

Payment system governance

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This document builds on our [Statement of principles: payment system oversight](#) (PS1).¹ It sets out and explains the Reserve Bank's views on payment system governance.

Introduction

In this document we set out our views on payment system governance. We consider and discuss:

- the importance of good governance in payment systems;
- general corporate governance principles (namely, the OECD Principles of Corporate Governance² and the New Zealand Securities Commission's Corporate Governance in New Zealand - Principles and Guidelines³);
- industry-specific payment system governance principles (i.e. the relevant CPSS Core principles for systemically important payment systems⁴ and CPSS/IOSCO Recommendations for securities settlement systems⁵);
- the application of governance principles at the system level versus their application at the legal entity level; and
- key features of good payment system governance arrangements.

The importance of good governance in payment systems

Good governance underpins the market's confidence in an organisation. It defines relationships and accountabilities within an organisation, and between the organisation and its owners and other stakeholders. It also provides a framework for setting objectives, aligning interests, and monitoring risks and performance. Good governance arrangements also contribute to the optimal allocation of resources and, therefore, to wider economic efficiency and growth.⁶

More specifically, good governance is central to the soundness and efficiency of payment systems. Through appropriate governance arrangements the interests of those affected by a payment system's soundness or efficiency can be considered and, as appropriate, accommodated. Appropriate governance arrangements make it more likely that risks are adequately identified and are appropriately priced, allocated and managed, resulting in a more sound and efficient payment system. Appropriate governance arrangements can also add to the dynamic efficiency of the payment system over time by ensuring that interested voices are heard and, as appropriate, taken into account in strategic planning.

Promoting good governance is, therefore, central to the Reserve Bank's payment system oversight framework – if soundness and efficiency issues can be effectively dealt with by payment systems themselves (i.e. through appropriate governance arrangements), there is less cause for regulators to have an intrusive or prescriptive role in relation to those issues. This is analogous to the emphasis we place on self-discipline in our banking supervision framework.

The effect and importance of payment system governance on risk management and strategic decision-making is well recognised in other countries. For example, in the UK governance was one of the matters considered by the Payment Systems Task Force whose work culminated in the establishment of a new payments industry governance structure in the form of the Payments Industry Association.⁷ In the US, the Federal Reserve System's January 2007 policy statement on payment system risk identifies sound governance arrangements as a crucial part of payment system risk management frameworks.⁸ Governance also often features in central bank publications and speeches relating to payment and settlement system soundness and efficiency.⁹

Payment system governance principles

Payment system governance should build on general corporate governance principles such as the OECD or New Zealand Securities Commission principles referred to above.¹⁰ Many of those principles can be readily applied to payment systems.

The main aspect of general corporate governance principles that warrants elaboration in the context of payment systems is the role of stakeholders in governance arrangements. It is generally recognised that stakeholders have a role to play in governance. For example, Principle 9 in the Securities Commission's Principles and Guidelines is:

The board should respect the interests of stakeholders within the context of the entity's ownership type and its fundamental purpose.

However, because general governance principles are designed to apply across a range of entities and industries, it is difficult for such principles to be specific about the appropriate role of stakeholders – what is appropriate will be different for different entities and industries. As we are concerned with industry-specific governance arrangements (i.e. payment system governance arrangements) it is easier to be specific about that role.

In our view it is desirable for payment system governance arrangements to incorporate checks and balances to ensure that owners' interests do not unduly eclipse or undermine the interests of stakeholders. We see those checks and balances as being necessary because the natural monopoly and network characteristics of many payment systems mean that payment systems tend to have a significant degree of market power. Having a significant degree of market power tends to dull the incentives to accommodate the interests of non-owners which, in turn, may erode payment system soundness and efficiency.

Key payment system stakeholders

In our view, key payment system stakeholders include users and the wider financial system. The interests of the wider financial system broadly translate into "public interest issues". Therefore, in our view, payment system governance arrangements should at least accommodate the interests of users and the public interest. Depending on the circumstances there may also be other key stakeholders whose interests ought to be accommodated.

We see users as being key stakeholders because they are the group most affected by the soundness and efficiency of a payment system. They also bear the brunt of any abuse of market power.

The wider financial system is also a key stakeholder because the payment system is part of the core infrastructure of the financial system. Also, by definition, systemically important payment systems give rise to public interest issues.

Other key stakeholders could include:

- prospective users;
- those who are materially affected by the pricing and operational performance of the system;
- those to whom the system allocates settlement risk; and
- those who might have a material interest in the strategic development of the system.

Thus consumer groups, retailer groups, service providers to payment systems, and large customers of direct participants may be seen as key stakeholders.¹¹ Similarly, if a deferred settlement system leaves settlement risk with the customers of direct participants (rather than allocating it to the participants themselves), arguably those customers are also key stakeholders.

Industry-specific governance principles

The most relevant industry-specific governance principle is Core Principle X in the *CPSS Core principles for systemically important payment systems*:¹²

The system's governance arrangements should be effective, accountable and transparent.

Putting Core Principle X into the context of general governance principles, we would restate it as: ***A payment system's governance arrangements should be effective, accountable and transparent with respect to its owners, users and other stakeholders.***

A key point to note is the reference to the *system's* governance arrangements. It is the system's governance arrangements that are relevant for the purposes of payment system oversight rather than the governance arrangements of the owner of the system. In contrast, corporate governance is focused on the governance of "the corporate", i.e. the legal entity. Therefore, in applying general corporate governance principles to payment systems, there needs to be a shift in focus from the owner of the payment system to the system itself.

Effectiveness, accountability and transparency reflect general corporate governance principles. As such, those concepts provide a useful framework for considering governance arrangements:

- Effectiveness is about having a relevant and clear framework for developing and adopting strategic objectives and plans, and for monitoring and managing risks and performance. Effectiveness is also about defining the relationships and accountabilities between and among a payment system's management, owners, users and other stakeholders.
- Accountability underpins effectiveness, requiring that major decisions and actions are justified to owners, users and other stakeholders.

- Transparency underpins both effectiveness and accountability by ensuring that the governance framework and the payment system more generally are open to scrutiny by owners, users and other stakeholders.

Because the economic and structural characteristics of securities settlement systems are similar to those of payment systems, another industry-specific governance principle that is relevant is Recommendation 13 of the *CPSS/IOSCO Recommendations for securities settlement systems*.¹³

The governance arrangements for [securities settlement systems] should be designed to fulfil public interest requirements and to promote the objectives of owners and users.

As with CPSS Core Principle X, Recommendation 13 focuses on the governance arrangements of *systems*. Recommendation 13 also expressly recognises users and the wider community as stakeholders.

Payment system focus not entity focus

As discussed, a key aspect of payment system governance is that the focus should be on the system rather than on the owner of the system. That focus is particularly important if the owner of a payment system (or the owner's corporate group) carries on a range of activities and the payment system is less important in the context of the owner or the wider corporate group.¹⁴ Consequences of a focus on entities rather than systems could include:

- Responsibility for the management of the system may be overshadowed by other matters that are more important to the owner or its corporate group as a whole.
- Stakeholders who are important in the context of the system may not be important in the context of the owner or its corporate group as a whole.
- In dealing with conflicts of interest between the system and the other activities of the owner or its corporate group, the interests of the system, the public interest or the interests of users or other stakeholders may not be given due weight.
- Financial reporting, risk management reporting and disclosure requirements, to the extent they apply, may not give meaningful information about the system itself (as opposed to about its owners). This is particularly relevant in relation to analysing whether a system's pricing and investment strategy is reasonable. Without reliable financial information and reliable data on transaction volumes, it is difficult to determine whether market power is affecting price levels or investment.¹⁵

Key features of effective, accountable and transparent governance arrangements

Building on the above, we set out below what the Reserve Bank believes to be key features of effective, accountable and transparent governance arrangements for payment systems. The key features are relevant to all payment systems to varying degrees but are more relevant to systemically important payment systems.

Management

Responsibility for the management and strategic oversight of a payment system should be clearly vested in a competent group or individual whose primary roles, to the exclusion of other significant roles, are to:

- manage, or oversee the management of, the payment system;
- engage with the owners of the payment system, as appropriate;
- ensure that the interests of users and other key stakeholders are considered; and
- ensure that public interest issues are considered.

Annual reporting

Annual reports should be prepared on a payment system as if it were a separate entity.

Information and disclosure

Relevant information in relation to a payment system should be readily available to owners, users and other stakeholders, and the disclosure of relevant information should be made to owners, users and other stakeholders in a timely manner.

The key features described above are intended to be:

- views on best practice rather than expected minimums standards, however, the more systemically important a payment system, the more we would expect it to either conform with best practice or be taking positive steps to conform;
- outcomes focused – the Reserve Bank is more interested in seeing the features accommodated than in how they are accommodated; and
- neutral as to organisational form and neutral as to ownership, management and reporting structures – different organisational forms and different ownership, management and reporting structures may give rise to particular governance issues, but the same governance principles should apply and the same range of issues should be addressed regardless of whether a payment system is owned wholly or in part by a public sector agency or by users, regardless of whether it is owned by a limited liability company, a partnership, a mutual or co-operative entity or a joint-venture, and regardless of whether the entity has a profit objective.

¹ The *Statement of principles: payment system oversight* is available on our website at <http://www.rbnz.govt.nz/finstab/payment/1911038.html>.

² *OECD Principles of Corporate Governance*, OECD, 2004, - available on the OECD website at http://www.oecd.org/document/49/0,2340,en_2649_37439_31530865_1_1_1_37439,00.html.

³ *Corporate Governance in New Zealand - Principles and Guidelines*, New Zealand Securities Commission, 2004 – available on the Securities Commission website at <http://www.sec-com.govt.nz/publications/documents/governance-principles/index.shtml>.

⁴ *Core principles for systemically important payment systems*, CPSS Publications No. 43 (January 2001) - available on the Bank for International Settlements website at <http://www.bis.org/publ/cpss43.htm>.

⁵ *Recommendations for securities settlement systems*, CPSS Publications No. 46 (November 2001) - available on the Bank for International Settlements website at <http://www.bis.org/publ/cpss46.htm>.

⁶ For a more comprehensive discussion on corporate governance more generally and why it is important see the Preamble in *OECD Principles of Corporate Governance*, OECD, 2004, - available on the OECD website at http://www.oecd.org/document/49/0,2340,en_2649_37439_31530865_1_1_1_37439,00.html.

⁷ See the *Final Report of the Payment Systems Task Force*, February 2007, on the Office of Fair Trading (UK) website at http://www.ofst.gov.uk/advice_and_resources/publications/reports/financial/.

⁸ Board of Governors of the Federal Reserve System, Docket No. OP-1259, pages 13 and 14, available on the Federal Reserve Board website at <http://www.federalreserve.gov/paymentsystems/psr/press.htm>.

⁹ See for example:

- The Bank of England's Payment System Oversight Reports, in particular, Box 4 on page 22 of the 2006 Report (Issue 3, February 2007), available on the Bank of England website at <http://www.bankofengland.co.uk/publications/psor/index.htm>;
- H Allen, G Christodoulou and S Millard (2006), *Financial infrastructure and corporate governance*, Bank of England Working Paper no. 316, available on the Bank of England website at <http://www.bankofengland.co.uk/publications/workingpapers/wpabst06.htm#wp06>;
- a speech given on 16 September 2005 by Phillip Lowe, Assistant Governor, Reserve Bank of Australia, on *Innovation and Governance of Payment Systems* - available on the Reserve Bank of Australia website at http://www.rba.gov.au/Speeches/2005/sp_ag_160905.html; and
- a speech given on 4 April 2006 by Jean-Claude Trichet, President of the European Central Bank, on *Issues related to central counterparty clearing* – available on the European Central Bank website at <http://www.ecb.int/press/key/date/2006/html/sp060404.en.html>.

¹⁰ See notes 2 and 3 above.

¹¹ In this regard, note the role and composition of:

- the Canadian Payment Association's Stakeholder Advisory Council which is described on the Association's website at http://www.cdnpay.ca/about/stakeholder_overview.asp and http://www.cdnpay.ca/about/stakeholder_comp.asp, respectively; and
- the Australian Payments Clearing Association's Advisory Council – see http://www.apca.com.au/Public/apca01_live.nsf/WebPageDisplay/MemberList_Advisory.

¹² See note 4 above.

¹³ See note 5 above.

- ¹⁴ For a discussion of conflicts between competing interests in a European context see D Russo, T Hart, M C Malaguti and C Papathanassiou, *Governance of securities clearing and settlement systems*, European Central Bank Occasional Paper Series, No. 21, October 2004 - available on the European Central Bank website at <http://www.ecb.int/pub/scientific/ops/date/html/ops2004.en.html>.
- ¹⁵ In this regard, note that unbundling services and implementing accounting separation is a feature of the November 2006 European Code of Conduct for Clearing and Settlement, available on the European Commission's website at http://ec.europa.eu/internal_market/financial-markets/clearing/communication_en.htm#code.