RESERVE BANK
OF NEW ZEALAND
TE PŪTEA MATUA

Consultation Document: Oversight of Designated Financial Market Infrastructures

The Reserve Bank invites submissions on this consultation document by 3 July 2015.

Submissions and enquiries should be addressed to:

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Please note a summary of the submissions may be published. If you consider that any part of your submissions should properly be withheld on the grounds of commercial sensitivity or for any other reason, you should indicate this clearly.

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SECTION ONE: INTRODUCTION

The Reserve Bank has a key interest in the soundness and efficiency of financial market infrastructures (FMIs), such as payment and settlement systems, in New Zealand. FMIs are essential to the functioning of the New Zealand financial system and economy, and are therefore highly relevant for the Reserve Bank's core responsibilities arising from its financial stability objective.

In 2013, the Reserve Bank publicly consulted on its assessment of the existing statutory payments oversight framework, and a proposal to enhance that framework by establishing a Recognition Regime for systemically important FMIs[1].

Most submitters agreed that there was a case for the Reserve Bank to strengthen the current framework, and there was general agreement that the focus of the new regime should be on FMIs that were of systemic importance. In addition, some submitters suggested that the scope for the new framework could be wider, to also include domestically important payment systems that might not meet the criteria of systemic importance[2].

After the initial consultation, the Reserve Bank concluded that there were merits in the extension of the regime to cover domestically important FMIs, or FMIs of system-wide importance. The view was based on the heavy reliance within New Zealand on some of the retail payment systems, and the potential for widespread disruption if the operation of such payment systems were to fail.

Subsequently the Reserve Bank has continued to engage with a wide range of stakeholders and market participants. The Reserve Bank also collected and analysed additional information from a number of domestic payment system providers, including those that could be considered domestically important. The Reserve Bank concluded that these FMIs do not need to be captured by the strengthened oversight regime, because of the diversity of the retail payment systems in New Zealand and the availability of substitutes. They will continue to be monitored by the Reserve Bank as part of its landscape scanning. Should any domestically important payment systems evolve to the point where they meet the criteria of systemic importance, the extent of oversight upon them would be reconsidered.

The Reserve Bank's foremost regulatory concern in the FMI sector is to ensure that large wholesale payment systems and other FMIs that give rise to systemic risks are operated in a sound and efficient manner, and positioned to enable the most efficient possible resolution if they fail. This is consistent with the *Principles for Financial Market Infrastructures* (PFMIs)[3], the international best practice published by the Committee on Payments and Market Infrastructures (CPMI) and the Technical Committee of the International Organisation of Securities Commissions.

Another aspect of the 2013 consultation was the proposed establishment of a new Recognition Regime to run parallel to the existing Designation Regime, to separate oversight from legal certainty for netting and settlement. An alternative option of modifying the existing Designation Regime was also discussed in the consultation document.

The Reserve Bank is now of the view that the alternative option of modifying the existing Designation Regime would be preferable, as it would avoid the complexity of running two regimes. This approach would not hinder the effectiveness of the proposed regime and would provide a better alignment with many overseas jurisdictions' FMI framework.

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[1] http://www.rbnz.govt.nz/regulation_and_supervision/payment_system_oversight/5195423.pdf
[2] For more details on the submissions and the Reserve Bank's response, please see http://www.rbnz.govt.nz/regulation_and_supervision/payment_system_oversight/5476599.pdf
[3] http://www.bis.org/cpmi/publ/d101a.pdf

Overall, the revised proposal to modify the existing Designation Regime with a focus on systemically important FMIs represents a simpler statutory framework for FMI oversight that is consistent with the Reserve Bank's risk-based supervisory approach.

In summary, the Reserve Bank is proposing certain changes to the existing Designation Regime to improve the oversight of systemically important FMIs and in particular, to provide the Reserve Bank and the Financial Markets Authority (FMA) with powers to effectively manage crises involving such entities. This consultation paper is intended to provide more details on the proposed new Designation Regime, explaining the scope of the proposed framework, the criteria for designation, and broadly how the Reserve Bank and FMA would conduct oversight of designated FMIs.

Question 1: Do you agree with the Reserve Bank's proposed scope for the new oversight regime focusing on systemically important FMIs only? If not, please provide more details.

Question 2: Do you have any views on the Reserve Bank's proposal to strengthen the FMI oversight framework via modifying the existing Designation Regime? If so, please provide more details.

SECTION TWO: OBJECTIVES AND PURPOSES OF FMI OVERSIGHT

It is expected that modified Parts 5B and 5C of the Reserve Bank of New Zealand Act 1989, or a new Financial Market Infrastructure Oversight Act (replacing both Parts 5B and 5C), would provide the statutory backing to the Reserve Bank and FMA's role in FMI oversight. The objectives of this modified regime would be to:

- promote the maintenance of a sound and efficient financial system;
- avoid significant damage to the financial system that could result from the failure of a financial market infrastructure or the failure of a participant in a financial market infrastructure;[4]
- promote the integrity and effectiveness of financial market infrastructures and related markets in New Zealand; and
- enhance the confidence of investors and other market participants in financial market infrastructures and related markets in New Zealand.

Under the modified regime, the Reserve Bank would have to exercise its powers for the purpose of the first two of these objectives, and the FMA would be required to exercise its powers for the second two of these objectives. We note that these objectives are also closely based upon the Reserve Bank's and FMA's current purposes for carrying out oversight under Part 5B and Part 5C of the Reserve Bank of New Zealand Act 1989.

Furthermore, the proposed changes to the Designation Regime would broaden the regime to improve the oversight of those systemically important FMIs that are crucial to financial stability in New Zealand. FMIs that are systemically important can either be a channel for contagion through which risks are transferred amongst system participants, or they themselves can become the source of risks. It is therefore important that these FMIs are sound and efficient on a business-as-usual basis, and even more so during times of stress. The current Designation Regime, which is voluntary, provides limited scope for the joint

[4] Section 156K of the Reserve Bank of New Zealand Act 1989 states that the exercise of powers must be for the purposes of: a) promoting the maintenance of a sound and efficient financial system; and b) avoiding significant damage to the financial system that could result from the failure of a participant in a settlement system.

regulators to oversee all systemically important payment and settlement systems. It does not cover all types of FMIs and the joint regulators do not have any crisis management powers. The enhanced Designation Regime would give the Reserve Bank and FMA a more comprehensive set of statutory tools to support their oversight of FMIs and the objectives that oversight seeks to achieve.

Question 3: Do you agree with the proposed objectives of the revised regime? If not, please provide more details.

SECTION THREE: OVERVIEW OF THE ENHANCED DESIGNATION REGIME

The proposed new legislation would deal with the oversight of designated FMIs. It would give the Reserve Bank and FMA the ability to recommend to the Government that systemically important FMIs be designated. Once designated, these FMIs would be subject to formal oversight by the Reserve Bank and FMA, including standards imposed on them. While the Reserve Bank and FMA would also be jointly responsible for the oversight of non-systemically important FMIs in New Zealand, the focus of this paper is on those that are systemically important and designated under the proposed new Designation Regime.

For the rest of the paper, when referring to carrying out oversight duties or exercising oversight powers, both the Reserve Bank and FMA are expected to act jointly, unless the FMI is a payment system only, in which case the Reserve Bank would continue to be the sole regulator.

3.1 Requiring Designation of FMIs

An "FMI" is *a multilateral system among participating institutions, including the operator of the system, used for the purposes of clearing, settling, or recording payments, securities, derivatives or other financial transactions. An FMI includes a payment system, securities settlement system, central securities depository, central counterparty, and trade repository.*

Virtually all financial transactions are cleared, settled and recorded through FMIs. FMIs allow consumers and firms to safely and efficiently purchase goods and services, make financial investments, and transfer funds. FMIs are a broad set of entities that can differ significantly in organisation, function and design. They include:

- payment systems, which are systems or arrangements for: 1) the clearing or settlement of payment obligation or the processing of payment instructions; and 2) include any instruments, rules, and procedures that are related to the matters referred in 1);[5]
- securities settlement systems, which facilitate the transfer and/or settlement of securities and other financial assets according to the rules of the system;
- central securities depositories (CSDs), which provide securities accounts, central safekeeping and asset services;
- central counterparties (CCPs), which become the buyer to every seller and seller to every buyer of a financial contract to ensure that, even if a buyer or a seller fails to meet its obligation to the CCP, obligations will be met on all contracts; and
- trade repositories, which maintain centralised electronic databases of transaction data.

[5] See Section 2 of the Reserve Bank of New Zealand Act 1989

FMIs are, in essence, sets of system rules, procedures, and operational arrangements for managing, allocating and mitigating risks arising from transactions between their participants, and therefore cover participants, operators, governance structure and payment instruments.

The regime would require FMIs that are considered to be systemically important be designated. An FMI is of systemic importance if disruption within it will have the potential to trigger or transmit systemic disruptions across the financial system. Whether or not an FMI meets this criterion would determine whether or not the Reserve Bank and FMA would recommend that it be designated.

Designation Notices would be in the form of an Order in Council, and provide details on the operational arrangements of the FMI. The regulators would be required to consult with relevant stakeholders before recommending designation. The Order in Council would be made by the Governor-General, on the advice of the Ministers of Finance and Commerce, given in accordance with the recommendations of the Reserve Bank and FMA.

The legislation would also specify the matters the Reserve Bank and FMA would need to consider in recommending that the FMI be designated. The key factors for identifying when an FMI would be systemically important include:

- *The size, degree of market penetration and concentration of financial risks within the FMI*. The value of transactions settled in the system in aggregate and/or individually provides an indication of the size of those risks. FMIs that settle large value transactions such as wholesale systems are generally classified as systemically important, because of the greater credit and liquidity risk exposures likely to be associated with the larger value transactions;

- *The role of the FMI and the nature of the transactions processed*. Where an FMI is used to settle payments of other systems or to settle financial market transactions, that FMI is likely to be systemically important. Infrastructure such as central securities depositories, central counterparties and trade repositories, because of their central role in the operation of key financial markets, will also generally be systemically important;

- *The degree of substitutability*. The systemic importance of a particular FMI will, all other things equal, be reduced where its critical services are substitutable and readily available elsewhere in the market;

- *Interdependencies with other FMIs or markets.* The greater the interdependencies, the greater the potential for a problem in one FMI to affect other FMIs. Interdependencies may be system-based (direct linkages between systems), institution-based (common participants or an institution that provides services to two or more systems) and environmental (broader, less direct factors like reliance on a common service provider).

The Reserve Bank and FMA would have the ability to also consider other factors that are relevant for the purpose of maintaining soundness and efficiency of the financial system in New Zealand.

Based on the above key indicators of systemic importance, the Reserve Bank's preliminary assessment is that there are six domestic FMIs that might be of systemic importance (with four of them already designated), and three offshore FMIs that could be of systemic importance to New Zealand. They are:

1. The Exchange Settlement Account System (ESAS), operated by the Reserve Bank, is the real time large value inter-bank payment system, processing on average around $30 billion of payments each day. The sound and efficient operation of the money and capital markets hinges upon the smooth functioning of ESAS. The safe and efficient operation of ESAS has a bearing not only on the markets it directly serves but on New Zealand's whole financial system. ESAS is used to settle payments associated with, or originating in, a number of other systems, such as the retail payment system SBI. ESAS also has an important role to play in the settlement of foreign exchange transactions in the CLS system. The smooth operation of that system relies on the ability to make and receive payments in all currencies settled in CLS including the New Zealand dollar.

2. The CLS system is a global high value inter-bank payment system used to settle foreign exchange transactions involving 17 currencies including the New Zealand dollar. Settlement in CLS allows both currency legs to be settled simultaneously. The foreign exchange market is a key financial market in New Zealand. Disruption to the CLS system could re-introduce significant foreign exchange settlement risk to the New Zealand financial system.

3. NZClear, operated by the Reserve Bank, is a securities settlement system that is used to settle fixed interest and equity transactions and cash transfers, with an average total value of around $7 billion a day. It includes a central securities depository that represents a critical record of the beneficial ownership of a substantial proportion of NZD securities. Any disruption to NZClear could have a significant impact on securities markets. NZClear also provides contingency arrangements for SBI to allow the continued exchange of retail payments in the event that SBI participants are unable to exchange payment instructions using SWIFT. Both NZClear and ESAS are important for the implementation of monetary policy.

4. The NZCDC settlement system includes a securities settlement system, securities depository and central counterparty and performs a key role for all NZX markets. NZX is the only registered exchange in New Zealand and operates both securities and derivatives markets.

5. The Settlement Before Interchange (SBI) arrangements for retail payments are operated by Payments NZ. SBI is used by banks to exchange retail payments, processing on average close to $3 billion of payments each day. The net inter-bank positions settle in ESAS.

6. Paymark is a network for processing point of sale debit and credit card transactions in New Zealand. It provides switching services for the majority of point of sale transactions, processing on average around $140 million of transactions daily.

7. LCH Clearnet Ltd (LCH) is the largest Interest Rate Swap central counterparty (CCP) in the world. Following the financial crisis and associated regulatory reform, the largest four New Zealand banks are now clearing a substantial and increasing amount of their trades in NZD-denominated Interest Rate Swaps through LCH's Swapclear service. As of December 2014, Swapclear's total NZD outstanding was NZD $3.2 trillion, representing about 76% of the NZD Interest Rate Swap market.

8. ASX Clear (Futures) is a CCP that clears NZD interest rate futures, including 90 Day Bank Bill Futures, 3 year and 10 year Government Bonds, and NZ energy futures and options traded on the ASX 24 market.

9. DTCC Singapore is a trade repository that major banks are reporting OTC derivative transactions to under the Australian reporting rules.

This list represents a preliminary assessment by the Reserve Bank. Should the proposed regime be implemented, the Reserve Bank and FMA would conduct a thorough analysis of each of these FMIs, including consulting with the relevant stakeholders, before making a recommendation on whether they should be designated.

Designation would not mean that the Reserve Bank, FMA or Crown endorse the FMI or its participants. Neither would designation indicate that an FMI would receive financial support of any kind by the government in the event of its distress. When a designated FMI is no longer considered to have systemic importance, the regime would allow for the FMI's designation to be revoked.

Question 4: Do you agree with the proposed definition of financial market infrastructures (FMIs)? If not, please provide more details.

Question 5: Are there any additional factors that the Reserve Bank and FMA should take into account when making an assessment of systemic importance of an FMI? If so, what are those factors?

3.2 Settlement systems voluntarily opting in for designation

Operators of settlement systems that are not considered systemically important by the regulators would still be able to seek designation for legal protection to the netting and settlement of their transactions if they considered the benefits would outweigh the costs. Once designated, the settlement systems would be subject to applicable standards. The benefits of designation to a settlement system include the following:

1) The rules of the system are valid and enforceable despite any enactment or rule of law to the contrary, subject to the rules of the system providing for certain essential matters

2) Settlements effected in accordance with the rules of the system cannot be reversed or set aside, irrespective of any enactment or rule of law to the contrary;[6]

3) Netting effected in accordance with the rules of the system is valid and enforceable despite any enactment of rule of law to the contrary

4) Transfer of property effected in accordance with the rules of the system cannot be refused on the grounds that the transfer was not effective; and

5) Section 103A of the Personal Property Securities Act may apply, giving that operator a "super priority" on collateral posted by a defaulting participant.

3.3 Process for Designation and Revoking Designation

The Reserve Bank and FMA would be able to recommend that an FMI be designated whether it operates in New Zealand or has direct or indirect participants in New Zealand. The process of designation would be able to be initiated by the regulator(s) or the operator(s) of the FMI.

Before recommending designation, the regulators would be obligated to consult with the operator(s) of the FMI that is being considered for designation.

[6] This is subject to an exception in a limited range of circumstances where a participant is subject to an insolvency event (section 156S of the Reserve Bank of New Zealand Act 1989).

The regulators would be required to have regard to any submissions of affected stakeholders. Before recommending designation, the Reserve Bank and FMA would need to be satisfied that the FMI has systemic importance in the New Zealand financial system.

The regulators would jointly consider whether designation would be appropriate, and would need to take into account the factors that are detailed in Section 3.1, which would be specified in the legislation.

In considering whether or not to recommend designation, the joint regulators would need to determine whether the FMI is a payment system or not. If the FMI is a payment system the regulators would still jointly consider designation, but the ongoing oversight of the FMI would lie solely with the Reserve Bank.

If the joint regulators consider the FMI meets the criteria for designation, they would make a joint recommendation to the Ministers of Finance and Commerce, who would advise the Governor-General that an Order in Council be made. The Reserve Bank and FMA would then inform the operator(s) of the FMI of the decision.

The designation notice for an FMI would specify, in as much detail as is reasonably practicable:

- the arrangements that constitute the FMI, including whether the FMI is a payment system;
- the operator(s) of the FMI, the contact person within the operator(s), including whether the operator is a participant and whether an operator is an operator to which section 103A of the Personal Property Securities Act applies; and
- the specific documents that constitute the rules of that FMI.

For these purposes:

- “Operator” would be defined as any persons who are legally responsible for carrying out or managing the services provided by the FMI, and maintaining and administering the rules of the FMI. For the avoidance of doubt, an operator could also be the owner of an FMI, or a participant.

- “Rules” would be defined as bylaws, agreements, procedures, contracts or other documents that provide the basis for how clearing, settling, or recording payments, securities, derivatives or other financial transactions are effected, and include the FMI’s system design, operations, rights and obligations of participants, risks of participation and how risks are addressed and mitigated.

The joint regulators would also have the ability to recommend revocation of a designation notice, when the designated FMI is no longer systemically important. The joint regulators would be able to consider requests from operator(s) of the designated FMI itself to revoke the designation notice.

The process for revoking a designation would be the same as that for designation: before recommending that designation be revoked, the joint regulators would need to consult each other, notify the operator(s) of the designated FMI, and consider any representations made to them. The Order in Council that originally designated the FMI would be repealed by another Order in Council made in the same way.

Question 6: Do you have any comments about the proposed process for Designation and revoking Designation? If so, please provide more details.

SECTION FOUR: OVERSIGHT OF DESIGNATED FMIs

4.1 Matters to be considered before exercising oversight powers

Generally speaking, when exercising any of the proposed oversight powers for designated FMIs, the Reserve Bank and FMA would take into consideration the following matters:

- The existence of any relevant international co-operative oversight arrangements;
- Avoiding duplication of requirements;
- Minimising compliance costs;
- The desirability of industry-led solutions;
- Maintaining competitive neutrality.

These matters would either be specified in the legislation or statements of principles.

4.2 Information request

The regime would provide joint regulators with the power to require information be provided from the operator of an FMI, a participant in an FMI,[7] or an infrastructure provider of an FMI. This power could be exercised where joint regulators reasonably believe that this would be necessary or desirable to perform their functions and duties, or carry out their powers, under the legislation.

This power would allow joint regulators to seek information relating to an FMI's technical infrastructure, such as operational arrangements, software, data, as well as wider aspects such as rules, governance arrangements and critical participants. It would also allow joint regulators to obtain information about FMI's service providers, including their roles, relationships with FMIs, and the general business they undertake.

Information sought when using this power could be qualitative or quantitative in nature, and may be required to be provided on a one-off or periodic basis. Persons who are required to provide information would be given a date by which the information had to be provided (taking into account how long it should reasonably take to compile the information, and the urgency of the requirement to provide the information).

Any information obtained by the regulators in the exercise of their functions or powers under the regime would be subject to confidentiality provisions equivalent to those currently contained in sections 156G and 156H of the Reserve Bank of the New Zealand Act 1989.

In addition, it is important to note that this power could also be used to obtain information from the operators, participants and infrastructure providers of FMIs that are not designated, where the Reserve Bank and FMA have reasonable grounds to believe that this is necessary to fulfil the objectives of the modified designation regime.[8] This aligns with the scope of the current information gathering power in Part 5B of the Reserve Bank of New Zealand Act 1989, and allows the Reserve Bank and FMA to:

- carry out oversight of the broader FMI sector; and
- seek information relating to non-designated FMIs in order to determine whether they are systemically important and should be designated as a result.

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[7] For these purposes "participant" would be defined as "a person that participates in the FMI in accordance with the rules of that FMI, including those that contract such persons to act on their behalf". Participants include both direct participants (persons that hold membership with the FMI) and indirect participants (persons that contract a person to act as a direct participant on their behalf).

[8] See the objectives set out in page 3 of this paper.

This is the only regulatory power in the proposed regime that could be exercised in relation to non-designated FMIs (except the power to designate a non-designated FMI in the first place).

4.3 Prescribing standards

The Reserve Bank and FMA would set minimum standards for designated FMIs to enhance their soundness and efficiency, and to limit systemic risk and foster transparency and financial stability. These standards could apply to individual FMIs, classes of FMIs, or all FMIs.

We propose that the following procedural safeguards apply to the making of standards:

- Standards would only be able to relate to certain matters prescribed in legislation;
- Before making, amending or revoking a standard, joint regulators would be required to consult with affected entities, and take into account submissions received;
- Standards would be legislative instruments for the purposes of the Legislation Act 2012, which means that they would be subject to scrutiny by the Regulations Review Committee[9] and could be disallowed by Parliament;
- Joint regulators would be required to notify standards in the Gazette, make standards publicly available, and make standards available for purchase at a reasonable price on request; and
- Joint regulators would be required to assess the regulatory impacts associated with applying particular standards to newly designated FMIs, making new standards, or amending standards that are already in place (unless the amendment to the standard was of a minor or technical nature).

The table below sets out the matters that standards could relate to and provides an indication of the types of standards that might be imposed.

Matters set out in legislation that standards may relate to	**Standards that might be imposed**
The governance of the FMI	Operators are likely to be required to ensure that their FMIs have clear and transparent governance arrangements that promote the soundness and efficiency of the FMI, and support the stability of the broader financial system. There may also be specific governance requirements for operators, such as a minimum number of independent directors and fit and proper requirements for directors and senior management (subject to the organisational form of the operator).
Risk management of the FMI	Operators are likely to be required to have a sound risk-management framework for comprehensively managing legal, credit, liquidity, operational and other risks associated with their FMIs. For example, the operators are likely to be required to comply with capital and liquidity requirements, if relevant.

[9] The Regulations Review Committee is a standing Parliamentary Select Committee that is responsible for scrutinising regulations to ensure, amongst other things, that they are not inconsistent with the objectives and principles of the legislation under which they are made, or otherwise used for a legally inappropriate purpose.

The systems and processes used to deal with the failure of a participant and its own failure	Operators are likely to be required to have appropriate mechanisms in place to minimise disruptions associated with the failure of one or more of their FMI's participants. An operator would be required to ensure that its FMI would also be required to have appropriate processes, recovery and resolution plans in place to manage its financial, governance or operational failure.
The reliability, resilience and responsiveness of the FMI	Operators would be required to ensure that their FMIs are able to continue to provide core services in all circumstances. For example, operators are likely to be required to have a business continuity plan. They may also be subject to requirements designed to ensure that their FMIs are responsive to customer/market needs.
Access to services provided by the FMI	Operators are likely to be required to ensure that their FMIs have objective, risk-based, and publicly disclosed criteria for participation, which promote fair and open access with no unwarranted barriers to entry.
Reporting to regulators and public disclosure relating to the FMI	Operators are likely to be required to regularly provide information on their FMIs, as specified or approved by the joint regulators and in accordance with timing and form specified or approved by joint regulators, to joint regulators and other stakeholders as determined by the joint regulators. Generally, this periodic reporting and disclosure is expected to be in three forms: • An annual report on the FMI, to be delivered to the joint regulators and published within 3 months of the operator's balance date; • Disclosure in accordance with international standards. The current relevant international standards are the *Disclosure Framework and Assessment Methodology*[10] issued by CPMI and IOSCO. Operators should publish disclosures based on the *Disclosure Framework* at least every 3 years; • A self-assessment against international standards to be provided to the joint regulators every three years or more frequently if there is a material change to the designated FMI or its environment. Operators are also likely to be required to, as soon as reasonably possible: • notify the joint regulators of certain major events, including change of its senior management, material changes to risk management of their FMIs, material change to the core business of their FMIs, and proposed change to the operator or ownership of their FMIs; • notify the joint regulators of any outages or material incidents involving the FMIs.

[10] http://www.bis.org/cpmi/publ/d106.htm

In respect of settlement systems, settlement finality	Operators are likely to be required to ensure that the rules of their settlement systems provide clear and certain final settlement for transactions effected through those systems.

Some designated FMIs may outsource certain core technical infrastructure services, for example (but not limited to) message switching and data processing, to third parties. These FMIs are therefore relying on the continuous and adequate functioning of these infrastructure providers. The Reserve Bank and FMA may require such designated FMIs to address certain matters in their contractual arrangements with their infrastructure providers.

This approach differs from the 2013 consultation, where the Reserve Bank proposed that such technical infrastructure providers be designated separately. Following further engagements with market participants, the Reserve Bank considers that a lighter oversight approach for these entities would be more appropriate, given the indirect risks they generate for designated FMIs. Such an approach would also be more consistent with international best practice (such as the *PFMIs*), and the Reserve Bank's outsourcing policy in bank supervision.

Question 7: Do you have any views on the proposed process for setting standards, and the proposed matters that standards may relate to? If so, please provide more details.

Question 8: Do you agree with the proposal to oversee core technical infrastructure providers via their contractual arrangements with designated FMIs? If not, please elaborate further.

4.4 FMI rules supervision

An FMI's rules are likely to be one of the most important aspects of how it operates, as they usually set out a common platform and procedures for participants, and identify areas that require risk management. FMI's rules are "*bylaws, agreements, procedures, contracts or other documents that provide the basis for how clearing, settling, or recording payments, securities, derivatives or other financial transactions are effected, and include the FMI's system design, operations, rights and obligations of participants, risks of participation and how risks are addressed and mitigated".*

An Order in Council declaring an FMI to be a designated FMI may specify those rules that are within the scope of the oversight – i.e. which rules the regulators may require to be amended and where the operators will be required to notify any proposed changes. For the purpose of this requirement, "the rules" could be the whole rule book of the FMI, only parts of it, or the rules plus certain procedures. This may differ for different FMIs.

Any proposed changes in the rules specified in the Order in Council would need to be notified to the Reserve Bank and FMA, and be subject to the disallowance process. In considering whether to disallow any rule changes, the joint regulators would have to take into account whether the rules would continue to adequately provide that the FMI complies with the standards applicable to it, and whether there would be any potential impact on the soundness and efficiency of the FMI from adopting the rule.

The joint regulators could also require a rule change or the establishment of a new rule if any gaps or deficiencies are identified in the existing FMI rules. We propose that this process would operate as follows:

- Where the Reserve Bank and FMA consider that it is necessary or desirable to achieve the objectives of the regime, they could request that an FMI prepare a draft

change to its rules on a specified matter. In making this request, they would indicate how long the FMI would have to prepare a draft rule change (but would have to provide the FMI with at least 20 working days);

- If the Reserve Bank and FMA were not satisfied that the draft rule change prepared by the FMI is sufficient to achieve the objectives of the regime, they could direct the FMI to make a specified change to its rules in relation to the specified matter. Before directing that a rule change be made, they would have to consult with the affected FMI. This kind of direction could also only be given with the consent of the Ministers of Finance and Commerce (as with the other kinds of directions discussed below in the context of crisis management powers).

Question 9: Do you have any comments about the proposed process for requiring that an existing rule be changed or a new rule be adopted? If so, please provide more details.

4.5 Investigation and Enforcement

Investigative powers

Joint regulators could use the information gathering power described above in section 4.2 for the purposes of investigating any actual or potential breaches of requirements. In addition, we propose that the legislation provide for two additional powers for investigative purposes: specifically, the power to require independent reports on designated FMIs, and the power to enter and search places with a warrant.

Using these powers, joint regulators could require the operator of an FMI to provide a report relating to any aspect of the FMI's business, operation or management, prepared by a person approved by joint regulators. We propose that this kind of report could only be required where joint regulators reasonably believe that this would be necessary or desirable to perform their functions and duties, or carry out their powers, under the Act.

Joint regulators would also be able to seek a warrant from the Court allowing them to enter any premises in order to obtain evidence in relation to the actual or potential commission of an offence, or which is necessary to determine whether to exercise any powers under the regime.

In applying to the Court for this kind of warrant, we propose that joint regulators would have to show that they have reasonable grounds to believe:

- That a person has, or may have, committed an offence under the legislation and that evidence relating to the actual or potential offence may be on the premises, or
- That there may be evidence on the premises that is necessary for joint regulators to have access to for the purposes of determining whether to exercise any powers conferred on joint regulators under the regime.

We anticipate that the relevant parts of the Search and Surveillance Act 2012 (which provides more detailed rules about obtaining a warrant and conducting a search of premises) would also apply in respect of this power.

Enforcement powers

We propose that the regime also provide for a graduated range of remedies, which would allow the regulators to respond more proportionately to breaches.

Where actual or potential breaches occur, the regulators currently have the ability to issue a public warning. This would be supplemented by the ability to enter into enforceable undertakings with parties who have failed to comply, or may have failed to comply, with their obligations under the regime.[11]

The regime would also provide for a range of criminal and civil remedies for breaches of requirements. As with the liability regime in the Financial Markets Conduct Act 2013:

- Reckless or intentional breaches of requirements would be criminal offences, carrying fines and/or terms of imprisonment equivalent to those applying under the prudential regime for registered banks; and
- Other breaches of requirements would result in civil pecuniary penalties with equivalent or smaller financial penalties.

Unlike criminal offences, civil pecuniary penalties do not result in a criminal conviction, and can only carry a financial penalty (rather than potentially a term of imprisonment). As such, they are likely to be more appropriate penalties for less morally culpable types of breaches.

4.6 Crisis management

The Reserve Bank and FMA would have a number of crisis management powers to prevent the systemic damage caused by disorderly failure of either a participant or the FMI itself.

1) FMI failure

In the event of an FMI failure, the focus of the Reserve Bank and FMA would be on the continuation of core services provided by the FMI. The Reserve Bank and FMA would exercise the crisis management powers in circumstances where:

- the operator is insolvent or is likely to become insolvent; or
- the affairs of the FMI are being conducted in a manner prejudicial to the soundness of the financial system; or
- the operator has acted fraudulently or recklessly; or
- the operator has been involved in serious or repeated breaches of its obligation under the Act

To carry out effective recovery or resolution of FMIs, the regulators would have extensive powers for intervention in the management and corporate structure of the FMI. These would include the power to:

- Issue a direction to an operator (with ministerial consent). The scope of directions would include requirements that the operator:
    - consult with the Reserve Bank/FMA immediately, and from time to time, about the circumstances of the operator and the methods of resolving any difficulties facing the operator or the FMI; or
    - carry on its function(s) or business, in accordance with the direction; or
    - cease to carry on its function(s) or business, in accordance with the direction; or
    - take the action that is specified in the direction to address a breach of any obligation that has been imposed; or

[11] An enforceable undertaking is a legally binding agreement between a regulator and regulated entity requiring the regulated entity to take certain agreed actions. Enforceable undertakings can also be enforced in the courts.

- take the action that is specified in the direction to address any circumstances of financial difficulties.

- Remove, replace or appoint a director of an operator (with ministerial consent)

- Appoint a statutory manager. The legislation would establish a tailored statutory management regime for operators of FMIs that could be invoked in order to ensure that the FMI continues to provide its critical services. The regime is expected to have the following basic features:

  - An operator may be placed into statutory management by an Order in Council made on the advice of the Ministers of Finance and Commerce given in accordance with recommendation of the Reserve Bank and FMA;
  - A moratorium may be placed on the liabilities of the operator, and the statutory manager would have the power to suspend or part pay the debts of the operator;
  - The statutory manager would take over the management of the operator;
  - The statutory manager would have the power to shift all or part of the operator's business relating to the FMI to a bridging institution, or sell some or all of that part of the business to a third party.

  In exercising the above powers, the statutory manager would need to consider the following matters, to be prescribed in the legislation:

  - The need to maintain public confidence in the operation and soundness of the financial system;
  - The need to avoid significant damage to the financial system;
  - the need to resolve as quickly as possible the difficulties of that FMI; and
  - the advice of the Reserve Bank and FMA, if applicable.

  In a statutory management situation, the objective would be the continuation of services provided by the FMI, rather than the continuation of the operator itself. For example, in some cases it may be possible to shift the part of the operator's business relating to the FMI to a bridging institution, and then remove the operator from statutory management and allow it to be liquidated in the normal manner.

2) Participant failure

A participant default on obligations arising in an FMI would typically be a result of a credit event that takes place outside the system; the system may then become the mechanism by which the loss is transmitted. How widely losses are transmitted depends on the FMI's design and the role the FMI plays in the financial system. The focus of dealing with a participant default is to limit the flow-on effect it could have on other participants, and ensure that the FMI's default rules do not hamper efforts to manage the failure of the participant.

For this reason, one of the grounds for issuing a direction would be where the participant of an FMI has failed and the Reserve Bank and FMA have reasonable grounds to believe that this raises a risk to the soundness of the financial system that cannot be adequately addressed through the rules of the FMI.

Question 10: Do you agree with the proposed crisis management powers? If not, please provide more details.

SECTION FIVE: COOPERATIVE OVERSIGHT WITH OVERSEAS AUTHORITIES

The proposed revised Designation Regime would apply to offshore FMIs that are of systemic importance to New Zealand's financial system. Establishing such a regulatory framework would, in the first instance, provide legislative backing to New Zealand regulators' interests in such FMIs. International FMIs, in general, are overseen by their home central bank or other relevant authority. The actual requirements and standards that New Zealand regulators would be able to then impose on such offshore FMIs would vary, depending on the type and level of home regulation to which they are already subject. In practice, the Reserve Bank would look to be involved in cooperative oversight arrangements with the home regulator to ensure that requirements on such FMIs would not be duplicated. While there might be limitations in the extent to which the New Zealand regulators could influence offshore FMIs, the proposed framework would at least provide New Zealand regulators a channel through which to engage with the home regulators. In the event of a crisis, this would facilitate New Zealand input to the management of such an event.

The Reserve Bank has had experience of operating as part of a co-operative arrangement for a systemically important FMI, having been part of such an arrangement for the CLS system since the NZD became eligible for settlement in that system in 2004. The Reserve Bank is committed to ensuring effective oversight via co-operation between both local authorities and authorities in different jurisdictions. The Reserve Bank continues to look to the key considerations in the PFMIs (*Cooperation with Other Authorities: Responsibility E)* in conducting its oversight, actively seeking input from and sharing information with interested relevant international authorities, to avoid gaps and duplication of activity and minimise the imposition of conflicting requirements.

Question 11: Do you agree that offshore FMIs should be included in the proposed revised Designation Regime? If not, please provide more details.

SECTION SIX: FINANCIAL IMPLICATIONS

The proposal in this consultation document would result in additional powers and responsibilities for the Reserve Bank and FMA, which may require additional resource for both agencies, once the legislation is passed. The additional resource would be required for preparing Designation Orders for both new and existing designated FMIs, and the on-going supervision of the designated entities. Currently a fee is charged for settlement systems that seek to be designated.

The Reserve Bank is currently considering options for funding the additional resource, including whether these costs could be absorbed by the Reserve Bank, or whether it should seek contribution from the industry. The FMA and the Ministry of Business, Innovation and Employment would also consider options for funding the additional resource.

The proposed regime would also likely to result in designated FMIs incurring additional costs, such as those in relation to the initial designation process and ongoing reporting obligations.

Question 12: Do you have any views on how the additional costs for the proposed revised Designation Regime could be funded? If so, please elaborate.

Question 13: Could you provide some details on the likely costs that a designated FMI would incur?

Comparison of the Existing and Proposed Regulatory Frameworks (asterisks indicate new proposed regulatory tools)