HM Treasury

# Critical Third Parties

## Approach to Designation

March 2024

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# Chapter 1
# Designating critical third parties

## Context

1.1 Financial services firms and financial market infrastructure firms (‘firms’) are increasingly relying on third parties outside the finance sector for key functions or services through outsourcing and other third-party arrangements. These arrangements can come with many benefits but can also create risks.

1.2 In particular, if many firms rely on the same third party for key functions and services, the failure or disruption of this ‘critical’ third party could threaten the stability of, or confidence in, the UK financial system.

1.3 The Bank of England’s Financial Policy Committee (FPC) has been monitoring this risk since 2017, and particularly in relation to cloud service providers, since 2018. In 2021, the FPC concluded that “the increasing reliance on a small number of [cloud and other critical providers] for vital services could increase financial stability risks in the absence of greater direct regulatory oversight of the resilience of the services they provide”.[1]

1.4 In response to the FPC’s conclusion, the Government set out in 2022 its intention to bring forward a regime to manage the risk from ‘critical third parties’ (CTPs).[2] The Government delivered the statutory framework for the regime in the Financial Services and Markets Act 2023. This gives HM Treasury the ability to designate a third-party service provider to the UK financial services sector as ‘critical’, and gives the Bank of England, the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA) – collectively, the financial regulators – the power to set and enforce rules, as well as the ability to gather information and conduct investigations on designated CTPs. In December 2023, the financial regulators published a consultation on their proposed rules for CTPs.[3] The CTP regime is designed to be

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1 https://www.bankofengland.co.uk/-/media/boe/files/financial-policy-summary-and-record/2021/july-2021.pdf

2 https://www.gov.uk/government/publications/critical-third-parties-to-the-finance-sector-policy-statement

3 https://www.bankofengland.co.uk/prudential-regulation/publication/2023/december/operational-resilience-critical-third-parties-to-the-uk-financial-sector

proportionate to the risk it seeks to mitigate. It is targeted at services provided by CTPs to the UK financial services sector.

## Criteria for designation

1.5 The criteria for designating CTPs are set out in section 312L of the Financial Services and Markets Act 2000.[4] They provide that HM Treasury may only exercise its designation power if, in its opinion, a failure in or disruption to the provision of the services that the third party provides to firms could threaten the stability of, or confidence in, the UK financial system. In forming this opinion, HM Treasury must have regard to:

- "the materiality of the services provided to the delivery, by any person, of essential activities, services or operations (wherever they are carried out"; and
- "the number and type of authorised persons, relevant service providers or FMI entities to which the person provides services".

1.6 HM Treasury generally expects to make designations of CTPs on the basis of recommendations from the financial regulators. HM Treasury has asked the financial regulators to prepare recommendations in such a way that supports HM Treasury's assessment of the prospective CTP against the statutory criteria for designation. It is also possible for HM Treasury to designate a CTP without a recommendation from the financial regulators.

1.7 Because the regime aims to mitigate a systemic risk, HM Treasury expects that CTPs will represent only a small number of the overall number of third parties to the financial services sector. The list of CTPs will change over time (see below for the approach to de-designation).

1.8 Designations are made by Regulations, which means every designation is public and will be visible on legislation.gov.uk (see below for more information on public communication and designation).

## Process for designations

1.9 HM Treasury expects to receive recommendations for designations from the financial regulators over time. HM Treasury anticipates that each recommendation may take around six months to process: that is, it is generally anticipated that a period of around six months will pass between HM Treasury receiving a recommendation from the regulators and making a final decision (including, where the decision is to designate, making and publishing the Designation Regulations). It is possible that a particular case may proceed at a shorter, or longer timeframe. In such cases, HM Treasury will advise the prospective CTP of the expected designation timeframe.

[4] The Financial Services and Markets Act 2000 was amended by the Financial Services and Markets Act 2023, which introduced the critical third parties regime.

1.10 HM Treasury has a statutory obligation to consult the financial regulators and the prospective CTP when considering a designation. HM Treasury must also consult any other parties it considers appropriate. These other parties may include other Government departments or public sector regulators. The table below sets out the indicative process for a designation. While HM Treasury aims to follow this process, it is possible that a particular case could proceed differently depending on its circumstances. In such cases, HM Treasury will advise the prospective CTP of the expected designation timeframe.

## Table 1.A Indicative process for designation

| Process | Action |
|---|---|
| **Receipt of recommendation** | • HM Treasury considers recommendation<br>• HM Treasury writes to prospective CTP to open period for formal representations<br>• Prospective CTP is invited to send formal representations<br>• HM Treasury consults the financial regulators and, where appropriate, will also consult wider organisations |
| **Representations** | • Period for formal representations concludes |
| **Considerations and Decision** | • HM Treasury considers all evidence and representations<br>• HM Treasury makes final designation decision<br>• HM Treasury informs prospective CTP of outcome<br>• (If appropriate) HM Treasury makes and publishes the Designation Regulations |

Source: HM Treasury

1.11 As the table 1.A sets out, HM Treasury will first consider whether there is merit in the regulators' recommendation. If HM Treasury concludes that there is merit in the recommendation, HM Treasury will write to the prospective CTP to explain the process and invite formal representations.

1.12 During the period for formal representations, HM Treasury will welcome discussions with the prospective CTP, which could also include the financial regulators as needed. HM Treasury asks that any formal representations are made in writing, within a reasonable period (usually three months). This period gives the prospective CTP the chance to ask any questions, and to have its views on designation formally recorded and taken into account. It also provides the CTP an opportunity, but not an obligation, to provide HM Treasury and the regulators additional data and information which it considers may help inform HMT Treasury's final designation decision.

1.13 Once the period for representations has completed, HM Treasury will consider all of the evidence in relation to the prospective designation and assess that evidence against the statutory criteria. The evidence may include:

- The regulators' recommendation
- The representations from the prospective CTP
- Any additional information from the regulators in light of the representations from the prospective CTP
- Any relevant information from other organisations

1.14 HM Treasury expects to make a final designation decision generally within three months from the end of the period for formal representations. It is possible that a particular case may proceed at a shorter, or longer timeframe. In such cases, HM Treasury will advise the prospective CTP of the expected designation timeframe.

1.15 Although the regime is focused on the services CTPs provide, HM Treasury will designate CTPs at the entity rather than the service level.

1.16 Designation Regulations are not subject to debate or approval in either House of Parliament.

## Communicating a designation decision

1.17 HM Treasury will write to the prospective CTP to confirm its designation decision. If HM Treasury has decided not to make a designation, the process ends at the point HM Treasury issues its letter to the prospective CTP.

1.18 If HM Treasury decides to proceed with designation, HM Treasury will write to the prospective CTP to inform it of the decision, indicating which of its services are deemed material at the point of designation.[5] HM Treasury will then proceed to make the legal instrument (the Designation Regulations) which give effect to the designation. There is likely to be only a short period of time between HM Treasury notifying the prospective CTP of the outcome, and the making and publication of the Designation Regulations. Whenever it is practical to do so, HM Treasury intends to give the prospective CTP notice of the date on which the Designation Regulations will take effect so that the prospective CTP can make its own communications arrangements.

1.19 Designation Regulations will specify the date on which the designation takes effect, for example, the day after the day on which

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they are made. Every designation is made by a statutory instrument (Regulations) and is therefore automatically made public on legislation.gov.uk. HM Treasury will also maintain a list of designated CTPs on gov.uk. HM Treasury will coordinate the sequencing of public communications with the CTP.

1.20 Services deemed material will be reviewed periodically by the regulators and may change.

## De-designation

1.21 HM Treasury has asked the financial regulators to regularly assess the list of CTPs. In addition to submitting recommendations to make a new designation, the financial regulators will be able to submit recommendations to remove a CTP's designation. HM Treasury will generally only remove designations on the basis of these recommendations from the financial regulators. The ability to de-designate is an important part of ensuring the regime is proportionate and only applies to the providers capable of generating systemic risk to the financial services sector.

1.22 HM Treasury anticipates following a similar process for de-designation as set out above for designation. That means HM Treasury will consider the regulators' recommendation; ask the CTP and others for formal representations; and will communicate the decision to the CTP before making it public. It is possible that de-designation will proceed more quickly than designation, particularly if there is clear agreement between HM Treasury, the CTP and the financial regulators.

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