
Designation of payment systems – new Part VC of the Reserve Bank of New Zealand Act 1989

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This article looks at the new Part VC of the Reserve Bank of New Zealand Act, which deals with the designation of payment systems. It briefly describes payment systems and looks at why legislation designating them was required. The article then looks at the details of the legislative framework.

1 Introduction

The Reserve Bank of New Zealand Amendment Act 2003, which came into force in August last year, added two new parts to the Reserve Bank of New Zealand Act (the Act), both of which deal with payment systems. The first of these, Part VB, deals with oversight of payment systems by the Reserve Bank, and provides the Bank with the power to collect and publish information in relation to payment systems¹. The other new part of the Act, Part VC, provides for the designation of payment systems by Order in Council for the purpose of providing greater legal certainty to payments executed through designated payment systems. This article focuses on Part VC of the Act.

2 Background – Payment system risks, legal uncertainty and the adoption of payment system designation

Payment systems are a key part of the financial infrastructure of the economy. They are used to transfer funds among participants, which are usually financial institutions, acting on their own behalf or on behalf of their customers, by using a system or arrangement for the clearing and/or settlement of payment obligations or for the processing of payment

instructions. Sound and efficient payment systems play a vital role in maintaining financial stability and the smooth functioning of a modern economy. However, they can also transmit financial shocks and, in the case of payment systems dealing with large-value payments, can lead or contribute to systemic crises if they are poorly designed and managed. It is important therefore to contain risks in a payment system. These risks are of various types, including legal, credit, liquidity and operational risk.

As discussed in various articles in the *Bulletin* over recent years, a number of major changes have been implemented in New Zealand's payment systems to reduce risks, for the purpose of promoting a more robust and efficient financial system. These changes have included the implementation of real time gross settlement (RTGS) for large-value payment systems, in which payments between participants (typically banks and other financial institutions) and their customers are only executed upon the underlying settlement being made between the participants intra-day. Another important development was the introduction of robust laws to facilitate the enforcement of netting arrangements for payments settled on a deferred basis (which mainly affects smaller-value payments). Both of these developments have substantially reduced the credit risks associated with payments transactions between participants, and have thereby reduced the potential for the failure of one participant to contribute to the financial distress or failure of another. These reforms, together with the introduction of laws to facilitate electronic processing of cheque clearance in the mid-1990s, have also helped to promote greater reliability and efficiency in the payments system. The enactment of

¹ The oversight provisions were discussed in more detail when the Bill was still at the introduction stage, in Allison Stinson & Michael Wolyncewicz, 'Recent developments in the payment system', *Reserve Bank of New Zealand: Bulletin* Vol 66, No 1, p 21.

Part VC of the Act is a further step in strengthening the New Zealand payment system.

The enactment of Part VC will help to reduce the legal risks in payment systems to provide more legal certainty for payments made through a designated payment system, where a designation is made by Order in Council at the recommendation of the Reserve Bank. One of the Core Principles for Systemically Important Payment Systems – the international principles relating to payment systems – is that a payment system should have a well-founded legal basis. The Core Principles, which are published by the Committee on Payment and Settlements Systems of the G10 central banks², and operate under the auspices of the Bank for International Settlements, provide an internationally recognised framework for the sound design and operation of payment systems.

The legal basis of a payment system includes legislation and regulations, as well as industry agreements and contractual arrangements, which together govern the payments and operations of the system. New Zealand has few specific legislative and regulation requirements governing payment systems. Payment systems must operate within the general law, including general commercial and consumer law. The New Zealand Bankers' Association establishes industry standards and policies in some instances, but the payment services entities have their own governance arrangements, business strategies and rules. Specific legislation relating to payment systems includes the Bills of Exchange Act 1908 and the Cheques Act 1960³, as noted earlier, the Reserve Bank of New Zealand Act now gives the Bank formal oversight of the payment systems and provides for the designation of payment systems.

The Core Principles explain that “a sound legal basis for a payment system defines, or provides the framework for relevant parties to define, the rights and obligations of parties to payment transactions.”⁴ A legislative solution was required in New Zealand to eliminate uncertainty in relation to when

a payment transaction can be regarded as final. The law was not totally clear in this area, primarily because there existed the possibility that settlements through a payment system might have to be unwound if a participant became insolvent. This uncertainty was caused chiefly by the voidable preference provisions in the Companies Act 1993. The voidable preference provisions are legislative provisions in the insolvency law which apply to transactions that occurred within a specified period prior to the commencement of liquidation, statutory management or adjudication as bankrupt and which have the effect of preferring one creditor of the debtor over another. The most well known of these provisions is probably section 292 of the Companies Act 1993 – transactions having preferential effect.

The solution to this uncertainty is the designation of payment systems pursuant to the new powers in Part VC of the Act. As discussed in greater detail later in this article, the effect of designation is to provide for legal certainty over the finality of payments made via payment systems designated by Order in Council. In legislating to allow for the designation of payment systems and seeking to reduce some of the risks associated with this key part of the financial infrastructure, New Zealand joins a number of other jurisdictions that have adopted similar arrangements, including the United Kingdom, Canada, Australia and Singapore⁵.

The development of a payment system designation framework was motivated in part by New Zealand's intention to participate in an international arrangement designed to reduce another element of payment system risk – the risk associated with time lags in the paying and receiving of foreign exchange transactions. This arrangement involves the establishment of CLS Bank – an international continuous linked settlement system designed to reduce the risk associated with the settlement of foreign exchange transactions.⁶ Foreign exchange settlement risk (or Herstatt risk) may include both credit and liquidity risk, and arises

² Bank for International Settlements, Committee on Payment and Settlement Systems, *Core Principles for Systemically Important Payment Systems*, Jan 2001 (Available at www.bis.org)

³ The Cheques Act 1960 is deemed to be part of the Bills of Exchange Act 1908

⁴ Above note 2, p 16

⁵ See in this regard, United Kingdom: Statutory Instrument 1999 No. 2979, *The Financial Markets and Insolvency (Settlement Finality) Regulations 1999*, Canada: *Payment Clearing and Settlement Act 1996*, c 6, Sch; Australia: *Payment Systems and Netting Act 1998*. Singapore: *Payment and Settlement Systems (Finality and Netting) Act 2002*

⁶ For a more detailed description of CLS see above note 1, Stinson & Wolyncewicz., *Reserve Bank of New Zealand: Bulletin* Vol 66, No 1, p 21

because of the time lag between the settlement of the two legs of the transaction. A major component of foreign exchange settlement risk is the risk that the sold currency will be paid away before the bought currency has been received. This time lag arises because of the time zone differences between countries and the lags involved in the processing of different stages of a payments transaction and its associated settlement. The lags can range from just a few hours to, in some instances, over 24 hours. Over 60 international banks moved to reduce this risk by establishing CLS (Continuous Linked Settlement) Bank International ("CLS Bank"), which links the RTGS systems of the central banks of the currencies involved.

CLS has agreed in principle to include the New Zealand dollar in the currencies it would settle if CLS' requirements are satisfied. For this satisfaction to occur, it was necessary to remove the uncertainty that existed in New Zealand law over the finality of payments made via New Zealand's payment systems. With the enactment of the new payment system designation framework, coupled with other steps underway, it is expected that the New Zealand dollar will be accepted into CLS Bank in the second half of this year. CLS Bank is expected to be one of the first payment systems to apply for designation, but the legislation will apply to any payment system that is designated.

Designation of a payment system will provide finality for settlements made through the designated payment system. Secondly, it will also make netting under the rules of the designated system valid and enforceable in the event of insolvency. Finally, designation will provide that the rules of the payment system, to the extent that they deal with payment instructions and settlements and the taking of action in the event of a participant failing to meet its obligations, are valid and enforceable. However, the legislation does not prevent the operation of any enactment or rule of law in relation to an underlying transaction⁷. These points are elaborated on in the section on the effects of designation, later in this article.

⁷ These include the voidable transaction provisions under sections 56, 292, 297 and 298 of the Companies Act 1993 and section 56 of the Insolvency Act 1967.

3 The designation regime

Designation is voluntary and will only be considered where a person applies under Part VC for a payment system to be assessed for the purpose of becoming designated. Payment systems can continue to operate, as they do now, without being designated. Applications for designation are made to the Reserve Bank, with the actual designation to be effected by Order in Council made on the advice of the Minister of Finance acting on a recommendation from the Bank. The powers under Part VC must be exercised for the purpose of promoting the maintenance of a sound and efficient financial system or avoiding significant damage to the financial system that could result from the failure of a participant in a payment system.

In determining whether to make a recommendation to the Minister for the designation of a payment system, the Act enables the Reserve Bank to have regard to the following factors:

- the purpose and scope of the payment system;
- the rules of the payment system;
- any laws or regulatory requirements relating to the operation of the payment system and the extent to which the payment system complies with those laws or regulatory requirements;
- the importance of the payment system to the financial system; and
- any other matters that the Reserve Bank considers appropriate.⁸

The designation Order must specify the payment system, the documents that set out the rules of the payment system⁹, and the name or title of a person to whom notices relating to the designation must be given ("contact person"). A designation Order may specify that it is subject to conditions and that a particular operator is a participant in the payment

⁸ Section 156W(2) of the Act

⁹ As noted later, in the case of a designated payment system, "rules" means the rules of that payment system that are contained in documents and specified in the designation under section 156M; and includes any amendment to those rules that have been motivated to, and agreed, by, the Bank.

system¹⁰. Designation Orders can be varied¹¹ or revoked¹², again by Order in Council made on the advice of the Minister of Finance in accordance with a recommendation from the Reserve Bank. A variation or revocation will not affect settlements that were effected and netting that took place before the variation or revocation¹³.

Designation will not mean that the Crown or the Reserve Bank is in any way endorsing the payment system in question or its participants. Where the Reserve Bank recommends to the Minister that a payment system be designated under Part VC, it simply means that the Reserve Bank is satisfied that designation of the payment system will promote the maintenance of a sound and efficient financial system or avoid significant damage to the financial system that could result from the failure of a participant in the payment system, by providing legal certainty to payments made via that payment system.

In November 2003, the Bank released for consultation a paper on the proposed framework for considering applications for designation, entitled: "Application for Designation as a Designated Payment System"¹⁴. The Bank is presently considering the comments and submissions received on the proposals, with a view to finalising the criteria for designation. In the consultation paper, the Bank set out its proposals relating to the application process and the criteria that the Bank would use to assess an application. The proposed criteria draw heavily on the Core Principles for Systemically Important Payment Systems, which the Bank considers provide a sound framework for assessing applications for designation under the Act.

The Bank is proposing that, to be eligible for designation, a payment system should be a systemically important payment system or otherwise widely used by a broad range or number of participants or users. A systemically important payment system is one which can trigger or transmit shocks across domestic and international financial systems and markets, either because of the size or nature of the payments that are

processed through the system or because of the aggregate value of the payments. The Bank is proposing that it consider recommending for designation systems other than systemically important ones where the Bank is satisfied that designation will promote the smooth and effective functioning of the financial system.

The paper also proposes that the payment system should provide for the transfer of funds - ie the transactions must be financial in nature and should provide a mechanism for the payment and/or settlement of such transactions that is legally, financially and operationally robust.

In addition to the purpose of the payment system and its importance to the financial system, the paper lists proposed criteria covering the rules, the law or regulatory requirements and the following additional matters:

- requirements for participation in the payment system;
- matters relating to settlement;
- the management of operational risk;
- the governance of the payment system; and
- the financial resources of the payment system.

It is beyond the scope of this paper to go into detail about all of these issues. However, they include the following: the rules should be clear and comprehensive; the payment system should have a well-founded legal basis; the payment system should have the capacity to process the volume of transactions and a high degree of security and operational reliability; the payment system should have effective and transparent governance and accountability and sufficient financial resources for the proper performance of its function as a payment system.

Effect of designation - payments finality

Designation of a payment system will provide finality for the payments that are settled through the designated payment system. Finality will usually become relevant when a participant in the designated payment system goes into insolvency. In the case of a designated system, the liquidator will not be able to challenge settlements made through the payment system.

¹⁰ Section 156M of the Act

¹¹ Section 156Y of the Act

¹² Section 156Z of the Act

¹³ Section 156ZA of the Act

¹⁴ Available on the Bank's website: <http://www.rbnz.govt.nz>, under the heading "Payment & Settlement System"

Transactions which underlie the payments that are going through the system will not receive protection: only the payments settled in the payment system are legally protected. The transactions which underlie those payments will still be subject to challenge by a liquidator or statutory manager under conventional liquidation principles. "Underlying transaction" is defined for this purpose as a transaction that gives rise to a payment or a payment obligation but does not include a payment instruction or a settlement in accordance with the rules of a designated payment system.¹⁵ Also, a party is not prevented from acting against another party that has acted fraudulently or dishonestly; although such action will not affect the validity and enforceability of the rules, payment finality or netting under the designated payment system.

The proposals will allow for finality of settlements and for netting beyond the point of insolvency until notice of the insolvency is received by the payment system, up to a maximum period of 24 hours after the commencement of the insolvency. The Act specifies that the notice is to be to the "contact person". An applicant for designation must provide to the Bank the name or title of a person to whom notices relating to the designation must be given. That person will be the contact person and will be specified in the designation Order.

Allowing settlement to continue after the time insolvency commences is a departure from the general insolvency law, which provides that the actual time of insolvency is the cut-off point beyond which transactions can no longer be processed. The departure was considered justified in this case as there may be a time lag between the time an insolvency commences and the time that notice of the insolvency is received by the payment system. To require settlements made between the time at which a liquidation commences and the time at which the liquidation becomes known to the payment system to be unwound could cause significant disruption to the financial system, with potentially severe liquidity problems. Also, because the underlying transactions can be challenged, the liquidator will be able to pursue these in the case of voidable transactions.

¹⁵ Section 156T(3) of the Act

Netting

Where a payment system has been designated, netting will be valid and enforceable where the rules of the designated payment system provide for netting. Netting is widely used in financial markets and many payment systems make use of netting. Netting agreements can be either bilateral or multilateral. A netting agreement is a contract whereby each party agrees to set off amounts it owes against amounts owed to it. The amounts owing are netted off and only the netted balance is payable. The result is that the total exposures between the parties are reduced.

Netting reduces systemic risk by enabling counterparties to reduce their risk exposures. Legislation was passed in April 1999¹⁶ to give netting agreements legal certainty. That legislation has some restrictions which will not apply in the case of designated payment systems. For example, the Companies Act requires that, for bilateral netting, the transactions to be netted must be mutual. Mutuality requires that claims must be between the same parties claiming in the same beneficial right¹⁷. In the case of multilateral netting, the legislation only applies where there is a recognised multilateral netting agreement. This requires that the multilateral netting agreement is contained in, or subject to, the rules of a recognised clearing house. The legislation gives to the Bank the power to declare a person to be a recognised clearing house. The definition of "multilateral netting agreement" in the Companies Act is quite specific,¹⁸

¹⁶ See, DeSourdy, 'New legislation on netting and payments finality', *Reserve Bank Bulletin* Vol 62, No 2.

¹⁷ Section 310D of the Companies Act 1993

¹⁸ A "multilateral netting agreement" is defined in section 310A of the Companies Act as: "an agreement that provides for the settlement, between more than 2 persons, of payment obligations arising under transactions that are subject to the agreement, and that provides, in respect of transactions to which it relates, that debits and credits arising between the parties are to be brought into account so that amounts payable by or to each party are satisfied by-

- (a) Payment by or on behalf of each party having a net debit to or on behalf of a clearing house (whether as agent or as principal) or a party having a net credit; and
- (b) Receipt by or on behalf of each party having a net credit from or on behalf of a clearing house (whether as agent or as principal) or a party having a net debit".

whereas the definition of “netting”¹⁹ in Part VC is not quite as restrictive.

The designated payment system regime allows for more flexibility, so that designated systems which use multilateral netting that does not come within the definition in the Companies Act will be covered, as will non-mutual bilateral netting. The netting provisions in the Companies Act will not apply to netting under the rules of a designated payment system.

Rules to be valid and enforceable

The rules of a designated payment system will be valid and enforceable despite any enactment or rule of law to the contrary.²⁰ This applies to the extent that the rules provide the basis on which payment instructions are given, payments are calculated, and settlements are made (either on a gross basis or using netting) and for the taking of action in the event that a participant is unable, or likely to become unable, to meet its obligations to another participant, the operator, or any other party to the rules. Rules are defined in the Act²¹ and in the case of a designated payment system they are the rules that are contained in documents specified in the designation order and any amendments to those rules that have been notified to and agreed to by the Reserve Bank.

Supply of information

Under Part VC of the Act, the Bank can require the operator, a participant, or the contact person of a designated payment system to supply the Bank with information relating to a designated payment system. The Bank must exercise this power only if it considers that the information is reasonably required to enable it to perform its functions and duties under Part VC. As already noted, the Bank must exercise its powers under Part VC for the purpose of promoting the maintenance of a sound and efficient financial system or avoiding significant damage to the financial system that could result from the failure of a participant in a payment system. The powers in Part VC are in addition to powers that the Bank has under Part VB to obtain information or data relating to a payment system²² and are expected to be used as reserve powers where the issues relate to designated payment systems or a particular system, rather than to payment systems more generally.

4 Conclusion

The addition of the new Part VC to the Act provides greater certainty for the payment systems that will be designated under it. The legislation has been drafted to allow for flexibility in the rules governing these payment systems. The legislation also removes a legislative hurdle to facilitate the acceptance of the New Zealand dollar into the CLS system. Taken together, these initiatives will further strengthen the New Zealand payment system and contribute to ongoing developments in the promotion of a sound and efficient financial system.

¹⁹ “Netting” is defined in section 156L as “the conversion into 1 net claim or obligation, or the set off, of different claims or obligations between participants in a payment system that results from the issue and receipt of payment instructions involving 2 or more participants in the payment system or that is otherwise provided for under the rules of the payment system,-

- (a) whether on a bilateral or multilateral basis; and
- (b) whether or not through the interposition of an operator of the payment system; and
- (c) whether or not the obligations or claims constitute mutual credits, mutual debts, or other mutual dealings; and
- (d) whether or not the obligations or claims are denominated in New Zealand currency”.

²⁰ Section 156O of the Act

²¹ Section 156L of the Act

²² Section 156C of the Act.