RESERVE BANK
OF NEW ZEALAND
TE PŪTEA MATUA

Summary of submissions and final policy proposals on the Consultation Paper: Crisis Management Powers for Systemically Important Financial Market Infrastructures

August 2016

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PART ONE: BACKGROUND

1. Financial market infrastructures (FMIs), such as payment and settlement systems and central counterparties, are multilateral systems or networks that facilitate and record financial transactions. They play a crucial role in the financial system by connecting financial institutions with various financial markets, centralising activities, and generally handling significant transaction volumes. By concentrating risks and creating interdependencies between participating institutions and other financial markets, some of these FMIs become systemically important, (i.e. disruptions within them have the potential to trigger wider disruption among participating institutions and more broadly through the economy).

2. If operating safely and efficiently, systemically important FMIs (SIFMIs) can contribute to a sound and efficient financial system. There are, however, serious consequences if a SIFMI fails. Because of the volume of transactions such FMIs typically handle, and their interconnections with the participants and other FMIs, their inability to continue to provide critical services would likely to have spillover effects across the financial system, exposing participants to solvency or liquidity issues, resulting in a breakdown of day to day transactions that could impose significant costs across the economy and causing contagion to the sound operation of other FMIs.

3. At the same time, FMIs can also be characterised by a number of market failures such as high concentration of market power and negative network externalities, resulting in a misalignment between operator's risk management decisions and the wider public interest.

4. The Reserve Bank's primary focus is on the soundness and efficiency of the financial system. The Reserve Bank does this by regulating at the level of the individual institutions where appropriate. The FMA's primary function is to promote and facilitate the development of fair, efficient and transparent financial markets. As a risk-based conduct regulator, it does this through the assessment of the risks of harm of particular activities and proportionate regulation of the conduct of financial markets participants, including through disclosure, governance and/or licensing requirements.

5. After two rounds of public consultations and extensive stakeholder engagements since 2013, the Reserve Bank published most of its final policy proposals in December 2015[1]. The proposals were to enhance the oversight framework in New Zealand primarily by creating a new Designation Regime, which would have the following key features:

[1] http://rbnz.govt.nz/-/media/ReserveBank/Files/regulation-and-supervision/financial-market-infrastructure-oversight/regulatory%20developments/summary-of-submissions-and-final-policy-proposals-FMI-oversight-dec-2015.pdf?la=en

- The Reserve Bank and the Financial Markets Authority (FMA) would have information gathering powers for all FMIs (not just SIFMIs) to monitor the sector and identify any emerging 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 SIFMIs, including powers related to setting standards and oversight of SIFMIs' rules, investigative and enforcement powers, and crisis management powers

- The proposed powers under the revised Designation Regime would be applied differently for different SIFMIs, depending on their level of systemic importance, level of New Zealand presence and legal form;

- Currently designated payment and settlement systems could continue to seek legal protection for netting, settlement and the transfer of collateral (if applicable) under the revised Designation Regime. Other new non-systemically important payment and settlement systems would also be able to opt-in to the designation regime to access these benefits.

6. There has been strong support for the regulators to have crisis management powers to prevent any systemic damage as a result of the disorderly failure of a SIFMI or its operator. Due to the complexity of establishing a tailored crisis management framework for SIFMIs, the Reserve Bank considered it beneficial for stakeholders to have more opportunity to provide input into the proposed crisis management framework. The Reserve Bank undertook a further round of consultation on the detailed design features of such a framework from March to May 2016.[2]

7. The proposed crisis management framework has the ultimate objective of ensuring the continuity of essential services provided by the SIFMIs that are designated, in order to reduce wider impacts of the financial system.

8. It was proposed that the crisis management framework would consist of two parts:

   - A requirement for operators of SIFMIs to have business continuity plans (BCPs) and recovery and orderly wind down (RWD) plans;
   - Direction powers for joint regulators and a statutory management regime.

9. The rest of this paper is structured as follows: Part Two provides a high level summary of the key themes from submitters' feedback; Part Three notes the key

[2] http://rbnz.govt.nz/-/media/ReserveBank/Files/regulation-and-supervision/financial-market-infrastructure-oversight/regulatory%20developments/FMIs-Consultation-crisis-management-powers-Jan16.pdf?la=en

issues that were raised and the Reserve Bank's responses; Part Four outlines our final policy proposals; and Part Five outlines the next steps.

PART TWO: HIGH LEVEL SUMMARY OF SUBMISSIONS

Key Themes

10. Eight submissions were received, including submissions from domestic and offshore operators and FMI participants.[3] The Reserve Bank would like to thank all submitters again for their feedback on this round of consultation.

11. Overall, the majority of submitters remained supportive of the proposed crisis management framework, although one submitter had a fundamentally different view and did not support the proposal. In general, submissions showed:

- broad support for the general approach (that at a high level, as it would be based on the same types of crisis management powers applicable to banks and insurers, and is mostly consistent with the FSB's *Key Attributes of Effective Resolution Regime (Key Attributes)*)[4]. Offshore based FMIs, in particular, noted that the proposals were largely aligned with the *Key Attributes* and consistent with regimes in their jurisdictions. Their main suggestion was that in addition to limited powers to support resolution measures by home regulators, the New Zealand authorities should have some reserve powers in respect of overseas SIFMIs to protect the New Zealand interest.[5] One also suggested that the legislation should specify what constitutes New Zealand presence;

- strong support for the proposed objectives around ensuring the continuity of essential services;

- either agreement to the two part model, or acknowledgement of the rationale for separate preventative risk management and explicit statutory powers;

- general agreement with how the proposed framework should apply in different crisis situations, and to SIFMIs with different legal forms and levels of presence in New Zealand. A couple of submitters sought clarification on how the framework would apply in their own situations and how the powers might be applied to an SIFMI with multiple operators;

[3] They are: ASX Limited, Bank of New Zealand, CLS Bank, LCH Clearnet, NZX Limited, Paymark, Payments NZ and Westpac NZ.
[4] http://www.fsb.org/2014/10/r_141015/
[5] We note that this was reflected in the proposals through the power to apply direction powers and/or statutory management to the New Zealand presence of an overseas SIFMI.

- broad support for the proposed matters to be included in Business Continuity Plans (BCPs) and Recovery and Wind down (RWD) plans. Submitters cautioned that the proposed list should not be too prescriptive as these would have to be tailored to the circumstances of individual SIFMIs, and should be proportionate to the risks being managed. They also agreed that regulators should not be responsible for approving BCPs/RWD plans;

- broad support for the proposed direction power and its scope (although three submitters questioned the value of the proposed power to issue a direction appointing, removing or replacing a director);

- general support for a very tightly constrained power to direct participants (primarily to require them to comply with the rules of the SIFMI in a crisis situation); and

- broad support for the proposed statutory management framework (although some submitters sought clarifications on how it could apply to an operator that does not manage a central infrastructure or where there are multiple operators).

12. One domestic operator did not support the proposal and did not agree with the market failure arguments. They argued that New Zealand's payment systems were working well and that there was no existing problem with New Zealand's current crisis management arrangements for payment systems. They also suggested that the proposed system would not be helpful and was intrusive and inflexible, with trigger thresholds for directions and statutory management being too low. It was also argued that any payment system problems would already be addressed by the Reserve Bank's current policy on outsourcing (BS11).

13. We have consulted widely on our rationale for the need to improve the current legislative oversight framework and our proposals are well understood by the industry. For example, it has been accepted that potential market failures are present in the New Zealand FMI sector, and that there is a need for the regulators to be better positioned to deal with failures of an SIFMI to minimise its negative impact. Our proposals recognise the value of ex-ante arrangements that SIFMIs themselves are incentivised to put in place. The proposed statutory powers can generally only be triggered when these ex ante arrangements fail, and their exercise is also subject to appropriate checks and balances. We also think that the compliance costs are likely to be relatively low, and that BS11 is not directly relevant here.

PART THREE: KEY ISSUES AND THE RESERVE BANK'S RESPONSES

14. While overall submitters have been supportive, they have also raised the following issues:

a) A couple of submitters suggested that regulators' powers be extended to a SIFMI's CSPs to ensure that the SIFMI can continue to provide essential services when a CSP fails.

   We note that the scope of the proposed crisis management framework, as published in December 2015, covers SIFMIs only and would not cover critical service providers directly. As outlined in the Consultation Document, the SIFMI or its operator would need to be satisfied that its critical service provider has effective BCPs in place to deal with any outage, and that the operator itself would also need to explicitly contemplate a situation where the service provider could no longer provide the service and provide a workaround to deal with this.

   Given that SIFMIs would be explicitly required to address in their BCPs a scenario where a critical service provider is no longer able to provide critical services, we are of the view that the proposed scope of crisis management power is appropriate.

b) A few submitters suggested that the proposed directions that could be given should not cover issues relating to the efficiency of an SIFMI.

   We agree that a direction with regards to the efficiency of an SIFMI would not be consistent with the primary focus of the proposed regime (continuity of essential services in a crisis).

   We therefore propose to amend the direction power to confirm that it could be triggered by actions that are prejudicial to the soundness (but not efficiency) of the financial system, and could only require that steps be taken to address soundness rather than efficiency issues. This would also be consistent with the direction power for banks, and also reflects the fact that, to the extent that is relevant, most efficiency issues could be adequately addressed through BAU powers.

c) There were also suggestions that the power to remove, replace and appoint directors would be of little practical value.

   We note that the inclusion of this power, which is consistent with the banking and insurance crisis management framework, is primarily due to the importance the Reserve Bank places on self-discipline in regulated entities as part of its regulatory philosophy (and the fact that directors are ultimately responsible for the operation of the SIFMI).

   The fact that joint regulators will not be carrying out suitability assessments for directors and senior officers of SIFMI operators under the proposed regime also adds to the importance of this power for addressing serious governance issues.

In addition, the power provides an additional tool that might potentially reduce the likelihood that more intrusive forms of intervention, such as statutory management, would need to be used, especially when governance issues are the main area of concern.

We therefore propose to retain this power.

d) How BCPs requirement should be categorised. A number of submitters argued that BCPs were strictly a BAU requirement and business operators were well incentivised to prepare them, and as a result it was inappropriate to classify this as a crisis management measure.

We originally included BCPs as the first tier of the proposed crisis management framework because it is designed to address threats to the SIFMIs ability to provide essential services. We do not have a strong view regarding its classification as a BAU or crisis management measure (i.e. this appears to be just a presentational issue).

Based on the feedback received, we propose that for presentational purposes, the BCP requirement be discussed with other BAU standards such as governance and disclosure.

15. Submitters have also sought clarifications on the following areas:

a) The crisis management framework needs to more explicitly recognise that some SIFMIs might have multiple operators.

That an SIFMI may have more than one operator has been envisaged under this framework from the outset. However, we acknowledge that the consequences of this could be set out more clearly in the proposed framework. We propose that in the Designation Order, the scope of the SIFMI be clearly defined and multiple operators be explicitly allowed, and the regulators would be able to impose obligations on the appropriate operator(s). In other words, different operators of an SIFMI might be subject to different requirements, or be jointly responsible for complying with particular requirements.

b) Clarification on how statutory management could apply to certain operators that do not operate a central infrastructure.

Generally speaking, we believe statutory management increases the likelihood of the failed business continuing to provide essential services. In the context of SIFMIs, given that the focus is to ensure the continuity of essential services that the SIFMI provides, statutory management would be appropriate when the SIFMI/operator typically has a central role and carry out or manage the services provided by the SIFMI.

The issue raised by submitters mainly relates to a different type of operator, whose main role is maintaining and administering the rules of the SIFMI

rather than the underlying infrastructure. Some submitters argued that because they might not be involved in the day-to-day running of the infrastructure, there was little point in putting such operator into statutory management as, without the operator, the SIFMI could still continue to operate.

While we do not disagree that the SIFMI could potentially still operate for a certain period under rules already agreed to by participants, we note that there might still be a case to put this kind of operator into statutory management. In addition to day-to-day operating rules, failure to settle procedures and related rules are also an important part of an SIFMI's rule set – and operators that manage rules have a key role to play in a failure-to-settle scenario. If one or more participants have failed to settle, directions or statutory management might be necessary to ensure that the operator's role in this respect continues to be carried out (at least until replacement arrangements have been put in place).

We could also envisage a situation where even if participants continue to operate without incidents, there could be a case for regulators to exercise crisis management powers when this kind of operator is no longer viable. Such an operator might have financial or governance issues, and there could be practical difficulties in participants agreeing on the rules going forward or how to transfer the problem operator's role to another entity. In these circumstances directions or statutory management might be necessary to ensure that the rules are being properly administered and enforced, until replacement arrangements are in place.

We therefore propose to retain the statutory management power for all SIFMI and operators that have a New Zealand presence sufficient to ensure to continuity of essential services provided by the SIFMI.

c) The hierarchy between directions and statutory management.

Some submitters raised concerns around triggers for statuary management being the same as those for directions. For example, they argued that the operator having been involved in serious or repeated breaches of obligations should be a trigger for direction power but not statutory management power.

We acknowledge that there is some ambiguity around the hierarchy of the two proposed powers. Statutory management is the most intrusive power and is intended to be reserved for the most serious circumstances. Accordingly, we propose to remove the following two triggers for statutory management (they would remain as some of the triggers for the direction power):

- Where the BCPs or RWD plans fail to address the required matters or are not adequate to deal with the circumstances in which the SIFMI may fail;[6] and

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

d) How the Corporations (Investigation and Management) Act 1989 (CIMA) and the proposed crisis management framework for SIFMIs interact.

Some submitters questioned why the statutory management regime in CIMA should continue to apply to SIFMIs once the proposed crisis management framework is in place.

Our preference here is to adopt the same approach as under the banking and insurance regimes – i.e. that CIMA would continue to apply to SIFMIs and their operators, but the FMA would have to consult with the Reserve Bank before recommending that an SIFMI and/or its operator be placed into statutory management under CIMA.

This consultation requirement would create a de facto hierarchy of statutory management regimes, where the statutory management of an SIFMI or its operator is first considered under the proposed crisis management regime, before being considered under CIMA.

We also note that the triggers for recommending statutory management under the proposed crisis management regime and CIMA are slightly different, and it makes more sense for the two regimes to overlap, rather than create a potential gap where an SIFMI or its operator:

- Cannot be placed into statutory management under the proposed regime because the necessary triggers are not satisfied; and

- Cannot be placed into statutory management under CIMA because they have been excluded from the application of that Act.

e) Clarification of what constitutes “presence in New Zealand”.

Whether an overseas SIFMI is considered to have a presence in New Zealand is critical, as many of the statutory powers regarding crisis management, such as the power to direct and statutory management, would only apply to the New Zealand presence of these SIFMIs (and only where their application to the New Zealand presence of the SIFMI would help to ensure the continuation of essential services by the SIFMI).

[6] This is also being removed because directions made on this ground should only be able to require changes to these plans, and not the broader range of actions that could be required under other directions.

The consultation paper provided some examples on what would be considered as the operator having a New Zealand presence for these purposes– e.g. company registration, physical infrastructure, assets and staff. Some submitters have requested that more clarity be provided as to the definition of "presence in New Zealand".

Our preference here is to use a well-recognised, well understood definition for this purpose. We propose that a good starting point would be that an overseas SIFMI or its operator has an "establishment" in New Zealand within the meaning of the UNCITRAL Model Law on Cross-Border Insolvency (which is incorporated into New Zealand law by the Insolvency (Cross-Border) Act 2006). This defines an "establishment" as "any place of operations where [a person] carries out a non-transitory economic activity with human means and goods or services".

We note that different issues may arise when assessing whether an overseas SIFMI has a New Zealand presence for other purposes. For example, if we wished to take court proceedings against an SIFMI it may be sufficient for them just to have assets in New Zealand rather than an establishment as such. However, we do not consider that it is necessary to provide more clarification about this, as it can be left to joint regulators' discretion and the general law.

PART FOUR: FINAL PROPOSAL FOR CRISIS MANAGEMENT FRAMEWORK

16. In summary, the Reserve Bank's proposed crisis management framework for SIFMIs would consist of two parts. Firstly, a requirement for operators of designated SIFMIs to have RWD plans. Secondly, direction powers for joint regulators and a statutory management regime. Outside of the crisis management framework, there would also be an additional requirement for operators to have BCPs as part of the BAU oversight requirement.

17. The joint regulators would have the power to prescribe minimum requirements for BCPs and RWD plans via standards. The joint regulators would monitor that these plans contain all the basic content required, and monitor requirements for regular testing and reviews of these plans. The joint regulators would not approve these plans but would also be able to direct operators (with the consent of joint Ministers) to amend these plans where they fail to address the required matters.

18. The second tier of the framework is comprised of a set of statutory powers that could be used by joint regulators when the designated SIFMI's BCPs, and/or RWD plans, are:

    - Not applicable to the situation giving rise to the direction; or

    - Not adequate to deal with the situation giving rise to the direction; or

- Are not being effectively implemented to deal with the situation giving rise to the direction; or

- Have failed to resolve the situation giving rise to the direction.

19. These statutory powers are:

    - A power for joint regulator to issue directions to the operator(s) of an SIFMI with the consent of joint Ministers

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

    - A power for joint regulators to recommend that an SIFMI be placed into specifically designed statutory management regime.

20. The proposed crisis management powers would apply differently in practice depending upon the SIFMI's legal form and level of New Zealand presence. For example

    - Where the SIFMI and its operator are a single legal entity all of the powers would apply, whereas when the SIFMI 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 SIFMI and its operator(s) have no New Zealand presence the majority of the powers would not apply, as the main focus would be to support the resolution of the SIFMI by the home country and/or at an international level.

21. With the consent of joint Ministers, joint regulators could issue a direction to the operator(s) of a SIFMI 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 SIFMI are being conducted in a manner prejudicial to the soundness of the SIFMI and 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 issue the direction to facilitate the resolution in its home jurisdiction of an SIFMI that is based in a foreign jurisdiction but has a corporate presence in New Zealand

22. These directions could 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 SIFMI; or

- In accordance with the direction, carry on, or cease to carry on, any functions or business that creates a risk to the sound and efficient operation of the SIFMI; 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 SIFMI, 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 SIFMI 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 SIFMI.

23. In addition, where any of the thresholds in paragraph 21 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 SIFMI, joint regulators could (with the consent of joint ministers):

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

24. The joint regulators would also have the power to direct participants to comply with the rules of a SIFMI where the circumstances in paragraph 21 are met. This ensures that the scope of a direction cannot extend beyond requirements that the participant has already agreed to comply with.

25. An SIFMI could 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:

- 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 SIFMI are being conducted in a manner prejudicial to the soundness of the SIFMI and the financial system; or

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

- The operator has failed to comply with a direction; or

- It is necessary to recommend that the New Zealand based component of the SIFMI be placed into statutory management in order to facilitate its resolution in its home jurisdiction.

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

27. Other features of the statutory management regime would include:

- The statutory manager being required to take into account specified considerations in exercising their powers:

- A moratorium applying to the debts and obligations of the entity in statutory management, as under other statutory management regimes;

- The statutory manager having the same basic capacities and powers as the statutory manager of a bank under Part 5 of the Reserve Bank of New Zealand Act 1989, including:

    - The power to suspend payment of money owing; and

    - The power to sell or otherwise transfer to a third party the whole or part of the business of the entity in statutory management.

28. The statutory manager would also be expected to respect the rules of the SIFMI except in very exceptional circumstances, as this will be necessary to maintain confidence in the operation of the SIFMI, and the continuity of essential services.

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

PART FIVE: NEXT STEPS

30. The Reserve Bank has concluded its consultations on the enhanced oversight framework for FMIs. The Reserve Bank would again like to thank all submitters and stakeholders for their constructive comments during the last three rounds of consultations, which have helped refine the final policy proposals, including the detailed design features of the tailored crisis management framework for SIFMIs.

31. The next steps in this project are as follows:

- Subject to Cabinet agreeing to the proposed oversight framework for FMIs, the Reserve Bank will publish the relevant Cabinet Paper and Regulatory Impact Statement on the Reserve Bank's website;

- Subsequently, the Reserve Bank plans to consult again via an Exposure Draft of the proposed legislation. At present this consultation is expected to take place at the end of this year or the beginning of 2017.