 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 is, however, 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 and financial penalties may be applied to supervised FMIs, qualifying parent undertakings 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.(1)(2)

The Bank's policy on the imposition and amount of financial penalties sets out a range of factors the Bank takes into account when considering whether to impose a financial penalty and in deciding the amount of the penalty. Although the Bank will consider the facts and circumstances of each case, the policy sets out considerations that may be relevant including the impact or potential impact on financial stability of the breach which motivates the penalty, the previous disciplinary and/or supervisory record of the FMI or parent company, and their conduct after the breach was committed.

The Bank's procedures for issuing warning and decision notices in connection with certain enforcement powers (fines and censures) will be set out for consultation in due course. This will provide RCHs with information on the procedure and decision-making framework for notices including how to make representations in respect of a warning notice. The Bank will ordinarily publish a decision notice unless there are reasons not to do so and may publish information about a warning notice.

(1) In some cases a part of the penalty may be used to meet costs incurred by the Bank in enforcement.
(2) See www.hm-treasury.gov.uk/press_90_12.htm.

7 Fees

The Bank is 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, is part of a common complaints scheme also covering FCA and PRA supervisory activities. The arrangements include an independent complaints commissioner. The scheme and information on making a complaint are available on the Bank's website.

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. 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 is 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 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 informs what controls are applied if and when relevant information is shared between parts of the Bank.

Annex 1: Financial market infrastructures supervised by the Bank

Recognised Clearing Houses (RCH)

The following firms currently have RCH status in the United Kingdom or have publicly stated their intent to apply to become RCHs.

- CME Clearing Europe Limited, which clears OTC commodity derivatives and IRS.
- 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 will be treated as an RCH from 1 April 2013.
- 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 United Kingdom. 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 2: Summary of legal regimes

Bank powers	Recognised payment systems	Recognised Clearing Houses	Securities settlement systems
Requirement setting			
	The Bank can issue Codes of Practice; can issue directions regarding standards, or issue principles (which systems must have 'regard to').	HMT sets recognition requirements in regulations, with potential for HMT to give the Bank power to make rules for the purposes of the Regulations.	HMT sets the requirements for approved operators in the Uncertificated Securities Regulations ('the USRs'), with potential for HMT to give the Bank power to make rules for the purposes of provisions in the Regulations.
	The Bank can direct to take a specific action; or direct to establish or change the system's own rules	The Bank can direct to take steps to come into compliance with requirements in or under FMSA. In certain circumstances, the Bank may also direct a UK CCP to take, or refrain from taking, specified action if the Bank is satisfied that it is necessary, for example to protect financial stability.	The Bank can direct to take steps to come into compliance with requirements under the USRs.
Available sanctions			
Fines	Yes.	Yes.	No.
Publication of details of compliance failures and fines	Yes.	Yes.	No.
Closure of a system	Yes.	Yes — by revoking recognition.	Yes — by withdrawing approval.
Disqualification of management	Yes.	EMIR provides for removal from Board.	No.
Enforcement via injunction	Yes.	Yes.	Yes.
Ownership			
Controls over ownership of FMI	No.	Yes — EMIR provides for terms on which potential acquirers of qualifying holdings are assessed.	No.
Information gathering			
Information requests	Yes.	Yes.	Yes.
Right to request an independent report	Yes.	Yes.	Yes.
Right to 'inspect' a system	Yes.	Yes.	No.
Relationship with Auditors	No.	Auditors protected when they share certain information with the regulator.	No.