

Title: Special administration regime for payment and settlement systems IA No: HMT 1308 Lead department or agency: HM Treasury Other departments or agencies: N/A	Impact Assessment (IA)
	Date: August 2013
	Stage: Final
	Source of intervention: Domestic
	Type of measure: Primary legislation
Contact for enquiries: Paul Clark HM Treasury 0207 270 4314	

Summary: Intervention and Options**RPC Opinion:** GREEN

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 and settlement services are critical to the efficient functioning of the financial system. They form part of the infrastructure upon which the financial sector relies. As things stand, there is no way to resolve in an orderly manner the operators of payment and settlement systems, nor their key service providers, meaning that the failure of one or more of them could cause significant disruption to financial markets and the real economy. Legislation is therefore necessary to safeguard against such a disorderly failure occurring.

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 securities settlement systems (SSSs) are maintained even in the event that the operator of such a system, or key service provider to the system, becomes insolvent. 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 following on from this
- protect households and businesses, who are end-users of payment systems and SSSs.

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

The legislation being brought forward by the Government to address the risks to financial stability posed by the failure of operators of payment systems and SSSs is:

- 1) A special administration regime (SAR). The legislation will introduce powers to enable a modified insolvency procedure for a failing operator of a systemically important payment system or SSS, or a key service provider to such a firm, in order for its services to be continued during administration, for as long as is necessary to protect UK financial stability.
- 2) The SAR is evaluated against a "baseline" option of maintaining the status quo, i.e. 'doing nothing'.

Will the policy be reviewed? Yes If applicable, set review date: 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.	Micro Yes	< 20 Yes	Small Yes	Medium Yes	Large No
What is the CO ₂ equivalent change in greenhouse gas emissions? (Million tonnes CO ₂ equivalent)			Traded: N/A	Non-traded: 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: 31/7/13

Summary: Analysis & Evidence

Policy Option 1

- 1) **Description:** The Government takes action to put in place powers to enable a special administration regime capable of being applied to a failing operator of a systemically important payment or settlement system, or a key service provider to such a firm, in order for its services to be continued during administration for as long as is necessary to protect UK financial stability.

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
COSTS (£m)	Total Transition (Constant Price) Years		Average Annual (excl. Transition) (Constant Price)		Total Cost (Present Value)
Low	Optional		Optional		Optional
High	Optional		Optional		Optional
Best Estimate	N/A		N/A		N/A
Description and scale of key monetised costs by 'main affected groups'					
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 zero .					
Other key non-monetised costs by 'main affected groups'					
Whereas in an ordinary insolvency procedure the objective is to maximise returns to creditors, in a special administration regime the interests of creditors are subordinated to the objective of maintaining a continuity of the insolvent firm's critical services in order to protect financial stability. The SAR may therefore be costly to some creditors relative to the status quo of a normal insolvency procedure, although this will not necessarily always be the case – the continuation of the FMI's functions may preserve value and result in a better outcome for creditors. The cost will vary among creditors but on aggregate the cost will be small relative to the potentially very significant benefits from strengthened financial stability.					
BENEFITS (£m)	Total Transition (Constant Price) Years		Average Annual (excl. Transition) (Constant Price)		Total Benefit (Present Value)
Low	Optional		Optional		Optional
High	Optional		Optional		Optional
Best Estimate	N/A		N/A		N/A
Description and scale of key monetised benefits by 'main affected groups'					
The key benefit of this proposal is the reduced risk of disruption to payment and settlement services which could threaten financial stability. This benefit cannot be monetised as it is impossible to predict exactly what would happen if such services were suspended as a result of the disorderly failure of a payment or settlement system operator or key service provider to such a firm. 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.					
Other key non-monetised benefits by 'main affected groups'					
The benefits are potentially very significant, as the policy reduces the risk of a suspension of payment and settlement services. These services are vital to the efficient operation of the financial system and any such suspension of service could have severe consequences given 1) the volume and value of transactions processed by payment and settlement systems on behalf of households and businesses, and 2) the absence of an efficient, 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 OIIO?	Measure qualifies as
Costs:	N/A	Benefits:	N/A	Net:
			N/A	No
				N/A

Introduction

1. In April 2013 the Government published a consultation document¹ setting out the proposal for a special administration regime to be introduced for payment and settlement systems. This policy was formulated by the authorities (the Bank of England, HM Treasury and the then Financial Services Authority) following an earlier consultation with industry in August 2012² to which respondents suggested that a modified insolvency regime would be the most appropriate tool to deal with the potential failure of such financial market infrastructure (other than central counterparties which were dealt with in the Financial Services Act 2012).
2. The Government received ten written responses to the recent consultation, mostly from firms in scope of the proposal – operators of payment and settlement systems and service providers to these systems. The Government also held meetings with several of the firms in scope of the legislation. Respondents were unanimous in their support for the proposal, agreeing that the identified payment and settlement systems are systemic to the financial sector and that action should be taken now to deal with the potential failure of such a system, even though a failure is unlikely to occur. Respondents were overwhelmingly in favour of a SAR as the most appropriate policy tool for dealing with a failure. Respondents supported the application of the regime not just to operators of critical payment and settlement systems, but also to the key service providers to these companies³.
3. Given the support for this approach in the consultation this final impact assessment only analyses the cost and benefits of the lead option of introducing a special administration regime against a baseline scenario of ‘doing nothing’, i.e. maintaining the status quo. It should be noted that separately to these proposals the Government is taking action to promote competition, for instance by proposing a new competition-focused regulator for retail payment systems. This is discussed briefly below.

Scope

4. The proposed regime will apply to the following types of firms, which are described in detail in the next section:
 - operators of recognised inter-bank payments systems;
 - operators of SSSs (i.e. central securities depositories⁴ (CSDs)); and
 - key service providers to these firms;
5. The Government does not believe that action is required at this stage for other types of financial market infrastructure (e.g. exchanges and trade repositories, non-recognised payment systems) and insurers. Industry responses to the recent consultation supported this view.

¹ https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/192483/consult_special_administration_regime_for_payment_and_settlement_systems.pdf

² HM Treasury, 2012, *Financial sector resolution: broadening the regime*: http://www.hm-treasury.gov.uk/d/condoc_financial_sector_resolution_broadening_regime.pdf.

³ The Government has published its response to the consultation, summarising the views of industry and setting out next steps. **[LINK WHEN PUBLISHED]**

⁴ The CSD for the UK is Euroclear UK and Ireland (EUI). EUI operates the securities settlement system CREST,

Payment systems, central securities depositories and securities settlement systems

6. Payment systems provide vital infrastructure for financial markets by processing financial transactions.
7. There are typically 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. In some cases, the scheme company and the infrastructure service provider may be part of the same company or group. This legislation would cover both scheme companies and their service providers.
8. The following systems are recognised inter-bank payment systems under the Banking Act 2009 and subject to Bank of England oversight. The Treasury may recognise a system if it is satisfied that design deficiencies or disruption would be likely to threaten financial stability or have serious consequences for business or other interests.
 - Bacs (recognised 5 January 2010)
 - CHAPS (recognised 5 January 2010)
 - 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)
9. The SAR would not apply to any other payment systems that are not recognised inter-bank payment systems.
10. Scheme companies, such as CHAPS Co, Bacs Payment Services Ltd. and Faster Payments Ltd., are owned and controlled by their members (the major banks), and are represented and co-ordinated by the Payments Council. CLS has some members which are not owners.
11. 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 scope of this proposed legislation.
12. The service providers to these scheme companies are currently 'outside' the regulatory perimeter as no service providers are currently recognised under the Banking Act 2009. It is the duty of scheme companies to provide oversight of their service providers. Nevertheless, as they are integral to payment systems and the critical market functions that rely on them, this legislation will apply to key service providers to the operators of payment and settlement systems.
13. This legislation will also apply to the operators of securities settlement systems (SSSs) and their service providers. SSSs 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. This legislation will apply to its operator, the central securities depository (CSD) Euroclear UK & Ireland (EUI). 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

14. 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

15. A failed payment systems or SSS could be a source of disruption or contagion to the rest of the financial system because as a result of the failure banks, businesses and households may not be able to settle their financial obligations to each other (pay salaries, collect bills, sell shares, etc.) in a timely manner or, potentially, at all. The infrastructure they provide is integral to the functioning of the financial sector.
16. If the operator of a payment system or SSS, or a key service provider to such a company, were to become insolvent, this may result in disruption to, or the cessation of, processing of payments or settlement of securities. 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 in light of the lack of available and efficient alternatives.
17. Due to the interconnected nature of the financial sector, these functions ceasing could cause a severe stress to other systemically important financial institutions, such as banks if they were unable to effectively manage liquidity as a result of not being able to make payments. By mitigating the risk of such disruptions occurring, and the knock-on effects that such disruptions may entail, this proposal will help to reduce systemic financial risk.

Table 1: Daily volumes and values through the UK payment systems in 2012⁵

	Average daily volume (000's)	Average daily value (£m)	Important payment types
CHAPS	135	284,591	Settlement of financial market transactions CLS pay-ins/outs House purchases
Bacs	22,287	16,318	Salary, pension and benefits payments Direct Debits
FPS	3,219	2,452	Telephone and internet banking Single immediate and forward dated payments Standing Order payments
CREST	164	420,561	Settlement of gilts, equities, corporate bonds and money market instruments
CLS (figures cover sterling)	45	212,588	Settlement of foreign exchange trades

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

18. Most obviously and crucially, if a payment or settlement service was suspended, end users would no longer be able to make payments or settle through that system. For the recognised systems, end

⁵ Bank of England Payments Oversight Report 2012 (March 2013)
<http://www.bankofengland.co.uk/publications/Documents/psor/psor2012.pdf>

users includes the full range of individuals, non-financial corporates, government and other public bodies, and banks and other financial institutions.

19. For certain payment types, there is only one established payment system. For example, CHAPS is the only real time gross settlement 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.
20. 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.
21. 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.
22. Due to Bacs's three day payment cycle, there may be a 'lag' in the disruption. Thereafter it is less certain. 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.
23. 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 on a daily basis; 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 if wanting to draw on funds. Again, volume capacity may be an issue. There is no alternate system for direct debits.
24. 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. While Bacs handles the highest volumes, FPS would also face disruption as it is the system that individuals can create payments for via internet and phone banking channels.
25. 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.
26. In terms of service providers, VocaLink operates the technical infrastructure for Bacs and the Faster Payments Service (as well as LINK). It also provides the 'sort-code' database to the industry which underpins the routing of payments from one bank to another. In the event of its failure, the consequences could be similar to those outlined above for Bacs and Faster Payments Service.
27. The Government recognises that there is a wider issue of weak competition in the payments systems industry that needs to be addressed. This is one of the reasons why the Government is proposing a new regulatory system for payment systems, which will establish a new competition-focused regulator for retail payment systems⁶. Future legislation in this area may increase the level of substitutability that exists between payment systems in the long term. This could reduce the likely length of time that services would be disrupted if a system failed. However, a SAR is still necessary to ensure that continuity of critical services is maintained while a successor arrangement is put in place. Indeed,

⁶ http://www.hm-treasury.gov.uk/consult_opening_up_uk_payments.htm

increased competition may shorten the required length of any SAR and allow for a smoother transition to a successor arrangement.

Rationale for action by the Government

28. 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 fail in a disorderly manner 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.
29. In response to the crisis, the UK Government put in place a special resolution regime (SRR) for banks, to ensure that, if banks do fail, they can be resolved safely without risk to the taxpayer or to financial stability.
30. 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. This is why resolution powers for CCPs were introduced in the Financial Services Act, and why the Government is now bringing forward this legislation to address gaps in the framework for dealing with payment systems and central securities depositories on a more accelerated timetable than that currently envisaged in ongoing international work.

Policy objectives

31. 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. This legislation is 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.
32. 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.
33. 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

34. 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).
35. 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

36. 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.
37. 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 2012⁷, which concluded: "it is vital that very robust arrangements exist for the recovery of FMIs and, if that fails, for their resolution."
38. There is no definite European timetable in place for introducing powers to deal with failing payment systems and central securities depositories. The European Commission consulted in 2012 on the need for recovery and resolution measures for non-bank financial institutions⁸. The UK has submitted its views to the Commission and will encourage developments in this area. However, the timetable for any legislation is highly uncertain. The Government does not expect that powers will be made available through the European process for a number of years. If powers are introduced in Europe in the future, we expect that they will be compatible with the SAR.

Description of policy options

39. The two broad options considered in this impact assessment 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 policy option is evaluated in this impact assessment);
 - Policy Option – Special administration regime': the UK Government takes action to put in place powers to enable a special administration regime that could be applied to a failing operator of a payment system or SSS, or a key service provider to such a firm, in order for its services to be continued during administration, for as long as is necessary to protect UK financial stability.

'Do nothing'

40. 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 and settlement system operators and service providers.
41. Under the status quo, a failing company would be put into a regular insolvency procedure, under which services may be suspended.
42. The Bank of England currently has the following powers over recognised payment systems, under part V of the Banking Act (2009).

⁷ www.bis.org/publ/cpss103 p.18

⁸ http://ec.europa.eu/internal_market/consultations/2012/nonbanks/consultation-document_en.pdf

- *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*
 - *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*
43. 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. Once the firm enters administration, the powers listed above would no longer apply. The company would then be in the hands of the administrator and crucially the authorities would have no power over the administrator to prevent the business from being wound down as opposed to seeking to rescue the firm as a going concern.
44. Scheme companies are primarily 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. Nevertheless, as things stand, if members did not rescue the failing firm, once it became insolvent the Government would have no power to prevent a winding down of the business.

Policy option – ‘special administration regime’

45. Under this policy option, the UK Government takes action to put in place powers to enable a modified insolvency procedure for failing payment or settlement system operators and key service providers, in order for their services to be continued during administration, for as long as is necessary to protect UK financial stability.

Regulatory oversight

46. The Bank of England would continue to have regulatory powers over ‘healthy’ (i.e. solvent) operators of payment and settlement systems, as detailed above. The difference is that under the SAR policy, even in administration the firm will be run with financial stability in mind. In addition to the special administrator’s financial stability objective, the authorities will also have a degree of control over the company in administration, indirectly, as the SAR will feature a power of direction for the Bank of England over the special administrator, as discussed below.

Special administration regime

47. 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. The administration order would give the administrator an overarching objective to continue the critical services of the firm during administration. The Bank of England would have the power to apply to a court to place a firm into the SAR 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.
48. The Bank of England is the appropriate authority to do this as it has 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.
49. In addition to the overarching objective of maintaining the continuity of services, the SAR would have the following features which differ from a normal administration regime: power of direction for the Bank of England over the special administrator, transfer powers and restrictions on early termination of third party contracts. In response to the consultation, industry unanimously supported the inclusion of these additional features in the SAR.

Power of direction

50. The Bank of England will be granted the power of direction over an administrator. The Bank of England could give directions to the administrator 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 is best able to achieve the objectives of the SAR and could be used to provide clarity to the special administrator over how best to meet these objectives.
51. 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 the core Direct Credit and Direct Debit transactions for Bacs rather than a range of ancillary services. 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.

Transfer powers

52. Transfer powers will give the special administrator 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

53. Under the SAR, there will be restrictions on the early termination of third party contracts to ensure that crucial third parties, such as service providers, do not terminate their contracts with a payment or settlement system solely because of its operator's entry into the SAR. A termination would be undesirable where the contract parties continue to perform their contractual obligations as normal, and this provision will further strengthen the protection provided to the FMI's critical services.

Impacts of policy options and analysis of costs and benefits

Cost-benefit analysis

54. All costs and benefits discussed in this impact assessment are indirect in the sense that they would only be incurred in the event that a firm failed and entered the SAR. Unless a firm in scope of this policy fails (which is highly unlikely, as recognised by the Government and by industry) the costs and benefits will be zero.

55. Costs and benefits are identified by the main affected groups: the customers and creditors of the firms in scope of this proposal. If a firm failed, its creditors could incur costs from the SAR as creditors' interests would be subordinated to the SAR's objective of maintaining a continuity of service, as opposed to a normal administration regime where the objective is to maximise returns to creditors. Operational costs of the SAR may also be higher than a normal administration procedure.
56. These costs may be transfers, for example if the SAR results in an alternative distribution of income among creditors. If money owed to creditors is used to finance the maintenance of a firm's critical services then there might be a transfer from creditors to providers of those critical services (either subcontractors or the employees of the now defunct firm under the control of the administrator).
57. 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 avoidance of the financial crisis that that could trigger or propagate.
58. This section considers in more detail the costs and benefits of the legislation to put in place a special administration regime, evaluated against the counterfactual of the Government taking no action.

Affected parties

59. This legislation is designed to target systemic firms, which in practice will be all of the recognised payment systems, EUI (which is currently the only CSD in the UK and operates CREST – the only securities settlement system in the UK) and the service providers to the recognised payment systems and EUI. The authorities' powers under the proposals (as described above) can only be exercised over such firms and related key system providers. Moreover, the proposals could only impact those systemic systems (and their direct members) in the event that a firm becomes insolvent.
60. The legislation could affect a range of parties in the event of a firm failing, for example the customers of banks who have transactions processed through payment and settlement systems, such as households and businesses making bank transfers. The impact on the parties who use these services represents an impact on economic activity more broadly. The recent financial crisis showed 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. There will also be distributional effects if a firm enters the SAR, as the SAR would likely have a different outcome to that of a normal administration procedure. These distributional effects will impact creditors the most as a normal administration procedure is run in creditors' interests but in a SAR their interests are subordinated to the objective of protecting and enhancing financial stability.

Small and micro business assessment

61. This legislation is expected to come into force in April 2014 and therefore is in scope of the small and micro business assessment.
62. A number of the firms within scope of this proposal are small or micro businesses (SMBs). Although the payment and settlement systems are owned by their members (who collectively employ hundreds of thousands of employees and manage assets worth trillions of pounds), the companies responsible for managing and operating payment and settlement systems themselves, which underpin all financial transactions, often employ less than fifty people directly.
63. We do not think it is necessary to carry out further assessment of options to mitigate burdens on SMBs, since regardless of the size of the firm they will face no costs. The cost of the SAR or ordinary insolvency will be zero unless a firm fails and is entered into insolvency. At the point where the firm becomes insolvent it ceases to exist as a going concern. The choice of insolvency regime will affect the costs and benefits to creditors and subcontractors, but not the insolvent firm which is actually subject to the regulation. This firm therefore does not face costs itself under either the SAR or the normal insolvency regime. The better regulation manual states that the Small and Micro Business Assessment (SMBA) is intended to mitigate disproportionate burdens on SMBs from regulation. Since

there are no burden imposed on the regulated firm it is unnecessary to appraise mitigation options further.

64. In any case since most of the key firms covered are SMBs it does not make sense to exempt SMBs from the regulation or specific requirements of it. It is also unnecessary to mitigate the upfront costs of SMBs complying with the regulation (by for instance providing an extended compliance period) since there will be no upfront costs. If small and micro businesses were exempt from this policy, the legislation would fail to capture a large portion of the critical payment or settlement systems; it would be redundant and the huge net benefits described in this impact assessment would be foregone.
65. It is possible that some of the creditors or those responsible for ensuring the continuation of critical services of an insolvent firm would be SMBs. However these SMBs are not subject to the SAR. Rather they will experience second order costs and benefits as the result of differences between a SAR and ordinary insolvency. Since they are not subject to the regulation they are not caught by the intention of the SMBA to make regulation less burdensome for SMBs. We have no reason to believe that SMBs would be particularly disadvantaged under the SAR rather than an ordinary insolvency in any case, as the impact on each creditor or service provider will depend on the particular circumstances of that insolvency and the surrounding economic conditions.
66. Benefits of the proposal are shared across the whole economy as all households and businesses benefit from improved financial stability, as explained in this impact assessment. Nevertheless, the companies responsible for operating payment and settlement systems (some of which are SMBs) benefit more from the proposal than the average businesses as their performance is especially dependent on a stable financial sector. It is worth noting that the Government recently consulted every firm (and therefore every relevant SMB) in scope of this proposal to gauge their views on its merits, and the firms unanimously and unequivocally supported its implementation.

'Do nothing'

67. As things stand an insolvent payment system operator, CSD, or service provider to one of these firms would go into a normal administration regime. In a normal administration regime the administrator would work under the objective of maximising returns to creditors and this may involve winding down parts of the business. Authorities would have no power over the administrator to prevent the administrator from electing to wind down the business rather than seeking to rescue the firm as a going concern and, as described in previous sections, this suspension of critical services could cause widespread disruption.
68. This 'do nothing' option has been chosen as the counterfactual against which the costs and benefits of a SAR are measured in this impact assessment. As it is the baseline scenario, the costs and benefits of the 'do nothing' policy option are by definition zero for the purposes of this impact assessment.
69. The disruption caused by the disorderly failure of a payment system, CSD or key service provider 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 the SAR, which serves to mitigate the risk of this disruption, and is evaluated relative to the 'do nothing' option.

Policy option 1 – special administration regime (SAR)

70. As expected, there was no discernible market reaction to the news of the proposal when the consultation document setting out this proposal was published in April 2013. This may be in part because, as evidenced by responses to the consultation, industry agrees with the Government that systemic payment and settlement systems are unlikely to fail, but that in the event of a failure a SAR is the most suitable policy tool for protecting financial stability. No market reaction is expected when legislation is brought forward.

Costs

71. The SAR does not require any ex ante action to be taken by the firms in scope of the legislation and therefore the upfront cost to such institutions is zero.
72. There would be costs associated with the SAR if it was executed, i.e. if a firm failed and was entered into the SAR. A normal administration procedure is carried out under the objective of maximising value to creditors whereas the objective of the SAR is to maintain continuity of the insolvent firm's critical services. In a SAR, the money that would have otherwise been paid back to creditors could be used to finance the continued functioning of the firm's services. This would result in a cost to creditors and a large benefit to the financial sector and wider economy. The impact on creditors will depend on the characteristics of the particular insolvency case. In one case the outcome could be similar to that of a normal administration regime with creditors repaid to the maximum extent possible; in another case all assets could be liquidated to pay for the continued operation of the firm's critical services.
73. In either case there is no obvious reason to think that SAR should have higher total costs than ordinary administration. In both cases it is necessary to divide up the insolvent firms assets. Under SAR, rather than being distributed to maximise returns to creditors, the assets may be used to pay for the running of vital services. The assets are nevertheless being distributed to somebody and there is no particular reason to think that the total value of the assets distributed should be affected by the form of the insolvency regime.
74. One possible deadweight cost effect is if the SAR takes longer than a normal insolvency procedure. If assets remain un-redistributed for longer than would have been the case under a normal insolvency, the recipients of those assets may forgo opportunities to put those assets to productive uses. It does not seem likely that assets under a SAR would remain dormant for a long period of time, since the objective of ensuring that payments systems are not disrupted would likely require swift action to ensure that services are running effectively (potentially requiring liquidation of assets) and that a stable outcome is quickly found. The total assets of these firms tend to be relatively small, meaning that any losses caused by a delay in releasing assets will also be small.
75. The impact on creditors may vary significantly from one creditor to another, depending on the nature of each creditor's claim and the actions taken by the special administrator. As a result some costs will represent a transfer between creditors. Creditors will not necessarily always lose out, however. The continuation of the FMI's functions may preserve value and result in a better outcome for creditors. Creditors will also share in the benefit of improved financial stability which results from the continued functioning of the firm's critical services.
76. The operational cost of a SAR may be different to the operational cost of an ordinary insolvency procedure. This will depend on the characteristics of the failed firm, the nature of the failure, the extent of the critical services that would be maintained in the SAR but shut down in a normal administration, and the length of the administration process. It is not clear that a SAR would always be more costly than an ordinary insolvency procedure. On average, a SAR may be slightly more expensive to operate than a regular insolvency procedure as the objective to preserve a continuity of service is likely to increase the longevity of the process and will require the administrator to take actions that go beyond the normal administration objective of maximising value for creditors. The extra cost of operating the administration may be financed by money owed to creditors. However, as noted above, payment and settlement system operators tend to have a low assets value and tend not to take on credit risk, meaning the operational cost of the administration is likely to be relatively small. Given the relatively small aggregate cost of an administration procedure, the incremental deadweight cost of a SAR on top of a normal administration regime (if on average a SAR is indeed slightly more costly than an ordinary insolvency procedure), will be very small and significantly outweighed by the benefit that will be realised from increased financial stability (discussed below).
77. The special administrator 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. Member banks have the incentive and capability to fund the administration. As a last resort funding 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. As any financial assistance from the authorities would be in the form of a loan, it would be paid back and therefore does not represent a cost at present value.

Benefits

78. The aim of enhancing the mechanisms available for managing the failure of systemic payment and settlement system operators and key service providers is to promote greater financial stability. In the absence of such a regime for these institutions, the insolvency of such a firm could cause severe disruption to the wider economy.
79. Given their size and importance, a failure would result in the removal or reduction of the firms' services, which are crucial to their customers, clients and 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.
80. 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 payment or settlement services 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 operator or key service provider failed.
81. For example, if Bacs or VocaLink failed, direct debit transfers would not be possible and salaries may not be paid. As a consequence a household may not be able to pay its housing costs and tenants could face penalties as a result. People may face charges if they are unable to repay debts on time as a result of not receiving their salary.
82. 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.
83. Accurately quantifying the benefits of the 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 this disruption would be reduced by implementing the SAR.
84. The cost of disruption would depend on the nature of the payment system operator, CSD (i.e. securities settlement systems operator) or service provider that became insolvent and the extent to which its critical services would be suspended in a normal administration procedure. 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 the Bacs 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.
85. It is also difficult to estimate how long the disruption would last. If there were viable substitutes 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 or cannot scale to the necessary volume.
86. 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.

87. For these reasons it is impossible to calculate an aggregated expected benefit from the legislation, which mitigates the risk of a financial disruption that could take any form. This was made clear in the ‘consultation stage’ impact assessment that was published in the annex of the consultation paper and is still the case now.
88. Furthermore, the failure of a firm 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 is unable to carry out transactions, it may be unable to manage its liquidity and 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.
89. The benefit of the SAR 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 ICB⁹ gave an illustrative estimate for the cost of a financial crisis of around £40bn per year in 2010 terms. It would be very difficult to assess accurately what impact each reform – including this 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 introduction of the SAR only need to reduce the probability of occurrence 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.
90. These large benefits comfortably outweigh the costs described in the previous section, which are small and made up in part of transfers.

Wider impacts

One In Two Out policy

91. In accordance with the One-in, One-out (OITO) Rule guidance, this policy is out of scope of OITO as it is a “measure which deals with issues falling under the OECD (2004) definition of financial systemic risk”¹⁰. A disruption to payment or settlement services 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 is unable to carry out transactions, it may not be able to manage its liquidity and may decide to withdraw from other transactions as a consequence. 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. In response to the Government’s consultation, firms strongly agreed with this assessment of the systemic nature of these services.

Equalities impact

92. The Government has considered its obligations under the Equalities Act 2010 and does 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

⁹ Independent Commission on Banking, 2011, *Final Report*: <http://bankingcommission.s3.amazonaws.com/wp-content/uploads/2010/07/ICB-Final-Report.pdf>.

¹⁰ 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.

93. A payment or settlement system can process millions of payments a day, which could be delayed 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 and settlement systems. 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 are unlikely to allow them to fail. Nevertheless, the impact of such a failure is potentially extremely large and therefore the Government and industry believe that a special administration regime is needed.

94. As discussed above, it is very difficult to quantify the costs and benefits of this policy. However, it is clear that:

- costs and benefits will only be incurred in the case of a payment or settlement system operator or key service provider failing. These are the only circumstances under which a SAR would be used;
- any costs will mostly arise from the costs of operating the administration regime and the re-distribution of income from creditors (who gain the most under a normal administration regime) to pay for the continued provision of the firm's critical services;
- since some of the costs will be transfers from one creditor to another, or from a creditor to a subcontractor who is paid for supporting the continued provision of the firm's services, the deadweight cost of an SAR over a normal administration is likely to be small, most likely resulting from the administrator taking longer than would otherwise have been the case and therefore creditors taking longer to be paid; 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.

Notwithstanding the difficulty in accurately assessing the costs and benefits, the Government believes that the cost-benefit analysis of the special administration regime is strongly positive relative to the counterfactual 'do nothing' approach. Any costs arising above and beyond those of a normal insolvency procedure will be minimal relative to the potential benefits from enhanced financial stability more broadly.