



HM TREASURY

# Special administration regime for payment and settlement systems

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April 2013





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# 1

## Introduction

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**1.1** This consultation seeks industry views on the Government's proposal:

*to introduce legislation allowing in certain circumstances for a special administration regime (SAR) to be applied to operators of recognised inter-bank payment systems, operators of securities settlement systems, and key service providers to these firms, in order to protect the stability of the UK financial system should any of these firms become insolvent.*

**1.2** Any reference in this document to "payment systems" relates exclusively to those inter-bank payment systems that are recognised under Part 5 of the Banking Act 2009 and subject to Bank of England oversight. Any payment system that is not recognised is outside of the scope of this proposal.

### Background

**1.3** In August 2012 the Government published the consultation document "Financial sector resolution: broadening the regime"<sup>1</sup>, which sought views on the extension of resolution powers for banks to other systemically important financial institutions. The response from industry was overwhelmingly in favour of the introduction of resolution powers for investment firms, parent undertakings and central counterparties (CCPs). Accordingly, the Government included provision in the Financial Services Act 2012 establishing these resolution powers.

**1.4** The response from industry was less clear on what action should be taken in relation to insurers and "non-CCP FMI", i.e. financial market infrastructure (FMI) other than CCPs. In its summary of consultation responses<sup>2</sup>, the Government said it would consider further the need for resolution powers, or other similar powers, for these types of firms.

**1.5** For insurers, the authorities have listened carefully to the arguments presented by stakeholders. Discussion of whether the current framework for dealing with the failure of insurers should be enhanced drew a mixed response. The Government will continue to review existing arrangements to ensure they provide the authorities with adequate tools to advance their objectives in the event of an insurer's failure, such as to secure appropriate continuity of cover for policyholders. There is an active work programme in Europe and international forums considering the appropriate policy measures for global systemically important insurers, and the Government will pay close attention to developments when considering the merits of UK action.

**1.6** For most "non-CCP FMI", such as exchanges and trade repositories, the Government does not believe that special arrangements are required at this time. However, for systemically important payment and securities settlement systems the Government does believe that special arrangements are needed, and following consultation with the Bank of England and Financial Services Authority the Government has developed the proposal presented in this document: that a SAR should be established which is capable, in certain circumstances, of applying to operators of recognised inter-bank payment systems, operators of securities settlement systems, and key service providers to these firms. The rationale for this proposal is explained in the next chapter.

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<sup>1</sup> [http://www.hm-treasury.gov.uk/d/condoc\\_financial\\_sector\\_resolution\\_broadening\\_regime.pdf](http://www.hm-treasury.gov.uk/d/condoc_financial_sector_resolution_broadening_regime.pdf)

<sup>2</sup> [http://www.hm-treasury.gov.uk/d/condoc\\_financial\\_sector\\_resolution\\_broadening\\_regime\\_responses.pdf](http://www.hm-treasury.gov.uk/d/condoc_financial_sector_resolution_broadening_regime_responses.pdf)

**1.7** On an international level, the European Commission recently consulted “on a possible recovery and resolution framework for financial institutions other than banks”<sup>3</sup>, which included certain types of FMI. The UK submitted its views to the Commission and welcomes developments in this area in the future. However, given the lack of a firm timetable for introducing any European legislation in this area, and the need to ensure continuity of the payment and settlement services that support economic activity, the UK Government is proposing to press ahead with domestic legislation.

## **How to respond**

**1.8** The Government seeks views on the proposals and questions set out in this consultation document. Responses are requested by Wednesday 19 June. The Government cannot guarantee that responses received after that date will be considered.

**1.9** This paper is available electronically at: [www.hmtreasury.gov.uk](http://www.hmtreasury.gov.uk). You may make copies of this document without seeking permission. Printed copies of this document can be ordered on request from the address below.

**1.10** Responses can be sent by email to: [non-bank.resolution@hmtreasury.gov.uk](mailto:non-bank.resolution@hmtreasury.gov.uk). Alternatively they can be posted to:

Financial Stability – Contingency Planning Team  
HM Treasury  
1 Horse Guards Road  
London  
SW1A 2HQ

**1.11** When responding please state whether you are doing so as an individual or representing the views of an organisation. If you have concerns about the way in which this document is being managed, please contact:

Tom Eland  
Transport, Regulation and Competition  
HM Treasury  
1 Horse Guards Road  
London  
SW1A 2HQ

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<sup>3</sup> [http://ec.europa.eu/internal\\_market/consultations/2012/nonbanks/consultation-document\\_en.pdf](http://ec.europa.eu/internal_market/consultations/2012/nonbanks/consultation-document_en.pdf)



# 2

## Rationale for action

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**2.1** Payment system scheme companies are unlikely to fail. They generally do not take credit risk and the owners and members of the systems typically have a strong incentive to provide the financial resources needed to support the continued provision of critical payment and settlement services. Moreover, the Bank oversees recognised payment systems under Part 5 of the Banking Act 2009 with the aim of ensuring that the design and operation of the systems have sufficient regard to the management and reduction of risks that could be posed to the UK financial system, businesses or other interests<sup>1</sup>.

**2.2** Operators of securities settlement systems are supervised by the Bank of England under the Uncertificated Securities Regulations 2001. The European Commission has proposed a new regulation that would establish an EU authorisation and supervision regime for Central Securities Depositories (CSDs) that operate securities settlement systems. This would replace the UK's existing regulatory regime and set out various regulatory and prudential requirements which entities would need to meet in order to be a CSD, thereby assisting in ensuring the resilience of payment and settlement service infrastructure.

**2.3** For these reasons, it is unlikely that a systemically important FMI of this nature would become insolvent. Nevertheless, it is possible. Moreover, if a FMI were to become insolvent an administrator or liquidator working under the standard objective of maximising value for creditors would not necessarily have cause (apart from under that objective) to keep critical payment and settlement services running.

**2.4** These services are vital to the efficient operation of the financial system and any suspension of service provision is likely to cause a severe disruption to the functioning of the wider financial sector and the real economy given 1) the volume and value of transactions processed by payment and settlement systems on behalf of households and businesses (hundreds of billions of pounds a day) and 2) the absence of alternative means of effecting these transactions. We believe that the proposal outlined in the following section is necessary to mitigate the risk, however remote, of such disruption occurring<sup>2</sup>.

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<sup>1</sup><http://www.bankofengland.co.uk/financialstability/Pages/fmis/default.aspx>

<sup>2</sup> See the impact assessment in Annex A for more detail on the potential disruption that could be caused by the suspension of critical payment and settlement services.



# 3

## Special administration regime

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**3.1** The responses to the consultation last year recognised that these FMI may be systemically important and could pose a risk to UK financial stability if they were left to an ordinary insolvency procedure. But as these firms generally do not incur substantial financial exposures, there was less support for full resolution powers over these firms. Instead it was stressed that the key objective of any special arrangements for payment and settlement systems should facilitate the continuity of critical services.

**3.2** This objective of ensuring continuity of service is at the core of our proposal. The Government proposes that a SAR should be introduced where the administrator would have the overarching objective to maintain the continuity of the FMI's critical payment and settlement services in the interest of UK financial stability.

**3.3** The SAR could only be triggered by a court order made on the application of the Bank of England. The Bank of England is the appropriate authority to do this as it will have an existing relationship and knowledge of those systems due to its responsibilities for the oversight of recognised payment systems and supervision of securities settlement systems. This role means it is the authority best placed to consider the impacts upon financial stability and continuity of critical services.

**3.4** The Government is consulting on changes to the regulation of the payment systems sector<sup>1</sup>. The Bank of England will still be the authority to trigger or give consent in relation to the SAR regardless of the outcome of these regulatory proposals for the sector, but any arrangements for consulting or notifying any further regulatory bodies will depend on the outcome of these regulatory proposals.

**3.5** The SAR would be a variant of a normal corporate administration and would broadly take as its model the kinds of special administration framework used in the utilities industries and the investment bank SAR. As such, many of the standard features of corporate administration would be applied. These would include, for example:

- the administrator having the power to manage the affairs, business and property of the company, to bring or defend legal actions, and to borrow money and grant security, in order to meet the administration objectives;
- the administrator making proposals as to how it will meet the objectives;
- a moratorium on other legal processes; and
- the administrator having certain reporting obligations and the ability to summon meetings of creditors.

**3.6** The special administrator (SA) could obtain funding to meet the relatively minor operational costs of maintaining critical payment and settlement services during the SAR, much as a corporate administrator could. As a last resort this could come in the form of a loan from the authorities, to be recovered as and when a permanent successor arrangement is put in place.

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<sup>1</sup> [http://www.hm-treasury.gov.uk/consult\\_opening\\_up\\_uk\\_payments.htm](http://www.hm-treasury.gov.uk/consult_opening_up_uk_payments.htm)

## Powers

3.7 The following modifications to the “normal” administration regime could be made, if deemed necessary:

- A power of direction for the Bank of England over the SA to enable the Bank of England to exercise a degree of control over the SAR process and to clarify to the SA how best it can meet its financial stability objectives. For example, the authorities may want to direct the SA to prioritise certain critical services.
- Transfer powers to give the SA the means to transfer all or part of the business to an acquirer on an expedited basis.
- Restrictions on early termination of third party contracts to ensure that crucial third parties, such as service providers, do not terminate their contracts with a recognised inter-bank payment system or operator of a securities settlement system solely because of its entry into the SAR. A termination would be undesirable where the contract parties continue to perform their contractual obligations as normal, and this provision would further strengthen the protection provided to the FMI's critical services.

### **SAR: consultation questions**

- Do you agree that a SAR would be sufficient to ensure continuity of service and therefore protect financial stability in the event that such an FMI was failing?
- Do you believe that a) a power of direction for the Bank of England over the SA, b) transfer powers for the SA, and c) restrictions on early termination rights, would strengthen the capability of the SAR to meet its objective of maintaining continuity of critical services?

# 4

## Scope

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**4.1** The objective of this proposal is to ensure the continuity of critical payment and settlement services. In order to achieve this, the SAR will be applied to operators of recognised inter-bank payment systems, operators of securities settlement systems, and key service providers to these firms.

**4.2 Operators of recognised inter-bank payment systems** are operators of payment systems recognised under Part 5 of the Banking Act 2009 and which are as such subject to the oversight of the Bank of England. Payment systems are recognised on the basis that they are of systemic importance to the UK financial system and the purpose of this proposal is to ensure that the core service that payment systems provide is protected in the event that an operator or a key service provider to the payment system is failing.

**4.3 CSDs**, which operate securities settlement systems, provide a number of critical services, such as transaction input, settlement, corporate action processing and maintaining the dematerialised legal register. Due to the intricacy of these organisations and their services, careful thought will need to be given as to how legislation can capture critical services sufficiently clearly for the SA to know with any confidence which parts of the business must be continued under the overarching SAR objective. We welcome the views of industry on which CSD services are critical and how best to capture these critical services in legislation.

**4.4** In many UK payment and settlement systems, the FMI outsources the technical operation of the system to **third party service providers**. These critical service providers can also be systemically important to the financial sector, as without infrastructure such as IT and telecommunications that is outsourced to service providers, the FMI may be unable to carry out its critical services. Primary responsibility for the effective management of a payment system, securities settlement system and any outsourced services lies with the scheme company. But due to the key role of some service providers, the Banking Act 2009<sup>1</sup> contains provision (section 206A) that allows the Treasury to apply by order the regulatory regime applicable to operators of recognised inter-bank payment systems to critical service providers in appropriate cases. To date, no order bringing a critical service provider within the Part 5 regulatory regime has been made.

**4.5** We welcome views on whether service providers should be within the scope of this proposal, and if so, how they should be captured. One option would be to apply the SAR to any service provider that is subject to regulatory oversight by the Bank of England pursuant to an order made by the Treasury under section 206A of the Banking Act 2009. Alternatively, the provision establishing the SAR could allow for key service providers that it is intended will be within the scope of the SAR to be designated by order of the Treasury for that purpose. In the latter case, criteria would have to be specified for the purpose of identifying which service providers should be designated, and we welcome views on possible criteria for identifying critical service providers.

**4.6** Any firms that would otherwise be within the scope of this proposal but are subject to existing special resolution regimes under the Banking Act 2009 (as amended by the Financial Services Act 2012) are excluded from this proposal. This will be the case for those recognised clearing houses that 1) act as central counterparties and 2) additionally operate recognised inter-

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<sup>1</sup> As amended by the Financial Services Act 2010.

bank payment systems or share settlement systems. If such FMI were to fail, the special resolution regime as applied by the FS Act 2012 would be activated, not this SAR.

**4.7** As domestic insolvency legislation cannot be applied to firms with a centre of main interest outside of the UK, this proposal would not offer a guarantee of the continuity of service provision in all circumstances. Firms outside the UK may also provide critical payment and settlement services within the UK, or they may provide critical services to UK payment and settlement systems. Directly or indirectly, their disorderly failure could cause a significant disruption to the UK financial system. It is therefore important that action is taken to address this risk on an international level and the UK Government will push for progress in this area.

**4.8** Within the UK, the majority of companies within the scope of this proposal are registered in England and Wales. However, this consultation does raise issues which apply across the whole of the UK. We welcome the views of industry on what should be the territorial extent of the proposed SAR.

**Scope: consultation questions**

- Does the scope of this proposal sufficiently capture all systemically important payment and settlement activity that operates under UK jurisdiction?
- Should any service providers to FMI be subject to this proposal, and if so, how should these service providers be identified and captured for the purposes of the regime?
- If you operate in Scotland or Northern Ireland, we would appreciate your views on whether or not a) there are any companies registered in Scotland or Northern Ireland that would be within the scope of this proposal, and b) any legislation to set up the proposed SAR should be extended to cover Scotland and/or Northern Ireland.

# 5

## Summary

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**5.1** Since the related consultation last year, the Government has been in talks with the Bank of England and Financial Services Authority to formulate a policy to safely manage the failure of systemically important financial market infrastructure. The outcome of this work is the proposal detailed in this document: to introduce the power for a SAR to be applied to operators of recognised inter-bank payment systems, operators of securities settlement systems, and key service providers to these firms.

**5.2** We welcome the views of industry on this proposal.

### **Summary of consultation questions**

- 1 Do you agree that a SAR would be sufficient to ensure continuity of service and therefore protect financial stability in the event that such an FMI was failing?
- 2 Do you believe that a) a power of direction for the Bank of England over the SA, b) transfer powers for the SA, and c) restrictions on early termination rights, would strengthen the capability of the SAR to meet its objective of maintaining continuity of critical services?
- 3 Does the scope of this proposal sufficiently capture all systemically important payment and settlement activity that operates under UK jurisdiction?
- 4 Should any service providers to FMI be subject to this proposal, and if so, how should these service providers be identified and captured for the purposes of the regime?
- 5 If you operate in Northern Ireland, we would appreciate your views on whether or not a) there are any companies registered in Scotland or Northern Ireland that would be within the scope of this proposal, and b) any legislation to set up the proposed SAR should be extended to cover Scotland and/or Northern Ireland.
- 6 Do you agree that special arrangements are not required at this stage for other forms of FMI?
- 7 Are there any other consequences of this proposed legislation which you think the Government should take into account?





# A

## Impact assessment

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**A.1** The impact assessment for the proposals contained in this consultation can be found overleaf.

<b>Title:</b> Special Arrangements for Insolvent Payment Systems and Central Securities Depositories  <b>IA No:</b> TBC  <b>Lead department or agency:</b> HM Treasury  <b>Other departments or agencies:</b> N/A	<b>Impact Assessment (IA)</b>		
	<b>Date:</b> January 2013		
	<b>Stage:</b> Consultation		
	<b>Source of intervention:</b> Domestic		
	<b>Type of measure:</b> Primary legislation		
<b>Contact for enquiries:</b> Paul Clark HM Treasury 0207 270 4314			
<b>Summary: Intervention and Options</b>			<b>RPC Opinion:</b> RPC Opinion Status

Cost of Preferred (or more likely) Option			
Total Net Present Value	Business Net Present Value	Net cost to business per year (EANCB on 2009 prices)	In scope of One-In, Measure qualifies as One-Out?
N/A	N/A	N/A	No   N/A

**What is the problem under consideration? Why is government intervention necessary?**

Payment systems and central securities depositories (CSDs) are systemically important financial institutions, providing infrastructure upon which the financial sector relies. As things stand, there is no way to resolve these institutions in an orderly manner, meaning that the failure of one or more of them could cause significant disruption to financial markets and the real economy. Legislation may therefore be necessary to safeguard against such an event materialising.

**What are the policy objectives and the intended effects?**

The proposal is intended to ensure that the critical services of systemically important payment systems and CSDs are not suspended during insolvency, but instead maintained for as long as is necessary to maintain UK financial stability. This will:

- reduce the likelihood of individual firms threatening the wider stability of the UK if they become insolvent;
- ensure the continuity of critical market functions; and
- protect households and businesses, who are end-users of payment systems and CSDs.

**What policy options have been considered, including any alternatives to regulation? Please justify preferred option (further details in Evidence Base)**

The three broad options being considered by the Government to address the risks to stability posed by the failure of payment systems and CSDs are:

- 1) 'Do nothing': the status quo is preserved; no action is taken.
- 2) Special administration regime (SAR), evaluated against maintaining the status quo: the Government takes action to put in place powers to enable a modified insolvency procedure for a failing payment system or CSD, in order for its services to be continued during administration, for as long as is necessary to protect UK financial stability. This is the Government's preferred option at this stage.
- 3) Special resolution regime (SRR), evaluated against maintaining the status quo: the Government takes action to put in place a range of powers (SAR, transfer powers, bridge company tool, temporary public ownership) for a resolution authority to resolve a failing payment system or CSD.

<b>Will the policy be reviewed? Yes If applicable, set review date:</b> October 2018					
Does implementation go beyond minimum EU requirements?				Yes	
Are any of these organisations in scope? If Micros not exempted set out reason in Evidence Base.		<b>Micro</b> No	<b>&lt; 20</b> No	<b>Small</b> No	<b>Medium</b> Yes
What is the CO <sub>2</sub> equivalent change in greenhouse gas emissions? (Million tonnes CO <sub>2</sub> equivalent)		<b>Traded:</b> N/A		<b>Non-traded:</b> N/A	

***I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.***

Signed by the responsible Minister:  Date: 18/01/2013

## Summary: Analysis & Evidence

## Policy Option 1

- 1) **Description:** The Government takes action to put in place powers to enable a modified insolvency procedure for a failing payment system or central securities depository (CSD), in order for its services to be continued during administration, for as long as is necessary to protect UK financial stability. This is the Government's preferred option at this stage.

### FULL ECONOMIC ASSESSMENT

Price Base Year N/A	PV Base Year N/A	Time Period Years N/A	Net Benefit (Present Value (PV)) (£m)		
			Low: Optional	High: Optional	Best Estimate: N/A
<b>COSTS (£m)</b>	<b>Total Transition</b> (Constant Price) Years		<b>Average Annual</b> (excl. Transition) (Constant Price)		<b>Total Cost</b> (Present Value)
Low	Optional		Optional		Optional
High	Optional		Optional		Optional
Best Estimate	N/A		N/A		N/A
<b>Description and scale of key monetised costs by 'main affected groups'</b>					
This proposal does not require the firms that are affected to take any ex ante action. The immediate direct cost of the proposal is therefore <b>zero</b> .					
<b>Other key non-monetised costs by 'main affected groups'</b>					
In the case of a firm entering a special administration regime, where the primary objective of the administrator is to maintain a continuity of service, the cost to creditors is likely to be higher than under the current insolvency regime where the aim is to maximise creditors' returns. However, this increase in cost is not expected to be significant, especially when set against the potentially very significant benefits from strengthening financial stability.					
<b>BENEFITS (£m)</b>	<b>Total Transition</b> (Constant Price) Years		<b>Average Annual</b> (excl. Transition) (Constant Price)		<b>Total Benefit</b> (Present Value)
Low	Optional		Optional		Optional
High	Optional		Optional		Optional
Best Estimate	N/A		N/A		N/A
<b>Description and scale of key monetised benefits by 'main affected groups'</b>					
The key benefit of this proposal is the reduced risk of disruption from a disorderly failure of a payment system or CSD. This benefit cannot be monetised as it is impossible to predict what would happen if such a company was to fail in a disorderly manner. There is no precedent for such a failure. The impact would be highly dependent on the market conditions in which the failure occurred, the nature of the firm that failed and the accessibility to alternative providers. Accordingly, a qualitative assessment is made of the impacts.					
<b>Other key non-monetised benefits by 'main affected groups'</b>					
The benefits are potentially very significant, as the policy reduces the risk of a suspension of service by a payment system or CSD. These services are vital to the efficient operation of the financial system and any such suspension of service provision could have disastrous consequences given 1) the volume of transaction processed by payment and settlement systems on behalf of households and businesses, and 2) the absence of alternative means of effecting these transactions.					
Key assumptions/sensitivities/risks N/A					Discount rate (%)

### BUSINESS ASSESSMENT (Option 1)

Direct impact on business (Equivalent Annual) £m:			In scope of OIOO?	Measure qualifies as
Costs: N/A	Benefits: N/A	Net: N/A	No	N/A

## Summary: Analysis & Evidence

## Policy Option 2

- 1) **Description:** Special resolution regime: the Government takes action to put in place a range of powers (special administration regime, transfer powers, bridge company tool, temporary public ownership) for a resolution authority to resolve a failing payment system or central securities depository (CSD).

### FULL ECONOMIC ASSESSMENT

Price Base Year N/A	PV Base Year N/A	Time Period Years N/A	Net Benefit (Present Value (PV)) (£m)		
			Low: Optional	High: Optional	Best Estimate: N/A
<b>COSTS (£m)</b>	<b>Total Transition</b> (Constant Price) Years		<b>Average Annual</b> (excl. Transition) (Constant Price)		<b>Total Cost</b> (Present Value)
Low	Optional		Optional		Optional
High	Optional		Optional		Optional
Best Estimate	N/A		N/A		N/A
<b>Description and scale of key monetised costs by 'main affected groups'</b>					
The proposals under Policy Option 2 do not require the firms that are affected to take any ex ante action. The immediate direct cost of the proposal is therefore <b>zero</b> .					
<b>Other key non-monetised costs by 'main affected groups'</b>					
There may be a minor market reaction to this policy announcement if it increases market participants' expectation of a failure. This could manifest itself as a small reduction in business, i.e. a cost, for the systems. However, communications by the Authorities will ensure that any such impact is small. There may be some costs to the Authorities of implementing the powers, particularly if temporary public ownership (TPO) is used. This cost will depend on the nature of the failing system.					
<b>BENEFITS (£m)</b>	<b>Total Transition</b> (Constant Price) Years		<b>Average Annual</b> (excl. Transition) (Constant Price)		<b>Total Benefit</b> (Present Value)
Low	Optional		Optional		Optional
High	Optional		Optional		Optional
Best Estimate	N/A		N/A		N/A
<b>Description and scale of key monetised benefits by 'main affected groups'</b>					
The key benefit of this policy is the reduced risk of disruption from a disorderly failure of a payment system or CSD. This benefit cannot be monetised as it is impossible to predict what would happen if a system was to fail in a disorderly manner. There is no precedent for such a failure. The impact would be highly dependent on the market conditions in which the failure occurred, the nature of the firm that failed and the accessibility to alternative providers. Accordingly, a qualitative assessment is made of the impacts.					
<b>Other key non-monetised benefits by 'main affected groups'</b>					
The benefits are potentially very significant, as the policy reduces the risk of a suspension of service by a payment system or CSD. These services are vital to the efficient operation of the financial system and any such suspension of service provision could have disastrous consequences given 1) the volume of transaction processed by payment and settlement systems on behalf of households and businesses, and 2) the absence of alternative means of effecting these transactions.					
Key assumptions/sensitivities/risks N/A					Discount rate (%)

### BUSINESS ASSESSMENT (Option 2)

Direct impact on business (Equivalent Annual) £m:			In scope of OIOO?	Measure qualifies as
Costs: N/A	Benefits: N/A	Net: N/A	No	N/A

## Introduction

1. In August 2012 the Government published a consultation document<sup>1</sup> discussing proposals for enhancing the mechanisms available for dealing with the failure of systemic non-bank financial institutions. The consultation document covered four broad groups of non-bank financial institutions, as follows:
  - (i) investment firms and parent undertakings;
  - (ii) central counterparties (CCPs);
  - (iii) **non-CCP financial market infrastructures (non-CCP FMIs)**; and
  - (iv) insurers.
2. The Government received a range of responses to the consultation, including from industry bodies (such as the British Bankers' Association and the Investment Managers' Association), banks, investment firms and CCPs. On non-CCP FMIs, the feedback from industry suggested that a full resolution regime was unnecessary and that modifying the existing insolvency regimes was more appropriate.
3. Following the consultation, the Government brought forward legislation in the Financial Services Bill to introduce powers to facilitate the resolution of systemic investment firms, parent undertakings and CCPs. In the Impact Assessment published alongside this legislation (20 September 2012)<sup>2</sup>, it was stated that the Government did not have a firm view on the best approach for dealing with threats to the viability of non-CCP FMIs but that it was continuing to develop its thinking.
4. Since then, the Authorities (the Bank of England, Financial Services Authority and HM Treasury) have come to the conclusion that for recognised payment systems, their service providers and central securities depositories (CSDs), including the securities settlement service (SSS) operated by the CSD, special arrangements are required to make sure that a systemic firm would not suspend its operations in insolvency, as this would put the stability of the UK financial sector at risk. The Authorities also concluded that the most desirable power at this stage is that which enables a special administration regime for a failing systemic payment system or CSD.
5. This Impact Assessment sets out the case for Government intervention, analysing the costs, benefits and likely impact of two policy options – 1) a special administration regime and 2) a special resolution regime – each evaluated against a baseline scenario of 'doing nothing', i.e. maintaining the status quo.

## Scope

6. The proposed regime will apply to the following types of firms, which are described in detail in the next section:
  - recognised payments systems;
  - service providers to these payment systems; and
  - central securities depositories (CSDs) – this will capture any securities settlement system (e.g. CREST) that is operated by a CSD<sup>3</sup>.
7. For other types of financial market infrastructure (e.g. exchanges and trade repositories) and insurers, although the consultation document (2012) acknowledged the likelihood of such institutions having some degree of systemic potential, the Government does not have a firm view on the appropriateness

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<sup>1</sup> HM Treasury, 2012, *Financial sector resolution: broadening the regime*:  
[http://www.hm-treasury.gov.uk/d/condoc\\_financial\\_sector\\_resolution\\_broadening\\_regime.pdf](http://www.hm-treasury.gov.uk/d/condoc_financial_sector_resolution_broadening_regime.pdf).

<sup>2</sup> LINK to IA

<sup>3</sup> The CSD for the UK is Euroclear UK and Ireland (EUI). EUI operates the securities settlement system CREST,

of introducing a similar regime to respond to the risk they may pose to financial stability. The Government is continuing to develop its thinking on these groups.

## Terminology

8. The costs and benefits identified for the policy proposals under consideration are classified as being either **direct** or **indirect**. Direct costs and benefits are first round effects that are directly attributable to the proposals coming into force, and will impact on the payment systems and CSDs that are directly affected. Indirect costs and benefits, on the other hand, are second round effects that can be expected to follow on dynamically from the implementation of the proposals.
9. Irrespective of whether costs and benefits are direct or indirect, their impact will also either be **monetisable** or **non-monetisable**. Monetisable costs and benefits are those that, given the current evidence, the Government is able to estimate quantitatively. As highlighted in later sections, the costs and benefits, whether direct or indirect, arising as a result of the proposed reforms will be difficult to monetise or will be non-monetisable. In these instances, a qualitative assessment is made of the likely impact.

## Payment systems, central securities depositories and securities settlement systems

10. Payment systems provide vital infrastructure for financial markets by processing financial transactions.
11. There are two parts that are crucial to the functioning of payment systems: scheme companies (e.g. CHAPS Clearing Company, Bacs Payment Services Ltd), which manage the governance, rules and contractual arrangements including membership; and service providers (e.g. VocaLink), to whom the actual processing of payment and technical infrastructure, such as IT and telecommunications, may be outsourced. This legislation would cover both scheme companies and their service providers.
12. The following scheme companies are recognised inter-bank payment systems under the Banking Act 2009 and subject to Bank of England oversight:
  - Bacs (recognised 5 January 2010)
  - CHAPS (recognised 5 January 2010)
  - Continuous Linked Settlement (CLS, recognised 5 January 2010)
  - CREST (recognised 5 January 2010)
  - LCH.Clearnet Ltd (recognised 5 January 2010)
  - Faster Payments Service (recognised 24 February 2010)
  - ICE Clear Europe (recognised 24 February 2010)
13. CHAPS, Bacs and Faster Payments Service are owned and controlled by their members (the major banks), and are represented and co-ordinated by the Payments Council.
14. LCH and ICE are already covered by resolution powers for central counterparties (CCPs), which were put in place through the Financial Services Act, and therefore are not in the scope of this proposed legislation.
15. The service providers to these scheme companies are currently 'outside' the regulatory perimeter as no service providers are currently recognised under the Financial Services Act 2010. Nevertheless, as they are integral to payment systems and the critical market functions that rely on them, service providers are within the scope of this legislation and are included in the definition of "payment systems" for the purpose of this Impact Assessment.
16. This legislation will also apply to securities settlement systems (SSSs). These companies perform a number of crucial services that allow the registration, issuance, safekeeping, and settlement of securities in exchange for cash, which supports the efficient processing of securities transactions in financial markets. CREST is the only SSS in the UK. It will be covered by this legislation as it is

operated by the central securities depository (CSD) Euroclear UK & Ireland (EUI), and this legislation will apply to CSDs. As it stands, EUI takes on only a very small amount of credit or liquidity risk and does not carry out banking services.

## Structure of this Impact Assessment

17. The rest of this Impact Assessment is structured as follows:

1. Background
2. Rationale for action by the Government
3. Policy objectives
4. Description of policy options
5. Impact of policy options and analysis of costs and benefits
6. Wider impacts

## Background

18. Payment systems and central securities depositories have the potential to be systemically important – because the financial system could not operate if they were not in place, rather than because they concentrate financial exposures. The infrastructure they provide is integral to the functioning of the financial sector.

19. If a payment system or central securities depository were to become insolvent, this may result in disruption to, or the cessation of, processing of payments. Given the number of transactions processed through these systems and their total value (see Table 1), this could cause substantial disruption to financial markets and the general public.

**Table 1: Daily volumes and values through the UK payment systems in 2011<sup>4</sup>**

	Average daily volume (000's)	Average daily value (£m)	Important payment types
CHAPS	136	254,489	Settlement of financial market transactions CLS pay-ins/outs House purchases
Bacs	22,777	17,383	Salary, pension and benefits payments Direct Debits
FPS	2,093	936	Telephone and internet banking Single immediate and forward dated payments Standing Order payments
CREST	172	473,041	Settlement of gilts, equities, corporate bonds and money market instruments

Sources: Bank of England, CLS Bank International, Euroclear UK & Ireland, ICE Clear Europe Ltd, LCH.Cleernet Ltd and UK Payments Administration Ltd.

20. Most obviously and crucially, end users would no longer be able to make payments or settle through that system. For the recognised systems, end users includes the full range of individuals, non-financial corporates, government and other public bodies, and banks and other financial institutions.

21. For certain payment types, there is only one established payment system. For example, CHAPS is the only real time payment system in the UK. CREST is the only securities settlement system in the UK. Only Bacs is able to process direct debit transactions. And almost all (over 99%) standing order payments in the UK are processed through the Faster Payments Service.

<sup>4</sup> Bank of England Payments Oversight Report 2011 (April 2012) <<http://www.bankofengland.co.uk/publications/Documents/psor/psor2011.pdf>>

22. The precise nature of disruption would depend on the system in question, given the different types of transactions processed by each, but the disruption would doubtlessly be costly, to potentially millions of people.
23. If Bacs were to become insolvent, we would expect disruption to all direct debits and most salaries, pensions, benefits, and government tax receipts. Corporate invoice payments (including public sector payments such as local government and NHS) would also be heavily disrupted.
24. Due to Bacs's three day payment cycle, there may be a 'lag' in the disruption. Thereafter it is less certain. We would not expect remaining 'in flight' transactions to be lost and they should be protected under settlement finality regulations, but the timing of that settlement (i.e. when they would reach end users) is not certain. And further payments might not be submitted by members or end users, or not processed by the service provider. Given Bacs processes on average over 22 million transactions per day, even a small drop in activity in percentage terms could have a material economic impact.
25. For those future transactions to be settled, they would need to be routed through different payment systems. There are a number of issues here: at present, neither CHAPS nor FPS (even together) are expected to have capacity to take all of those additional payments; the ability to re-route payments through different systems will vary between member banks as there is much variety in the internal IT systems of the banks; memberships of the different systems is not completely overlapping; FPS has an individual payment limit (max £100k); commercial banks usually charge customers for CHAPS payments so they would face a decision over whether to waive such a charge. Cheque payments are also an alternative, but an increasing number of businesses no longer accept cheques, and the clearing cycle is longer. Again, volume capacity may be an issue. There is no alternate system for direct debits.
26. There may also be indirect effects once the insolvency becomes widely known, and social media can often lead to wild and inaccurate rumours disseminating quickly. If individuals are concerned about not being able to send or receive payments (such as salary), they may seek to move funds and savings online or by telephone, straining the capacity of banks' own systems and Faster Payments Service, and risking contagion. Or they may seek to withdraw and stockpile cash. If this is through cash machines, it could cause capacity issues to the LINK interchange network. If it is through bank cashiers, it may cause queues in smaller or less prepared branches. Either way, it may cause localised shortages of bank notes and thereby spread further rumour or uncertainty. Disruptions to Faster Payments are likely to be similar, but potentially not on as large a scale as Bacs.
27. There are no realistic substitutes for CHAPS or CREST, and failure would cause huge disruption to UK financial activity including the Bank of England's monetary policy operations and to the Government through the operations of the Debt Management Office.
28. In terms of service providers, VocaLink is the sole service provider for Bacs and the Faster Payments Service (as well as LINK). In the event of its failure, the consequences could be similar to those outlined above for Bacs and Faster Payments Service.

### **Rationale for action by the Government**

29. The 2007-09 financial crisis exposed a great many flaws in the global financial system. In particular, systemic banks, when they ran into trouble, could not be allowed to collapse in a disorderly way, because of the damage that would have been done to the financial system and the wider economy. With no alternatives, the Government was forced to step in and bail out failing banks.
30. In response to the crisis, the UK Government put in place a special resolution regime (SRR) for banks, to ensure that banks are better able to cope with shocks in the future and that, if banks do fail, they can be resolved safely without risk to the taxpayer or to financial stability.
31. Banks are only one part of the financial system. Other types of financial institutions can also pose a risk to financial stability if there is no way for them to fail safely. The disorderly failure of systemically important financial market infrastructures (FMIs) – systems that connect market participants to each other – could severely disrupt both financial markets and the normal functioning of the wider economy. The potential economic cost of allowing FMIs to collapse means that they too may need taxpayer support should they run into trouble, if there is no way for them to fail safely. For example, in the recent crisis, the US authorities provided taxpayer-funded support to bail out Bear Stearns (an investment firm), AIG (an insurer) and also to underpin money market funds.



32. This is why resolution powers for CCPs were introduced in the Financial Services Act, and why the Government is now consulting on this legislation, exploring the case for addressing gaps in the resolution regime framework for payment systems and central securities depositories on a more accelerated timetable than that currently envisaged in ongoing international work.
33. A key consideration in taking forward these proposals is whether the best response at this stage might be to modify existing administration/run-off arrangements so as to ensure continuity of service provision as opposed to introducing a new, comprehensive resolution regime designed to achieve the same end. A balance needs to be struck between enhancing financial stability and ensuring that the regulatory regime is not unnecessarily complex or burdensome for the Authorities and industry.

## **Policy objectives**

34. The Government's overall rationale for acting is to protect financial stability by ensuring that robust arrangements are in place for managing the failure, or likely failure, of any non-bank financial institution with the potential to be systemic. The proposals set out in the consultation document are targeted at achieving this in line with the following objectives:
- strengthening the stability and resilience of the financial system by preventing contagion and maintaining market discipline;
  - reducing the likelihood of individual firms threatening the wider stability of the UK if they get into difficulties;
  - ensuring the continuity of critical market functions; and
  - protecting depositors, client funds and client assets.
35. The Government will be seeking to achieve the above objectives whilst also seeking to ensure that;
- taxpayer interests are protected; and
  - the interference with rights in contravention of a right within the meaning of the Human Rights Act 1998 is avoided.
36. These objectives are consistent with international initiatives to promote financial stability, in particular:
- work on resolution regimes by the Financial Stability Board (FSB); and
  - the publication of a joint consultation paper by the Committee on Payment and Settlement Systems (CPSS) and International Organization of Securities Commissions (IOSCO) working group (henceforth CPSS-IOSCO) in July 2012.

These are briefly discussed immediately below.

## **Financial Stability Board's Key Attributes**

37. The FSB published the Key Attributes of Effective Resolution Regimes for Financial Institutions in November 2011, which sets out, amongst other things, the responsibilities and powers that national resolution regimes should have in order to resolve a failing systemically important financial institution (SIFI). More specifically, the Key Attributes recommend that jurisdictions:
- ensure resolution authorities have a broad range of powers to intervene and resolve a financial institution that is no longer viable;
  - remove impediments to cross-border cooperation;
  - ensure that recovery and resolution plans are put in place for all global SIFIs; and
  - maintain Crisis Management groups for all global SIFIs.
38. The UK has a long term commitment, along with other G20 countries, to implement the Key Attributes for Effective Resolution Regimes published by the FSB. This includes introducing arrangements for

any type of financial firm with the potential for causing a systemic impact in the event of failure – including FMIs.

## CPSS-IOSCO consultation document

39. Following the publication of the FSB's Key Attributes, the FSB noted that not all resolution powers will be suitable for all sectors and all circumstances, and, in the context of FMI, the choice of resolution powers should be guided by the need to maintain continuity of critical FMI functions.
40. As such, CPSS-IOSCO has – with the support of the FSB – been conducting work on the application of the FSB's Key Attributes for resolution regimes for financial market infrastructure. CPSS-IOSCO published a consultation paper in July 2012<sup>5</sup>, which concluded: “it is vital that very robust arrangements exist for the recovery of FMIs and, if that fails, for their resolution.”
41. There is no definite European timetable in place for enabling powers for payment systems and central securities depositories. The UK Government does not expect that powers will be made available through the European process for a number of years.

### **Description of policy options**

42. The three broad options considered in this Impact Assessment to address the risks to financial stability posed by the failure of a systemic payment system or CSD are:
  - ‘Do nothing’: the UK Government does not take any action at this stage to implement these proposals (this is the baseline against which the two main policy options are evaluated in this Impact Assessment);
  - Policy Option 1 – Special administration regime’: the UK Government takes action, via domestic legislation, to put in place powers to enable a modified insolvency procedure for a failing systemic company, in order for its services to be continued during administration, for as long is necessary to protect UK financial stability.
  - Policy Option 2 – ‘Special resolution regime’: the Government takes action to put in place a range of powers (SAR, transfer powers, bridge company tool, temporary public ownership) for a resolution authority to resolve a failing payment system or CSD.

#### **‘Do nothing’**

43. Under this option, the UK Government does not take any action at this stage to address the risks posed by the failure of systemic payment systems and CSDs.
44. Under the status quo, a failing company would be put into a regular insolvency procedure, under which services may be suspended.
45. The Bank of England currently has the following powers over recognised payment systems, under part V of the Banking Act (2009).
  - *publish principles to which operators of recognised payment systems are to have regard (this is the only power they have exercised)*
  - *publish codes of practice about the operation of recognised payment systems*
  - *require the operator of a recognised payment system to make or change rules for the operation of the system. They must notify the Bank of any proposed change to the rules; and not to change the rules without Bank approval*
  - *give directions to the operator of a recognised payment system. A direction may require or prohibit the taking of specified action in the operation of the system; or set standards.*
  - *appoint one or more persons to inspect the operation of a recognised payment system*

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<sup>5</sup> [www.bis.org/publ/cpss103](http://www.bis.org/publ/cpss103) p.18

- *require the operator of a recognised payment system to appoint an expert to report on the operation of the system*
  - *publish details of a compliance failure by the operator of a recognised payment system*
  - *require the operator of a recognised payment system to pay a penalty in respect of a compliance failure. And give the operator an order to stop operating the system*
  - *prohibit a specified person from being an operator of a recognised payment system*
  - *prohibit a specified person from holding an office or position involving responsibility for taking decisions about the management of a recognised payment system*
  - *Collect fees.*
  - *require a person to provide information*
46. These powers enable the regulator to require a payment system to take action (or to refrain from taking action) to protect and enhance financial stability, and to maintain the continuity of services provided by the payment system, up until the point where the firm enters administration. Crucially, the Authorities would have no power over the administrator to prevent them electing to wind-down the business rather than seeking to rescue the firm as a going concern.
47. CHAPS, Bacs and Faster Payments Service are owned and controlled by their members (the major banks), and are represented and co-ordinated by the Payments Council. They do not take credit risk. It is in members' interests to keep these payment systems going as the reputational hit from failure would fall on the large banks. The cost of resolving a payment system should be very small compared to the size of the large member banks.

### **Policy option 1 – ‘special administration regime’**

48. Under this policy option, the UK Government takes action to put in place powers to enable a modified insolvency procedure for a failing systemic payment system or CSD, in order for its services to be continued during administration, for as long is necessary to protect UK financial stability.

#### Regulatory oversight

49. Under all policy options, the Bank of England would continue to have regulatory powers over ‘healthy’ (i.e. solvent) payment and settlement systems.

#### Special administration regime

50. Policy Option 1 proposes the power to introduce a special administration regime (SAR) for failing payment systems and CSDs. This SAR, drawing on that which is in place for other utility companies, would be designed to ensure that continuity of service would not be in doubt even if one of these companies should become insolvent. The administration order would give the administrator an overriding objective to continue the critical services of the firm during administration. The Bank of England would have the power to petition a court to place a payment system or CSD into administration but the court would appoint the administrator. No-one else could petition for insolvency against one of these firms without first giving the Bank proper notice.

#### Power of direction

51. The Bank of England would also be granted the power of direction over an administrator. The Bank of England could give directions to the person if satisfied that it is desirable to do so, having regard to the public interest in: protecting and enhancing the stability of the UK financial system; protecting and enhancing confidence in it; and maintaining the continuity of critical services. This power would ensure that the administrator can best achieve its objectives under the SAR and could be used to provide clarity to the special administration over how to meet its objectives.
52. One example of where the power of direction might be useful is for the Bank of England to be able to direct the administrator to prioritise certain payment types in the face of uncertainty over whether the

system in administration can continue processing all transactions submitted to it. For example, priority might be given to HMRC payment (such as benefits) or receipts (such as tax payments) through Bacs. Clearly, careful thought would be required as to the most desirable course of action, but the power of direction would strengthen the alignment of the insolvency procedure with financial stability objectives.

## **Policy option 2 – ‘special resolution regime’**

53. Under this policy option, the UK Government takes action to introduce a resolution regime, in addition to the special administration regime outlined in Option 2, to ensure that Authorities have the tools to allow them to manage the orderly resolution of payment systems and central securities depositories.

### Regulatory oversight and special resolution regime

54. Under this policy option, as with all policy options, the Bank of England would retain its regulatory oversight over ‘healthy’ payment systems. The policy would also enable the special administration regime and associated power of direction over an administrator that forms Option 1.

### Transfer powers

55. The additional powers under Option 2 are similar to the stabilisation tools available under the Banking Act 2009. The powers would provide the Bank of England with the ability to transfer ownership and/or some or all of the assets, rights and liabilities or securities of a failed firm (subject to a number of conditions) to either:

- a private sector purchaser;
- a bridge company wholly owned and operated by the Bank of England; or
- temporary public ownership.

56. Where only part of a failed firm is transferred to a private sector purchaser or bridge company, the remainder of the firm is likely to enter insolvency and the Bank of England would have a power of direction over the administrator to require the firm in administration to continue to provide services in support of the transferred business.

### Private sector purchaser

57. This tool would empower the resolution authority to transfer all or part of the business of a failing firm either by the transfer of the shares, or of its property, rights and liabilities, to a private sector purchaser who is willing to accept the transfer.

58. The resolution authority would only use this power in situations where the conditions for entering the resolution regime are met and there are sufficient public interest grounds for intervention.

### Bridge company tool

59. This tool would enable the resolution authority to facilitate the transfer of some assets, rights and liabilities to another company owned by the Bank of England (a ‘bridge company’) with the aim of ensuring that the new ‘good’ entity can continue to provide services whilst the original ‘bad’ firm continues to exist, albeit that it is wound down over time. This approach may reduce contagion risk by ensuring the continuing function of the services of the firm.

60. If the resolution authority decides that a bridge is the most appropriate resolution tool, it will establish a separate company and apply transfer powers to transfer property, rights and liabilities from the failing firm to the bridge. Following the transfer, the resolution authority will stabilise the business and once a suitable private sector purchaser has been found, the entity will be sold.

### Temporary public ownership

61. This tool would empower HM Treasury to transfer the business of a failing payment system or CSD, either by the transfer of the shares, or of its property, rights and liabilities, into temporary public ownership. This power would be available to the Government as a last resort.

## Impacts of policy options and analysis of costs and benefits

### Cost-benefit analysis

62. **Costs** can be considered in two broad categories. First, any direct costs imposed on those institutions directly affected by the proposals, i.e. payments systems and central securities depositories, and the banks that rely on them to operate their services and in some cases own them. Second, any indirect costs that arise from the way in which companies respond to the direct costs that they incur, for example in changes to the availability of the services provided by these institutions. Any constraints on availability of financial services would impose costs on customers and ultimately impact on GDP.
63. The **benefits** will principally derive from enhanced financial stability. By far the biggest potential benefit is the reduction in the expected disruption from any blockage in the financial system and the financial crisis that that could trigger or propagate.
64. This section considers in more detail the costs and benefits of the Government's options to put in place a special administration regime (Option 1 – the Government's preferred option at this stage) or a special resolution regime (Option 2), evaluated against the counterfactual of the Government taking no action at this stage.

### Affected parties

65. The Government's preferred proposal at this stage, presented in this Impact Assessment as Option 1, and also Option 2, are expected to **directly** affect payment systems and CSDs and the banks that rely on them for their services and in some cases own them.
66. Note, however, that the proposals are designed to target systemic firms, which in practice will be all of the recognised payment systems, their service providers and EUI, which is currently the only CSD in the UK and operates CREST – the only securities settlement system in the UK. The Authorities' powers under the proposals (as described above) can only be exercised over such firms and related system providers. Moreover, the proposals could only directly impact those systemic systems (and their users) that are insolvent.
67. The Government's proposals could **indirectly** affect a far wider range of parties, for example the customers of banks who have transactions processed through payment systems and CSDs, such as households and businesses making bank transfers. The impact on the parties who use these companies' services represents an impact on economic activity more broadly. The recent financial crisis has shown how connections within the financial sector, and between the financial sector and the wider economy, mean that events originating in the financial sector can impact on households, firms and governments.

### Impact on micro-businesses

68. None of the options would introduce new regulations on micro-businesses. None of the payment systems is a micro-business and neither is the UK CSD. As such the policy is out of scope of the moratorium on new regulation for micro-businesses.

69. The proposals could have an indirect impact on micro-businesses<sup>6</sup> who have transactions processed through payment and settlement systems. Given the interconnected nature of the financial services sector and its importance to the wider economy, the proposals have the potential to impact on micro-businesses indirectly, to the extent that the proposals have the social benefit of a more secure financial market infrastructure and a reduced likelihood and impact of financial crises.
70. The indirect impact is likely to be positive, as the benefits of increased financial stability can be expected to outweigh any social costs for the economy as a whole (discussed in more detail below).
71. The Government is committed to ensuring that regulation is proportionate and will not have a disproportionate impact on small firms. The Government is satisfied that the impact of the proposals on small firms will be minimal.

### ***'Do nothing'***

72. As things stand the Authorities would have no power over the administrator to prevent the administration from electing to wind-down the business rather than seeking to rescue the firm as a going concern. As described in previous sections, this suspension of critical services could cause widespread disruption.
73. This 'do nothing' option has been chosen as the counterfactual against which the costs and benefits of the other policy options considered in this Impact Assessment are measured. As it is the baseline scenario, the costs and benefits of this policy are by definition zero for the purposes of this Impact Assessment.
74. However, the disruption caused by the disorderly failure of a payment system or CSD would of course amount to a huge cost if compared to a scenario where the provision of critical services was maintained. This 'cost' will show up in this Impact Assessment as an estimated benefit of policy options 1 and 2, which both serve to mitigate this risk of disruption, and are evaluated relative to the 'do nothing' option.

### ***Policy option 1 – special administration regime (SAR)***

#### *Direct costs*

75. The proposals under Option 1 do not require any ex ante action to be taken by payment systems or CSDs so the direct costs to such institutions of these proposals are therefore zero.
76. There will be a cost involved with the special administration regime upon implementation, which will be incurred by shareholders, creditors and members of the failed system. These member banks have the incentive and capability to fund the administration. Payment and settlement systems tend to have a low assets value and tend not to take on credit risk, meaning the cost of administration is likely to be relatively small. The SAR administration may be slightly more expensive than a regular insolvency procedure as the objective to preserve a continuity of service is likely to increase its longevity and will require the administrator to take actions that go beyond the normal administration objective of maximising value for creditors. However, any extra cost of administration, above and beyond the cost of an ordinary insolvency procedure, will be significantly outweighed by the benefit that will be realised from increased financial stability.
77. There may be a market reaction with participants surprised that the Authorities believe that a failure of a payment system or CSD is likely enough to warrant legislation safeguarding the service. However, any reaction of this nature will be mitigated by communications by the Authorities and so any impact is likely to be negligible.

#### *Indirect costs*

78. There are very few foreseeable indirect costs associated with the policy. There may be some indirect costs for the Authorities in relation to operationalising the proposals under Option 1, for example in petitioning the court. However, it is not clear that these indirect costs would be greater than under a

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<sup>6</sup> Micro-businesses have fewer than 10 employees.

regular insolvency procedure. Also, these costs are likely to be negligible relative to the benefit of increased financial stability.

### Benefits

79. The aim of the Government's proposals to enhance the mechanisms available for managing the failure of systemic payment systems and CSDs is to promote greater financial stability. In the absence of such a regime for these institutions, there would be very significant disruption to the wider economy from such firms going into insolvency.
80. Given their size and importance, a failure would result in the removal or reduction of the provision of key services which are provided by the firms and crucial to its customers/clients/members. This would impair the functioning of financial markets by constraining the availability of critical financial services, with a knock-on adverse impact on the wider economy.
81. Moreover, the interconnected nature of modern financial markets and infrastructures means that the effects of a blockage in payment and settlement channels could spread quickly and widely across markets, leading to contagion and resulting in a general loss of confidence within financial markets as a whole. One contributing factor to the previous financial crisis was the lack of access to funds when required. This would be an issue if the services of a payment systems or CSD were terminated during administration. There would be a large impact on the real economy as CHAPS and the retail payment systems serve ordinary businesses and individuals, e.g. house purchases, salary payments, pensions and benefits payments, bill payments, company invoices, tax receipts to government, direct debits, standing orders, etc. All these payments could be significantly disrupted depending on which system failed.
82. For example, if Bacs failed, direct debit transfers would not be possible. If VocaLink failed, salaries may not be paid. As a consequence a household may not be able to pay their housing costs and could be evicted.
83. The 'special administration regime' outlined above would ensure that the continuous provision of critical financial services is maintained. And the potential for contagion to other financial institutions and markets, and loss of confidence in the financial system as a whole, would be contained.
84. Accurately quantifying the benefits of Option 1 (SAR) is extremely challenging – it would require an accurate assessment of the likelihood, duration and severity of a suspension of payment or settlement services under the counterfactual of 'doing nothing' and then a determination of how much these would be reduced by implementing Option 1.
85. The cost of disruption would depend on the nature of the payment system or CSD that became insolvent and the extent to which its critical services were suspended. The services that are carried out by the firms in scope of this legislation are so diverse that it is impossible to estimate what would be the cost of a disruption. For example, CREST is the only securities settlement system in the UK, and if it were to fail the whole financial system could freeze. It could reach a point where there would be no point in market participants agreeing to trades on trading venues, as trades would not be settled. For some transactions this may just mean a delay but for others it may mean that the trade does not happen at all. The cost would be different for each participant affected. If Bacs's service was suspended, some people may resort to payment by cheque or cash instead. This could be costly in terms of time taken to withdraw cash, or post a cheque, but again the cost would be different for each household and business affected.
86. It is also difficult to estimate how long the disruption would last. If there were viable substitutions for the failing system, disruption might only last the short amount of time needed for businesses to switch payment or settlement method. There would be the cost of switching which again is dependent on the firm and the scenario. For some systems, substitutes are not readily available.
87. It is difficult to predict how the systems and their members would react to a disruption. It would likely be in the members' interests to resolve a failed system, and therefore the expected duration of disruption may be short. On the other hand, a coordination problem between members could potentially slow down a response. As there is no precedent for this type of scenario, it is extremely difficult to calculate the likelihood of it occurring and to predict how it would play out.

88. For these reasons it is impossible to calculate an aggregated expected benefit from these policies, which mitigate the risk of a potential financial disruption that could take any form. Neither will it be possible to monetise such values in the final Impact Assessment on this legislation, for the same reasons.
89. Furthermore, the failure of a payment system or CSD may not only impact on the payments and settlements that it is processing but it also may have knock-on effects on other transactions. For example, if a bank has funds tied up in the failed payment system, it may withdraw from other transactions in order to retain liquidity. If this type of behaviour were to spread, the financial sector would dry up, potentially causing a sufficient loss of liquidity and confidence to trigger a wider crisis.
90. The benefit of this policy option is the reduction of the risks described above and detailed in the section titled 'rationale for action by the Government'. Given the uncertainties around the costs of future crises, meaningful modelling of the benefits of improved financial stability is not possible. The ICB<sup>7</sup> gave an illustrative estimate for the cost of a financial crisis to be around £40bn per year in 2010 terms. It would be very difficult to assess accurately what impact each reform – including those under consideration here – would have in isolation on the probability and severity of future financial crises. But because the costs of financial crises are so high, the proposed measures under Option 1 only need to reduce the probability and/or severity of a financial crisis by a small incremental amount in order to deliver a very significant benefit, in terms of a reduction in the expected annualised costs of financial crises that are inherent in the 'do nothing' scenario.

### ***Policy option 2 – special resolution regime (SRR)***

91. Many of the benefits associated with Policy Option 1 (SAR) are also associated with Policy Option 2 (SRR), as this option also seeks to ensure that the failure of a payment system or CSD would be avoided. Option 2, like Option 1, intends to reduce the probability and impact of a crisis by a similar extent, as both would ensure that a payment system or CSD would continue to operate its critical services even if became insolvent. For the reasons outlined above, it is impossible to monetise these benefits.
92. The proposals under Option 2 (SRR) also do not require any direct ex ante action to be taken by these companies so, again, the immediate direct cost to such institutions of these proposals is zero.
93. However, there are a number of reasons why Option 2 is likely to be more costly than Option 1. The costs for the Authorities in relation to operationalising the proposals under Option 2 (SRR) are likely to be higher than the equivalent costs under Option 1 as the powers in Option 2 are wider-ranging and more 'hands-on', requiring a greater degree of involvement by the Bank of England and HM Treasury. For instance, Option 2 enables a temporary public ownership (TPO) tool, which, if used, would generate a direct cost to the taxpayer.

## **Wider impacts**

### **One In One Out Policy**

94. In accordance with the One-in, One-out (OIOO) Rule guidance, this policy is out of scope of OIOO as it is a "measure which deals with issues falling under the OECD (2004) definition of financial systemic risk"<sup>8</sup>. The failure of a payment system or CSD would likely have knock-on effects for other financial institutions and could threaten financial stability and confidence in the markets. As pointed out in previous sections, if a bank were to have funds tied up in a failed payment system, it may withdraw from other transactions in order to retain liquidity. If this type of behaviour were to spread, the financial

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<sup>7</sup> Independent Commission on Banking, 2011, *Final Report*: <http://bankingcommission.s3.amazonaws.com/wp-content/uploads/2010/07/ICB-Final-Report.pdf>.

<sup>8</sup> The risk that the inability of one institution to meet its obligations when due will cause other institutions to be unable to meet their obligations when due. Such a failure may cause significant liquidity or credit problems and, as a result, could threaten the stability of or confidence in markets.



sector would dry up, potentially causing a sufficient loss of liquidity and confidence to trigger a wider crisis.

## Equalities Impact

95. The Government has considered its obligations under the Equalities Act 2010. We do not believe these measures will impact upon discrimination, equality of opportunity or good relations towards people who share relevant protected characteristics under that Act.

## Conclusion on costs and benefits of policy options

96. As discussed above, it is very difficult to accurately assess the costs and benefits of these policy options. However, it is clear that:

- any **direct** costs will mostly arise from the costs of operating the administration regime or resolution powers;
- any **indirect** costs, such as the removal or reduction of the perceived 'implicit guarantee' for systemic financial institutions, are likely to be very small; and
- while it is hard to quantify the **benefits** that will accrue, these could be very large, as the annualised cost of financial crises determined as set out above is £40bn, and a payment or settlement system can process in excess of £400bn in a single day.

97. Notwithstanding the difficulty in accurately assessing the costs and benefits, the Government believes that the cost-benefit analysis of both Option 1 and Option 2 is strongly positive relative to the counterfactual 'do nothing' approach, for two principal reasons. First, the reason for any direct costs arising will principally be because of a reduction in the perceived implicit government guarantee, which is relatively insignificant in the case of payment systems and CSDs and should in fact increase the incentive for banks to better manage the conduct and operations of the systems they use. And second, the costs around implementation are also minimal relative to the potential benefits from enhanced financial stability more broadly.

98. A payment or settlement system can process millions of payments a day, which could be tied up if critical services were suspended due to insolvency. This could cause significant cash flow problems for the systemic banks and their customers that use the payment systems and CSDs. The probability of a costly failure like this occurring is thought to be small, especially given that the banks that use and own these services would not be expected to allow them to fail. However, the impact of such a failure is potentially extremely large.

99. Option 2 (SRR) entails higher costs than Option 1 (SAR) due to the more complicated nature of the powers that it enables. However, we do not have any reason to think that the benefits of Option 2 would be greater than Option 1 – they would have similar benefits as they both reduce the risk of a failure of a payment system or CSD causing widespread instability by a similar margin. Certainly, at this stage, the options available from a special administration regime (Option 1) are sufficient and provide an appropriate range of options for maintaining the provision of critical services.





### **HM Treasury contacts**

This document can be found in full on our website: <http://www.hm-treasury.gov.uk>

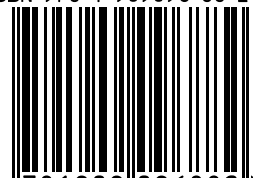
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