Bank of New Zealand's submission on the Financial Market Infrastructures Bill: Exposure Draft

26 September 2019

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1 Introduction

1.1 Bank of New Zealand ("**BNZ**") has prepared this submission in response to the Financial Markets Infrastructures Bill: Exposure Draft (the "**Bill**").

1.2 BNZ welcomes this opportunity to respond to the Bill and acknowledges the significant work that has been done to draft a new regulatory regime for Financial Market Infrastructures ("**FMIs**").

1.3 BNZ acknowledges that most of the impact of the Bill is upon FMIs (systemically important or not, designated or not). As a participant bank BNZ is impacted to a lesser extent but is still affected by the Bill by being either a shareholder of an FMI, an officer in the FMI, or a user of an FMI (or combination thereof) and this submission is drafted from that perspective.

2 Executive Summary

2.1 BNZ acknowledges that the Reserve Bank of New Zealand ("**RBNZ**") has specifically sought feedback on the more granular and technical detail reflected in the Bill and with that in mind considers that the key matters of importance are as follows:

a) **Definitions** - the definition of "FMI" appears to cover multilateral systems only and we consider that bilateral systems should also be included. Both the Payments NZ Settlement before Interchange ("**SBI**") and High Value Clearing System ("**HVCS**") are bilateral clearing and settlement systems (although the rules are covered by a multilateral contract). It is therefore unclear the extent to which these systems would be captured by the definition of FMI.

b) **Rules of designated FMIs** – BNZ submits that the prescriptive approach to rules for designated FMIs set out in the Bill is problematic and more flexibility is required. For example, the 40-day timeframe proposed for mandated rule changes (clause 40) is unlikely to provide enough time to enable complex matters to be adequately addressed and operational processes developed. Similarly, clause 52(3) requires an FMI to make mandated rule changes within 20 days, regardless of the potential scope or complexity of the changes that may be required. A timeframe for rule approval should be included to ensure certainty and accommodate planning processes. We also recommend that rule changes for technical or non-material matters should be allowed without approval with details provided to the RBNZ for noting.

c) **Criminal sanctions** - in our view the Bill's approach of introducing criminal sanctions for directors and body corporates who act in breach of the FMI Bill are disproportionately onerous and pecuniary penalties for body corporates are more proportionate in incentivising the right outcomes.

d) **Timing** - from a timing perspective, it would seem to make sense for the introduction of the FMI Bill to align with completion of the Phase 2 review of the RBNZ Act. There

is a risk that policy decisions that will be made as part of that review may have a direct impact on the FMI Bill thereby necessitating consultation.

Should the RBNZ have any questions in relation to this response, please contact:

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1 Transitional arrangements

1.1 BNZ agrees with the RBNZ that settlement systems currently designated under Part 5C of the Reserve Bank Act 1989 should be re-designated under the Bill rather than automatically treating them as designated under the Bill to ensure consistency in the approach for such systems and other FMIs that may be designated under the Bill.

2 Linkages to phase 2 of the Review of the Reserve Bank of New Zealand Act 1989

2.1 The exposure draft of the FMI Bill has been materially delayed significantly and there appears to be some challenges meeting the objective introducing the FMI Bill in the second half of 2019 given the consultation process will not finish until the end of the third quarter.

2.2 Given these delays it would seem appropriate to coordinate activities across the FMI review and Phase 2 of the RBNZ Act. This should include a review of this Bill, in parallel with changes being made to the rest of the RBNZ Act through the consultation process "Safeguarding the future of our financial system" being run by Treasury. For example, the policy objectives of the RBNZ may alter as a result of the RBNZ Act Phase 2 review which may impact the FMI Bill (potentially requiring subsequent amendment).

2.3 The RBNZ acknowledges the FMI Bill may need to be amended shortly after introduction to address changes necessary to align it with a new RBNZ Act. Given it is potentially less than 6 months between the proposed introduction of the FMI Bill and the introduction of a new RBNZ Act, the fact that the RBNZ has indicated it could take it up to 12 months to decide which systems to designate and that consultation has been continuing for over 6 years, there would seem to be a good case for aligning the timing of the FMI Bill with the proposed new RBNZ Act (i.e. delaying it for 6 months).

3 Part 1 Preliminary provisions and regulator

3.1 Section 3 sets out the purposes of the Bill. In our view the use of the word “avoid” in subsection (b) may be misplaced, as the Bill alone could not *avoid* significant damage to the financial system that could result from problems with an FMI, an operator of an FMI, or a participant of an FMI. We would suggest that subsection (b) is redrafted so that this purpose is reframed as being to “mitigate” or “reduce the risk of” significant damage to the financial system that could result from problems with an FMI, an operator of an FMI, or a participant of an FMI.

3.2 In our view subsections (a) to (e) are appropriate to define “distressed” but (f) and (g) do not appear to be necessary because these describe the effect of disruption on participants i.e. an *outcome* of distress on the FMI on other parties. Accordingly, we recommend removing subsections (f) and (g) from the definition of “distressed”.

3.3 The definition of FMI appears to cover multilateral systems only. However, we consider that ‘bilateral systems' should also be included as some FMI infrastructures operate in this fashion. For example, SBI and HVCS are bilateral clearing, settlement and recording infrastructures. We recognise that the cover note suggests that RBNZ considers these

systems are potentially in scope yet the FMI definition, and therefore the Bill, as it is currently written, does not cover them. The Payments NZ SBI and High Value rules are multilateral rules and are potential candidates for designation.

3.4 Based on the information in the cover note and the Bill, and subject to RBNZ agreeing with our FMI definition commentary in 3.3, it is expected the following FMIs are candidates to be classified as systemically important and designated under the Bill, (noting a), b), c) and f) are already designated under current provisions of RBNZ Act):

a) ESAS - a bilateral settlement system, operator RBNZ, multilateral rules RBNZ

b) NZ Clear - a bilateral system, operator RBNZ, multilateral rules RBNZ

c) CLS - a bilateral system, operator SWIFT, multilateral rules CLS

d) SBI - a bilateral system, operator SWIFT, closed user group administrator Payments NZ, multilateral rules PNZ

e) HVCS - a bilateral system, operator SWIFT, closed user group administrator RBNZ, multilateral rules PNZ

f) NZCDC - NZX's bilateral settlement system, operator NZX, multilateral rules NZX

3.5 BNZ supports the 5 types of FMI listed i.e. a payment system, a central securities depository, a securities settlement system, a central counterparty, and trade repository. However, it is not clear from the documentation what research has been done to compare the proposed Bill with legislation from other countries to ensure differences and complexities between each FMI type (particularly payment system against the others) are understood and therefore treated appropriately. For example, we understand that both Australia and the UK clearly distinguish between the regulation of clearing and settlement FMIs and payment systems with the latter having a less complicated regulatory model compared to other FMIs. In contrast, the Bill appears to apply a broad-brush approach to this which could result in inadequate protection, or unnecessarily excessive protection depending on the type of FMI involved.

3.6 It is unclear why the Bill needs to cover indirect participants and how the Bill will impact them - they have commercial contracts with Participants of FMIs for the provision of clearing and settlement services.

3.7 Section 10 – provides "If a designated FMI is a "pure payments system", the regulator's functions must be carried out by the RBNZ. There is no definition of "pure payment system" and we consider that it would be useful to include such a definition.

4 Part 2 Regulator's powers

4.1 BNZ supports the introduction of section 14 and the requirement to provide the Regulator with information, reviews and independent reports. We note however, that the Bill is silent on timeframes to respond by, and expect that, depending on type of request, this will be mutually agreed between the parties.

5 Part 3 Designated FMIs

5.1 In subsection (f) of section 23 (Matters to which regulator may have regard for purposes of recommendations) BNZ recommends the addition of the word "systemic" ahead of “importance” to better focus the intent of (f) which is linked to clause 27.

5.2 In relation to section 24: (Matters which regulator must take into account for purposes of deciding if FMI is systemically important) BNZ has the following observations/queries:

(a) in subsection (a), what are the “size” measures that determine if an FMI is systemically important? Is it based on level of balance sheet liabilities, volume and\or value of payments, or a combination of measures?

(c) in subsection (d), the way in which, and the extent to which, financial risks are concentrated within the FMI – the criteria for “financial risks” are missing. Does this mean balance sheet solvency risk, overweight in certain liabilities, liquidity risk etc?

(d) in subsection (e), were activities under the FMI to be disrupted, whether another FMI could promptly and effectively take it over – this suggests that if the FMI was disrupted, and another FMI could take it over, it meets one of the criteria to be designated and this would only be considered after disruption has occurred. If this is the intent of this subsection it may require redrafting to make this clear.

5.3 In section 26 (Process where regulator makes recommendation on own initiative) BNZ submits that, in addition to the regulator notifying the operator of the FMI of the proposal and of the reasons for the proposal, the regulator should also notify the participants of the proposal and allow them to make submissions.

5.4 Section 27 (Meaning of systemically important) potentially conflicts in some respects with clause 24. In our view, the meaning of systemically important is not drafted with sufficient clarity. BNZ submits that the Bill would benefit from clearer criteria and greater certainty about how an FMI is described and classified as systemically important.

5.5 BNZ supports the requirement of section 36 that operators of designated FMIs must publish a copy of rules. However, in our view the Bill should allow flexibility for the operator to mutually agree with the regulator what content should be released including the form of that content. This is because rules can be very technical, operational, and complex for the general public to understand. In addition, publishing them in their original form may also create risks such as cyber-security, fraud, intellectual property, and competitive disadvantage.

5.6 Furthermore, in relation to section 36, where (a) rules span multiple payment clearing systems such as the SBI Rules (e.g. 20% cover clearing and settlement, 80% products such as electronic credits & debits), and (b) only certain rules are designated, it is likely the full set of the Rules and Procedures will need to be significantly rewritten or two versions maintained (operator and public).

5.7 BNZ submits that the prescriptive approach to rules of designated FMIs set out in Subpart 3 of the Bill could be extremely challenging in practice and may create significant inefficiencies. We suggest sections 38 -45 are removed from the Bill or redrafted to align with the current process i.e. rules can be changed by operators but are subject to formal approval by the regulator. We are comfortable with the Regulator having a backup power to issue a direction if the regulator has reasonable grounds for being concerned about delays in implementing rule changes. If this approach is not acceptable, we suggest the following amendments:

(a) Inclusion of a provision in section 39 that compels the regulator to mutually agree with the operator on a response timeframe. Response timeframes may vary depending on whether the requested change is minor or major. However, operators do need some certainty about when they can expect to be able to move forward (or not) with a proposed change. Alternatively, we suggest including a requirement to obtain regulator approval only where changes to the rules are deemed major and that only regulator notice is required where the proposed changes are minor/immaterial. PNZ for example, makes many changes to its rules on a regular basis, from minor through to major and waiting for regulatory approval for minor changes is likely to be inefficient for both parties.

(b) Deletion of the requirement that the operator must apply a rule change within 40 working days after receipt of notice from the regulator. Having a timeframe enshrined in legislation is too prescriptive and while some simple changes could be implemented within 40 days, complex rule changes usually take much longer to work through and implement. Rule changes imposed on an operator will require detailed analysis by the operator and its participants to ensure the rule changes are relevant, appropriate, operationally achievable. Many rule changes are complex, necessitating a lot of industry assessment and feedback, and long lead times to implement when technology changes are required. The Bill should allow the regulator sufficient time to engage the operator, and to mutually agree a timeframe with the operator to review proposed rule changes with participants and other stakeholders including time to implement.

Currently, for example, rule changes at PNZ go through a predetermined process before the PNZ board signs them off for implementation 40 days later or longer by exception where changes require participants to invest in technology changes. If PNZ were unable to extend the timeframe for implementing a material change to the rules, the reality is participants would be in breach of the Bill.

5.8 In section 42 (Regulator's decision to not approve rule change required under section 40) – the cross reference is incorrect, and it should be 39 not 40.

5.9 In section 47 (Designated FMIs to have FMI contingency plans) subsection (1)(b) we consider that you could add the word "tested" after "reviewed" to strengthen the clause.

6 Part 4 Dealing with systemically important FMIs that are distressed, etc

6.1 RBNZ has requested specific feedback as to whether the 24-hour period in section 55(3)(a) should be extended in certain circumstances (and if so, for how long) and

whether this is just an issue for central counterparties clearing derivatives (so circumstances in which a period longer than 24 hours should be provided for should align with the circumstances in which the stay in clause 116 currently applies).

6.2 BNZ submits the 24-hour timeframe remains appropriate to determine if a participant has become subject to an insolvency event. However, it is equally important to note that as soon as a statutory manager is appointed to manage a participant put into statutory management, FMI operators ***immediately*** suspend the participant on instruction from the Payments NZ board or the RBNZ. BNZ does not consider that this is just an issue for central counterparties clearing derivatives but that it is a concern for all FMIs in the financial system.

6.3 BNZ submits sections 83-85 provide the regulator with an unfettered power of direction that may conflict with New Zealand corporate law and we would recommend that these sections are redrafted to require the regulator to consult with the shareholder(s) prior to appointing or removing directors.

6.4 In section 85 (How power to remove director is exercised) subsection (1) (b) the word "appointed" should be replaced with "removed".

7 Part 5 Offences and pecuniary penalties

7.1 RBNZ has specifically requested feedback on whether any of the criminal offences in the Bill would be better replaced by pecuniary penalties. In our view the Bill's approach of introducing criminal sanctions for directors and body corporates who act in breach of the FMI Bill are disproportionate and pecuniary penalties are more appropriate way of incentivising the right outcomes.

7.2 Our concerns with the introduction of criminal sanctions include:

a) Given directors do not currently have such criminal liability exposure, directors may be discouraged from continuing in their roles resulting in a loss of subject matter experts or professionals working in or with an FMI or operator. This is likely to create difficulties in attracting the right people to fulfil these roles.

b) This issue is exacerbated by the fact that it is highly unlikely that directors and officers' liability insurance would cover criminal liability, and also that the Bill disallows a director's employer (BNZ in our case) from compensating the director if he/she were penalised under the Bill.

c) There is no evidence that introducing criminal penalties is justified for FMIs. BNZ observation is that body corporates and directors of FMIs currently operate in accordance with strict legal documentation such as constitution, charters etc, which is subject to audit or assurance review and overseen by internal and external legal experts.

d) Criminal penalties may stifle FMI innovation as people could adopt a very conservative approach to avoid any perceived risks. This may not be a useful

disincentive tool when the Minister is trying to encourage innovation in the payments market place.

e) We assume Part 5 excludes officers (management) of the FMI and participant appointed officers acting in the best interests of the operator sitting on operator committees that manage multilateral rules and contribute to development of future initiatives of the operator. This exclusion may need to be made explicit in the Bill. If the intention is to bring these parties within the ambit of Part 5, points made under a) to d) apply.

7.3 Part 5 Subpart 3 – Supplementary provisions – section 128 Liability of directors. The director liability clauses go significantly further than the current liability regime for bank/shareholder appointed directors in an FMI. Further, we do not believe it is appropriate for directors to be exposed to criminal offences or pecuniary penalties in addition to the operator's exposure. We believe this clause (128) is not necessary and should be removed.

7.4 BNZ notes the relatively high standards set in relation to criminal sanctions in the Bill and is mindful of the potential for significant harm to be caused to customers where there is an FMI failure. As a rule, however, BNZ submits that criminal sanctions should be the preserve of knowing and egregious misconduct and the consent and knowledge thresholds in the Bill may be seen as being well below that. There are strong precedents for liability to the sheeted back to an entity in order to deliver the right outcomes (e.g. AML/ CFT legislation) and BNZ submits this should be adopted in this case. We note, in support of this, the regulator's powers to remove directors who it believes have failed to meet the required standards.