

CP26/23 – Operational Resilience: Critical third parties to the UK financial Sector

LINK’s response to the Bank’s Consultation Paper: Operational Resilience: Critical third parties to the UK financial sector published 7th December 2023.

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Introduction

1. On 21st July 2022 the Bank published a Discussion Paper (DP) on Operational Resilience: Critical third parties to the UK financial sector. A subsequent Consultation Paper (CP) was published on 7th December 2023.
2. LINK is responsible for the operation of the UK’s largest cash machine network, and other aspects of supporting access to cash. It is a not-for-profit organisation with a public interest objective. It is owned by its Members who are the UK’s major debit and ATM card issuers and ATM operators. Effectively, every cash machine in the UK is connected to LINK.
3. The LINK network is a systemically important infrastructure to the UK economy. It is recognised by the Treasury (HMT) as a Financial Market Infrastructure (FMI) and is supervised by the Bank of England (the “Bank”) and the Payment Systems Regulator (PSR).
4. Cash machines are the most important channel for consumers to withdraw cash in the UK, with consumers making about 18 million withdrawals a week at LINK ATMs, amounting to £1.5billion in cash. LINK also facilitates cashback without a purchase at participating retailer terminals.
5. In 2021, LINK took up a new independent co-ordinating role to protect access to cash. It reviews the impact of changes to banking provision and will commission new services (such as shared banking hubs and ATMs) where this is needed to support a community. It is expected to be supervised by the Financial Conduct Authority (FCA) in this area of work.
6. LINK welcomes the opportunity to respond to this important CP on how the supervisory authorities could use the proposed powers in the Financial Services and Markets Bill to assess and strengthen resilience of services provided by Critical Third Parties (CTPs) to firms and FMIs to reduce the risk of systemic disruption.

Executive Summary

7. LINK fully agrees with the importance of the effective management of CTPs and supports the need for a regulatory framework to manage systemic risks that CTPs pose to the supervisory authorities’ objectives e.g., financial stability, market integrity and consumer

protection. LINK therefore fully supports the sentiment of the Bank's proposals set out in CP26/23 and draft Supervisory Statement. The Bank's work is therefore important and welcome.

8. LINK agrees with the CP's proposals to build on and complement the operational resilience framework for firms and FMIs, not imposing additional requirements on firms and FMIs, but aligning with existing obligations on operational resilience and third-party risk management.
9. Third party supplier risks are of significant importance to LINK, which has clear oversight of Critical Service Providers (CSPs) within its own supply chains. LINK undertakes a programme of risk assessments and due diligence across its entire supply base. However, the scope of LINK's influence is limited to the suppliers within its own direct supply chain. The negotiating power it holds is restricted to these firms and the individual service being provided. It is therefore unable to take into account the whole CTP landscape or mitigate these broader risks effectively.
10. LINK supports the need for a stronger, holistic oversight of CTPs in the UK. Whilst HMT and the Bank already oversee important third-party suppliers to FMIs such as LINK, these have historically been viewed through an individual as opposed to a market lens. The new regulatory framework could address the gap in oversight of third-party suppliers which are critical across more than one FMI or financial market.
11. Whilst CTPs are expected to account for a small number and percentage of those third parties providing services to firms and FMIs, LINK proposes that the criteria for which functions and services are defined as "critical" are proportionate to avoid unintended consequences. For example, designation as "critical" could raise regulatory costs for those third-party suppliers considered a CTP. An increase in costs may make business models for these third parties unviable, causing them to raise costs to firms and FMIs or exit the market (increasing concentration risk).
12. In viewing third parties and designating a third party, as part of identifying potential CTPs, LINK questions if there is any correlation to identified designated Critical National Infrastructures (CNIs) as part of the CTP identification process. Explicit inclusion or exclusion of CNIs would add additional clarity.
13. Paragraph 2.23 of the CP notes that *"regulators are also unlikely to recommend certain third parties in other sectors (e.g. public telecommunications providers, energy suppliers) for designation if the regulators are satisfied that the services that these third parties provide to firms and FMIs are subject to a level of regulation and oversight that delivers at least equivalent outcomes to the proposed regime"*. LINK fully supports this position and agrees that duplication and / or overlap should be avoided where a third-party is already subjected to a satisfactory level of regulation and oversight. LINK is alive to the possibility of concentration risk within its own supply chain, but it does not hold details of suppliers used by other FMIs / payment systems and is not therefore aware of specific important cross-sector dependencies. An example of this could be the cross-sector risk presented by BT, which was raised by industry in response to the Bank's Operational Resilience Policy and Supervisory Statement published on 14th April 2022. LINK considers BT to be a constant corporate single point of failure in LINK's supply chain as it is a supplier dependency which is outside of LINK's control and oversight. This is likely to apply for other firms / FMIs. LINK therefore suggest that consideration is given to the inclusion of such critical service providers under the identification and designation process.

14. LINK suggests there is a need for alignment between the draft supervisory statement and existing regulations on outsourcing and third party supplier risk management. Regulators might helpfully consider how the CP and draft supervisory statement complement and enhance current regulation and strategic direction. LINK would like to highlight the importance of clarity in such areas as terminology and avoiding any overlap to ensure effective implementation and compliance.

For example, an unintended consequence of the terminology on the CP may be confusion around 'critical' in both the draft Supervisory Statement and the "Outsourcing and Third Party Risk Management Supervisory Statement: Recognised Payment System Operators and Specified Service Providers", with firms and FMIs interchanging this term and using out of context. In addition, regulators could consider initiatives already being looked at across the financial sector through various sector working groups i.e. CMORG and Operational Resilience Collaboration Group, in relation to existing regulation and terminology. This would enable firms and FMIs to understand which of the regulations apply to them, how they apply, and how firms and FMIs may support them all.

15. LINK's response is set out below, made in consideration of the CP and draft Supervisory Statement applying only to CTPs services to firms and FMIs and the receipt of these. Where feedback / comment is provided against a specific question or section of the CP, this is noted. LINK has not responded to all questions but chosen to respond to those questions where it has specific points to raise.

16. LINK is happy to discuss its observations and experience as required.

Response to Questions

Question 1: *Do you have any comments on the regulators' definitions of key terms and concepts outlined in Chapter 2 of the draft supervisory statement? Are there key terms or definitions the regulators could clarify or additional definitions to be included?*

17. **CNIs.** As noted under bullet thirteen, LINK considers the explicit inclusion or exclusion of CNIs would be beneficial, to cover any correlation to CNIs as part of the CTP identification process.

Question 2: *Do you have any comments on the regulators' overall approach to the oversight regime for CTPs outlined in Chapter 3 of the draft supervisory statement?*

18. Oversight regime:

3.6 of the draft Supervisory Statement notes "*CTP Fundamental Rules in section 4 apply to all of the services that a CTP provides to firms and FMIs. Other (more granular) requirements only apply to a CTP's material services. For instance, the Operational Risk and Resilience Requirements in section 5, the scenario testing requirements in section 6 and the incident notification requirements in section 7*".

3.11 of the draft Supervisory Statement notes "*Although the regulators' primary focus is on material services, they may also look at any non-material services that a CTP provides to firms and FMIs if appropriate to advance their objectives*".

LINK recognises the regulatory requirement to oversee the services that a CTP provides to firms, though considers that the focus should be on material services of the CTP, with

any non-material services only considered if they support the end-to-end delivery of a material service. This would ensure proportionality.

Question 4: *Do you have any comments on the regulators' proposal for the Fundamental Rules to apply to all services a CTP provides to firms or FMIs?*

19. **All services a CTP provides.** Please see response to question 2 above.

Question 7: *Do you have any comments on the regulators' proposal for the Operational Risk and Resilience Requirements to apply to a CTP's material services only?*

20. LINK supports the proposal for Operational Risk and Resilience Requirements to apply to a CTP's material services only. This proportionate approach will ensure the resources of the CTP are not adversely affected.

Question 11: *Do you have any comments on the regulators' proposals regarding what information should be included at each stage (initial, intermediate, or final) of notification?*

21. LINK considers the proposals relevant and proportionate for a CTP to manage an incident. LINK notes the additional information proposed under 7.26 of "Other notification requirements", and whilst some of the information proposed might be sensitive to a CTP, visibility to a firm or FMI could be useful to them in managing the situation and limit any potential impact to the firm or FMI. LINK recommends that the regulators put in place a process to inform impacted firms or FMIs of any such notifications, or to revise the final Supervisory Statement to include notification of such relevant situations under 7.26 to the respective impacted firm or FMI as well as the regulator.

Question 14: *What are your views on whether the regulators should include additional mandatory forms of regular testing for CTPs?*

22. LINK recognises the requirement for, and importance of, testing of services and that this topic is of significant importance to both a CTP, firm, FMI and regulators. LINK supports the requirement of additional testing, i.e. at the request of the regulators, though notes that outside of the prescribed testing requirements in the draft Supervisory Statement, any additional testing requests at a CTP should be proportionate to each individual designated CTP.

Question 15: *Do you have any comments on the regulators' proposals to require CTPs to share certain information with firms and FMIs?*

23. LINK supports the proposals to require CTPs to share information. This will be critical to ensure firms and FMIs such as LINK are better informed of third-party supplier risks. This could therefore also support LINK and other firms and FMIs with systemic risk management. LINK notes that regulators should consider any potential Competition Law implications in the context of information sharing.

24. There could be a heavy reliance on the Bank and supervisory authorities to gather, analyse and share insights with financial market participants, particularly around emerging risks. LINK encourages the supervisory authorities to develop a central information repository to facilitate sharing relevant information between firms and regulators.

Question 16: *Would the information the regulators propose to require CTPs to share benefit firms' and FMIs' own operational resilience and third-party risk management?*

25. LINK perceives that the information proposed to be required would benefit LINK's own operational resilience and third-party risk management, should any of its current outsourcing and suppliers, or future potential suppliers be designated a CTP. LINK is regulated and must adhere to the operational resilience and outsourcing and supplier frameworks in place for firms and FMIs. The sharing of information would therefore support LINK's operational resilience and third-party management, and LINK suggests this may be similar across other firms and FMIs.

26. LINK sees a need for third party supplier contracts to include contractual rights to audit and take part in scenario testing and business continuity plans. Historically, these have been difficult to secure with some of the larger (currently unregulated) suppliers. The information the regulators propose to require, set out in the CP and draft Supervisory Statement, could therefore help LINK to secure services in a way that reduces its own operational risk.

Question 17: *Do the regulators' proposals balance the advantages of sharing relevant information with firms and FMIs against potential confidentiality or sensitivity considerations for CTPs? Are there any additional safeguards that the regulators could consider to protect confidential or sensitive information?*

27. LINK supports the proposals, though notes that if the CTP provides service(s) to more than one firm or FMI, this might create either:

- increased reporting on the CTP if it were to notify each firm or FMI it provides services to separately in order to reflect specific and relevant confidential / sensitive information for that firm / FMI only; or
- potentially provide confidential / sensitive information to parties if one notification was made and circulated to all impacted firms / FMIs.

LINK suggests the final Supervisory Statement is clarified to make clear CTP expectations. In addition, Competition Law should be considered for any potential implications in the context of information sharing.

Question 18: *Do you have any comments on the regulators' proposals to restrict CTPs from indicating, for marketing purposes, that designation implies regulatory endorsement or that its services are superior?*

28. LINK supports this proposal. As noted in LINKs input to DP3/22, in the future FMIs / payment systems may choose to only use designated CTPs which could lead to a contraction in the number of suppliers in the market. This could have the unintended consequence of increasing concentration risk. Restricting CTPs in their marketing is supported and might help alleviate this potential consequence, however if firms / FMI are able to obtain information of designated CTPs via HMT then this may still result in unintended concentration risk.

Question 19: *Do you anticipate any other unintended consequences from the designation of CTPs? Are any further requirements necessary to avoid these unintended consequences?*

29. Under the current regulatory regime, providing an attestation on behalf of a firm is a serious obligation which comes with personal liability. While LINK recognises that firms

and individuals should be held accountable, it questions whether this is a proportionate approach for firms in the non-regulated sector.

30. It is important that the final regime and Supervisory Statement balances effective risk management with the need to give third parties scope to provide services that are innovative and cost effective. Otherwise, there is a risk that the new requirements and designation act as a deterrent to the provision of services and new entrants, and / or result in an increase in cost which forces CTPs to raise charges to FMI's, change their operating models, or withdraw from the market.
31. It is conceivable that certain firms and FMIs already subject to regulation might meet the criteria for being designated as CTPs. However, based on the CP and draft Supervisory Statement, such designation would likely occur only if regulators were concerned that these services aren't adequately regulated or overseen within existing frameworks. If a scenario arises where an existing regulated firm or FMI is proposed for designation and subsequently designated, it would be beneficial to have clarity on the regulatory approach.

Additionally, the CP proposals apply to designated CTP's services to firms and FMIs. LINK suggests the final Supervisory Statement should clarify the relationship between CTPs and firms and FMIs, as firms and FMIs themselves, by association, provide services to their members and participants. This clarification would assist firms and FMIs in managing their CTPs and complying with final requirements.

Question 20: *Do you have any comments on the cost-benefit analysis? Do you have any comments on the regulators' proposals to restrict CTPs from indicating for marketing purposes that designation implies regulatory endorsement or that its services are superior? Are there any other measures which the regulators could consider to mitigate potential, unintended adverse impacts on competition among third party service providers as a result of the designation of CTPs?*

32. Cost benefit analysis – see LINK's response below under point 34 Unintended adverse consequences.
33. Restricting CTPs from indicating designation, see LINK's response to question 18.
34. Unintended adverse impacts. In addition to point 30, LINK notes the following needs for consideration to avoid unintended competition consequences because of the designation of CTPs:
 - a. An approach that balances the requirement for effective risk management with proportionality, so that suppliers (both critical and non-critical) do not withdraw from the marketplace.
 - b. An approach that balances resilience with innovation, to not unduly stifle innovation and third parties either withdrawing from the marketplace, or perceived barriers to entry.
 - c. An approach which does not hinder CTPs in meeting regulatory requirements and service delivery to firms and FMIs to an extent that non-designated third parties, existing and new to market, can offer firms and FMI service delivery for some of their services at a more favourable cost, due to non-designation.
 - d. Final requirements could raise regulatory costs for those third-party suppliers considered a CTP. An increase in costs may make business models for these

third parties unviable, causing them to raise costs to firms and FMIs or exit the market (increasing concentration risk). The criteria for which functions and services are defined as “critical” therefore needs to be proportionate.

ENDS