

CPMI-IOSCO DISCLOSURE FOR BACS PAYMENT SCHEMES

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1 CPMI-IOSCO DISCLOSURE FOR BACS PAYMENT SCHEMES

1.1 VERSION HISTORY

VERSION	DATE	DESCRIPTION
1.0	12/10/15	2015 version for public disclosure
1.1	20/12/16	2016 version for public disclosure
1.2	29/12/17	2017 version for public disclosure

1.2 DOCUMENT REVIEWERS

STAKEHOLDER	ACTION	STAKEHOLDER	ACTION
Mike Morrissey	P	Dave Stockwell	R
		Fergus Ryan	R
		Michael Chambers	A

Action: P – Producer; C – Contributor; R – Reviewer; A - Authoriser; I - Information only

1.3 COPYRIGHT STATEMENT

All rights reserved.

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2 SECTION I – EXECUTIVE SUMMARY

The Bacs payment system is recognised by HM Treasury for oversight by the Bank of England. In this respect Bacs is defined as a Financial Market Infrastructure, and consequently assesses and discloses how it meets a set of international Principles designed to ensure stability (the Principles for Financial Market Infrastructures: Disclosure framework and Assessment methodology, published by the Committee on Payments and Market Infrastructures and the Board of the International Organization of Securities Commissions – CPMI-IOSCO). This document sets out how Bacs measures against these principles, and is set out in accordance with the disclosure framework.

2.1 BACKGROUND TO BACS

Bacs, founded in 1968, is a not-for-profit, membership-based body owned by 16 of the leading banks and building societies in the UK, Europe and the US. Bacs has been maintaining the integrity of payment related services for over 45 years, and is responsible for the schemes behind the clearing and settlement of automated payments in the UK: Direct Debit and Bacs Direct Credit.

Since its inception, over 115 billion transactions have been debited or credited to UK bank accounts via Bacs. In 2017, over 6.3 billion UK payments were made this way with a total combined value of nearly £5 trillion. A new record was also set in June 2017, with over 111 million items processed in a single day.

Bacs has a clearly defined set of rules and legal agreements (governed by English Law), and the Bacs system has been designated – and continues to meet designated requirements – under the Settlement Finality Directive. Bacs processing and settlement is conducted in the UK only, although some participants are incorporated outside of the UK / European Union.

The key risks faced by Bacs are a significant central processing outage, or a failure of the settlement process (including Participant failure to meet settlement obligations).

There are a range of resilience measures in place to prevent a significant central processing outage, including service levels and monitoring, secure messaging, secure dual site processing, tested Incident Handling and Disaster Recovery arrangements, and strict change control.

To mitigate settlement risk, Bacs operates a settlement prefunding model which guarantees settlement between all Bacs Participants and significantly reduces the financial risks to the system and its Participants arising from the default of a Bacs Participant. Under this model, all Bacs Participants lodge a cash deposit sufficient to cover their largest potential net debit settlement position in an earmarked account at the Bank of England – these funds will only be accessed to settle the obligations of a Participant if it were unable to meet its settlement obligations through existing arrangements. There is also an upper value limit on single items which could have a disproportionate impact on settlement values, where these would be more appropriately processed by a high-value payment system, i.e. CHAPS.

2.2 DISCLOSURE – PRINCIPLES IN AND OUT OF SCOPE

There are 16 Principles in scope: 1, 2, 3, 4, 5, 7, 8, 9, 13, 15, 16, 17, 18, 19, 21, and 23.

The remaining Principles are out of scope. Principles not applicable to Payment Systems: 6, 10, 11, 14, 20, 24 (as stated in the CPSS-IOSCO “Principles for Financial Market Infrastructures” document,

table 1, page 14). Additionally, Principle 12 is considered to be out of scope, as Bacs is not an exchange-of-value settlement system, and Principle 22 is considered to be out of scope as Bacs is not a cross-border payment scheme. Principles out of scope are also verified by Bacs Internal Audit each year.

2.3 SUMMARY OF KEY POINTS FROM THE DISCLOSURE

On the basis of developments since 2014 Bacs considers from its own self-assessment, as verified by Internal Audit, that it now meets or exceeds the requirements of the applicable Principles, as summarised below:

RATINGS SUMMARY		
Assessment category	Principle	Actions in place
Observed	1, 2, 3, 4, 5, 7, 8, 9, 13, 15, 16, 17, 18, 19, 21, 23	n/a
Broadly observed	Nil	n/a
Partly observed	Nil	n/a
Not observed	Nil	n/a
Not applicable	6, 10, 11, 12, 14, 20, 22, 24	n/a

Principles are numbered as follows: 1 Legal basis, 2 Governance, 3 Framework for the comprehensive management of risks, 4 Credit risk, 5 Collateral, 7 Liquidity, 8 Settlement finality, 9 Money settlements, 13 Participant default rules and procedures, 15 General business risk, 16 Custody and investment risks, 17 Operational risk, 18 Access and participation requirements, 19 Tiered participation requirements, 21 Efficiency and effectiveness, 22 Communication procedures and standards, 23 Disclosure of rules, key procedures and market data.

The eight principles not applicable to Bacs are: 6 Margin, 10 Physical deliveries, 11 Central securities depositories, 12 Exchange-of-value settlement systems, 14 Segregation and portability, 20 FMI links, 22 Communication procedures and standards, 24 Disclosure of market data by trade repositories.

3 SECTION II: SUMMARY OF MAJOR CHANGES SINCE THE LAST DISCLOSURE

Since Bacs made its last public disclosure in December 2016, the following major changes have occurred.

3.1 FRAMEWORK FOR THE COMPREHENSIVE MANAGEMENT OF RISKS

The Bacs Enterprise Risk Management Framework (ERMF) continued to be refined during 2017 and Bacs completed three cycles of quarterly risk reviews across the business. A suite of Key Risk Indicators (KRIs) and metrics have been developed and confirmed with risk owners, facilitating the production of a dashboard view of KRIs to support the ERMF and provide an additional strand in a suite of MI/data that enables us to effectively assess risk namely:

- Quarterly risk review
- KRI data
- Incidents & risk event data
- Audit & governance data
- Control review data

Additionally Bacs has started to evaluate the control review methodology in order to enhance it and explore how the evaluation frequency and processes can further align to the ERMF, including Control Evaluation Templates (CETs) as part of the above holistic approach to risk assessment.

3.2 OPERATIONAL RISK

In response to a Bank of England Priority, Bacs introduced the following measures to further mitigate Operational risk:

To address risks emanating from Participants, the following measures were introduced:

- Bacs identified a number of key risk-based Operational performance targets for its Participants, and included these in the codes of conduct to enabling Participants to identify and comply with these targets.
- Measures to enhance the assurance of participant self-attestation have been identified - Key Risk Indicators (both lead and lag) arising from Participants.
- Measures to enhance the enforcement regime for Participants' compliance with Bacs requirements were agreed by Board in March 2017, resulting in the implementation of a clear escalation path, which includes liaising with regulators where appropriate.
- Bacs is tracking Participant change events to enable concentration risk to be identified and addressed where possible.
- Bacs identified and conducted a number of potential new scenario tests focusing on risks from Participants. These scenarios are based on events that are considered plausible, or have previously crystallised.

- Bacs has updated its approach to incident identification, classification, and management.

In 2016, in response to an external review, Bacs revised its Business Continuity and Disaster Recovery policies and procedures including;

- The governance processes for updating the Business Continuity Management System
- The templates for training /testing
- The Management Review process
- Introduction of an automated Crisis Communications tool to help the Crisis Management Team quickly inform staff at the time of an emergency.

4 SECTION III: GENERAL BACKGROUND

4.1 GENERAL DESCRIPTION OF BACS AND THE MARKETS IT SERVES

Following several Government investigations, Participants restructured the Bacs Payment System into two separate legal entities, a Scheme Company (the System Operator) and an Infrastructure Services Company (the Supplier):

The System Operator, Bacs Payment Schemes Limited (Bacs), is a not-for-profit, membership-based industry body, owning the Payment System and Schemes, and with responsibility for maintaining the integrity and development of the core clearing and settlement services.

The Supplier is a shareholder-run private company whose principal role is the provision of payment processing services. It was set up to operate the core clearing and settlement services on a cost recovery basis, and can exploit new opportunities in payment services and other markets on a commercial, for-profit, basis.

For full participation in the Payment System, membership of the System Operator (Bacs) is required.

Bacs is designed to process automated retail payments (overall, a means to pay salaries, pensions, benefits, suppliers, and to collect payments including regular consumer payments e.g. utilities, insurance, mortgages, subscriptions). Over 4 billion Direct Debit payments were processed by Bacs in 2017 and 79% of UK adults have at least one Direct Debit commitment, with 73% of household bills paid this way. Over 90% of the UK workforce is paid via Bacs Direct Credit, which is also used to make one billion welfare payments.

As stated in section I above, a record number of items were processed on 30 June 2017, and the Bacs system is capable of processing comfortably in excess of this if required.

4.1.1 BACS PAYMENT SYSTEM – PROCESSING CYCLE

Bacs operates on a three-day processing cycle, summarised below, which enables its 16 Participants, 100,000+ Service Users (around 50,000 with direct payment submission access to the Bacs system, the remainder submit via Commercial Bureau), and over 750 Commercial Bureaux to submit payment instructions electronically, protected by encryption and digital signing:

Day 1. Input of payment messages by Participants and their customers, and bureau. Input can take place ahead of Day 1 in accordance with submitter requirements, this will be stored (“warehoused”) and retrieved for processing on the required day. Receipt of input reports by submitters occurs on the day of input.

Day 2. Processing of input and warehoused submissions. Output of payment details to Participants (and some agencies).

Day 3. Net settlement at Bank of England. Application of individual payments to customer accounts.

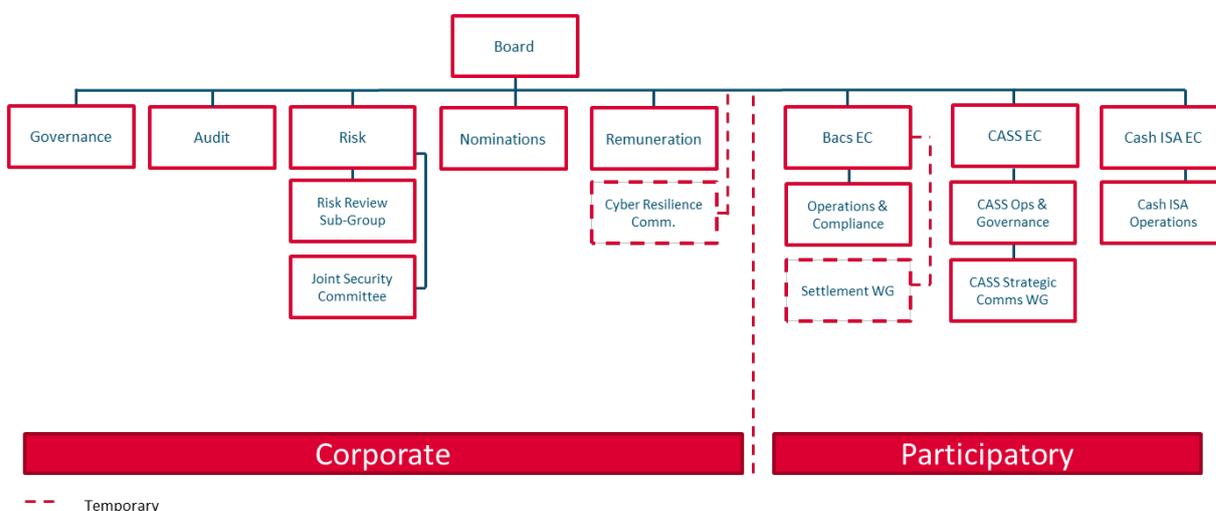
4.2 GENERAL ORGANISATION OF BACS

Bacs has clearly defined governance arrangements, through membership agreements, and the company’s Articles of Association. The latter sets out clearly the governance arrangements for Participants and directors and the key points are summarised as follows:

- Membership criteria
- Composition, execution, and recording of General Meetings
- Participant voting rights, including Proxies and Resolution arrangements
- Directors' Powers, Appointment and Removal process
- Establishment and functioning of Committees

There is a clear committee structure, and each committee has clearly defined objectives and Terms of Reference (see section IV. Principle 2 Governance for detail):

Bacs committee structure



4.2.1 BACS TEAM RESPONSIBILITIES - OVERVIEW

The organisational and management structure of the Bacs Scheme Company is designed to meet the needs of payments industry participants in an efficient and effective manner:

Operations - responsible for ensuring the integrity and reliability of the clearing and settlement operations of the Bacs service. This is achieved through the setting and monitoring of Service Levels both with suppliers and Participants, the provision of Security services for the Bacs Schemes, and the Bacs Approved Bureaux Scheme. The team is also responsible for ensuring incident management and business continuity arrangements are in place for both Bacs and suppliers.

Risk Assessment & Assurance – responsible for providing the company's second line of defence services, including risk management and Participant and key supplier assurance, and the interface with Internal and External Audit.

Product & Strategy - Responsible for managing the Bacs Direct Debit and Bacs Direct Credit Schemes and associated payment-related services and co-ordinating resources to support development activities. Responsible for Bacs managed services (Cash ISA Transfer and Current Account Switching Service). Manages the implementation of the scheme strategy in relation to the development of existing and new scheme products.

Change Management - To lead change management activity across the Company, to manage a project team in delivering the change management activities.

Scheme Support & Development - The SS&D business objectives are:

- To be accountable for the external image of Bacs and its two principle schemes (Direct Debit and Bacs Direct Credit)
- To be accountable for the company's PR and social media presence
- To be responsible for identifying and pursuing opportunities that generate additional Direct Debit and Bacs Direct Credit volume
- To support the wider business through the provision of marketing collateral, online and digital marketing services
- To be responsible for identifying and developing agreed added value propositions
- To monitor and understand the market as far as Bacs' products are concerned including an understanding of competitive payment methods.

4.3 LEGAL AND REGULATORY FRAMEWORK

Bacs has legal agreements in place with all relevant stakeholders (Participants, Infrastructure Supplier, Settlement Service Provider, Commercial Bureaux, Managed Services participants, Affiliates). All contracts were drawn up on behalf of Bacs by professional lawyers (Allen & Overy).

To ensure a well-founded, clear, transparent and enforceable legal basis for Bacs, the following contractual structure is in place (see section IV. Principle 1 Legal basis for detail):

- (a) Agreements between Bacs and Participants
- (b) Agreements between Bacs and the Suppliers of Infrastructure and of Settlement Services
- (c) Agreements between the Infrastructure Supplier and Participants
- (d) Agreements between Bacs, the Infrastructure Supplier and Participants
- (e) Other Agreements (between Bacs and other entities, e.g. Commercial Bureaux, Cash ISA Transfer and Current Account Switching Service Participants)

The above agreements cover the provision of the various elements of the Bacs service (per the “Bacs processing cycle” diagram below).

4.3.1 LEGAL AGREEMENTS – STANDARD FEATURES

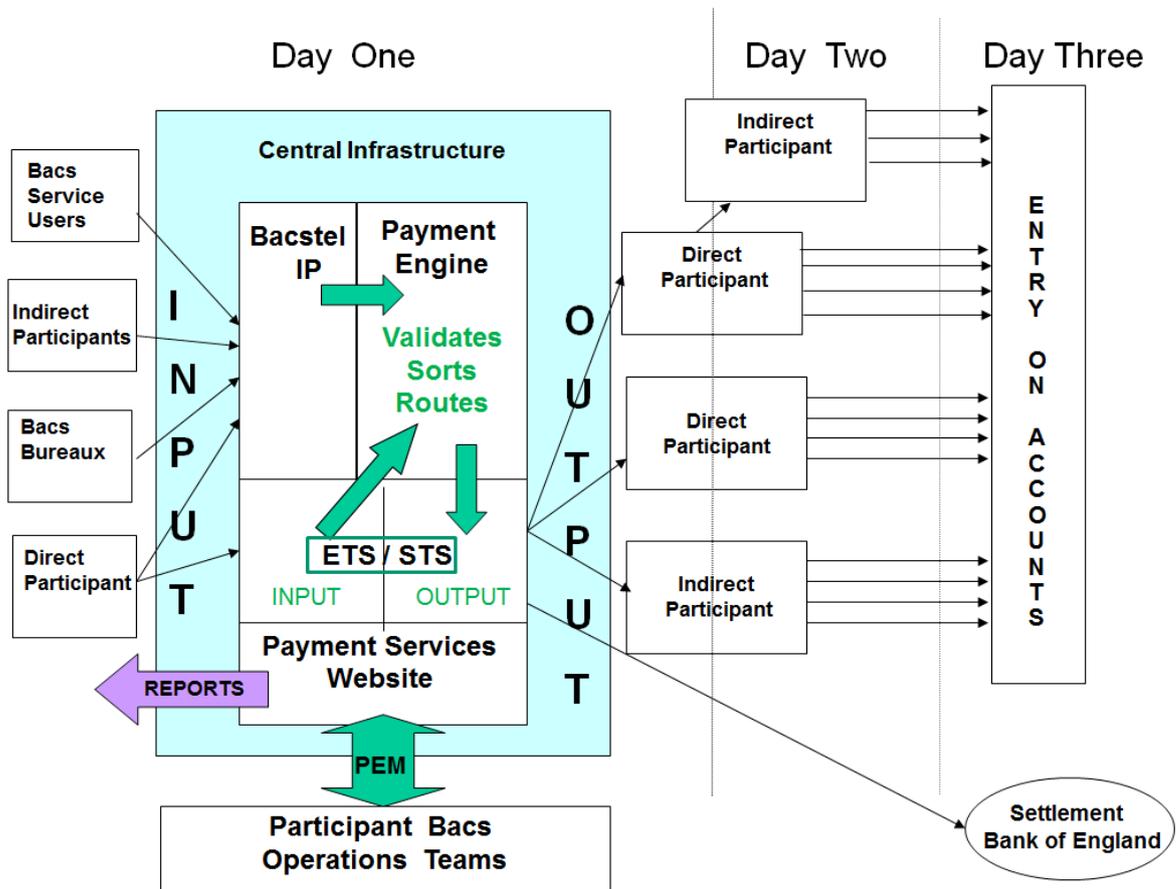
Bacs Legal Agreements all contain a number of standard legal clauses which are commonly used in outsourcing agreements, e.g. covering Governing Law (English Law), Confidentiality, Security, Supplier Personnel, Data Protection.

Bacs Risk Committee monitors regulatory developments as a standing agenda item. This is supplemented by the Bacs Company Secretary function.

4.4 SYSTEM DESIGN AND OPERATIONS

As stated in section III, Bacs operates on a three-day processing cycle, which is the minimum time taken for a payment instruction submitted to Bacs for processing to reach the destination account. The processing cycle has three main stages: input (day 1), processing (day 2) and entry (day 3), and is illustrated in the diagram below:

4.4.1 BACS PROCESSING CYCLE



The following elements are core to the Bacs service, with access to all elements controlled using Public Key Infrastructure security:

Bacstel-IP service. Bacstel-IP is the main access channel used by participants to interface with the Bacs service. Service users can connect to Bacstel-IP using the internet or other connectivity methods such as extranet. Bacstel-IP is accessed by service users via Bacs Approved Software, which ensures that all software used to connect to the Bacstel-IP service meets a minimum set of standards and performs a minimum set of requirements.

Enhanced Transmission Service (ETS). The ETS channel supports service users and banks sending input (credit and debit payment information applicable to customers, and related reports) and banks collecting output (credits and debits to be applied to their customers' accounts, and related reports).

SWIFTNet Transmission Service (STS). STS uses the SWIFT service for connectivity and routing, enabling banks to reuse existing SWIFT infrastructure to connect to Bacs, and delivering the same Bacs functionality as ETS.

Bacs Payment Services Website (PSW). The PSW is the main user interaction portal for the Bacs service, and is used by service users, scheme Participants and agency banks to manage customer account data and address advice of breaches of value limits, and enables participants to collect reports relating to their use of the Bacs service.

4.4.2 BACS PAYMENTS AND ASSOCIATED MESSAGES

Direct Debits and Direct Credits

A Direct Credit or Direct Debit payment item is a transaction, in a standard format (Standard 18), containing payment amount, credit and debit account details, as well as originator and submitter details (the submitter may be a bureau acting on behalf of one or more third-party originators). The submitter transmits encrypted files containing these payment items to the Infrastructure Supplier, where they are authenticated (to check they are from a valid user), their contents are validated and then routed to receiving Participants (Bacs Participants and some Agency banks) who apply these to the destination accounts.

The totals of transactions between all Participants are summed at the end-of-day and the final net position for each Bacs Participant is sent to the Settlement Service Provider (Bank of England) for settlement.

Direct Debit Instructions (DDI)

DDIs are sent by the service user to the payer's bank / building society as the authority to pay Direct Debits from the payer's account.

AUDDIS (Automated Direct Debit Instruction Service) enables organisations to send new DDIs to their customers' bank electronically through Bacs, instead of in paper format. AUDDIS automates the transfer of DDIs from collecting organisations to the paying banks and building societies via Bacs. With AUDDIS, the organisation keeps the original signed DDI and electronically sends the details to the customers' bank to validate and, if accepted, set up the Instruction on its database.

Transfer of Direct Debit and Direct Credit advice information

For consumers, these transfers form part of the Current Account Switching Service, which was introduced in September 2013 to allow customers to transfer their current account to a new bank in seven days.

Messaging Advice Information

There are a number of key message types:

Amend payment details. Direct Debit instructions can be amended from time to time, either by the originator, or by a bank/building society (e.g. if an account number is changed). Changes may include amendments to the customer's account or a request from the customer to cancel a Direct Debit. ADDACS (Automated Direct Debit Amendments and Cancellation Service) is the electronic service allowing banks / building societies to advise Direct Debit service users, via Bacs, of any amendments to or cancellations of Direct Debit Instructions. ADDACS is designed to reduce the number of unpaid

Direct Debits and resulting indemnity claims. Cancellations are processed in a similar way to amendments.

Redirect payments. When a Direct Credit item quoting incorrect account details is passed to the Receiving Bank, the Receiving Bank validates the details and applies the payment to the correct account. If it is unable to do so, the receiving bank sends out an AWACS (Advice of Wrong Account for Automated Credit Services) message to the originator informing it that the account details have changed. If it is unable to apply the Direct Credit then the payment will be returned.

The Bacs User Guide and Rules document set, available to all service users, explains the above in detail.

5 SECTION IV: PRINCIPLE-BY-PRINCIPLE SUMMARY NARRATIVE DISCLOSURE

5.1 PRINCIPLE 1: LEGAL BASIS

An FMI should have a well-founded, clear, transparent, and enforceable legal basis for each material aspect of its activities in all relevant jurisdictions.

Bacs has a clearly defined set of rules and legal agreements (governed by English Law), and the Bacs system has been designated – and continues to meet designated requirements – under the Settlement Finality Directive. Bacs processing and settlement is conducted in the UK only, although some participants (including one Bacs Participant) are incorporated outside of the European Union.

Bacs has legal agreements in place with all relevant stakeholders (Participants, Infrastructure supplier, Settlement Service Provider, Commercial Bureaux, Current Account Switching participants, Cash ISA transfer participants, Affiliates). All contracts were drawn up on behalf of Bacs by professional lawyers (Allen & Overy). Bacs does not contract with individual consumers, whose relationship is with their own bank, and consumers are consequently protected against error through facilities such as the Direct Debit Guarantee.

Bacs Risk Committee monitors regulatory developments as a standing agenda item. All risks to Bacs, including regulatory, are monitored by Risk Committee. This is supplemented by the Bacs Company Secretary function.

The Bacs Governance Guide sets out, inter alia, the legal basis for Bacs activities and is available to Participants (and potential new Participants under NDA). All Bacs legal agreements, rules and procedures are communicated to – and reviewed by as appropriate – Participants and the regulatory authorities.

Scheme rules (e.g. for the Direct Debit and Direct Credit schemes, Bacs Commercial Bureau) are published through the Bacs.co.uk website, available to the specific users. All agreements are governed by English Law.

Bacs, as a UK-based Sterling payments system, operates under UK jurisdiction. As some Bacs participants are incorporated outside of the UK, there is a small risk of conflict of laws in the event of the insolvency of one of these participants. This risk has been fully considered by all Participants, and has been accepted as very low and in the interests of access to the Bacs system for non-EU incorporated participants.

5.2 PRINCIPLE 2: GOVERNANCE

An FMI should have governance arrangements that are clear and transparent, promote the safety and efficiency of the FMI, and support the stability of the broader financial system, other relevant public interest considerations, and the objectives of relevant stakeholders.

Bacs has a set of company objectives, which cascade through all Bacs activities to ensure the safety and efficiency of the system. Performance against these objectives is evidenced through monthly monitoring and reporting to committees and Board as appropriate.

Financial stability is explicitly stated in the Bacs Articles of Association, supported by the requirements of the Balanced Scorecard. The underlying system aspects all contribute to supporting financial stability.

Bacs has clearly defined governance arrangements, through membership agreements, and Memorandum and Articles of Association. The latter set out clearly the governance arrangements for Participants and directors.

There is a clear committee structure, and each committee has clearly defined objectives and Terms of Reference which are reviewed annually. Minutes of Board meetings are publically disclosed on the Bacs.co.uk website.

All the above information is available to Participants, other participants and regulators, and much of this information – including the Articles of Association – is available on the Bacs website.

Bacs Board directors' roles and responsibilities are defined in the Memorandum and Articles of Association, and are expanded upon in the Directors' Handbook. The Bacs Board has clear Terms of Reference, (as defined in the Articles of Association) and there is a defined conflict resolution process, supported by the disciplinary and appeals process.

A review of Board's performance was conducted by independent consultants in 2014, and the outcome of this review, including any actions arising, was discussed at Board in June 2014.

In addition to the Bacs Chief Executive Officer and three independent directors (the Board Chair, the Chair of the Audit and Risk Committees, and the Chair of the Current Account Switching Service), Bacs Board comprises non-executive directors appointed by their Participant organisation as being the most appropriate individual for the role.

Bacs management has clearly defined roles and responsibilities, as set out in job descriptions and team objectives. Bacs management are drawn from the payments industry or from specialist professions. The formal recruitment process and individual performance reviews by the Bacs CEO are in place to ensure management maintains the appropriate experience, a mix of skills, and integrity. The Bacs CEO's performance is reviewed by the Bacs Chairman in the same way.

Bacs has a risk-management framework in place, supported by a risk management policy and clear risk appetite statements and Key Risk and Performance Indicators. Bacs overarching risk appetite statement is that all recorded risks must have mitigating and effective controls and treatments in place to reduce each risk to a residual level that is acceptable to Risk Committee and Board. All risks are reviewed at least annually and more frequently if required) – all risks must have a decision allocated to them; whether to action, tolerate, terminate or transfer. The likelihood of risks crystallising is contained by a set of controls in operation (both preventative and mitigatory responses), which are independently assessed annually.

Bacs has crisis management procedures, which incorporates the Board decision making process where appropriate (e.g. in the event a Participant bank fails to settle) and provides for specific incident handling teams, who have clearly defined procedures covering the scenarios thought likely to impact the Bacs system. These procedures include direct access to Bacs Board.

Bacs has an Affiliates Interest Group, comprising representatives from different stakeholder groups (e.g. Government Departments, Agency Banks, utilities, telecoms, insurance, Bacs bureau, Software Solution Suppliers). Bacs Affiliates are advised of Bacs Board decisions at quarterly meetings. See Bacs website.

Bacs operates a stakeholder consultation process, which is regularly reviewed to ensure it remains fit for purpose.

In 2016 Bacs commissioned an external expert review of the effectiveness of its governance, both in relation to current best practice and to the Bank of England draft Code of Practice and Supervisory Statement relating to governance in recognised payment system operators (September 2016). A major outcome of this review is a revised committee structure and supporting terms of reference, including the purpose and prime areas of responsibility for each committee. This was agreed by Bacs Board in December 2016, for implementation from the start of 2017. The new Governance structure comprises Corporate Board reporting committees (including Governance, Risk, and Remuneration) and Participatory Board reporting committees (including Operations & Compliance).

5.3 PRINCIPLE 3: FRAMEWORK FOR THE COMPREHENSIVE MANAGEMENT OF RISKS

An FMI should have a sound risk-management framework for comprehensively managing legal, credit, liquidity, operational, and other risks.

The Bacs Risk Policy sets out the ownership, applicability, and responsibility obligations of the company's management and directors. The policy specifies the approach to be taken by Bacs and its suppliers. The identification, measurement, monitoring, and management of the risks to Bacs is articulated through the risk appetite statements, the company risk taxonomy and supporting data and analysis, which is reviewed by the Risk Committee and reported to the Bacs Board, all on a quarterly basis. Risk Review Group (a sub-group of Risk Committee) conducts reviews of risks outside of appetite and/or emerging risks that require 'deep dive' analysis.

As part of the hard debit caps and monitoring process inherent in Prefunding, Bacs Participants are provided with management information to enable them to examine their own customers' use of the system and how settlement risk can be further reduced. This is designed to eliminate credit and settlement risk from the system.

Participants' customer risks are managed through the appropriate Bacs rules (e.g. Direct Debit, Direct Credit). These documents are available to Bacs users as appropriate. Assurance from Bacs Participants on the adequacy of their own risk management systems including their sponsored customers – as they relate to Bacs – is gained through the annual Codes of Conduct exercise.

These risks, along with all other risks to Bacs, are reviewed regularly by the Risk Review Group, reporting to the Risk Committee.

A plan is in place which explores appropriate provisions to mitigate the risk of disruption to essential services provided by Bacs together with a plan to address a disruption should it occur. Bacs' critical activities – and supporting critical service provision activities - are identified and prioritised.

The Bacs Enterprise Risk Management Framework (ERMF) continued to be refined during 2017 and Bacs completed three cycles of quarterly risk reviews across the business. A suite of Key Risk Indicators (KRIs) and metrics have been developed and confirmed with risk owners, facilitating the

production of a dashboard view of KRIs to support the ERMF and provide an additional strand in a suite of MI/data that enables us to effectively assess risk namely:

- Quarterly risk review
- KRI data
- Incidents & risk event data
- Audit & governance data
- Control review data

Additionally Bacs has started to evaluate the control review methodology in order to enhance it and explore how the evaluation frequency and processes can further align to the ERMF, including Control Evaluation Templates (CETs) as part of the above holistic approach to risk assessment.

5.4 PRINCIPLE 4: CREDIT RISK

An FMI should effectively measure, monitor, and manage its credit exposures to participants and those arising from its payment, clearing, and settlement processes. An FMI should maintain sufficient financial resources to cover its credit exposure to each participant fully with a high degree of confidence.

A robust framework is in place to manage credit exposures between Participants, primarily articulated in the Settlement Agreements; legal agreements signed by all Bacs Participants.

The implementation of hard debit caps manages credit exposures by ensuring Participants' exposures are capped at pre-defined levels, and understood by all.

In the Bacs system, credit risk results from the Deferred Net Settlement nature of the three-day processing cycle. These exposures are regularly measured and reported to all Participants.

There are a number of system-enforced credit risk management processes in place:

- Credit limits on individual Bacs files and items (set by sponsoring Participant)
- A system-enforced cap applies a maximum value of £20m for customer grade transactions
- Hard debit caps alert Bacs when unusual or extraordinary values are input to the system, and there is a mechanism in place to remove these items if necessary.

There are sufficient resources (cash collateral) held to cover the settlement default of between one and all Bacs Participants, as defined in the Prefunding model.

Participants are contractually obliged to fund Bacs (through the Membership Agreements), and this is also one of the Bacs Membership eligibility criteria (in the Payment System Rules). In the event of Participant default, surviving Participants take on a higher share of Bacs running costs.

Company reserves are sufficient to provide for eight months operational running costs, even in the event of no other income.

5.5 PRINCIPLE 5: COLLATERAL

An FMI that requires collateral to manage its or its participants' credit exposure should accept collateral with low credit, liquidity, and market risks. An FMI should also set and enforce appropriately conservative haircuts and concentration limits.

All Bacs Participants' settlement obligations are covered by cash held in reserve at the Bank of England, in Sterling accounts designed specifically for the purpose. These reserve limits are adjusted on an ongoing basis to match the largest debit position for each Participant, and are directly maintained at the Bank of England by Bacs. This is conducted on a 24 hour basis as required.

Accordingly, there are no credit, liquidity, or market risks inherent in the Bacs system, which obviates the need for haircuts or concentration limits.

5.6 PRINCIPLE 7: LIQUIDITY RISK

An FMI should effectively measure, monitor, and manage its liquidity risk. An FMI should maintain sufficient liquid resources in all relevant currencies to effect same-day and, where appropriate, intraday and multiday settlement of payment obligations with a high degree of confidence under a wide range of potential stress scenarios that should include, but not be limited to, the default of the participant and its affiliates that would generate the largest aggregate liquidity obligation for the FMI in extreme but plausible market conditions.

Liquidity risk to Bacs only arises through Participants (as participants and settlement banks), through their liquidity commitments for daily settlement positions. The settlement agreements provide the framework to manage this.

All collateral is in the form of cash in Sterling and is lodged with the Bank of England in the Central Bank RTGS system. Bacs has no liquidity dependency on nostro agents or other entities.

Settlement positions are reported to each Participant at least 24 hours before settlement is due, in the Settlement Agent Summary. Monthly reports, showing half-hourly settlement positions for every settlement day are produced and distributed to Participants monthly. Additionally, end of day settlement reports are sufficiently granular to allow Participants to monitor agency bank exposures on behalf of whom they settle.

To further strengthen this process, the Bacs system allows Participants to monitor their real-time, intra-day positions. Bacs Participants set two trigger points that alert them and Bacs when their debit position passes thresholds, e.g. threshold one could be 60% of collateralised debit limit, and threshold two could be set at 90%. This allows Participants to place additional cash on reserve at the Bank of England to meet higher debit positions.

Bacs carries out modelling based on a number of stressed scenarios to provide an understanding of liquidity requirements should one of these stress scenarios materialise. This analysis is carried out monthly and provided to all Participants. The hard debit cap functionality provides tools to allow Participant debit caps to be increased provided there is sufficient collateral to support the increase.

Bacs board has agreed a model where all settlement obligations are pre-funded with the pre-funded amounts only being used in the event of a default. This arrangement covers the default of multiple

Participants (up to the entire Bacs membership, excluding the Bank of England which is not deemed to carry credit risk) – settlement would complete regardless of the number of Participant failures.

Bacs is a Sterling-only system. Under the pre-funding model referred to above, all liquid resources to cover settlement default are held at the Bank of England.

Bacs does not assume access to a line of credit from the Central Bank or elsewhere. Bacs Participants must continue to meet the eligibility criteria requirements in the Payment System Rules, which include settlement obligations.

In order for Bacs to settle each day, each of its Participants in a net debit position must have sufficient funds in its RTGS account at the Bank of England to meet its settlement obligation at 09:30. On settlement day, the Bank of England receives the settlement figures for each Participant automatically via SWIFT at 08:00. This prompts the funding/collection advices to each Participant for the 09.30 settlement.

The updated ERMF agreed by Risk committee (May 2017) and Board (June 2017) includes two Level 1 risks “Settlement, Credit & Financial Model” and “Financial”, with associate appetite statements and KRI/KPIs against which this risk will be measured.

In order to effect deferred net settlement, the Bacs rules and Settlement Agreements explicitly define obligations of all Participants at different stages of the process. Liquidity obligations are capped through the use of hard debit caps as described in Principle 4 Credit Risk.

5.7 PRINCIPLE 8: SETTLEMENT FINALITY

An FMI should provide clear and certain final settlement, at a minimum by the end of the value date. Where necessary or preferable, an FMI should provide final settlement intraday or in real time.

The point of settlement finality in relation to a Bacs Cycle is the point at which the Settlement Service Provider (Bank of England) transfers the relevant funds on the settlement day, in accordance with the Settlement Agreement and the Settlement Service Provider Agreement. The Bacs Settlement Agreement defines the point of settlement irrevocability, and the point at which settlement is final. In practice settlement becomes irrevocable (i.e. cannot be undone or unwound) at 09:30 on day three of the clearing cycle (i.e. value day) at which time final settlement takes place.

The Bacs Settlement Agreement clearly defines the point beyond which a payment cannot be revoked, defined as the “cut-off of extractions”. The point of irrevocability is 23:00 on day one of the clearing cycle.

5.8 PRINCIPLE 9: MONEY SETTLEMENTS

An FMI should conduct its money settlements in central bank money where practical and available. If central bank money is not used, an FMI should minimise and strictly control the credit and liquidity risk arising from the use of commercial bank money.

Bacs conducts its money settlements in central bank money. This is scheduled to occur automatically at 09:30 at the Bank of England each day (excluding weekends and bank holidays).

Bacs does not conduct settlement on its own books.

Each Bacs Participant has signed the Settlement Agreement, which states when settlement completes. As a multilateral net settlement system, settlement across all Participants' books – at the Bank of England - is simultaneous.

5.9 PRINCIPLE 13: PARTICIPANT-DEFAULT RULES AND PROCEDURES

An FMI should have effective and clearly defined rules and procedures to manage a participant default. These rules and procedures should be designed to ensure that the FMI can take timely action to contain losses and liquidity pressures and continue to meet its obligations.

The Bacs Settlement Agreements (section 5) and rules clearly and explicitly define the rules and procedures and enable the default of a Participant to be managed without affecting the ability of the system to continue.

In the event of a default, the defaulting Participant(s) cash collateral would be accessed at the Bank of England and employed to meet the settlement obligation.

To ensure that all parties (Bacs, its Participants and the Bank of England) are aware of the procedures required to fund and defund their collateral accounts at the Bank of England – both in and out of hours – a programme of testing throughout the year is in place.

Bacs rules and procedures are included in the Settlement Agreement, which is publicly available.

5.10 PRINCIPLE 15: GENERAL BUSINESS RISK

An FMI should identify, monitor, and manage its general business risk and hold sufficient liquid net assets funded by equity to cover potential general business losses so that it can continue operations and services as a going concern if those losses materialise. Further, liquid net assets should at all times be sufficient to ensure a recovery or orderly wind-down of critical operations and services.

General business risk is managed through a number of key measures:

The Bacs budget monitoring process, which is carried out monthly by the Company, and reviewed quarterly by the Audit Committee, and signed off annually by board.

Bacs maintains a reserve to cover unexpected or excessively large operating expenses arising from periods of stress. This comprises a financial reserve of six months (plus a two-month buffer) operating costs. These liquid net assets are held in cash only, on deposit at a UK commercial bank.

Bacs has identified scenarios that may potentially prevent it from being able to provide its critical operations and services as a going concern, and has assessed the effectiveness of a full range of options for recovery or orderly wind-down, and planned for this eventuality. In particular, the Bacs rules allow for additional equity to be raised from its Participants outside of the annual budget process if required.

5.11 PRINCIPLE 16: CUSTODY AND INVESTMENT RISKS

An FMI should safeguard its own and its participants' assets and minimise the risk of loss on and delay in access to these assets. An FMI's investments should be in instruments with minimal credit, market, and liquidity risks.

Bacs Participant assets to protect against settlement default are held at the Bank of England in the RTGS account. The Bank's accounts are audited by KPMG LLP, who gave an unqualified opinion in the Annual Report, as at 28 February 2017.

Bacs company assets are held in cash at a supervised and regulated UK commercial bank and Ernst & Young gave an unqualified opinion on the annual accounts to 31 December 2016.

As part of company risk management BAU, the company's bank credit rating is monitored at least monthly, and is classified as Investment Grade by the three Ratings Agencies used.

Bacs does not hold any realisable investments; the company strategy is to hold cash at a commercial bank.

5.12 PRINCIPLE 17: OPERATIONAL RISK

An FMI should identify the plausible sources of operational risk, both internal and external, and mitigate their impact through the use of appropriate systems, policies, procedures, and controls. Systems should be designed to ensure a high degree of security and operational reliability and should have adequate, scalable capacity. Business continuity management should aim for timely recovery of operations and fulfilment of the FMI's obligations, including in the event of a wide-scale or major disruption.

Operational risk management and monitoring forms a key part of the Bacs risk management function. The risk management framework has been established to identify, monitor, and manage operational (and other) risks, and has been accepted by Board.

The Bacs risk taxonomy and KRI / KPI data are the vehicle for the measuring and reporting operational risk to Board. Risks – including Operational Risks - are reviewed quarterly by the Bacs risk owners, and reported to Risk Committee and Board. The risk management process (risks and controls) is audited by both Internal Audit and External Audit (Deloitte) annually.

Bacs has in place clear and explicit Service Levels with suppliers, which are monitored at company and committee level.

Bacs and its Participants forecast volumes two years in advance, including expected peak item and file volumes. The system's processing capacity includes 25% headroom up to which it would still perform to agreed service levels. A capacity planning function is provided as part of the contract to ensure capacity to process forecast volumes with a significant amount of headroom.

The Bacs security policy explicitly covers confidentiality, integrity, availability, authenticity, accountability, and access control. The policy is applicable to Bacs, its Participants and suppliers as appropriate to role and requirements.

One of the ways Bacs receives assurance on its key suppliers' control environments is through independent audits, as follows:

- The Infrastructure Supplier's physical and information security is assessed and demonstrated through the annual ISAE 3000 service audit. With the signing of the new infrastructure supply contract in November 2014, Bacs has the contractual right to have coverage of specific risks included in the ISAE 3000, and included key topics for coverage by KPMG in its 2016 review.
- With regard to RTGS, the Settlement Service Provider's physical and information security is demonstrated through the ISAE 3402 service audit.
- Bacs office services supplier introduced ISAE 3402 accreditation in 2015, and Bacs has input to the coverage requirements.

Each report is reviewed by Bacs and Risk Committee annually.

Processing of Bacs payments is carried out at a secure location, with at least one standby site (over 30 miles away) which can take over all payment processing in the event the main site is unavailable, with key systems up and running within two hours. Business continuity (including planning and testing) is reviewed and tested annually. Business continuity is covered by specific service levels appropriate to a 3 day cycle batch processing system.

Outsourcing risk has been recognised as a key area given the criticality of the infrastructure to the Bacs payment system, and Bacs has developed mechanisms for not only flagging incidents with a major/critical impact but also trend analysis of lower level issues that are consistently manifested over a period of time.

The updated ERMF agreed by Risk committee (May 2017) and Board (June 2017) includes a Level 1 risk "Critical Infrastructure Supply", with a Level 2 risk "VocaLink (Operational Failure)" which are the focal points for managing infrastructure supply operational risk.

Bacs revised its Business Continuity and Disaster Recovery policies and procedures, covering;

- The governance processes for updating the Business Continuity Management System
- The templates for training /testing
- The Management Review process
- An automated Crisis Communications tool to help the Crisis Management Team quickly inform staff at the time of an emergency.

As part of this review Bacs facilitated training for Crisis Management which included a Disaster Recovery (DR) exercise for staff to participate as team members at the various levels (Gold/Silver/Bronze) as dictated by the type and severity of the incident(s).

To address risks emanating from Participants, the following measures were introduced:

- Bacs identified a number of key risk-based Operational performance targets for its Participants, and included these in the codes of conduct to enabling Participants to identify and comply with these targets.

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- Measures to enhance the assurance of participant self-attestation have been identified - Key Risk Indicators (both lead and lag) arising from Participants.
 - Measures to enhance the enforcement regime for Participants' compliance with Bacs requirements were agreed by Board in March 2017, resulting in the implementation of a clear escalation path, which includes liaising with regulators where appropriate.
 - Bacs is tracking Participant change events to enable concentration risk to be identified and addressed where possible.
 - Bacs identified and conducted a number of potential new scenario tests focusing on risks from Participants. These scenarios are based on events that are considered plausible, or have previously crystallised.
 - Bacs has updated its approach to incident identification, classification, and management.

The risk Bacs brings to other FMIs is volume-based initially. An extended outage in Bacs may cause Participants and their customers to push credits through Faster Payments (and to a lesser extent CHAPS) in the short-term, and possibly via cheque in the longer term. Unavailability of pull payments (DDs) may lead to a further shift to credit payments as e.g. utilities called for push payments from their customers. This would also lead to unexpected settlement values in the Faster Payments Scheme (and possibly in Cheque & Credit Clearing).

The risks that other FMIs bring to Bacs are that unexpected settlement values may arise if there was a migration to Bacs DC in the short term, and DD in the longer term. These settlement values are contained by hard debit caps, and guaranteed by pre-funding. Individual Participant debit cap values are set at 150% of the Participant's largest debit position over the last 12 months, which provides headroom to cope with some additional pressure on debit positions (with the capacity for Participants to deposit further collateral as required). The capacity of the Bacs system is considered sufficient to accommodate inward-migration of other schemes' volumes.

There is also associated reputational risk to the electronic payments industry overall if one FMI were to introduce uncertainty through degraded integrity or availability.

A summary of Bacs monthly item volumes and settlement values for 2017 is set out below.

MONTH	NUMBER OF BACS ITEMS	VALUE OF BACS PAYMENTS
January	521,239,538	£409,233,813,640.52
February	500,326,775	£364,637,793,860.99
March	570,824,087	£444,515,977,944.26
April	517,601,564	£389,828,761,227.98
May	549,826,526	£412,417,026,963.42
June	567,460,084	£421,599,687,719.89
July	526,398,106	£399,526,057,069.37
August	557,099,729	£419,447,765,584.86
September	551,931,863	£430,637,061,501.76
October	550,431,918	£409,051,796,531.79
November	565,309,642	£418,965,597,195.38
December	559,389,522	£410,039,337,055.09

5.13 PRINCIPLE 18: ACCESS AND PARTICIPATION REQUIREMENTS

An FMI should have objective, risk-based, and publicly disclosed criteria for participation, which permit fair and open access.

Bacs has published eligibility criteria for various interested parties to join or connect with Bacs, including Direct Participants, Affiliates, and Participants of the Managed Services (via its public website, and in the Payment System Rules for Direct Participants). These criteria are considered to strike an appropriate balance between openness of membership and stability of the payment system.

The Bacs system has been designated – and continues to meet designated requirements – under the Settlement Finality Directive – this includes membership criteria, per above.

Compliance is monitored by Bacs, e.g. operational requirements (SLAs, event monitoring, credit ratings monitoring). Suspension and orderly exit procedures are included in the Settlement Agreement, which is publicly available.

5.14 PRINCIPLE 19: TIERED PARTICIPATION ARRANGEMENTS

An FMI should identify, monitor, and manage the material risks to the FMI arising from tiered participation arrangements.

Bacs procedures allow for the identification of agency Management Information (e.g. settlement values, number of customers, number of transactions).

Bacs has identified and agreed the dependencies between agencies and Participants, and this analysis has been reviewed by Risk Committee, and is regularly updated and revisited.

This analysis identified the volumes and values for all agency banks, and the concentration risk by sponsoring Participant. Review and analysis of this data revealed a spread of sponsorship of agencies, with no disproportionate relationships in terms of volume or value. Bacs introduced risk tolerance metrics in 2016 – which include tiering - and is reviewing tiered Participation arrangements and statistics in H1 2017 against these metrics as it may be outside of appetite. Due to Prefunding, there are no material risks to Bacs arising from tiering – the risk is between the sponsoring Bacs Participant and its customers.

Bacs regularly reviews risks relating to agency banks in terms of settlement (agency values) and operational risk (agency access to the system if their sponsoring Participant fails). These risks, which are reviewed on an ongoing basis, have been accepted by Risk Committee.

5.15 PRINCIPLE 21: EFFICIENCY AND EFFECTIVENESS

An FMI should be efficient and effective in meeting the requirements of its participants and the markets it serves.

Automation and the consequent removal of paper to support processing (e.g. AUDDIS, DDICA) continues as an objective to Bacs, and opportunities for further enhancement to meet end-user needs are considered through the Bacs Development Committee.

To meet wider market requirements, Bacs provides the message processing element of the Cash ISA Transfer service and the Current Account Switching Service.

Bacs' objectives are defined in a monthly Performance Scorecard report, which is reviewed by Bacs Board.

Operational requirements are set and tracked through the Service Level Agreement – these are monitored directly by Bacs and the Operations & Compliance Committee, and feed into the KPIs and Balanced Scorecard.

Bacs meets the needs of its participants (Participants) and the retail market (users) by review and update of the Direct Debit and Direct Credit rules in consultation with Participants and affiliates. A full list of Bacs affiliates is available on the bacs.co.uk website.

5.16 PRINCIPLE 23: DISCLOSURE OF RULES, KEY PROCEDURES, AND MARKET DATA

An FMI should have clear and comprehensive rules and procedures and should provide sufficient information to enable participants to have an accurate understanding of the risks, fees, and other material costs they incur by participating in the FMI. All relevant rules and key procedures should be publicly disclosed.

Bacs rules and procedures are fully disclosed to all Participants, and where relevant are published on the Bacs website (specific to the user community, e.g. banks, bureau). The Payment System Rules are publicly available.

This information is all made available to existing Participants. Prospective Participants who enter discussions with Bacs are provided with this information in full, under signed Non-Disclosure Agreement.

Bacs procedures and rules are comprehensively documented, and published to relevant parties. The major risks are the impact to the participants of operational outage, and other Participant default (calling for agreed contributions). These – and all other risks - are captured in the Risk Register, which is reviewed by Risk Committee and board.

Processing fees are fully disclosed to all Participants (including clear descriptions) and the same tariff applies to all (no discounts are given). The tariff document describes the application of these fees. Membership costs of Bacs is similarly disclosed to participants, with a flat membership fee applicable to all, supplemented by a volume-based call proportionate to volumes submitted by the Participant. In all cases, the higher their relative volumes, the more is paid by Participants.

Costs of Admission are summarised in a document published separately to this report.

Bacs follows the “Disclosure framework and Assessment methodology” published by the Committee on Payments and Market Infrastructures and the Board of the International Organization of Securities Commissions in December 2012. There are six Principles which do not apply to Payment Systems (per CPMI-IOSCO “Principles for Financial Market Infrastructures” document, table 1, page 14), listed overleaf.

5.17 PRINCIPLES NOT APPLICABLE TO PAYMENT SYSTEMS:

CPMI-IOSCO specifically excludes Bacs from having to comply with six Principles:

6: Margin	A CCP should cover its credit exposures to its participants for all products through an effective margin system that is risk-based and regularly reviewed.
10: Physical deliveries	An FMI should clearly state its obligations with respect to the delivery of physical instruments or commodities and should identify, monitor, and manage the risks associated with such physical deliveries.
11: Central securities depositories	A CSD should have appropriate rules and procedures to help ensure the integrity of securities issues and minimise and manage the risks associated with the safekeeping and transfer of securities. A CSD should maintain securities in an immobilised or dematerialised form for their transfer by book entry.
14: Segregation and portability	A CCP should have rules and procedures that enable the segregation and portability of positions of a participant's customers and the collateral provided to the CCP with respect to those positions.
20: FMI links	An FMI that establishes a link with one or more FMIs should identify, monitor, and manage link-related risks.
24: Disclosure of market data by trade repositories	A TR should provide timely and accurate data to relevant authorities and the public in line with their respective needs.

Additionally, as Bacs is not an exchange-of-value settlement system, nor does it make cross-border payments, it is considered that the following Principles do not apply.

12: Exchange-of-value settlement systems	If an FMI settles transactions that involve the settlement of two linked obligations (for example, securities or foreign exchange transactions), it should eliminate principal risk by conditioning the final settlement of one obligation upon the final settlement of the other.
22. Communication procedures and standards	An FMI should use, or at a minimum accommodate, relevant internationally accepted communication procedures and standards in order to facilitate efficient payment, clearing, settlement, and recording.

6 SECTION V: LIST OF PUBLICLY AVAILABLE RESOURCES

In addition to the information contained in this report - and all publicly available resources on www.bacs.co.uk - the following information is available:

- Bacs Articles of Association
- Bacs Settlement Agreement
- Payment System Rules
- Costs of admission – summary

Other documents mentioned in this report are available through the Non-Disclosure Agreement process.