In Confidence

Office of the Minister of Finance

The Chair

ECONOMIC GROWTH AND INFRASTRUCTURE COMMITTEE

AN ENHANCED OVERSIGHT FRAMEWORK FOR FINANCIAL MARKET INFRASTRUCTURES

PROPOSAL

1 This paper seeks Cabinet agreement to an enhanced framework for the oversight of financial market infrastructures in New Zealand.

EXECUTIVE SUMMARY

Introduction

2 Financial market infrastructures, or FMIs, are multilateral systems or networks that provide trading, clearing, settlement and reporting services in relation to payments, securities, derivatives and other financial transactions. FMIs generally include payment and settlement systems, central securities depositories, central counterparties, and trade repositories. Well-managed and operated FMIs contribute to an efficient financial system by connecting intermediaries (such as banks) with various financial markets, providing essential services, connecting counterparties, reducing transaction costs through economies of scale, managing counterparty and systemic risks, and fostering transparency.[1]

3 The regulation of FMIs has been considered as part of the IMF's recent Financial Sector Assessment Programme (FSAP) review of New Zealand. The conclusions of this review are currently being finalised, and I understand they are likely to be published early next month. A full list of the IMF's preliminary recommendations are set out in the appendix to this paper. However, I understand that the IMF will:

- confirm the Reserve Bank's assessment that the current regulatory regime for FMIs leaves room for systemic risks to build up within FMIs and exposes society to negative externalities in case of an FMI failure;

[1] The appendix to the attached regulatory impact statement contains a glossary of the technical terms used in this paper.

- express its strong support for the legislative framework proposed in this paper, and indicate that if it is adopted, it will address the major shortcomings of the current framework.

- recommend that more resources might be required to effectively supervise FMIs (the IMF are likely to raise this resourcing issue in relation to some other supervisory areas as well, and I anticipate that it will be considered through further work on the appropriate level of supervisory resource across all of these areas. While the level of resourcing may influence the degree and manner of supervision carried out by the Reserve Bank, it is unlikely to have any implications for the design of the legislative framework for FMI oversight proposed in this paper).

Reasons for regulating FMIs

4 The global financial crisis has highlighted the extent to which modern financial markets are closely interconnected. There are serious consequences if an FMI fails – be it from a prolonged breakdown, or failure to settle by one of its participants. Failure to complete payments for financial market transactions, or even failure to complete such payments on time, can subject the entire financial system to serious credit and liquidity risks, because of the interconnections between an FMI's participants, and FMIs themselves.

5 A stable financial system therefore depends on careful management and mitigation of the risks that can arise in the operation of FMIs (e.g. credit risk, liquidity risk, operational risk). It also relies on the continuing provision of essential services by key FMIs, even in the event of their becoming insolvent or suffering an infrastructure failure.

6 Owners and operators of FMIs are generally aware of the key role FMIs play in a modern financial system. However, FMIs are also characterised by a number of market failures. These include:

1) Negative network externalities, where the FMI has direct and indirect connections with other FMIs, its participants and third parties in the real economy. An FMI operator might not fully consider the wider social costs of their conduct, which could lead to their risk management decisions being misaligned with the wider public interest and additional costs falling on society (for example, the economic disruption that could result from an FMI failure);

2) Coordination difficulties, where participants of an FMI may have incentives to focus only on their private costs and benefits and not act in a way that improves the operation of the FMI as a whole (or helps to resolve the FMI if it has failed);

3) High concentration of market power and the potential for quasi-monopoly behaviour. Most markets tend to be characterised by a very small number of FMIs due to relatively high fixed costs and the need for economies of scale.

This increases systemic risks and could have an adverse impact on innovation. There is also scope for quasi-monopolistic behaviour because FMIs are often owned by their largest participants. These owners and participants might exert their influences on the FMI's rules to their own advantage, while restricting their competitors and new entrants from participating in the FMI. Again, this might have a negative impact on competition and innovation; and

4) Imperfect information, where participants may not be aware of all the risks the FMI is exposed to due to its complex nature and its various interconnections, and FMI operator(s) may not be fully aware of all their participants' risks and exposures. This could lead to inefficiencies and systemic risk.

7 Financial markets in New Zealand rely upon certain key FMIs whose failure would be likely to have an impact on the soundness of the New Zealand financial system. These key FMIs range from the real time high value inter-bank payment system that is key to the money and capital markets (ESAS), the global high value inter-bank payment system for the New Zealand foreign exchange market (CLS), the retail payment system where New Zealand consumers and businesses conduct their financial transactions (SBI), the securities settlement system for the fixed interest and equity securities market (NZClear) and securities settlement system and securities depository for the exchange markets (NZCDC). There are also some other foreign FMIs, such as LCH Clearnet and ASX Clear (Futures), that could be of systemic importance to New Zealand because of the services they provide to the New Zealand interest rate swap and interest rate futures markets. Some of these FMIs are also closely connected to each other – for example, CLS transactions are settled in ESAS.

8 These FMIs are of systemic importance to the New Zealand financial system due to their significant transaction volume, high degree of market penetration, and the lack of ready substitutes. Other factors, such as the nature of their role in the transaction process and their interdependencies, are also relevant. It is important that these FMIs operate in a sound and efficient manner, as there would likely be serious consequences if they were to fail or have a serious breakdown.

9 These FMIs also demonstrate the potential market failures noted above. Examples of negative externalities and information asymmetries were visible in industry's overhaul of the retail payment system in 2012 (after about a decade of the Reserve Bank highlighting the settlement risks in the system). The payment model chosen by industry, Settlement Before Interchange (SBI), removed the inter-bank settlement risk but left the settlement risk between underlying customers unaddressed.[2] It also lacked incentives for banks to settle more frequently throughout the day. As a consequence of this, the majority of transactions were being settled towards the end of each day, which increased

[2] In SBI, there is a delay between the time customers issue their payment instructions and the time banks act on the instructions, meaning customers are still faced with settlement risks if their banks fail before the payee receives the money.

the risks associated with a breakdown of SBI. The model also meant that customers may not have been aware of the settlement risk to which they were exposed. These problems with the model have only recently been addressed through a separate stream of work instigated and overseen by the Reserve Bank.

10 Because of the key role FMIs play in maintaining financial stability and the potential market failures they typically exhibit, central banks and market regulators, including those in New Zealand, are responsible for the oversight and supervision of FMIs, monitoring their activities and inducing changes where necessary to promote financial stability. The Reserve Bank currently oversees payment systems for the purpose of promoting the maintenance of a sound and efficient financial system. The powers available to the Reserve Bank for carrying out this role are limited to requiring operators of systems, or participants in systems, to provide relevant information.

11 In addition, the Reserve Bank and Financial Markets Authority (FMA) jointly administer the Designation Regime for designated settlement systems. The Regime provides legal protection for finality of settlement, netting and transfer of collateral on a designated settlement system. While it also provides the joint regulators with stronger powers for the oversight of these systems, including the ability to induce changes by imposing particular conditions on designation and disallowing rule changes, it only applies to those systems that choose to apply for designation.

12 A review of the current regulatory arrangements has identified significant gaps within the existing framework. Given the growing importance of FMIs, the Reserve Bank is currently not well-placed to fulfil its mandate of promoting a sound and efficiency financial system with regards to FMIs. The increasing importance of FMIs for financial system stability and efficiency has also led to regulatory changes in the international arena, with New Zealand's current framework looking increasingly out of step with those of comparable jurisdictions. The most significant gaps in the existing framework are:

- *Limited ability to induce changes in systems that are not designated*

  The opt-in nature of the Designation Regime has resulted in some systemically important FMIs (SIFMIs) not being designated. Regulators can only rely on moral suasion to induce changes in non-designated SIFMIs, which has not worked in an effective and timely manner to date. By international standards, the joint regulators' current oversight powers are very limited.

- *Lack of crisis management powers*

  Neither the Reserve Bank nor the FMA has crisis management powers or a role in dealing with failures of FMIs. In the extreme case of an SIFMI failing, this could lead to critical services no longer being available, causing severe systemic disruption to the financial system and broader economy (which could

also increase fiscal risks to the Crown by making it possible that the SIFMIs participants would require taxpayer support. However, the joint regulators would have very limited ability to facilitate an orderly recovery or resolution of the situation at the moment.

- *The current Designation Regime not suitable for general oversight*

  As the Designation Regime is designed to provide backing for settlement finality and netting, its focus is narrower than general oversight, and does not normally cover issues such as business continuity, crisis management or access policy. The Designation Regime also lacks an appropriate set of graduated tools to induce changes. For example, the only effective statutory option for dealing with noncompliance with conditions of designation is to review and potentially revoke a designation, a very strong response that should only be reserved for very serious breaches.

- *Limited scope of the current legislative regime*

  Both general oversight and the Designation Regime only cover payment and settlement systems, and do not extend to other important FMIs, such as central counterparties (CCPs), Central Securities Depositories (CSDs), and Trade Repositories (TRs). Consequently, the New Zealand framework is out of step with a strong drive internationally to increase oversight of these types of FMIs, which might affect the equivalence status other regulators give New Zealand and affect our regulators' access to information held by overseas trade repositories about New Zealand firms.

13 These gaps are a significant departure from the prudential oversight powers the Reserve Bank has over other important sectors such as banking and insurance, and pose risks to how FMIs could be overseen effectively. Since the review, the Reserve Bank has undertaken three rounds of public consultations to fine-tune the proposed new oversight framework for FMIs set out in this paper (while ensuring that it also minimises the compliance burden). It has also held bilateral discussions and industry forums to clarify its proposals and better understand stakeholders' views. Where appropriate, the Reserve Bank has also taken into consideration alignment with international regulatory developments, which may also have the benefit of avoiding New Zealand firms having to incur costs due to a lack of regulatory equivalence.

Proposed new oversight regime for FMIs

14 Given this context discussed above, I recommend that the legislative framework for FMI oversight be modified to better align with both the Reserve Bank and the FMA's objectives. More specifically, I am proposing that an enhanced framework be introduced with the following features:

- The Reserve Bank and FMA would have information gathering power for all FMIs (not just payment systems) to identify potential systemic risks;

- An FMI that is identified as being systemically important would be required to be designated under a revised Designation Regime;

- The Reserve Bank and FMA would have enhanced oversight powers for designated FMIs, including powers related to setting regulatory requirements, overseeing FMIs' rules, investigative and enforcement powers and crisis management powers;

- Also in order to keep compliance costs low, the proposed powers under the revised Designation Regime would be applied differently for different FMIs, depending on their level of systemic importance, level of New Zealand presence and their legal form;

- The currently designated payment and settlement systems that have voluntarily opted into the regime could continue to seek legal protection for netting and settlement under the revised Designation regime. Other new non-systemically important payment and settlement systems would also be able to opt into the regime for these benefits.

15 The proposals, after several rounds of consultations with stakeholders, seek to achieve the joint regulators' objectives while minimising compliance costs (for example, by adopting a risk-based approach that aligns with the Reserve Bank's prudential regulation of other sectors. This approach is reflected in the way that most aspects of the proposals apply to SIFMIs only).

16 While this regime has been designed with prudential issues in mind in the first instance, this paper proposes that powers be exercised jointly by the Reserve Bank and FMA in respect of all FMIs except payment systems (for which the Reserve Bank is the sole regulator). This reflects the fact that the operation of FMIs can significantly affect the conduct of participants in financial markets (which is the concern of the FMA), as well as the soundness and efficiency of the financial system (which is the concern of the Reserve Bank). It also parallels the approach taken to the oversight of settlement systems under the existing designation regime.

BACKGROUND

FMIs' roles, potential market failures and recent international global developments

17 Payment and settlement systems are two types of core FMIs that underpin modern financial systems, which are made up of intermediaries, markets and infrastructures. Intermediaries, such as banks and asset managers, act as principals in assuming liabilities and acquiring claims. These claims are in turn exchanged in markets, including

those for equities and fixed income securities, but also in exchanges or over-the-counter (OTC) markets for foreign exchange.

18 The essential role of FMIs is important from a financial stability perspective, as modern financial systems can only function well if financial institutions, FMIs and financial markets, and the interrelationships between them, are operating soundly, even under stress.

19 Payment and settlement systems, as well as other types of FMIs such as central counterparties (CCPs), also support wider public policy objectives, as they promote a stable financial system that functions normally even when subject to severe stresses. At the same time, market forces alone may not always be effective in promoting the maintenance of a sound and efficient financial system due to potential market failures. FMIs are networks that are typically characterised by:

- Negative network externalities: operators or participants in an FMI may not have sufficient regard to the risk of an FMI failure as they themselves would not bear all the costs of a failure thereby increasing systemic risk. This arises due to the network effect of an FMI, meaning an isolated problem could transmit quickly to other participants and related FMIs, causing wider impacts and costs.

- Coordination difficulties: FMIs are networks that benefit from coordinated planning and management to achieve optimal network size, efficiency and quality. Individual participants may, however, be incentivised to only focus on their own private costs and benefits and neglect the wider systemic implications of their individual actions. An example of a lack of coordination amongst FMI participants is provided by the response to the 2012 ANZAC Day outage of the SBI system. (Withheld under section 9(2)(ba)(i) of the Official Information Act 1982) As a result, payments were delayed for an extended period and bank customers did not have funds available when they expected to. A more long-term cost from a lack of coordination could be a loss of innovation opportunities.

- High concentration of market power and quasi-monopoly: FMIs typically exhibit economies of scale with large up-front costs and small marginal costs. This can lead to a small number of systems managing the financial infrastructure underlying most of the market's financial transactions. Potential low-levels of competition may increase systemic risk by reducing the incentives for investment and innovation in FMIs.[3] FMIs are also often owned by their largest participants possibly allowing for the owners to demonstrate quasi-monopoly or

[3] High levels of competition can also lead to systemic risk by creating incentives for excessive risk taking.

"club behaviour" by restricting their competitors and new entrants from participating in the FMI or its governance.

- Imperfect information: FMIs are typically complex and highly interconnected in a way that is not visible to many participants directly through their performance. Therefore participants in an FMI are often not able to be aware of, and to monitor and manage all of the risks they are exposed to through an FMI. Likewise, an FMI's operator(s) may not be aware or even able to be aware of all their participants' risks and exposures. The New Zealand domestic landscape for FMIs is heavily interconnected, with many FMIs having the same members. The IMF has observed during their recent FSAP of New Zealand that the financial or operational failure of a given FMI or participant could quickly transmit systemic risks through the financial system if proper safeguards are not in place.

20 These potential market failures exist within the FMIs operating in New Zealand. As financial markets have become increasingly integrated in recent years, the volume of financial transactions such as payments, securities, and derivatives contracts have grown significantly. This leads to certain FMIs becoming systemically important, where disruptions within one has the potential to trigger or transmit further disruptions among participants, or to disrupt the financial system more widely. For example, each day in New Zealand there are around $30 billion of payments processed through ESAS (the real time large value interbank payment system) and $7 billion of payments processed through SBI, the retail payment system. The net value of batches of SBI transactions are also settled in ESAS. A major disruption to a SIFMI - be it from a prolonged breakdown, fraud, or failure to settle by one of its participant - could subject the entire financial system to serious credit and liquidity risks, becoming a channel through which risks are transferred amongst market participants.

21 Some FMIs also have the potential to pose systemic risk where the inability of one participant to meet its obligations to the FMI could cause other participants to be unable to meet their obligations. At the same time, FMIs can also play an important part in improving the management of risks and promoting financial stability by simplifying inter-participant arrangements and enhancing transparency. Given the risk they might pose, and the importance of these FMIs to the soundness and efficiency of our financial system, there is a need to ensure their operation and management are aligned with the public interest, so that systemic risks are adequately managed.

22 In response to the growing focus on improving the resilience in the modern SIFMIs, the international bodies responsible for setting risk management standards for FMIs - the Committee on Payments and Market Infrastructures (CPMI) and the Technical Committee of the International Organisation of Securities Commission (IOSCO) - in 2012

issued the *Principles for Financial Market Infrastructures* (PFMIs)[4].. The PFMIs form part of a set of 12 key standards for sound financial systems that the international community considers essential to strengthening and preserving financial stability[5] and have been adopted widely. CPMI-IOSCO's more recent focus is on the recovery of FMIs,[6] which is consistent with the Financial Stability Board's (FSB) *Key attributes of Effective Resolution Regimes for Financial Institutions*[7]. Work is in train on stress testing and loss allocation.

Current regulatory regime for payment and settlement systems and joint regulators' objectives

23 Both the Reserve Bank and FMA have an interest in the oversight of FMIs in New Zealand.

24 Parts 5B and 5C of the Reserve Bank of New Zealand Act 1989 (the RBNZ Act) provide for the oversight of payment systems. Part 5B provides the Reserve Bank with the power to require operators and participants in a payment system to supply information to the Reserve Bank. The Reserve Bank is also able to require the information to be audited if it has reasonable grounds to believe the information or data is inadequate or inaccurate.

25 Part 5C "Designated Settlement Systems" relates to legal finality in relation to settlement and netting arrangements of a settlement system. The Reserve Bank and the FMA are the joint regulators for designated settlement systems, except for "pure payment systems" where the Reserve Bank is the sole regulator. The joint regulators have greater powers in relation to designated systems, including powers to:

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

Problems with the current regulatory framework

26 Previous experience overseeing payment and settlement systems in New Zealand, and international regulatory developments (such as the publication of the PFMIs), highlight the following problems with the current regulatory regime for FMIs in New Zealand:

- *Opt-in nature of the current designation regime*

[4] http://www.bis.org/cpmi/publ/d101.htm
[5] http://www.bis.org/cpmi/info_pfmi.htm
[6] http://www.bis.org/cpmi/publ/d121.htm
[7] http://www.fsb.org/2014/10/r_141015/

Apart from the power to require information to be provided from the operator of a payment system, the existing oversight framework only applies to payment and settlement systems that opt-in. Where a system has not opted-in, the approach to date has been to make progress through cooperation and consultation with the industry, and by relying on moral suasion to induce changes in cases where deficiencies or gaps have been identified.

Such an approach was appropriate when Parts 5B and 5C of the RBNZ Act were originally enacted, especially given the Reserve Bank's ownership and operation of two SIFMIs in New Zealand (ESAS and NZClear). However, as the payments landscape has developed in the last decade, more SIFMIs have emerged, and moral suasion has not been sufficient to achieve prudential objectives in a timely manner.[8] If a non-designated payment system is of systemic importance, the inability to induce changes effectively could compromise the Reserve Bank's ability to meet its objectives in promoting the soundness and efficiency of the financial system. An example would be where an SIFMI's governance structure does not allow all stakeholders' interests to be represented.If the owner or operator either does not see the need to change,or cannot be induced to do so,it could disadvantage smaller players and create inefficiencies by setting up unwarranted barriers to entry. In extreme cases, this could impact on the soundness and efficiency of the financial system.

More generally, the Reserve Bank is unable to require non-designated systems to comply with industry best practice. An example is the CPMI-IOSCO's *PFMIs*, an operating and risk management standard which has been widely adopted globally. The Reserve Bank adopted the PFMIs in 2015 as the basis for its oversight[9], after assessing that they are relevant for the FMIs that are considered to be of systemic importance to New Zealand. However, the Reserve Bank does not have the power to require compliance with the PFMIs from systems that do not opt in to the designation regime. The Reserve Bank's self-assessment against the responsibilities for authorities specified by the PFMIshas identified this as a material gap in its observance of those responsibilities[10].

- *Lack of crisis management provisions*

[8] One example was the Reserve Bank's concerns raised with the payments industry about settlement risks in New Zealand's retail payment system. The New Zealand Bankers Association formally commenced a project called *Failure to Settle* in 2001, finally resulting in the implementation of *Settlement Before Interchange* in 2012. As previously noted, while SBI removes inter-bank settlement risk, the settlement risk between customers remained until recently..

[9] http://rbnz.govt.nz/-/media/ReserveBank/Files/regulation-and-supervision/financial-market-infrastructure-oversight/oversight-of-financial-market-infrastructures-in-new-zealand.pdf?la=en

[10] For example, the Reserve Bank is unlikely to fully observe Responsibility A where "FMIs should be subject to appropriate and effective regulation, supervision, and oversight by a central bank, market regulator, or other relevant authority".

Neither the Reserve Bank nor the FMA have crisis management powers or a role in dealing with situations that may impact on the soundness of the financial system. A failure of a SIFMI, albeit a low probability event, could lead to its critical services no longer being available. Because of the volume of transactions such SIFMIs typically handle, and their interconnections with the rest of the financial system, their inability to continue to provide critical services could have significant spillover effects across the whole financial system. This could expose market participants to solvency or liquidity issues, and result in a breakdown of day-to-day transactions that imposes significant costs across the economy and threatens financial stability (as well as potentially creating a risk of some affected entities requiring taxpayer support).

The scale of such impacts makes it important that there be an established crisis management framework in place to deal with these events, to minimise the costs and disruption to the financial system and broader economy. Robust resolution and recovery mechanisms for FMIs have been an area of focus for international bodies such as the CPMI, IOSCO and the FSB, whose *Key Attributes for effective resolution regimes* extends to FMIs and their participants. Many overseas regulators are in the process of implementing a resolution regime for FMIs, including Australia, where consultation on a resolution regime for FMIs was concluded[11] in November 2015.

- *Designation Regime not suitable for general oversight*

  While the Reserve Bank and FMA have stronger powers in respect of designated settlement systems, designation is focused on ensuring that the system operates in a sufficiently rigorous manner to justify it having the benefit of settlement finality and netting protections. Because this is a tighter focus than general oversight, it does not deal directly with significant matters like access, governance, and business continuity.

  The Designation Regime also lacks an appropriate set of graduated tools to induce changes. Non-compliance with conditions of designation is not an offence, so the regulators have to rely on system operators voluntarily complying with the conditions. Once the regulators are aware of any non-compliance, the only effective statutory option is to review and potentially revoke a designation, which is a very strong response that should only be reserved for very serious breaches. Also, while the regulators can disallow a rule change, they currently have no other measures to initiate rules changes except through moral suasion.

[11] http://www.cfr.gov.au/publications/cfr-publications/2015/resolution-regime-financial-market/pdf/report.pdf

- *Designation regime restricted to payments an settlement systems*

  Both general oversight and the Designation Regime only cover payment and settlement systems. A number of other types of FMIs that have emerged or become increasingly important in recent years, such as trade repositories (TRs) and central counterparties (CCPs), are outside of the existing legislative regime and therefore not subject to oversight (or the ability to opt into the regime). Internationally, there has been a strong drive to increase the use of TRs and CCPs and to ensure that they are subject to robust oversight.

  The Reserve Bank has also identified some of these FMIs as potentially systemically important to New Zealand. For example, LCH Clearnet Ltd (LCH) which processes around 80% of the NZD Interest Rate Swap market, and ASX Clear (Futures), which clears NZD interest rate futures. The current regime does not explicitly include these FMIs in New Zealand and the New Zealand regulators do not have any powers for these potentially systemically important FMIs.

27 As a whole, the current legislative oversight framework for payment and settlement systems does not reflect the importance of certain FMIs to the New Zealand financial system. I do not consider that the issues described above can be adequately addressed by self-discipline backed by the threat of regulatory intervention. There is a high risk that regulators do not have all of the tools necessary to respond to failures of a SIFMI, and the regulatory regime may not cover all systemically important FMIs. These are major gaps that require a change to the regulatory framework.

Assessment of the IMF as part of the current Financial Sector Assessment Programme

28 The IMF carried out an FSAP review of New Zealand in 2016. As part of this review (the conclusions of which are expected to be published in May 2017) the IMF prepared a draft technical note on the regulation and supervision of FMIs in New Zealand. This includes a review of the legislative framework that is being proposed in this paper. In their draft technical note the IMF are strongly supportive of the proposed framework and its prompt adoption. They have also made a number of detailed recommendations relating to the regulation and supervision of FMIs in New Zealand (which are set out in the appendix to this paper), and these recommendations have been addressed in this paper as appropriate. The remaining recommendations are focused on resourcing, supervisory approach and administrative matters, and do not have any obvious implications for the framework being proposed here. The framework could accommodate any plausible decision around what the level of adequate resources going forward should be. These recommendations will be considered later as part of a formal response to the IMF's final reports on banking, insurance, crisis management and FMIs.

COMMENT

Proposed new oversight regime for FMIs

29 In light of gaps and issues identified, I recommend an enhanced framework for the oversight of FMIs be established in New Zealand. This framework would replace Parts 5B and 5C of the RBNZ Act, and be divided into two parts:

- Information gathering powers that allow for the ongoing oversight and monitoring of the broader FMI sector, including non-systemically important FMIs; and

- A new designation regime that provides for enhanced oversight of all systemically important FMIs

30 This model recognises that for those FMIs that are identified as of systemic importance to New Zealand, a higher level of oversight, accompanied by more formal powers, is required to reflect the significance of these infrastructures to the New Zealand financial system and the risk they pose. It also helps to ensure that regulatory interventions under the framework are proportionate, minimise unnecessary compliance costs, and do not create undue barriers to market entry. These kinds of efficiency considerations have been a key factor in the design of the proposed framework, particularly in the way it distinguishes between systemic and non-systemic FMIs. Restricting the revised mandatory part of the Designation Regime to SIFMIs only is also unlikely to adversely affect market behaviour. Most of these SIFMIs are quasi-monopolies with no real substitutes, while overseas SIFMIs generally already have to comply with similar or more stringent requirements in their home jurisdictions.

Administration of new oversight regime

31 I recommend that the joint regulatory approach under the current Designation Regime between the Reserve Bank and FMA be maintained under the modified oversight framework.

32 In substance, this means that under the proposed regime powers would be exercised:

- In the case of pure payment systems, by the Reserve Bank, and in respect of certain powers, the Minister of Finance; and

- In the case of all other FMIs, jointly by the Reserve Bank and the Financial Markets Authority (joint regulators), and in respect of certain powers, the Ministers of Finance and Commerce (joint Ministers).

33 The basic functions of the joint regulators under the regime would be to:

- Recommend the designation of systemically important FMIs;
- Undertake supervision of designated FMIs;
- Take appropriate action in respect of designated FMIs and other persons that have failed, are failing, or are likely to fail to comply with this Act or are otherwise in financial or other difficulties;
- Act as the resolution authority for a designated FMI that is distressed or has failed; and
- Carry out other functions and duties and exercise powers conferred on it by the legislation.

34 I recommend that the Reserve Bank should be required to exercise its powers under the proposed regime for the purposes 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 financial market infrastructure or the failure of a participant.

35 I also recommend that the FMA should be required to exercise its functions under the proposed regime for the purposes of:

- Promoting the confident and informed participation of businesses, investors, and consumers in financial markets; and
- Promoting and facilitating the development of fair, efficient, and transparent financial markets.

36 These purposes reflect the prudential and market conduct mandates of the Reserve Bank and FMA respectively, and align with their objectives under other regulatory regimes.

Principles to be taken into account when carrying out functions and exercising powers

37 I propose that when carrying out their functions and exercising their powers under the regime, joint regulators be required to take into account certain principles. This will help to guide joint regulators' approach, and provides an additional level of transparency around how joint regulators will operate and the outcomes they will seek to achieve. At a minimum, these principles will include:

- The importance of considering the costs and benefits of alignment with international standards on the regulation of FMIs;

- The importance of minimising compliance costs and avoiding unjustified constraints to innovation as a result of regulatory actions;

- The importance of adequate information being available to participants to allow them to make informed decisions when joining and transacting through a FMI, including decisions about the risk they choose to bear and their exposure to potential losses;

- In dealing with designated FMIs that are in financial distress or other difficulties, the importance of (as applicable):

    - achieving continuity and timely completion of critical payment, clearing, settlement and recording functions;

    - facilitating the timely settlement of obligations of the FMI;

    - maintaining continuous access of participants to securities or cash accounts provided by the FMI and securities or cash collateral posted to and held by the FMI that is owed to such participants;

    - avoiding any disruption in the operation of links between the FMI in resolution and other FMIs that would have a material negative effect on financial stability or the functioning of markets;

    - safeguarding, preserving and enabling continuous processing of, and access to, data stored in a Trade Repository; and

    - minimising any financial risks to the Crown associated with the resolution of a distressed or failed FMI (other than those arising out of the Crown's own role as a participant of the FMI).

Information gathering powers in respect of FMIs

38 Part 5B of the RBNZ Act currently provides a power to require certain people to provide information to the Reserve Bank, such as an operator of a payment system. I recommend retaining this power, and extending it to all FMIs, including those that are not designated. I consider this necessary for the joint regulators to monitor the wider FMI landscape, both to understand the potential risk other FMIs pose to designated FMIs, and to help identify any FMIs that have become (or seem likely to become) sufficiently important to merit designation.

Designation of systemically important FMIs

39 I recommend that FMIs identified as systemically important by joint regulators be designated by Orders in Council made on the advice of joint Ministers given in accordance with the recommendation of joint regulators.

40 Before recommending designation, the joint regulators would have to be satisfied that the FMI is systemically important, taking into account the following factors:

- The size and concentration of financial risks in the FMI;
- The FMI's role and the nature of the transactions it processes;
- The extent to which there are alternatives available to the essential services provided by the FMI (i.e. substitutability);
- The FMI's interdependencies with other FMIs or markets.

41 Prior to recommending that an FMI be designated, joint regulators would also have to follow appropriate natural justice procedures, including consultation with affected stakeholders (notably the FMI and its members).

42 An Order in Council designating an FMI would specify:

- the arrangements that constitute the FMI, including whether the FMI is a payment system (and hence is regulated by the Reserve Bank alone);
- the operator(s) of the FMI (if the FMI is not a legal entity) and the contact person(s) within the operator(s);
- whether the FMI's rules have legal certainty with relation to netting, settlement and transfer of collateral (where appropriate); and
- the specific documents that constitute the rules of that FMI.

43 A similar criteria and process would apply to the revocation of designation (i.e. an FMI that was not longer systemically important and did not want to continue to be designated could have their designation revoked by an Order in Council).

Current FMIs that may be systemically important

44 The Reserve Bank has currently assessed the following five FMIs as likely to meet systemic importance criteria (the first four are also designated under the current regime):

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.

2) The CLS system is a global high value inter-bank payment system used to settle foreign exchange transactions involving 18 currencies including the New Zealand dollar. Settlement in CLS allows both currency legs to be settled simultaneously. 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 also 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 $4 billion of payments each day. The net inter-bank positions settle in ESAS.

45 The Reserve Bank has also conducted a preliminary assessment on the systemic importance of other FMIs, and concluded that the following four FMIs may, subject to further analysis) also meet systemic importance criteria:

1) High Value Clearing System (HVCS). HVCS currently processes an average of $21 billion per day. HVCS is a set of rules administered by Payment NZ for

customer to customer real time payments and for high value payments between participating financial institutions. Settlement occurs in ESAS.

2) LCH Clearnet Ltd (LCH), a London domiciled central counterparty, is the largest Interest Rate Swap central counterparty (CCP) in the world. 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 May 2016, Swapclear's total NZD outstanding was NZD $4.3 trillion, representing about 82% of the NZD Interest Rate Swap market.

3) ASX Clear (Futures) is a Sydney domiciled 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.

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

46 The last three of these FMIs are domiciled overseas and have little or no legal or physical presence in New Zealand. This makes it practically difficult to compel compliance with requirements that might result from designation. However, these FMIs are in most cases familiar with and already bound by comparable regimes in other jurisdictions (including their home states), and our understanding is that most of them may have no objection to being designated in New Zealand. In addition, I would expect them to generally be exempt from many requirements stemming from their designation in New Zealand, in recognition of equivalent regulation in their home jurisdiction, and in other areas subject to requirements that align with their obligations in their home jurisdictions. If necessary, the designation of offshore FMIs and their compliance with any New Zealand regulatory requirements can also be encouraged through formal and informal cross-border cooperative arrangements, including the joint regulators' engagement with home country regulators and the international supervisory colleges that oversee many transnational FMIs. Any other potential issues with designating FMIs with no physical presence in New Zealand will be considered further in the drafting of the legislation.

Oversight powers for designated FMIs

47 To ensure that joint regulators have sufficient powers to support their oversight functions, I recommend that designated FMIs be subject to a number of oversight powers, in addition to the information gathering powers that I am proposing would apply to all FMIs. The following sections of this paper set out the specific powers I propose that joint regulators have in respect of designated FMIs.

48 The approach taken to oversight should reflect the nature and level of risks raised by different FMIs. Given that designated FMIs would have the most significant impact on the soundness and efficiency of the New Zealand financial system, I propose that joint regulators general oversight powers cover the following matters:

- A power to set regulatory requirements for designated FMIs;
- A power to require independent reports on the operation of a designated FMI; and
- Oversight of the rules of designated FMIs.

Setting regulatory requirements

49 The legislation would provide a power for the joint regulators to set regulatory requirements in accordance with which an individual FMI, class of FMI, or all FMIs must operate their business. The types of requirements that joint regulators would prescribe are likely to be those that they consider relevant for the soundness and efficiency of the designated FMI, and would be primarily based on relevant principles of the CPSS-IOSCO's PFMIs, customised for the New Zealand context.

50 These regulatory requirements could only relate to certain subject areas set out in legislation. I propose that these subject areas be:

- Governance of the FMI and its operator (or operators);
- An FMI's management of any of the following risks:
    - General business risk;
    - Operational risk;
    - Credit risk;
    - Liquidity risk;
    - Custody and investment risk;
    - Legal risk;
    - Risks arising out of linkages with other FMIs;
- Access to the services provided by the FMI and arrangements for parties to participate in those services;

- Public disclosure of information relating to the FMI and its operator (or operators);
- Business continuity, recovery, and resolution arrangements for the FMI;
- The relationship between the FMI and its operator (or operators), and any provider of critical services to the FMI;
- The default of one or more participants of the FMI;
- Any other matters prescribed by regulations.

51 These subject areas are designed to cover all of the matters discussed in the PFMIs, which as noted above are the main international standards for the regulation of FMIs. Some of the concepts in this list (such as "general business risk" and "operational risk") are drawn directly from the PFMIs, which provides guidance as to their intended scope.

52 Whether these regulatory requirements would be set through conditions, standards, or some other form of legal instrument is a matter that would be considered further during the drafting of legislation [12] However, whatever legal instrument is chosen, the requirements would be set directly by joint regulators, through a process that would be subject to appropriate natural justice and constitutional protections. In addition to these regulatory requirements only being able to relate to specified matters, this would include a requirement to take into account the principles noted in paragraph 37 when setting regulatory requirements, a requirement to consult with affected parties on proposed requirements,[13] a requirement to publish an assessment of the regulatory impact of policies reflected in the regulatory requirements, and an obligation to publish regulatory requirements and make them available to the public. If the decision was made to use standards rather than conditions to set these regulatory requirements, the standards would be subject to the Parliamentary disallowance procedure as well.

Require independent reports

53 Alternative channels for obtaining or verifying information, in addition to audits, would also be useful. Given the more technical nature of certain FMIs, having the ability to seek information from an independent specialist would provide a higher level of flexibility for joint regulators. Accordingly, I propose that joint regulators may require the operator

[12] As discussed in paragraphs 96 and 97 below, I am recommending a report back to Cabinet on this matter during the drafting process. It may also be consulted on as part of the release of an exposure draft of the proposed legislation.

[13] As the Reserve Bank is currently required to do in respect of most policies it imposes under the existing regulatory regimes for banks, insurers, non-bank deposit takers, and payment and settlement systems.

of a designated FMI to obtain a report on the operation of that designated FMI from a person approved by joint regulators.

Oversight of the rules of a designated FMI

54 An FMI's rules are likely to be one of the most important matters governing how that FMI operates, as they usually set out a common platform and procedures for participants using the FMI. They also set out arrangements for managing the default or distress of a participant to the FMI. It is therefore important that in addition to a power to impose regulatory requirements, the joint regulators should also have powers that enable effective oversight of the rules of a designated FMI (without joint regulators also becoming involved in aspects of the rules that should be left to private contractual arrangements).

55 As noted above the Order in Council designating an FMI would specify the documents that evidence the rules. The documents specified would be limited to material aspects of the designated FMI's functions.

56 Where the operator of the designated FMI proposes to amend the rules of that designated FMI, they would need to notify the joint regulators. Upon such notification, the joint regulators would have up to 20 working days to disallow the proposed amendments. This reflects the process by which joint regulators can disallow changes to the rules of a designated settlement system at present under Part 5C of the RBNZ Act.

57 I consider that joint regulators should also have the power to require the operator of a designated FMI to prepare a rule change to address an issue identified by joint regulators, subject to certain thresholds being met. If joint regulators do not consider that the rule changed proposed by the operator is adequate to address the issue, they may, subject to appropriate safeguards,[14] direct the operator to make a rule change.

58 Finally, I note that it may not be practical or desirable to apply these powers around the oversight of the rules of a designated FMI where it is based overseas and its rules are overseen by its home country regulator. I propose that the Order in Council designating an FMI that is based overseas may also exempt the FMI from the application of these powers.

[14] Whether these safeguards would include a requirement for Ministerial consent before a direction was issued is a matter that, as noted below, I am recommending a report back to Cabinet on. In the draft technical note on the regulation and supervision of FMIs that they have prepared as part of the New Zealand FSAP, the IMF have recommended that no requirement for Ministerial consent be included, and this is a matter I consider would benefit from further analysis. It may also be consulted on as part of the release of an exposure draft of the proposed legislation.

Investigations, offences and penalties

Investigative powers

59 In investigating potential breaches of regulatory requirements under the proposed regime, joint regulators would be able to use the general information gathering power applying to all FMIs that is being proposed. To reflect the information gathering powers the Reserve Bank and the Financial Markets Authority have under most of their other regulatory regimes, I also propose that joint regulators have the power to enter premises for supervisory or investigative purposes. This power would be subject to appropriate procedural constraints. For example, where joint regulators proposed to enter premises for the purpose of investigating a potential breach of regulatory requirements they would require a warrant from the court and need to show that they have reasonable grounds to believe:

- It is reasonably necessary to identify whether joint regulators should exercise any of their powers under the proposed regime, or the FMI or its operator has failed to provide information that it has been required to provide, or there are reasonable grounds to believe that the FMI or its operator has provided incorrect or misleading information; and

- The premises will contain the relevant information.

Offences and penalties

60 Part 5B and Part 5C of the RBNZ Act 1989 currently contain criminal offences for breaches of obligations imposed under those parts of the Act. I recommend that the proposed regime contain a more graduated range of offences and penalties. By making it possible to take more proportionate enforcement action in the event of breaches, this will help to provide improved incentives for compliance by operators and other parties who may be subject to obligations under the proposed regime.

61 Subject to further discussions between my officials and the Ministry of Justice, I propose that this more graduated range of offences and penalties have three tiers, specifically:

- Criminal offences for intentional or reckless breaches of significant requirements;

- Civil pecuniary penalties for other breaches of significant requirements;

- Administrative penalties for breaches of minor requirements (i.e. infringement notices imposed in accordance with the Summary Proceedings Act 1957).

62 I anticipate that the criminal offences and civil pecuniary penalties will be set at levels that are proportionate the severity of an breach and are consistent with the level of offences and penalties applying under the RBNZ Act.[15]

63 I also consider that joint regulators should have the power to enter into enforceable undertakings[16] with persons who may have breached obligations imposed under the proposed regime. I note that this is also already a power the Financial Markets Authority has at present.[17]

Crisis management powers for designated FMIs

64 To provide the regulators a number of crisis management powers to help avoid any significant damage to the financial system that could result from the distress or failure of a designated FMI, its operator(s), or one of its participants, I recommend that a tailored crisis management framework be established, with the ultimate objective being to ensure the continuity of essential services provided by the designated FMI (if not the FMI itself), or an orderly wind down, in order to reduce impacts on the financial system.

65 The crisis management framework would consist of two elements. Designated FMIs would be required to have business continuity plans and recovery and orderly wind down plans (this requirement would be imposed under the power to impose regulatory requirements discussed earlier). The recovery and orderly wind down plans would include a requirement for there to be rules and procedures around participant-default management including arrangements for the allocation of losses to owners and participants in the system (where appropriate[18]). These plans would be backed up by direction powers for joint regulators and a statutory management regime.

Business continuity plans, and recovery and orderly wind down plans

66 Designated FMIs would be required to have in place the following plans::

- A business continuity plan to achieve rapid recovery and timely resumption of essential services or to facilitate the replacement of the designated FMI's operator(s) following a failure of technology, a natural disaster, or other physical disruption, and the operator being unable to perform their functions for non-financial reasons; and

[15] Under the prudential regime for registered banks maximum offences for the most serious breaches are: 1) for individuals, imprisonment for a term of up to 18 months and/or a fine of up to $200,000; and 2) for a body corporate, a fine of up to $2,000,000.

[16] An enforceable undertaking is a binding agreement between a regulated party and their regulator that they will take certain actions.

[17] See sections 46-48 of the Financial Markets Authority Act 2011, which provides the Financial Markets Authority with a general power to enter into enforceable undertakings under any of the legislation that it administers.

[18] Loss allocation measures designed to allocate any losses suffered by an FMI to its owners and/or participants is primarily an issue for FMI s that take on credit risk, such as central counterparties.

- Recovery and orderly wind-down plans to respond to financial threats to the continued provision of essential services. For example, losses on the system that could arise where a participant becomes insolvent with unsettled transactions, margin or default fund shortfalls; securities shortfalls and other events where the system itself generates losses. These plans would cover loss allocation or trade portability in a way designed to ensure that the FMI keeps running or is wound up in an orderly manner

67 The requirement to have these plans in place will help to make it more likely that that the failure of a designated FMI can be resolved without the need for public intervention or financial support. This approach also has the merit of leveraging off the existing rules and plans that will already be in place for many FMIs, and allowing for certain matters such as loss allocation to be agreed in advance between participants and operators.

68 I do not propose that joint regulators be responsible for approving these plans, as this would be resource intensive and operators themselves will usually be best placed to determine the detailed design of these plans, and the most cost effective ways of ensuring they achieve the required outcomes.

69 However, joint regulators would be required to ensure that the plans were in place and met the requirements set out in the relevant regulatory requirements set by joint regulators. Using their power to set regulatory requirements, joint regulators would also have the ability to change the required content of these plans. This provides a backstop to deal with rare instances where plans may be inadequate.

Direction powers and statutory management

70 The second element of the regulatory framework is comprised of regulatory powers available to the joint regulators, which in practice would generally be used when the designated FMI is in difficulties and its business continuity plans and/or recovery and resolution plans are:

- Not applicable or inadequate to the situation; or
- Not being effectively implemented to deal with the situation; or
- Have failed to resolve the situation.

71 These statutory powers (which would be subject to appropriate procedural constraints) are:

- A power for joint regulator to issue directions to the operator(s) of an FMIs;

- A power for joint regulator to appoint, replace or remove the directors of an operator;

- A power for joint regulators to recommend that an FMI be placed into statutory management.

72 The first two powers are designed to ensure operators take certain actions to address threats to the soundness and efficiency of designated FMIs, and the ability of these designated FMIs to continue to provide essential services. The procedural constraints applying to these powers would include a statutory threshold having to be met before they can be exercised, and further consideration will be given during drafting as to whether Ministerial consent to the issuing of directions should be required.[19]

73 Statutory management would be a tool of last resort, which would see a statutory manager take direct control of the designated FMI in order to hand over to a new operator who can run it, or to manage its resolution directly. The purpose of all of these powers would be to ensure the continuity of essential services provided by the designated FMI, not to resolve the affairs of the operator itself.

74 The proposed crisis management powers would also apply differently in practice, depending upon the designated FMI's legal form and level of New Zealand presence. For example:

- Where the designated FMI and its operator are a single legal entity all of the powers would apply,

- Where the designated FMI is a set of arrangements between participating institutions:

    - The power to issue directions, and the power to appoint, replace or remove directors, would apply to the operator(s); and

    - Statutory management would apply to the FMI business of the operator(s) where it could be severed from the rest of their business, and the operator(s) themselves where it could not;

- Where the designated FMI and its operator(s) have no legal or physical presence in New Zealand, the majority of the powers would not apply. The main

[19] As noted below, I am recommending a report back to Cabinet on this matter during the drafting process. In the draft technical note on the regulation and supervision of FMIs that they have prepared as part of the FSAP, the IMF have recommended that no requirement for Ministerial consent should be included, and this is a matter I consider would benefit from further analysis. It may also be consulted on further as part of the process of publishing an exposure draft of the legislation.

focus would be to support the resolution of the FMI by the home country and/or at an international level.

Direction powers

75 I propose that joint regulators be able to issue a direction to the operator of a systemically important FMI where:

- The operator is insolvent, likely to become insolvent, or otherwise unable to perform its role as operator; or
- The business of the operator and/or FMI are being conducted in a manner prejudicial to the soundness of the FMI or the financial system; or
- The operator has acted, or is acting, fraudulently or recklessly; or
- The operator has been involved in serious or repeated breaches of obligations imposed by, or under, the Act; or
- It is necessary to facilitate the resolution in its home jurisdiction of an FMI that is based in a foreign jurisdiction but has a corporate presence in New Zealand.

76 These directions may require the operator(s) to

- Consult with joint regulators immediately and/or from time to time, about the circumstances of the operator and the methods of resolving any difficulties facing the operator or the FMI; or
- In accordance with the direction, carry on, or cease to carry on, any business; or
- Take the action that is specified in the direction to address a breach of any obligation that has been imposed; or
- Take the action that is specified in the direction to address any circumstances that create a risk to the sound functioning of the FMI, or the operator's ability to effectively carry out the role of operator; or
- Ensure that any officer or employee of the operator ceases to take part in the management or operation of the FMI except with the permission of the joint regulators and so far as that permission extends; or
- Prevent a person from being involved in the management of the operator and/or FMI.

77 In addition, where any of the thresholds in paragraph 75 are met, and joint regulators have reasonable grounds to believe that it is necessary to remove, replace, or appoint a director of the operator of a systemically important FMI, I propose that joint regulators may:

- Remove or replace a director; or
- Appoint any person as a director.

78 Finally, I note that there may be merit in a very limited power to direct participants where they may be acting in a way that obstructs the effective resolution of a designated FMI. At the same time, any such power should be tightly constrained and not inappropriately impinge upon the ability of participants to make private commercial decisions in a crisis event.

79 Given this context, I propose that joint regulators have the power to direct participants to comply with the rules of a designated FMI where the circumstances in paragraph 75 are met. This ensures that the scope of a direction cannot extend beyond requirements that the participant has already agreed to comply with. This kind of power could also be particularly useful in the resolution of a designated FMI with New Zealand participants but no New Zealand presence where there may be practical issues with the ability to enforce the rules of the FMI against the New Zealand participant, short of suspending their membership.

Statutory management

80 The operators of FMIs are currently subject to the statutory management regime in the Corporations (Investigations and Management) Act 1989 (CIMA). However, the statutory management regime in CIMA is not well tailored to the specific circumstances of FMIs, nor in some respects to the resolution of a systemically important institution.

81 Accordingly, I propose that a separate statutory management regime be provided for designated FMIs in the same way that separate statutory management regimes apply to banks and insurers.

82 Under this regime, a designated FMI may be placed into statutory management by an Order in Council made on the advice of joint Ministers given in accordance with the recommendation of joint Ministers. Joint regulators could only recommend statutory management where they have reasonable grounds to believe that any of the grounds for issuing a direction exist (except serious or repeated breaches of obligations imposed by, or under, the Act) or the FMI has failed to comply with a direction.

83 The statutory management would only apply to the FMI rather than its operator(s), unless the FMI could not practically be separated from its operator(s).

84 The statutory management regime would also have the following features:

- The statutory manager would be required to take into account the following considerations in exercising its powers:
    - The need to maintain public confidence in the financial system;
    - The need to avoid significant damage to the financial system;
    - The need to ensure the continuity of essential services provided by the FMI;
    - To the extent not inconsistent with the preceding points, respecting the rules of the FMI, and preserving the position of creditors and maintaining the ranking of creditors;
    - The advice of joint regulators;
- A moratorium would apply to the debts and obligations of the entity in statutory management, except those which are owed to participants of the FMI acting in their role as participants;
- The statutory manager would have the following basic capacities and powers, which are modelled on provisions in Part 5 of the RBNZ Act 1989, including:
    - The management of the entity in statutory management vesting in the statutory manager;
    - The statutory manager having the rights of shareholders and a board of directors;
    - The statutory manager being empowered to carry on the business of the entity in statutory management;
    - The power to suspend payment of money owing, pay creditors, and compromise claims;
    - The power to sell or otherwise transfer to a third party the whole or part of the business of the entity in statutory management;
    - The power to place the entity in statutory management into liquidation;

- The joint regulators would have the power to direct the statutory manager and issues guidelines to the statutory manager on the appropriate conduct of the statutory management.

85 The statutory manager would be expected to be bound by the rules of the FMI as they relate to payments, settlements, and netting, as this will be necessary to maintain confidence in the operation of the FMI, the continuity of essential services, and provide ex ante certainty to participants.

86 Other aspects of the statutory management regime would be based upon the statutory management regime for banks under Part 5 of the RBNZ Act 1989, modified as necessary to reflect the specific characteristics of FMIs.

Treatment of creditors in statutory management

87 I note that the FSB's *Key Attributes* provide that "resolution powers should be exercised in a way that respects the hierarchy of claims while providing flexibility to depart from the general treatment of equal (*pari passu*) treatment of creditors within the same class, with transparency about the reasons for such departures, if necessary to contain the potential systemic impact of a firm's failure or maximise the value for the benefit of creditors as a whole".

88 Legal advice on the statutory management regime applying to registered banks indicates that the statutory manager's powers can, in summary, be used to depart from the equal treatment of creditors within the same class and the ranking of classes of creditors, on financial stability grounds. This would also be the case under the statutory management model proposed here, and goes slightly beyond what is suggested in the *Key Attributes*.

89 It is not expected this power would be used in respect of creditors who are participants, as the FMI's own rules and procedures for the allocation of default and non-default losses would govern the treatment of those creditors.

90 Notwithstanding this context, I consider that some additional accountability arrangements should apply to the exercise of this power given its effect on property rights. These arrangements would be:

- That the statutory manager be required to observe the equal treatment of creditors within a class and the ranking of classes of creditors unless directed otherwise by the Reserve Bank;

- That the Reserve Bank should only be able to direct otherwise when this is necessary given:

- The need to maintain public confidence in the financial system;
- The need to avoid significant damage to the financial system; or
- The need to ensure the continuity of essential services provided by the FMI;

- That the RBNZ must, within a reasonable timeframe, provide a notification to Parliament of its reasons for issuing such a direction.

91 I am also proposing in paragraphs 96 and 97 that before a Bill giving effect to the recommendations in this paper is submitted to the Cabinet Legislation Committee for approval to introduce into the House, I report back to Cabinet on:

- Whether the power should continue to allow for the reordering of classes of creditors, rather than just departures from equal treatment of creditors within the same class (as in this respect, the power currently extends beyond that recommended in the FSB's *Key Attributes*); and

- The appropriate accountability arrangements that should apply to the power under both the proposed statutory management regime for FMIs, and the existing statutory management regime for banks.

Legal certainty for payment and settlement systems, and opting in to the modified Designation Regime

92 Designation provides a high degree of legal certainty to participants in a designated settlement system that they can rely on the settlements they receive. In turn, this contributes to the ongoing flow of liquidity in the financial system, the overall soundness and efficiency of the financial system, and the confidence of investors and other market participants. Designation is considered to be particularly relevant for systemically important payment and settlement systems; therefore I recommend that all designated payment and settlement systems would receive legal certainty on their netting, settlement arrangements and transfer of collaterals where relevant, subject to their rules meeting the settlement finality and netting requirement set by the joint regulators. This would involve carrying across the legal certainty provisions of Part 5C of the RBNZ Act.

93 Similarly, operators of non-systemically important payment and settlement systems might perceive that there are benefits for the system to have a high degree legal certainty on the netting and settlement arrangements. Subject to these payment and settlement systems' rules being assessed to meet the requirements of designation, I recommend that there remain an option for operators of non-systemically important payment and settlement systems to opt into the proposed designation regime. In these cases, joint regulators could recommend that the payment of settlement system be designated despite it not being systemically important, and the payment or settlement

system is likely to be subject to lesser regulatory requirements than systemically important FMIs.

Transitional arrangements for currently designated FMIs

94 Subject to detailed analysis and consultation with relevant stakeholders, it is likely that the four FMIs that are designated under the current Designation Regime would be re-designated under the new Designation Regime.

95 The following transitional arrangements would be provided for:

- Information gathering powers in the new legislation would apply immediately;
- Other powers in Part 5C, the provisions providing settlement finality and netting protections for designated FMIs, and existing Orders in Council designating FMIs would remain in force;
- A 12 month period would be provided for to identify which FMIs should be designated under new legislation, which wish to opt in, and the regulatory requirements that should apply to them;
- At the end of that period relevant FMIs would be designated under the new legislation, relevant regulatory requirements would come into force with their own transitional periods, and the rest of the new legislation (including the new provisions providing for settlement finality and netting protection) would come into effect.

Reports back on certain matters

96 There are a number of unresolved technical issues relating to the proposals in this paper that require time for further consideration. Specifically:

- The type of instrument used to by joint regulators to set regulatory requirements for designated FMIs (standards, conditions, etc);
- Whether joint regulators should require Ministerial consent before exercising any of their proposed direction powers;
- Whether there needs to be some form of stay on the exercise of termination rights against the FMI which may be triggered by its entry into statutory management;[20] and

[20] The purpose of such a stay would be to stop further deterioration in the FMIs financial position, which could add to the risks around its ability to continue to provide essential services. A stay on termination rights is expected to be recommended by the IMF as part of the recent New Zealand FSAP.

- In respect of the power in statutory management to depart from the equal treatment of creditors within a class, or the ranking of classes of creditors:
    - Whether this power should continue to allow for the reordering of classes of creditors (as in this respect, the power currently extends beyond that recommended in the FSB's *Key Attributes of Effective Resolution Regimes for Financial Institutions*); and
    - What accountability arrangements should apply to this power under the proposed statutory management regime for FMIs and the other statutory management regimes where it exists (i.e. the statutory management regime for banks.

97 I propose to report back to Cabinet on these matters before the Bill giving effect to the proposals in this paper is finalised. Prior to Cabinet decisions being sought on these matters, they may be consulted on further as part of the release of an exposure draft of the Bill.

98 While it is unlikely that the FMI-related recommendations made by the IMF as part of their recent FSAP of New Zealand will have a material affect on the framework proposed in this paper, the Reserve Bank (in consultation with Treasury) will also be reporting back to me on this prior to the Bill being finalised.

Other matters related to the proposed Designation Regime

Potential conflict of interest

99 Two of the current designated settlement systems, ESAS and NZClear, are run by the Reserve Bank and are likely to be designated under the modified Designation regime as SIFMIs. The proposed powers for the regulators would apply to the Reserve Bank operated FMIs as well, and therefore give rise to perceived conflict of interest between the Reserve Bank's oversight and operator functions.

100 This issue already exists under the current Designation Regime, where ESAS and NZClear are both regulated and operated by the Reserve Bank. Under the modified Designation regime, the Reserve Bank would continue to manage the potential conflict via organizational separation and transparency of policy application, including the application of consistent requirements on all FMIs, separate reporting lines, and in the case of NZClear, the joint regulatory arrangements with the FMA.

Efficiency considerations

101 Since 2001, the Reserve Bank has been promoting open access and transparent governance in payment systems, and continues to monitor developments in these areas.

102 Other aspects of efficiency are also relevant. In the PFMIs, efficiency refers generally to the use of resources by FMIs and their participants in performing their functions. Efficient FMIs contribute to well-functioning financial markets, whereas an FMI that operates inefficiently may distort financial activity and the market structure, affecting not only the financial and other risks of its participants, but also the risks of its participants' customers and end users. These distortions may lead to lower aggregate levels of efficiency and soundness, as well as increased risks within the broader financial system. For example, if an FMI is inefficient, a participant may choose to use an alternate arrangement that poses increased risks to the financial system and the broader economy.

103 These efficiency considerations would be reflected in the FMI oversight framework, in that the joint regulators would promote:

- efficient and reliable FMIs that are effective in meeting the requirements of its participants and the market it serves;
- clear and transparent governance in an FMI, which provides the proper incentives for its board and management to pursue objectives that are in the interest of its stakeholders and that support relevant public interest; and
- fair and open access with no unwarranted barriers to entry, and fostering competition.

104 As part of a more explicit consideration of efficiency issues during FMI oversight, it is important that there is close cooperation and engagement between joint regulators and the Commerce Commission, which enforces the Commerce Act 1986 (which prohibits various forms of anti-competitive behaviour). I note that joint the Reserve Bank, FMA, and Commerce Commission may look to establish an MOU to provide a framework for dealing with efficiency issues.

105 Other efficiency issues regarding the retail payment systems, such as interchange fees and business models, are being considered by the Minister of Commerce and Consumer Affairs. The Reserve Bank has been consulted on that work, primarily due to the Reserve Bank's role as a prudential supervisor of the overall payments sector. However, it should be noted that the focus of that work is on market conduct and competition issues, which are beyond the Reserve Bank's efficiency objective and the scope of the proposal in this paper.

CONSULTATION

106 Three rounds of public consultations on the proposals in this paper have been carried out since March 2013. A wider range of stakeholders have also been engaged either via the formal consultation process, industry forums or informal bilateral discussions.

107 The original proposals have been amended based on the feedback received throughout the three rounds of consultation. Overall, there has been a high level of stakeholders' support for the proposals in this paper.

108 The Treasury, MBIE, FMA, and Parliamentary Counsel Office have been consulted on this paper. No significant concerns were raised by these departments and agencies. The Department of Prime Minister and Cabinet has been informed.

FINANCIAL IMPLICATIONS

Implications for the FMI Sector

109 Overall, the Reserve Bank expects the costs to FMIs of complying with the new regime will be small for most FMIs. This is firstly because four of the nine FMIs that may be considered systemically important are already designated under the current regime. Additional compliance costs for FMIs that are already designated are expected to be minor. Secondly, additional costs to foreign FMIs are expected to be minor. This is because the new regime proposed in this paper is relatively flexible and like many other jurisdictions is based on the PFMIs. However, the proposals are also much less onerous than the regimes of many foreign jurisdictions. Taking these points together, we expect that for many foreign FMIs already complying with the regulation of their home regulator, very little will be required on their part to comply with the proposed regime for New Zealand. Thirdly, as the Reserve Bank's proposals are based on the PFMIs, they represent best business practices and so we expect some FMIs will not need to make anymore than minor changes once designated.

110 (Withheld under section 9(2)(b)(ii) of the Official Information Act 1982)

111 (Withheld under section 9(2)(b)(ii) of the Official Information Act 1982)

(Withheld under section 9(2)(b)(ii) of the Official Information Act 1982)

112 The additional costs to Payments New Zealand likely represent the majority of the additional costs to industry arising from these proposals. This is because Payments NZ are the operator of one SIFMI and one FMI identified as potential SIFMI (by the Reserve Bank) and neither of these systems are currently designated. At the stage, the Reserve Bank does not envisage any domestic FMIs beyond SBI and HVCS that are not already designated would be required to do so, at least in the near future. Furthermore, and as previously stated, we expect costs to foreign FMIs already designated domestic FMIs to be minimal.

Implications for the regulators

113 The proposals in this paper will result in additional powers and obligations for the Reserve Bank and FMA, which is likely to require both agencies to allocate more resources to this area once the legislation is passed. The new resource would be allocated to matters including preparing new Designation Orders during the transition period, and the on-going supervision of designated entities during business-as-usual oversight. Once the regime is fully in force, there is likely to be a larger number of responsibilities for the regulators (including reviewing and issuing new regulatory requirements, monitoring compliance with those requirements, and formally overseeing a larger number of FMIs).

114 The Reserve Bank considers that in the first instance, it may need to allocate 1-2 additional FTEs to the supervision of FMIs, and that this cost can be met within the scope of its existing five-year funding agreement (which runs from mid-2015 to mid-2020), Consideration of whether additional funding may be appropriate in the longer term will be factored into the negotiation of the Reserve Bank's next five-year funding agreement (which should be in place by mid-2020).

115 The FMA's funding was reviewed in 2016 and adjustments to the FMA's appropriation will come into effect in July this year. The estimated cost of 1 additional FTE required to implement the recognition regime can be met within the scope of the FMA's increased appropriation.

116 Consistent with existing practice under Part 5C of the RBNZ Act 1989, it is likely that payment and settlement systems that opt into the regime (to access the legal finality protections) would be required to pay a fee to joint regulators. However, this fee is only expected to contribute to the costs of considering the application to be designated

HUMAN RIGHTS

117 There are no human rights implications arising out of the proposals in this paper.

LEGISLATIVE IMPLICATIONS

118 (Withheld under section 9(2)(f)(iv) of the Official Information Act 1982) [redacted]

119 The Bill will repeal Part 5B and 5C of the RBNZ Act. However, a number of provisions will be carried across in the Bill (with consequential modifications as necessary). These include the settlement finality and netting rules for existing designated systems.

120 The Bill will bind the Crown.

REGULATORY IMPACT ANALYSIS

121 The Regulatory Impact Analysis requirements apply to the proposals set out in this paper. A Regulatory Impact Statement (RIS) has been prepared, and is attached to this paper.

122 A senior analyst in the Prudential Supervision Department at the Reserve Bank has reviewed the RIS prepared by the Reserve Bank and the associated supporting material, and considers that the analysis summarised in the RIS meets the quality assurance criteria.

123 I have considered the analysis and advice of my officials, as summarised in the attached RIS, and I am satisfied that the regulatory proposals recommended in this paper:

- are required in the public interest; and
- will deliver the highest net benefits of the practical options available.

PUBLICITY

124 The Reserve Bank will inform Payments NZ and other interested stakeholders of the decisions made by Cabinet on the proposals in this paper. A press release announcing these decisions will also be published.

RECOMMENDATIONS

125 The Minister of Finance recommends that the Committee:

1. **Note** that FMIs include payment systems, settlement systems, central securities depositories, central counterparties and trade repositories and that the concept encompasses a system for processing transactions according to rules, which may not always correlate with a distinct legal entity;

2. **Note** that the regulation of FMIs has been considered by the International Monetary Fund as part of their recent Financial Sector Assessment Programme (FSAP) review of New Zealand, and that the findings of this review are expected to:

    2.1 confirm the Reserve Bank's assessment that the current regulatory regime leaves room for systemic risks to build up within FMIs and exposes society to negative externalities in case of an FMI failure;

    2.2 express the IMF's strong support for the legislative framework proposed in the following recommendations, and indicate that if it is adopted, it will address the major shortcomings of the current framework;

    2.3 recommend that more resources might be required to effectively supervise FMIs (the IMF are likely to raise this resourcing issue in relation to some other supervisory areas as well, and I anticipate that it will be considered through further work on the appropriate level of supervisory resource across all of these areas. While the level of resourcing may influence the degree and manner of supervision carried out by the Reserve Bank, it is unlikely to have any implications for the design of the legislative framework for FMI oversight proposed in this paper).

3. **Note** that Parts 5B and 5C the Reserve Bank of New Zealand Act 1989 currently provide for the oversight of payment systems and designated settlement systems;

4. **Note** that the purpose of the designation regime for settlement systems in the Reserve Bank of New Zealand Act 1989 is largely to provide legal certainty around the status of transactions undertaken through those systems;

5. **Note** that the FMI sector has become more diverse and is of increasing importance;

6. **Note** that the Reserve Bank has conducted three rounds of public consultation on changes to the oversight regime for FMIs, and there is a broad level of support for an enhanced oversight framework for FMIs;

Proposed Financial Markets Infrastructure Bill

7. (Withheld under section 9(2)(f)(iv) of the Official Information Act 1982) [redacted]

8. **Agree** that the existing designation regime be replaced by a new oversight regime divided into two parts:

8.1 Information gathering powers that allow for the ongoing oversight and monitoring of the broader FMI sector, including non-systemically important FMIs;

8.2 New designation regime that provides for the enhanced oversight of all systemically important FMIs;

Administration of new oversight regime

9. **Note** that, with the exception of payment systems, the operation of other types of FMIs raises both prudential and market conduct issues;

10. **Agree** that under the FMI Bill, powers would be exercised:

10.1 In respect of payment systems, by the Reserve Bank, and in certain circumstances, the Minister of Finance;

10.2 In respect of all other FMIs, jointly by the Reserve Bank and the Financial Markets Authority (joint regulators), and in certain circumstances, jointly by the Ministers of Finance and Commerce (joint Ministers);

11. **Agree** that the functions of joint regulators under the proposed regime would be to:

11.1 Recommend the designation of systemically important FMIs;

11.2 Undertake supervision of designated FMIs;

11.3 Take appropriate action in respect of designated FMIs and other persons that have failed, are failing, or are likely to fail to comply with this Act or are otherwise in financial or other difficulties;

11.4 Act as the resolution authority for a designated FMI that is in distress or has failed; and

11.5 Carry out other functions and duties and exercise powers conferred on it by the legislation;

12. **Agree** that the Reserve Bank must exercise its powers under the FMI Bill for the purposes of:

12.1 Promoting the maintenance of a sound and efficient financial system; or

12.2 Avoiding significant damage to the financial system that could result from the failure of an FMI or the participant of an FMI;

13. **Agree** that the Financial Markets Authority must exercise its powers under the FMI Bill for the purposes of:

    13.1 promoting the confident and informed participation of businesses, investors, and consumers in the financial markets; and

    13.2 promoting and facilitating the development of fair, efficient, and transparent financial markets;

14. **Agree** that when carrying out their functions and exercising their powers under the FMI Bill, joint regulators be required to take into account certain principles, which will include, but not be limited to (subject to drafting)

    14.1 The importance of considering the costs and benefits of alignment with international standards on the regulation of FMIs;

    14.2 The importance of minimising compliance costs and avoiding unjustified constraints to innovation as a result of regulatory actions;

    14.3 The importance of adequate information being available to participants to allow them to make informed decisions when becoming a participant and transacting through a FMI, including decisions about the risk they choose to bear and their exposure to potential losses;

    14.4 In dealing with designated FMIs that are in financial distress or other difficulties, the importance of (as applicable):

        14.4.1 achieving continuity and timely completion of critical payment, clearing, settlement and recording functions;

        14.4.2 facilitating the timely settlement of obligations of the FMI;

        14.4.3 maintaining continuous access of participants to securities or cash accounts provided by the FMI and securities or cash collateral posted to and held by the FMI that is owed to such participants;

        14.4.4 avoiding any disruption in the operation of links between the FMI in resolution and other FMIs that would have a material negative effect on financial stability or the functioning of markets;

        14.4.5 safeguarding, preserving and enabling continuous processing of, and access to, data stored in a Trade Repository; and

14.4.6 minimising any financial risks to the Crown associated with the resolution of a distressed or failed FMI (other than those arising out of the Crown's own role as a participant of the FMI).

Information gathering powers in respect of FMIs

15. **Agree** that joint regulators have an equivalent information gathering power in respect of the operators and participants of any FMI to that which is currently included in Part 5B of the Reserve Bank of New Zealand Act 1989;

Process for designating systemically important FMIs

16. **Agree** that the FMI Bill set out matters that the joint regulators must take into account when considering whether to recommend to joint Ministers that an FMI be designated;

17. **Note** that the matters referred to in recommendation 16 are likely to include::

17.1 The size and concentration of financial risks within the FMI;

17.2 The role of the FMI and the nature of the transactions process by, involving, the FMI;

17.3 The degree of substitutability in the services provided by the FMI; and

17.4 The interdependencies the FMI may have with other FMIs or markets.

18. **Agree** that Joint Ministers may advise the Governor-General that an Order in Council be made designating an FMI on the recommendation of joint regulators;

Joint regulators' power to set regulatory requirements

19. **Agree** that the FMI Bill empower joint regulators to prescribe regulatory requirements that the operator(s) of a designated FMI, or class of designated FMI, must comply with;

20. **Note** that the regulatory requirements referred to in recommendation 19 are likely to be able to relate to (subject to drafting):

20.1 Governance of the FMI and its operator (or operators);

20.2 An FMI's management of any of the following risks:

20.2.1 General business risk;

20.2.2 Operational risk;

20.2.3 Credit risk;

20.2.4 Liquidity risk;

20.2.5 Custody and investment risk;

20.2.6 Legal risk;

20.2.7 Risks arising out of linkages with other FMIs;

20.3 Access to the services provided by the FMI and arrangements for parties to participate in those services;

20.4 Public disclosure of information relating to the FMI and its operator (or operators);

20.5 Business continuity, recovery, and resolution arrangements for the FMI;

20.6 The relationship between the FMI and its operator (or operators), and any provider of critical services to the FMI;

20.7 The default of one or more participants of the FMI;

20.8 Any other matters prescribed by regulations.

21 **Agree** that joint regulators be required to consult with affected parties before setting any regulatory requirements;

22 **Note** that further consideration will be given during the drafting of the legislation to whether joint regulators should impose these regulatory requirements via standards, conditions of designation, or some other form of instrument, subject to natural justice and constitutional procedures relevant to the form of the instrument;

Independent reports

23 **Agree** that joint regulators have the power to require an operator of an FMI to obtain at its own expense an independent report on the operation of the FMI from a person approved by joint regulators;

Oversight of the rules of a systemically important FMI

24 **Agree** that the provisions of Part 5C of the Act relating to rules disallowance by joint regulators and related procedures be included in the Bill and apply to any designated FMI;

25 **Agree** that that joint regulators may require the operator of an FMI to prepare a rule change to address an issue, when joint regulators are satisfied that certain thresholds to be included in the Bill are met;

26 **Agree** that were joint regulators do not consider that the proposed rules change prepared by the operator adequately addresses the issue, they may direct the operator to make a change to the rules of the FMI;

Investigations, offences and penalties

27 **Agree** that joint regulators have the appropriate powers to search the premises of an FMI operator for supervisory or enforcement purposes;

28 **Agree** that, subject to further discussions between the Reserve Bank and the Ministry of Justice not raising any issues with this approach, offences and penalties under the proposed regime be based upon three tiers:

28.1 Criminal offences for intentional or reckless breaches of significant requirements, with penalties based upon those applying under the Reserve Bank of New Zealand Act 1989;

28.2 Civil pecuniary penalties for other breaches of significant requirements;

28.3 Administrative penalties for breaches of minor requirements (i.e. infringement notices imposed under the procedure provided in the Summary Proceedings Act 1957;

29 **Agree** that joint regulators have the power to enter into enforceable undertakings with persons who may have breached obligations imposed under the proposed regime, and the ability to apply to court to enforce the undertaking and for costs associated with non-compliance with the undertaking;

Crisis management powers for systemically important FMIs

30 **Agree** that the crisis management regime for systemically important financial market infrastructures be comprised of two elements, specifically:

30.1 A requirement for these FMIs to have business continuity plans, and recovery and orderly wind down plans (including loss allocation rules) in accordance with prescribed regulatory requirements; and

30.2 The following statutory powers:

30.2.1 A power to issue directions to the operator(s) of an FMI (including directions appointing, removing or replacing directors of the operator);

30.2.2 A statutory management regime that would apply to the FMI or its operator as appropriate depending upon the structure of the FMI;

31 **Note** that the power to set regulatory requirements referred to in recommendation 19 would be used to:

31.1 require that systemically important FMIs have business continuity plans and recovery and orderly wind down plans, and

31.2 prescribe matters that these plans must address or include.

32 **Agree** that, subject to the appropriate procedural constraints, joint regulators may issue a direction to the operator(s) of a systemically important FMI where (subject to drafting):

32.1 The operator is insolvent, likely to become insolvent, or otherwise unable to perform its role as operator; or

32.2 The business of the operator and/or FMI are being conducted in a manner prejudicial to the soundness of the FMI and the financial system; or

32.3 The operator has acted, or is acting, fraudulently or recklessly; or

32.4 The operator has been involved in serious or repeated breaches of obligations imposed by, or under, the Act; or

32.5 It is necessary to facilitate the resolution in its home jurisdiction of an FMI that is based in a foreign jurisdiction but has a corporate presence in New Zealand;

33 **Agree** that the directions referred to in recommendation 32 may (subject to drafting) require the operator(s) to:

33.1 Consult with joint regulators immediately and/or from time to time, about the circumstances of the operator and the methods of resolving any difficulties facing the operator or the FMI; or

33.2 In accordance with the direction, carry on, or cease to carry on, any business; or

33.3 Take the action that is specified in the direction to address a breach of any obligation that has been imposed; or

33.4 Take the action that is specified in the direction to address any circumstances that create a risk to the sound functioning of the FMI, or the operator's ability to effectively carry out the role of operator; or

33.5 Ensure that any officer or employee of the operator ceases to take part in the management or operation of the FMI except with the permission of the joint regulators and so far as that permission extends; or

33.6 Prevent a person from being involved in the management of the operator and/or FMI;

34 **Agree** that where the threshold in recommendation 32 is met, and joint regulators have reasonable grounds to believe that it is necessary to remove, replace, or appoint a director of the operator of a systemically important FMI, joint regulators may (subject to appropriate procedural constraints):

34.1 Remove or replace a director;

34.2 Appoint any person as a director;

35 **Note** that joint regulators will generally only issue one of the directions referred to in recommendations 32 and 34 where they have reasonable grounds to believe that the FMI's business continuity plans, and/or recovery and orderly wind down plans are not sufficient to address the situation or are not being invoked appropriately;

36 **Agree** that joint regulators, subject to the appropriate procedural constraints, have the power to direct participants of a designated FMI to comply with the rules of that FMI in the event that the thresholds in recommendation 32 are met;

37 **Agree** that a statutory management regime for FMIs be provided for to reflect the specific characteristics of FMIs;

38 **Agree** that the operator of a systemically important FMI may be placed into statutory management by an Order in Council made on the advice of joint Ministers given in accordance with the recommendation of joint regulators;

39 **Agree** that joint regulators may recommend statutory management where (subject to drafting):

39.1 One of the grounds for issuing a direction in recommendation 32 is met (except involvement in serious or repeated breaches of obligations imposed by, or under, the Act); or

39.2 The operator has failed to comply with a direction;

40 **Note** that joint regulators will generally only recommend statutory management where they have reasonable grounds to believe that the FMI's business continuity plans, and/or recovery and orderly wind down plans are not sufficient to address the situation or are not being invoked appropriately;

41 **Agree** that the statutory manager should be required to take into account the following considerations in exercising their powers:

41.1 The need to maintain public confidence in the financial system;

41.2 The need to avoid significant damage to the financial system;

41.3 The need to ensure the continuity of essential services provided by the FMI;

41.4 To the extent not inconsistent with recommendations 41.1-41.3, respecting the rules of the FMI, and preserving the position of creditors and maintaining the ranking of creditors**;**

41.5 The advice of joint regulators;

42 **Note** that the ranking of considerations in recommendation 40 provides the statutory manager with the implied ability to depart from the equal treatment of creditors within a class, or of the ranking of classes of creditors, where it is justified in light of the considerations in recommendations 41.1, 41.2 or 41.3;

43 **Agree** that the statutory manager's ability in certain circumstances to depart from the equal treatment of creditors within a class, or of the ranking of classes of creditors, be amended so that:

43.1 The statutory manager be required to observe the equal treatment of creditors within a class and the ranking of classes of creditors unless directed otherwise by the Reserve Bank;

43.2 The Reserve Bank only be able to direct otherwise when this is necessary given:

43.2.1 The need to maintain public confidence in the financial system;

43.2.2 The need to avoid significant damage to the financial system; or

43.2.3 The need to ensure the continuity of essential services provided by the FMI;

43.3 The Reserve Bank must, within a reasonable timeframe, provide a notification to Parliament of its reasons for issuing such a direction;

44 **Agree** that a moratorium apply to the debts and obligations of the FMI or operator in statutory management (excluding debts owed in its capacity as a participant in an FMI to other participants of the FMI);

45 **Agree** that the statutory manager has capacities and powers modelled on the statutory manager of a registered bank under Part 5 of the Reserve Bank of New Zealand Act 1989, including:

45.1 The management of the entity in statutory management vesting in the statutory manager;

45.2 The statutory manager having the rights of shareholders and a board of directors; and

45.3 The statutory manager being empowered to carry on the business of the entity in statutory management;

45.4 The statutory manager having the power to suspend payment of money owing, pay creditors, and compromise claims;

45.5 The statutory manager having the power to sell or otherwise transfer to a third party the whole or part of the business of the entity in statutory management;

45.6 The statutory manager having the power to place the entity in statutory management into liquidation;

46 **Agree** that joint regulators have the power to direct the statutory manager;

Legal protections around settlement finality and netting, and opting into designation under the proposed regime

47 **Agree** that the legal protections in Part 5C around the finality of settlement and netting agreements on designated settlement systems be carried across to the FMI Bill;

48 **Agree** that these legal protections apply automatically to systemically important FMIs that are designated, where they are relevant to the operation of those FMIs;

49 **Agree** that non-systemic FMIs can seek to be designated under the proposed regime in order to access these legal protections and that provisions relating to the application process be modelled on Part 5C of the Act;

Drafting of legislation

50 **Invite** that the Minister of Finance to issue drafting instructions to the Parliamentary Counsel Office to give effect to the above recommendations;

51 **Agree** that the provisions of Part 5C of the Act not referred to elsewhere in these recommendations be included in the Bill as appropriate, and subject to any appropriate technical revisions;

52 **Note** that the Minister of Finance will report back to Cabinet on the following matters prior to the Bill being finalised:

52.1 The type of instrument used to by joint regulators to set regulatory requirements for designated FMIs (standards, conditions, etc);

52.2 Whether joint regulators should require Ministerial consent before exercising any of their proposed direction powers;

52.3 Whether there needs to be some form of stay on the exercise of termination rights against the FMI which are triggered by its entry into statutory management;

52.4 In respect of the power in statutory management to depart from the equal treatment of creditors within a class, or the ranking of classes of creditors:

52.4.1 Whether the power should continue to allow for the reordering of classes of creditors (in this respect, the power currently extends beyond that recommended in the Financial Stability Board's *Key Attributes of Effective Resolution Regimes for Financial Institutions*); and

52.4.2 What accountability arrangements should apply to this power under the proposed statutory management regime for FMIs and the other statutory management regimes where it exists (i.e. the statutory management regime for banks.

53 **Authorise** the Minister of Finance to make any other changes, consistent with the policy framework in this paper, on any issues that may arise during the drafting process.

Authorised for lodgement

Hon Steven Joyce
Minister of Finance

APPENDIX – Recommendations in the IMF's draft technical note on the regulation and oversight of financial market infrastructures

Recommendations on the oversight of FMIs	Timing	Comments on relationship with proposed regulatory regime
Pursue the adoption and implementation of the proposed legislation to improve the regulation and oversight of FMIs in New Zealand	Short term	The reference to proposed legislation in this recommendation is referring to the regime proposed in this paper.
Adopt the PFMI principles through detailed requirements in secondary legislation	Medium term	The proposed power to set regulatory requirements is designed to cover all of the matters covered by the PFMIs. The technical note also refers to high level principles of the PFMIs being reflected in primary legislation. The current approach where the legislation sets out the matters that regulatory requirements may relate to does this to a certain extent. I do not support a higher level of prescription in the primary legislation due to this creating a loss of flexibility.
Formalize supervisory practices, in particular by conducting standard assessments, and regular monitoring of the FMI landscape	Medium term	No impacts on proposed legislation. The Reserve Bank considers that it has adequate resources to carry out supervision under the proposed framework using its current approach. In addition, a significant change in the level of resourcing would not change the design of the proposed framework (instead it would potentially change the nature and frequency of the Bank's interactions with regulated entities and the extent to which it carry out independent verification of information provided by these entities). The IMF are also making similar recommendations in respect of the level of resources devoted to the supervision of banks and insurers, and I consider that these questions about resourcing and supervisory approach should be considered collectively across banks,
Increase resources significantly	Medium term	

		insurers, and FMIs as part of a separate piece of work.
Enhance compliance of the designated FMIs with PFMI requirements	Medium term	No impacts on proposed legislation.
Adapt the existing MOU between RBNZ and Treasury by including FMIs, clearly stating the roles of each organization, and harmonizing cooperation between the authorities for the different types of supervised entities	Short term	No impacts on proposed legislation.
Change in the proposed regime the frequency of FMI self-assessments from three to two years	Short term	No impacts on proposed legislation. If recommendation is adopted it may be implemented under the existing legislation in respect of currently designated FMIs, then expanded to cover other relevant FMIs using the powers to set regulatory requirements which is proposed under new regime.
Publicly disclose oversight responsibilities and policies	Short term	No impacts on proposed legislation.
Translate mandates into day to day oversight responsibilities	Short term	No impacts on proposed legislation
Streamline cooperation arrangements with Australian authorities	Short term	No impacts on proposed legislation.
Develop and publish formal policy for oversight of foreign FMIs	Short term	No impacts on proposed legislation.
Recommendations for crisis management and interdependencies	**Timing**	**Reserve Bank comments on relationship with proposed regulatory regime**
Broaden the use of crisis management powers beyond a failure in business continuity plans / recovery and orderly wind down plans	Short term	This is given effect in the proposed legislation

Reflect specific features of FMI resolution in the proposed legislation for a FMI crisis management	Short term	Most of the relevant principles for FMIs as outlined in the Key Attributes are reflected in the proposed framework, and this recommendation is suggesting that the remaining principles for FMIs as outlined in the Key Attributes should also be included. Some of these are matters which I consider should be reflected in guidance material setting out how the powers would be used and our supervisory approach (e.g. that recovery tools should generally be exhausted prior to an FMI entering into resolution). Others relate to aspects of the Key Attributes which are not reflected in the other crisis management regimes in New Zealand for various reasons, and which I do not propose be included here at this time (e.g. no creditor worse off provisions). The one matter which is still being considered and may have legislative implications is the idea of a stay on the exercise of termination rights against an FMI when it enters into resolution. This is a complex area which is interrelated with the design of the moratorium that would apply in statutory management. I propose that the power to decide this matter be delegated to me during the drafting process.
Pursue protection for assets of FMIs at bank accounts during crisis	Medium term	No impacts on proposed legislation
Establish and test an operational crisis management framework	Medium term	To be considered as part of the implementation of the proposed framework, but does not affect its current design.
Analyze exposures to OTC derivatives market and foreign CCPs	Short term	No impacts on proposed legislation