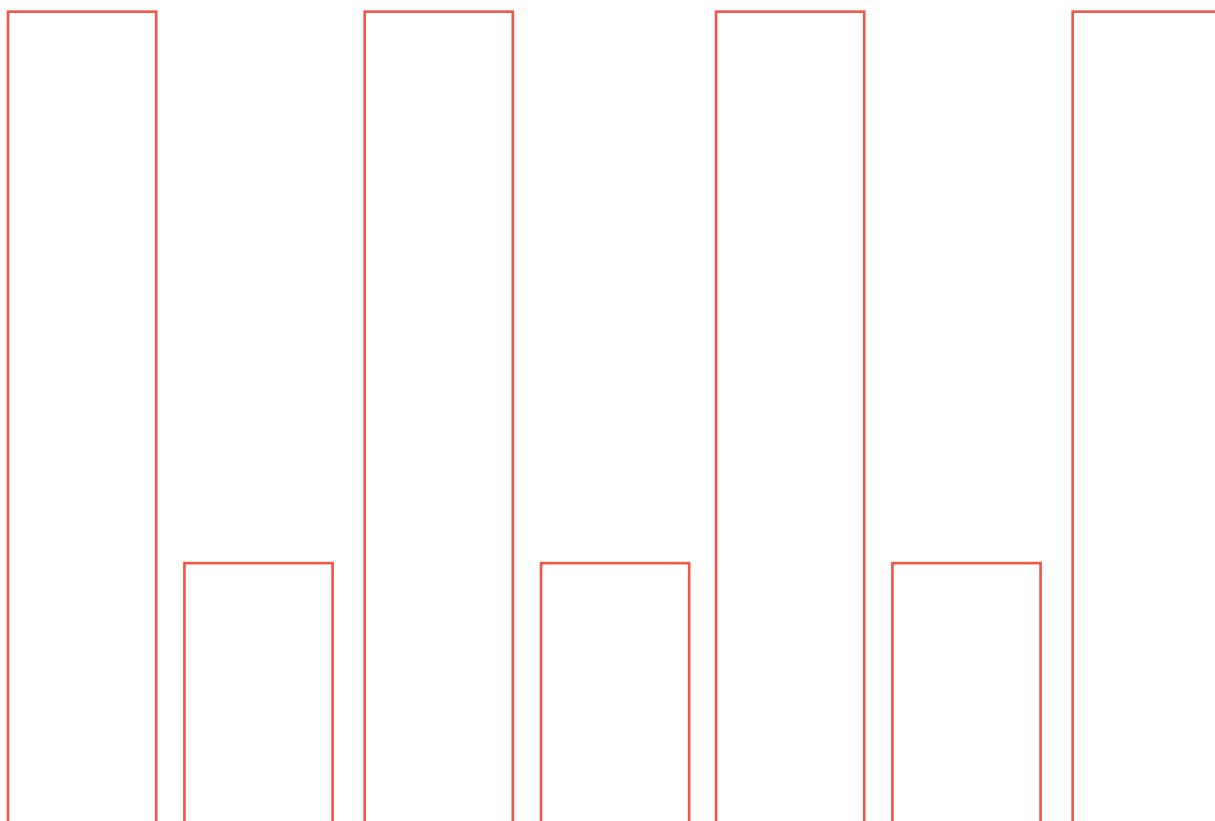




# SERVICE SUBSTITUTION

## SECTOR PRINCIPLES

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CMORG-endorsed capabilities (including good practice guidance, response frameworks and contingency tools) have been developed collectively by industry to support the operational resilience of the UK financial sector. The financial authorities support the development of these capabilities and collective efforts to improve sector resilience. However, their use is voluntary, and they do not constitute regulatory rules or supervisory expectations; as such, they may not necessarily represent formal endorsement by the authorities.

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## 1 INTRODUCTION

In the interconnected financial ecosystem and continued evolution of the risk landscape, more strategic and sector-wide solutions may be required for the most severe forms of operational disruption.

These principles for service substitution follow on from the Sector Response Principles for an Operationally Paralysed Global Systemically Important Bank (GSIB), published in September 2021. In Section 2 of the publication, the conclusions from the GSIB Heat Map highlighted that:

*Firms and the sector should collectively continue to push for substitutability solutions that lower the overall systemic dependency. Custody and Payment, Clearing & Settlement should be prioritised.*

Development of thinking on service substitution received further impetus following the Bank of England's market-wide simulation exercise (SIMEX22) completed in November 2022, which aim to validate the above principles on the operational paralysis of a GSIB. The post-exercise report released in March 2023 had the following recommendation on managing long-term outages:

*#4: CMORG should consider observations from SIMEX in alignment with its existing thinking on substitution. CMORG should consider developing an approach to support future industry collaboration on substitution which considers issues around substitutability options, competition and privacy law, liability and data protection.*

The other major influence on this work relates to individual firm activity to meet the Prudential Regulation Authority's (PRA) and Financial Conduct Authority's (FCA) policy requirements on operational resilience due in March 2025, specifically the requirement that any regulated firm or FMI:

*[PRA Rule 2.5] Must ensure it can remain within its impact tolerance for each important business service in the event of a severe but plausible disruption to its operations.*

Drawing from these inputs, these sector principles have been developed to help firms and the Authorities develop solutions for substituting one or more of their important business services with the aim of mitigating risk to consumers / clients and the financial stability of the UK in the context, uncertainty and compressed timeframes of a severe operational disruption event.

The development of these sector principles was performed as an exploratory phase of work and represents the sector's initial attempt to define the conditions required for substituting a service with another firm. Key lessons were identified during the development of these principles, specifically in relation to potential legal, operational and regulatory liabilities involved with execution (for all parties). Whilst development of these principles has advanced discussions on the subject, service substitution should still be considered as a theoretical concept which has yet to be proven as viable in practice.

These liabilities and other practical implementation considerations are recommended for further investigation as part of a future phase of work which tests these principles against a targeted set of important business services to be substituted (e.g. payments).

## 2 DEFINITION

### SERVICE

These principles relate to the substitution of a business service. Per the definition in the PRA and FCA's

policy on operational resilience, a business service is defined as delivering:

*A specific outcome or service to an identifiable user external to the firm and should be distinguished from business lines, which are a collection of services and activities.*

These principles do not assume whether any business service has been assessed as Important by individual firms. However, they accept that this is likely to be the case when developing and maintaining alternative solutions, in light of correlated thresholds such as Impact Tolerance.

### SUBSTITUTION

Substitution assumes that delivery of the business service is undertaken by an alternative method. In achieving any alternative, the following key participants would need to have a shared understanding of the principles below:

- the impacted organisation, that delivers the business service in normal circumstances;
- an alternate organisation, which may be internal or external to the impacted organisation; and
- financial authorities.

Consumers / clients are not given here as key participant. This assumes that they will be agnostic to how the business service is maintained, within the context of a severe operational disruption event and in line with established protocols on other forms of outsourcing.

These methods or solutions can take a variety of forms proportional to the scope and severity of the operational disruption event. These might include but are not limited to:

- **intra-firm:** The impacted business service is delivered by the same firm/organisation.
- **inter-firm:** The impacted business service is delivered by another firm/organisation.

## 3 SECTOR PRINCIPLES

The principles below are applicable to any business service being considered for substitution in the event of operational disruption to one or more providers. While they may have applicability for service substitution in normal circumstances, this is not the intended scope of this work.

They have been designed to apply to inter-firm service substitution but may also be useful for consideration in intra-firm solutions.

Each principle indicates:

- I. **preparatory actions** that a firm may consider useful to take as a first step to provision of a substitute service.
- II. longer term **maturity actions** that are likely to require industry-wide collaboration and will necessitate significant commitment to drive a level of service substitution maturity.

### 3.1 PRE-CONDITIONS FOR SERVICE SUBSTITUTION

Prior to any service substitution capability being entered into there are pre-conditions that should be considered.

**Principle #1: Sectoral solutions for service substitution must operate on a non-competitive, cost- neutral, and transparent basis.**

- Preparatory Action: Industry agreement on potential model (s) of substitution; third party, bilateral etc. that would allow this principle to hold and be open to all.
- Preparatory Action: Detailed and full understanding of cost implications for participant firms. This must include initial build / provision and any subsequent level of use / invocation. Consideration of how this would be apportioned between participant firms and modified as others on-board is required.

**Principle #2: Any material obligations or implications should be agreed, documented, and communicated to relevant stakeholders before entering any new service substitution arrangements.**

- Preparatory Action: Any branch of an international firm has discussed with their domestic regulator the implications of utilising a service substitution.
- Preparatory Action: Firms to establish stakeholder appetite regarding substitution of service across their business services.
- Preparatory Action: It is presumed the substitution arrangement would be treated as any other outsourcing arrangement meaning consumers / clients do not need to be informed in advance. Data protection and other legal / regulatory implications must however be fully understood.

### 3.2 PREPARING FOR SERVICE SUBSTITUTION

To ensure invocation of service substitution at point of need is as effective and efficient as possible for firms and their consumer / clients, it would be beneficial to have achieved a number of pre-conditions well in advance of any severe event necessitating invocation arising.

**Principle #3: Individual and joint communication plans must be established and maintained by parties involved in the delivery of substitutable services.**

- Preparatory Action: Firms to consider how existing corporate communication mechanisms and strategies may need to change for extremis scenarios; considering for example the needs of differing consumer / client cohorts in such severe events and potential limitations surrounding the available communication channels.
- Preparatory Action: Firms to consider data requirements and its availability to support any communication approach.

- Preparatory Action: Significant consideration to be given to how the stricken organisation and substitute provider communicate with each other before, during and after the event. Agreement regarding roles and responsibilities surrounding execution of communications to the many and varied interested parties is also required.
- Maturity Action: Communication to consumers of the substitute service must be clear on any deviation or limitation in comparison to the business-as-usual norm.

**Principle #4: Service substitution arrangements must be tested regularly to demonstrate capability to execute in line with stakeholder expectations.**

- Preparatory Action: Firms to define a suitable test strategy including robust acceptance criteria. Acceptance criteria should consider, for example, agreed transaction volume or value limits. A test approach will need to consider people, process and technology factors and will likely require acceptance by many varied interested parties.
- Maturity Action: Plan and execute routine test exercises to demonstrate ability to operate at agreed service levels to be offered by the substitute. Testing should include both invocation and switch back activity and consider reconciliation and downstream synchronisation.

**Principle #5: Alternate service providers should receive timely, accurate and complete data sets to support any substitutable service.**

- Preparatory Action: Firms collaborate to agree an industry wide schema which would facilitate and support data input (and output) into any given potential service substitution offering. This schema should consider both data quality and age. Lessons from global initiatives such as Sheltered Harbor (U.S.) may be beneficial.
- Preparatory Action: To ensure required input data is available to the substitute service at point of need firms will need to agree an approach to securely sharing point-in-time data files, access to any such data should not be dependent on production systems that will likely be unavailable.
- Preparatory Action: Firms work to understand data transfer, validation, and ingestion timescales into any proposed substitution solution as part of the wider test strategy.
- Preparatory Action: Legal and regulatory implications of such a data share must be fully understood, socialised, and governed appropriately.

### 3.3 DURING SERVICE SUBSTITUTION

For service substitution to be effective as an operational resilience or business continuity capability, all stakeholders (existing provider, alternative provider, consumers / clients and authorities) should be clear on the scope of what can be provided and/or requested in the conditions (e.g. stress, volatility, uncertainty) and timeframes appropriate to an operational disruption event.

**Principle #6: Financial authorities will act in line with their objectives in the event of operational disruption that triggers service substitution and consider the need for relevant interventions based on individual circumstances.**

- Preparatory Action: Financial authorities will only consider the need for forbearance (for example on financial or legal liability) in the interest of regulatory objectives at the

time of the operational disruption event and tailored to both the situation and parties involved.

- Maturity Action: Financial authorities will only consider whether long-term or permanent service substitution should be mandated if the impacted firm is no longer operationally or financially viable.

**Principle #7: Affected firms should make every effort to restore business as usual operations promptly (where viable to do so), on the premise that service substitution is typically a temporary arrangement.**

- Preparatory Action: Where the impacted firm is still viable, firms substituting any service to an alternative provider will assume that such substitution is a temporary position and make every effort to restore business as usual operations at the first opportunity.
- Maturity Action: In the event that a market-wide capability is available as an in-extremis alternative provider, the above principle remains and should be part of the terms of using such a capability, with impacted firms committed to restoring the full business service per client contract.

**Principle #8: Service substitution arrangements should only support existing consumers / clients.**

- Preparatory Action: Firms will substitute the service for existing and on-boarded consumers / clients only; on-boarding of new clients is not considered a critical activity during an operational disruption event and so not in scope.
- Maturity Action: Client firms should routinely discuss with their own clients any concentration risk and the contingency offered from having multiple banking relationships in place, if not actually used.

**Principle #9: All parties involved in service substitution accept that invocation and return-to- normal operations are not immediate or instantaneous transitions.**

- Preparatory Action: Firms using a substitution capability will accept that both invocation of this capability and switch-back is not immediate/instantaneous.
- Preparatory Action: In line with the above, firms can expect that the alternate provider will make every effort for substitution to be in place intraday.
- Maturity Action: All parties either offering and using service substitution should aim to ensure that this supports the ability of important business services to remain within their Impact Tolerance.