Oversight of Financial Market Infrastructures in New Zealand (FMI1)

March 2015

1. Introduction

Financial market infrastructures (FMIs) provide channels through which payments, securities, derivatives or other financial transactions are cleared, settled or recorded. Well-functioning and efficient FMIs play a critical role in promoting financial stability and economic growth. FMIs can strengthen the markets they serve; if not managed properly, they can pose significant risks to the financial system and be a potential conduit or source of contagion. A stable financial system therefore depends on careful management and mitigation of credit, liquidity and operational risks in the FMIs.

FMIs are multilateral systems inclusive of the operator and participants. FMIs typically establish a set of common rules and procedures for all participants, a technical infrastructure, and a specialised risk-management framework appropriate to the risks they incur. In New Zealand, there are four key types of FMIs: payment systems, securities settlement systems, central securities depositories, and central counterparties[1].

FMIs are essentially the network for economic agents (financial institutions, governments, business and individuals) to transmit money and financial instruments. Sound and efficient FMIs contribute to maintaining and promoting financial stability and economic growth. They are therefore highly relevant for the Reserve Bank's core responsibilities that stem from its financial stability objective.

The Reserve Bank is also interested in selected infrastructure providers that provide services to an FMI (such as IT infrastructure, messaging services, communications and data processing) that are critical to the sound and effective provision of the FMI's core function.

2. Role of the Reserve Bank

The Reserve Bank of New Zealand Act 1989 ("the Act") provides in section 1A that the Reserve Bank, as the central bank of New Zealand, is responsible for (among other matters, notably monetary policy designed to promote price stability) promoting the maintenance of a sound and efficient financial system.

[1] The international definition of "FMIs" also includes a fifth type of infrastructure: trade repositories. However, trade repositories are considered outside of the New Zealand FMI oversight context at the moment, as the current regulatory framework does not extend to them.

Reference to the promotion of the maintenance of a sound and efficient financial system is also found in the following sections of the Act:

- section 68 of the Act, which determines the purposes for which the Reserve Bank carries out its prudential supervision of registered banks.
- sections 156B and 156K, which determine the purposes for which the Reserve Bank carries out its regulatory oversight of payment and settlement systems.

It is also provided in the Non-bank Deposit Takers (NBDTs) Act 2013 as one of the purposes for which the Reserve Bank is regulator of NBDTs.

FMIs are a critical element of the financial system and the entities that the Reserve Bank regulate both interact with FMIs and depend on their operational performance. Therefore, in order to pursue its statutory purpose, the Reserve Bank seeks to influence the activities of FMIs and their interactions with participants.

3. Regulatory framework

Parts 5B and 5C of the Act provide the statutory backing for the Reserve Bank's payment oversight activities.

Part 5B "Oversight of payment systems" provides the Reserve Bank the power to require information relating to a payment system to be provided by an operator of a payment system, any person who is wholly or partly responsible for the operation of a payment system (such as infrastructure providers), or a participant in a payment system. The Reserve Bank may require the information to be audited and failure to supply information is an offence. The Act also specifies the circumstances in which the Reserve Bank may publish or disclose the information.

Part 5C "Designated settlement systems" provides the Reserve Bank and Financial Markets Authority (FMA) with powers in relation to designated payment or settlement systems (including central counterparties that have an embedded settlement system). The FMA and the Reserve Bank are the joint regulators of designated systems except when the system is a pure payment system, in which case the Reserve Bank is the sole regulator. The Reserve Bank can:

- Require information to be provided;
- Recommend the designation be subject to conditions, and seek changes to those conditions; and
- Disallow proposed changes to the system's rules.

For more information on the roles and policies of the Reserve Bank and FMA in relation to the designation and oversight of designated settlement systems, please refer to the *Designation and Oversight of Designated Settlement Systems (DSS1).*

For other FMIs that are not payment or settlement systems and infrastructure providers that provide critical services to FMIs that are not payment or settlement systems, and over whom the Reserve Bank does not have regulatory power, the Reserve Bank endeavours to achieve its statutory purpose through issuing non-binding guidance, seeking opportunities to engage with FMIs and infrastructure providers, and by promoting internationally-developed guidelines.

4. Oversight objectives

The Reserve Bank oversees FMIs for the purposes of promoting the maintenance of a sound and efficient financial system, and for designated settlement systems, avoiding significant damage to the financial system that could result from the failure of a participant in the designated system(s).

Broadly speaking, the high level objectives mean that the Reserve Bank aims to encourage FMIs, which provide the services and facilities underpinning financial market activities, to be sound and efficient.

To promote the soundness and efficiency of FMIs, the Reserve Bank aims for the following outcomes:

- That FMIs have clear and transparent governance arrangements that promote the soundness and efficiency of the FMIs, and support the stability of the broader financial system
- That FMIs have a sound risk-management framework for comprehensively managing legal, credit, liquidity, operational and other risks
- That FMIs ensure they provide clear and certain final settlement
- That FMIs have appropriate failure-to-settle mechanisms in place to minimise disruptions associated with the failure of one or more of their participants
- That FMIs ensure they can continue to provide critical services in all circumstances
- That FMIs have objective, risk-based, and publicly disclosed criteria for participation, which promote fair and open access with no unwarranted barriers to entry
- That FMIs be efficient and effective in meeting the requirements of their participants and the markets they serve
- That FMIs publish all relevant rules and key procedures, and provide sufficient information to enable participants to have an accurate understanding of the risks, fees and other material costs they incur by participating in the FMIs.

The operational reliability of an FMI may be dependent on the continuous and adequate functioning of infrastructure providers that are critical to an FMI’s operations. The Reserve Bank therefore expects that the operations of an FMI’s critical infrastructure providers are held to the same standards as if the FMI provided the service itself.

These outcomes are reflected in the regulatory approach adopted by the Reserve Bank in respect of payment systems and settlement systems and in its engagement approach with other FMIs.

5. Approach to risk management

Expanding on the points on managing risks, a guiding principle for the Reserve Bank's engagement with the industry has been, and continues to be, that risks and costs should be borne by those best placed to manage them. This approach maximises the market incentives to manage and appropriately price risks, and reduce costs. Where FMI risks and costs are borne by FMI operators and participants, the Reserve Bank is interested in seeing that those risks and costs are managed appropriately. Where FMI risks and costs are borne by parties other than the operators and participants, the Reserve Bank views it as important that the operators and participants have sufficient regard to those risks and costs in the design and operation of the FMI, and that there is a high level of transparency relating to the incidence of those risks and costs.

The Reserve Bank's expectation of critical infrastructure providers is that they will support the FMI's overall soundness and efficiency. The Reserve Bank therefore encourages infrastructure providers that provide critical services to FMIs to have appropriate policies, procedures and resources for risk identification and management, reliability and resilience, robust information security management, effective technology planning and strong communications with users.

These objectives and expectations underpin the Reserve Bank's FMI oversight activities and are well aligned with the international standards, the *Principles for Financial Market Infrastructures (PFMIs)*[2], developed by the Committee on Payments and Market Infrastructures (CPMI)[3] and the Technical Committee of the International Organisation of Securities Commissions (IOSCO). The PFMIs, released in 2012, recognise the increasingly critical role played by FMIs in the financial system, and constitute a single set of harmonised operational standards that relate to risk management, governance, efficiency and transparency. The Reserve Bank bases its oversight on the PFMIs and the Annex F "*Oversight expectations applicable to critical service providers*" for the oversight of critical infrastructure providers.

6. Oversight approach

Risk-based approach

The Reserve Bank's general approach is to focus its oversight activities on the largest risks to the financial system. Its FMI oversight is typically accompanied by an assessment of the importance of particular FMIs to financial stability and to the functioning of the economy as a whole. Generally, FMIs that are determined to be of systemic importance are of most interest to the Reserve Bank.

An FMI is of systemic importance if disruption within it could trigger or transmit further disruptions amongst participants or disrupt the domestic financial system more widely.

To determine the systemic importance of an FMI, the following aspects are relevant:

- The size and concentration of financial risks within the FMI. The value of transactions settled in the FMI in aggregate and/or individually provides an indication of the size of those risks. FMIs that settle large value transactions such as wholesale FMIs are generally classified as systemically important, because of

[2] http://www.bis.org/cpmi/publ/d101a.pdf
[3] The CPMI was formerly the CPSS - Committee on Payment and Settlement Systems

the greater credit and liquidity risk exposures that are likely to be associated with large value transactions;

- The role of the FMI and the nature of the transactions processed. Where an FMI is used to settle payments of other FMIs or make payments in settlement of financial market transactions, that FMI is likely to be systemically important. Infrastructure such as central securities depositories and central counterparties, 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 there are other FMIs that can process the transactions or FMIs that can process similar instruments; and

- 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 FMI-based (direct linkages between FMIs), institution-based (common participants or an institution that provide services to two or more FMIs) and environmental (broader, less direct factors like reliance on a common service provider).

International standards

The PFMIs represent a harmonised and strengthened set of international standards for FMIs. The PFMIs outline a comprehensive set of minimum standards for FMIs, covering general organisation, credit and liquidity risk management, settlement, default management, general business and operational risk management, access, efficiency and transparency. The Reserve Bank bases its oversight of FMIs on the PFMIs. However, in applying the PFMIs, the Reserve Bank also recognises the specific characteristics of the New Zealand financial system and its FMI landscape.

The Reserve Bank's view is that all systemically important FMIs should comply with the PFMIs where relevant. Infrastructure providers that provide critical services to one or more FMIs are also encouraged to comply with applicable standards in the Annex F of the PFMIs. For other FMIs, the Reserve Bank encourages them to comply with applicable PFMIs unless the costs of compliance are clearly impracticable.

The Reserve Bank has also adopted the accompanying PFMIs *Disclosure Framework and Assessment Methodology*[4]. The Reserve Bank encourages FMIs, especially those that are systemically important, to comply with the disclosure requirements in the *Disclosure Framework.*

A number of principles in the PFMIs are considerably stronger than the previous standards (such as the CPSS' *Core Principles for Systemically Important Payment Systems*[5]). While the Reserve Bank's expectation is that all systemically important FMIs in New Zealand be generally observant of relevant PFMIs, it acknowledges that FMIs may need to take certain actions to achieve full observance. The Reserve Bank will continue to engage with FMIs on their observance of the PFMIs.

[4] http://www.bis.org/cpmi/publ/d106.pdf
[5] http://www.bis.org/cpmi/publ/d43.pdf

Engagement and monitoring

The Reserve Bank conducts regular meetings with senior staff of FMI operators, their major participants and critical infrastructure providers to discuss their strategic plans and risk management practices.

The Reserve Bank also engages with a broad range of stakeholders on both a regular basis and on specific projects. Through these engagements, the Reserve Bank is kept informed of current issues and developments, seeks information to enhance its understanding, and identifies issues that should be addressed or might benefit from the Reserve Bank's involvement.

In addition, the Reserve Bank collects periodic and ad-hoc information and data, such as system performance statistics, transaction volumes and value and system outages, from FMI operators, major participants and infrastructure providers. These are important sources for understanding current trends and help inform the Reserve Bank's analysis. This is also the main channel through which it monitors the wider FMI landscape.

Assessing

With information collected from regular meetings and data reporting, the Reserve Bank assesses and evaluates the operation of FMIs and infrastructure providers, their risk management arrangements and their governance.

Inducing change

If the Reserve Bank's assessment identifies gaps and issues, the Reserve Bank may make recommendations to the FMI or infrastructure providers to take certain actions. The Reserve Bank has a number of ways to induce change in the FMI or infrastructure provider.

- For designated settlement systems, the Reserve Bank, jointly with the FMA, may alter the conditions of designation, review the designation, or disallow proposed rule amendments

- For other FMIs and infrastructure providers, the Reserve Bank may write formally, setting out its guidance and encouraging implementation of the recommendations

- The Reserve Bank may also comment publicly including report on FMI and infrastructure provider issues in half-yearly Financial Stability Reports

7. Potential Conflict of Interest

Currently, two FMIs that are considered systemically important (ESAS and NZClear) are owned and operated by the Reserve Bank. The Reserve Bank is also the regulator for both FMIs, which may give rise to a perceived conflict of interest between the Reserve Bank's oversight and operator functions.

The Reserve Bank manages the potential conflict through:

- organisational separation and separate reporting lines. The oversight and owner/operator functions reside in different departments within the Reserve Bank, and each has a separate reporting line to the senior management of the Reserve Bank;

- transparency of policy application, including the application of consistent expectations on all FMIs, and

- in the case of NZClear, the joint regulatory arrangements with the FMA.

8. Cooperation with other regulators

Co-operation with domestic regulators

In New Zealand, the FMA oversees market infrastructure and securities markets activity, and the Reserve Bank oversees the payment system. Both are joint regulators for settlement systems designated under Part 5C of the Act. The FMA and the Reserve Bank have published a *Memorandum of Understanding*[6] in relation to Part 5C of the Act, which sets out a readily available record of how they work together as joint regulators of designated settlement systems.

In addition to soundness and efficiency, other public policy objectives such as control of money laundering, price regulation, and the avoidance of anti-competitive practices are relevant in the design and operation of a FMI. The Reserve Bank therefore works with other public sector agencies such as the Commerce Commission on specific projects from time to time.

Co-operation with overseas regulators

Some FMIs and critical infrastructure providers operate across borders. Where relevant and practical, the Reserve Bank seeks to participate in the cooperative oversight of cross-border FMIs and critical infrastructure providers whose activities have the potential to affect the stability of the financial system in New Zealand.

The Reserve Bank will share information and consult with overseas authorities as part of its oversight process. Cooperation may take other forms, such as arrangements via Memorandum of Understanding, informal arrangements or regular communications. The Reserve Bank acknowledges that cooperative oversight will enhance the effectiveness of oversight by helping to avoid gaps and duplication of activity, and minimise the risks of subjecting the FMIs to conflicting regulation. The Reserve Bank is committed to the effective supervision of overseas FMIs operating in New Zealand, and will continue as invited to contribute to the co-operative arrangements set up by other authorities for the FMIs in their jurisdictions.

To date, the Reserve Bank has entered into a Memorandum of Understanding[7] with the Reserve Bank of Australia in relation to co-operation with respect to the oversight of cross border clearing organisations. The Reserve Bank is also a member of the CLS Oversight Committee, governed by the Protocol for Co-operative Oversight Arrangement of CLS[8].

---

[6] http://rbnz.govt.nz/regulation_and_supervision/payment_system_oversight/4621382.pdf

[7] http://rbnz.govt.nz/regulation_and_supervision/banks/relationships/5818099.pdf

[8] http://www.federalreserve.gov/paymentsystems/cls_protocol.htm

As part of its involvement in EMEAP[9] (the Executives' Meeting of East Asia-Pacific Central Banks), the Reserve Bank also participates in the EMEAP Working Group on Payment and Settlement Systems.

[9] http://www.emeap.org/