



**RESERVE  
BANK**

O F N E W Z E A L A N D  
T E P Ū T E A M A T U A

## **Consultation Document: Strengthening Statutory Payment Oversight Powers**

### *Consultation Document*

The Reserve Bank invites submissions on this consultation document by 3 May 2013.

Submissions and enquiries should be addressed to:

Richard Dean  
Manager Operational Policy  
Reserve Bank of New Zealand  
PO Box 2498  
Wellington 6140  
Email: [richard.dean@rbnz.govt.nz](mailto:richard.dean@rbnz.govt.nz)

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

**March 2013**

## SECTION ONE: INTRODUCTION

1. The Reserve Bank oversees payment and settlement systems 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 participant in a payment system.
2. The Reserve Bank has recently completed a review of its existing oversight powers for payment and settlement systems (hereafter simply “payment oversight powers”) under the Reserve Bank of New Zealand Act 1989 (the Act), based on its experience with the payments industry in the last decade and the overall changing payments landscape, both domestically and internationally. The review was also conducted against the backdrop of the recent international regulatory developments in the payment oversight area, brought about by the Global Financial Crisis (GFC).
3. The review concludes that the Reserve Bank’s existing payment oversight powers are insufficient and need to be strengthened. The proposals in this consultation paper are focused on seeking additional powers for the Reserve Bank’s oversight of systemically important systems in New Zealand. The Reserve Bank has consulted with the Ministry of Business, Innovation and Employment (MBIE) and the Treasury during the course of developing the proposals.
4. The review also includes some initial discussion on the extent of the interest of the Reserve Bank in efficiency related matters as part of its oversight activities.
5. The remainder of this paper is structured as follows:

**Section 2** provides a summary of the review, including gaps and issues with the existing powers and the Reserve Bank’s assessment of their adequacy;

**Section 3** describes the proposals on the regulatory framework and the co-regulatory arrangements with the Financial Markets Authority (FMA);

**Section 4** outlines a range of graduated powers for the oversight of systems that are considered systemically important;

**Section 5** describes two models of how the regulatory framework could fit with the designation regime under Part 5C of the Act;

**Section 6** provides a high level discussion on the efficiency objectives the Reserve Bank considers as part of its oversight of the sector.

6. The Reserve Bank invites submissions from interested parties on its proposals by 3 May 2013.

## SECTION TWO: THE REVIEW

### A. *Payment oversight objectives and approach*

7. For the financial system to be sound and efficient its core infrastructure, of which payment systems are an important component, must be sound and efficient. A sound and efficient payment system is one:
- that does not generate high levels of risk to participants or to users of financial services, and in which any risks that are generated are managed appropriately by system participants;
  - that incorporates delivery-versus-payment arrangements where appropriate, and especially with respect to high-value transactions;
  - that can continue to operate without disruption in the event of the sudden financial or operational incapacity of a participant, or following other types of financial crises or natural disasters, etc.;
  - in which the status of payments is certain at all times, and, in particular, in which the attributes of “finality” and “irrevocability” are supported;
  - in which payment services are efficient and reliable, and are responsive and relevant to customer needs; and
  - that is open, flexible and competitive, with no unwarranted barriers to entry<sup>1</sup>.
8. How “soundness” and “efficiency” translate into more specific objectives may evolve over time. Those matters, as noted above, have been the basis of the Reserve Bank’s stated payment system objectives for a number of years, and they continue to be relevant and overlap substantially with the Committee on Payment and Settlement Systems (CPSS) *Core Principles for Systemically Important Systems*<sup>2</sup>.
9. CPSS has defined oversight of payment and settlement systems as
- “a central bank function whereby the objectives of safety and efficiency are promoted by monitoring existing and planned systems, assessing them against these objectives and, where necessary, inducing changes”*<sup>3</sup>
10. The Reserve Bank’s payment oversight role is closely related to its responsibilities arising from its financial stability objective, and therefore reflects an assessment of the importance of particular systems to financial stability and to the function of the economy as a whole. As a result, the Reserve Bank has adopted a risk-based

---

<sup>1</sup> *Statement of Principles (PS1)*, Reserve Bank of New Zealand, August 2005:

[http://www.rbnz.govt.nz/regulation\\_and\\_supervision/payment\\_system\\_oversight/1911038.html](http://www.rbnz.govt.nz/regulation_and_supervision/payment_system_oversight/1911038.html)

<sup>2</sup> <http://www.bis.org/publ/cpss43.htm>, published in 2001. The Core Principles are a set of comprehensive statement of soundness and efficiency objectives for payment systems. They have recently been replaced by *Principles for financial market infrastructures*, published in 2012 by CPSS and Technical Committee of the International Organisation of Securities Commission (IOSCO). The Reserve Bank is currently preparing specific proposals on how to adopt these new principles, and plans to consult on these later this year.

<sup>3</sup> *Central Bank oversight of payment and settlement systems*, CPSS, May 2005:

<http://www.bis.org/publ/cpss68.htm>

approach where the objectives of oversight are identification, reduction and management of risks of systems that are of systemic importance.

11. Payment system oversight is the process by which the Reserve Bank aims to achieve those objectives. The process encompasses gathering information, assessing the information, and inducing changes where those objectives are not being met. The Reserve Bank may seek to influence through dialogue to ensure systems are operated in a manner that is consistent with financial stability, or may impose particular specific requirements and enforce those requirements.

## ***B. Main issues of current payment oversight powers***

### *Current legislative powers*

12. Parts 5B and 5C of the Act provide the statutory backing to the Reserve Bank's payment oversight activities. Part 5B "Oversight of Payment Systems" provides the Reserve Bank the power to request information from an operator of a payment system, any person who is wholly or partly responsible for the operation of a payment system, or a participant in a payment system. The Reserve Bank may require the information to be audited and failure to supply information is an offence. The Act also specifies the circumstances in which the Reserve Bank may publish or disclose the information.
13. Part 5C provides the Reserve Bank with greater powers in relation to designated payment or settlement systems. The FMA and the Reserve Bank are the joint regulators of designated systems except when the system is a pure payment system, in which case the Reserve Bank is the sole regulator. The Reserve Bank can:
  - require information to be provided;
  - recommend the designation be subject to conditions, and seek changes to those conditions; and
  - disallow changes to the system's rules.

### *Part 5B issues*

14. Part 5B enables the Reserve Bank to gather information to carry out its oversight, and Part 5C provides the Reserve Bank powers to induce changes in designated systems by imposing particular conditions. However, for systems that are not designated, the Reserve Bank's ability to induce changes is limited to moral suasion. The Reserve Bank comments on issues publicly to try to reinforce market discipline and apply pressure for change when weakness in a system is identified. The Reserve Bank also works closely with key stakeholders to try to encourage them to act differently. While such level of engagement might be appropriate for some systems, for those that are considered systemically important, a higher level of oversight is required to enable the Reserve Bank to exercise its oversight to a degree commensurate with the risks to the financial system.
15. The absence of formal powers in Part 5B to induce changes in systemically important systems is, in the Reserve Bank's view, a significant weakness in its payment oversight powers. While the Reserve Bank's engagement with the payments industry to date has been generally positive, experience of two main industry projects, *Access and Governance* and *Settlement Before Interchange*, has highlighted how lack of

explicit oversight powers limits the Reserve Bank's ability to deliver sensible policy objectives in a timely manner (see Appendix 1 for a summary of the history of both projects). Both projects have taken close to or more than a decade to complete and a number of significant policy issues remain outstanding.

16. While the Reserve Bank could try to use its powers in Part 5C to impose conditions on designated systems to achieve its oversight objectives in Part 5B, this would require all systemically important systems to be designated. The Reserve Bank notes that Part 5B and Part 5C have different purposes, and using Part 5C to achieve the objectives of Part 5B might lead to unintended consequences. For example, not all systemically important systems will benefit from designation. This is discussed in more detail in Section Five.
17. The need for formal powers for effecting changes has become more pressing over time, given the increasingly critical roles played by systemically important payment and settlement systems in the New Zealand financial market. These systems can, through their design and rules, reduce systemic risk in financial markets. Conversely, poor design and inadequate rules and procedures could lead to significant economy-wide disruptions. International developments have also led to increased reliance on certain types of infrastructure – such as the CLS system and SWIFT. Oversight of these systems should therefore be an important role for the Reserve Bank.
18. Another aspect of the Reserve Bank's payment oversight powers under review is their scope. The Reserve Bank cannot give directions to an operator of, or participant in, a payment or settlement system unless it is also a registered bank in New Zealand. The fast-changing payments landscape has generated a wave of new payment operators, many of them non-banks. Having the power to direct relevant payment operators and participants ensures consistent treatment and provides a level playing field with respect to the prudential requirements for banks, non-bank deposit takers (NBDTs) and other non-bank entities.
19. The Reserve Bank also notes that there is currently no specific statutory management regime for payment and settlement systems, although the statutory management powers in the Corporations (Investigations and Management) Act 1989 (CIMA) already apply. The Reserve Bank, despite its oversight role for these systems, does not have an explicit role in decisions to place a system operator in statutory management, nor in providing guidance to the statutory manager. More broadly, the Reserve Bank does not currently have any crisis management powers in relation to a payment and settlement system.

#### Part 5C issues

20. There are also a couple of obvious issues in relation to Part 5C. Firstly, the opt-in nature of the designation regime restrains the Reserve Bank's ability to fully exercise powers such as the imposition of conditions and disallowance of rules. Designation is about designating system rules to provide legal certainty to the settlement and netting of transactions of that system. While not every system needs to be designated, it is foreseeable that the Reserve Bank would consider designation beneficial for some systemically important systems, in terms of promoting the soundness and efficiency of the overall financial system. In such cases, it would be desirable for the Reserve Bank to have the ability to require designation, instead of having to rely on a designation application from the operator.
21. Secondly, Part 5C lacks a graduated set of tools that the Reserve Bank could use, when the need arises, to induce changes to remedy deficiencies. Because non-

compliance with the conditions is not an offence in itself, the Reserve Bank must rely on system operators to comply with the conditions attached to the designation. Once the Reserve Bank is aware of any non-compliance, it could comment publicly on the non-compliance, but the only effective statutory option is to review and potentially revoke a designation. This seems to be a very strong response that should only be used for serious breaches. To vary the conditions of a designation, the Reserve Bank must (jointly with the FMA) recommend a change to the Order in Council designating the system, which can be a rather long and complicated process. While the Reserve Bank can disallow a rule change, it currently has no other measures to initiate rule changes except through moral suasion.

### **C. Other drivers for strengthening oversight powers**

22. When assessing the adequacy of its existing payment oversight powers, the Reserve Bank has also taken into consideration recent international regulatory developments, most of which are followed from the 2008 financial crisis. In particular, the Reserve Bank has focussed on the following:

- CPSS and IOSCO have recently published “*Principles for financial market Infrastructures (the PFMI)s*”<sup>4</sup>. Amongst the five responsibilities for central banks is one that central banks should “have the powers and resources to carry out effectively their responsibilities in regulating, supervising and overseeing financial market infrastructures”. The key consideration in fulfilling this responsibility is the ability to obtain timely information and to induce change or enforce corrective action. The document suggested that these responsibilities be incorporated into individual authorities’ legal and regulatory frameworks by end of 2012.

While the Reserve Bank has an explicit statutory authority and power to oversee payment systems, it only has data collection and disclosure powers to formally review and highlight areas of concern and encourage actions to remedy deficiencies, but no authority to impose regulatory requirements. The payment oversight powers are significantly more limited than those for the supervision of banks and do not, for instance, include regulation-making or direct intervention powers – despite the fact that payment and settlement systems play a critical role in the financial system. The Reserve Bank’s current payments oversight powers are unlikely to fully meet the responsibilities set out in the *PFMI)s*.

- The GFC has brought sharp focus on the systemic importance of “over the counter” (OTC) derivatives markets and the potential inherent risks in these markets. This resulted in a global push for substantial regulatory reforms in strengthening the functioning of OTC markets and improving regulation in this area, such as the Dodd-Frank Act in the USA. As part of the work aimed at improving the resilience of the financial system, the G20 committed to having all standardised OTC derivatives contracts traded on exchanges or on electronic trading platforms where appropriate, and cleared through central counterparties by the end of 2012. The G20 has also agreed that the

---

<sup>4</sup> <http://www.bis.org/publ/cpss101a.pdf>, published in April 2012 (as mentioned in footnote 2). The new Principles contain more demanding international standards for payment, clearing and settlement systems, including central counterparties, and are designed to ensure that critical infrastructure that supports financial markets is more robust and thus well placed to withstand financial risks. They also include five responsibilities for central banks and market regulators.

transparency of OTC transactions should be improved by maintaining a central registry of OTC derivatives contracts (a trade repository – “TR”).

Many jurisdictions are now in the process of reshaping their regulatory frameworks applicable to OTC derivatives. While there are currently no OTC derivatives CCPs operating in New Zealand, it is foreseeable that some overseas infrastructure may provide services to New Zealand institutions and/or process NZD transactions. The same applies to TRs. The Reserve Bank is therefore likely to be involved in co-operative oversight arrangements for these entities.

- Another area of international focus is crisis management. When a systemically important system has failed for whatever reason, maintaining critical operations is paramount. Given the nature of their functions, it is essential that an effective and tailored resolution regime can be applied to systemically important systems so that the choice is not simply between taxpayer support and liquidation. This is recognised in the *Key Attributes of Effective Resolution Regimes for Financial Institutions* (Key Attributes) by FSB and the consultative report on *Recovery and resolution of financial market infrastructures* by CPSS/IOSCO<sup>5</sup>.

Both documents note that because the traditional bankruptcy process does not have the preservation of financial stability as an objective, and could cause a systemic disruption through delays or cessation of a financial market infrastructure’s (FMI) critical functions, it is necessary to also have a resolution regime available for use on FMIs. The documents discuss a number of new tools required to deal with financial institutions in difficulty – such tools should be designed to safeguard financial stability, ensure the continuity of any critical financial services, avoid any unnecessary destruction of value, and minimise costs for taxpayers. A number of countries, such as the US, UK, Eurozone and Australia, are in the process of either consulting or introducing new legislation in these areas<sup>6</sup>.

As mentioned in paragraph 19, the Reserve Bank does not currently have an explicit role in the crisis management process of a payment and settlement system. This is a gap that this review aims to address.

- The Reserve Bank’s current payment oversight powers are rather “light” when compared to those of many other central banks (see Appendix 2 for a comparison of payment oversight powers of a number of central banks and other relevant regulators). While this might have been appropriate for the Reserve Bank in the past, the payment landscape has changed with the global regulatory developments, emerging new payment technologies and innovations, increasingly diverse new players and new risks. A growing number of central banks have direct statutory power to require systems to comply with their oversight responsibilities. These powers usually include the ability to grant initial approvals to operate a system, to require or approve changes to system rules and procedures, to issue “cease and desist orders” and to suspend or revoke membership. Additional tools exist in the areas of enforcement and sanctions, such as the ability to impose penalties. Reserve

---

<sup>5</sup> [http://www.financialstabilityboard.org/publications/r\\_111104cc.pdf](http://www.financialstabilityboard.org/publications/r_111104cc.pdf) and <http://www.bis.org/publ/cpss103.pdf>

<sup>6</sup> [http://www.financialstabilityboard.org/publications/r\\_111104cc.pdf](http://www.financialstabilityboard.org/publications/r_111104cc.pdf)

Bank experience shows that its payment system oversight would benefit from moving towards the international norm.

23. A further consideration is that the Reserve Bank's statutory payment oversight powers are limited when compared to its other supervisory functions, such as for banks, NBDTs and insurance companies. Changes to the environment have underscored the need to bring the payment oversight powers into line with other Reserve Bank regulatory roles.

#### **D. Conclusion**

24. After considering the issues and gaps with the existing payment oversight powers, the Reserve Bank believes it should establish a clear and robust framework for payments sector oversight that reflects its risk-based approach. In particular, there is a need for more explicit powers for the oversight of systemically important systems. When seeking additional powers, the Reserve Bank should focus on developing a well-designed set of graduated powers for the oversight of these systems, which will support the effectiveness of its oversight function and ensure the right incentives for industry and participants to act prudently, cooperate and progress in a timely manner. This will also bring the Reserve Bank more in line with many central banks around the world and meet the responsibilities set out by the new *PFMIs*.
25. The redesign of the regulatory payment oversight framework should also incorporate lessons learned from the recent financial crisis and factor in emerging areas where international regulatory developments are taking place, such as crisis management.

*Question 1: Do you agree with the gaps and issues identified and the conclusion reached? Are there any other factors that the Reserve Bank should be taking into account – if yes, please provide more details.*

### **SECTION THREE: PROPOSED REGULATORY FRAMEWORK**

26. To reflect the emphasis on seeking explicit powers for systemically important systems, and bearing in mind the existing co-regulatory framework between the Reserve Bank and FMA, the new legislative framework should have the following key features:
- The Reserve Bank should retain the oversight responsibility for all systems;
  - There should be a process by which the Reserve Bank identifies pure payment systems that are systemically important and formally recognises them for increased oversight; for other settlement systems, the FMA and the Reserve Bank should be joint regulators, for both recognition decisions and ongoing oversight;
  - The Reserve Bank should continue to use its current oversight tools (such as moral suasion, formal and informal engagements with industry, publishing assessments of the payment and settlement systems every six months in the Financial Stability Reports (FSR)), with additional formal powers to draw on when necessary;



- The Reserve Bank should have strengthened powers aligned to accepted international norms for ongoing oversight of recognised systems, including powers to obtain information, powers to direct, enforcement powers and a tailored statutory management regime; and
  - The oversight framework should ensure the Reserve Bank meets the responsibilities for central banks set out in the *PFMIs* (see Appendix 3 for the preliminary assessment based on the proposals set out in this paper).
27. The redesign of the regulatory payment oversight powers should result in the realignment with the Reserve Bank’s overall prudential supervision approach which, while comparatively light-handed by international standards, rebalances regulatory discipline alongside the well-established market and self-disciplines, with a significantly more active approach to institutional engagement and information provision<sup>7</sup>.

#### **A. Scope of oversight**

28. The legislation has used the term “systems” to generally refer to both payment and settlement systems. As new systems develop, it’s important that all systemically important systems are overseen. In the last few years, the international regulatory movements have been gearing towards stepping up oversight of central counterparties (CCPs), and more recently, TRs, given the critical roles they play in the financial markets. CPSS and IOSCO have defined all systemically important payment systems (PSs), central securities depositories (CSDs), securities settlement systems (SSSs), CCPs and TRs as “FMIs”. These infrastructures facilitate the clearing, settlement, and recording of monetary and other financial transactions, such as payments, securities, and derivatives contracts (including derivatives contracts for commodities)<sup>8</sup>. CPSS and IOSCO have published a combined set of principles that covers all FMIs.<sup>9</sup>
29. In order to create a flexible framework that could respond to future changes and accommodate financial innovation, it is proposed that the term “system” is defined clearly in legislation, to include any infrastructures that facilitate the clearing, settlement and recording of monetary and other financial transactions, and cover system rules or arrangements, system operators, participants, infrastructure providers (including critical service providers<sup>10</sup>), governance structure and payment instruments.
30. The Reserve Bank notes that *PS1* already includes a discussion on “systems”, where it states that

*“the Bank is not only interested in payment and settlement systems in a narrow sense, it is interested in a broader range of payment system issues, which may relate to 1) the design and operation of a payment system; 2) how payment systems interconnect; 3) operators; 4) infrastructure providers; 5) participants; 6) business*

<sup>7</sup> Fiennes, T and O’Connor, C (2012), “*The evolution of prudential supervision in New Zealand*”, Reserve Bank of New Zealand *Bulletin*, 75(1), March

<sup>8</sup> <http://www.bis.org/publ/cpss101.htm>

<sup>9</sup> These principles harmonise and, where appropriate, strengthen the existing international standards for PSs that are systemically important, CSDs, SSSs, and CCPs. The revised standards also incorporate additional guidance for OTC derivatives CCPs and TRs.

<sup>10</sup> Principally SWIFT. It is noted that critical service providers are not FMIs, so adoption of the FMI definition could be problematic.

*continuity arrangements; 7) the availability of data and information from or relating to payment systems; 8) the rules; 9) the governance structure; 10) market practices and behaviours.”*

31. In an updated *PS1*, the Reserve Bank proposes to recognise that within these general boundaries, the scope and depth of oversight may change over time, as the financial market infrastructures themselves evolve. A key consideration for the Reserve Bank in setting the scope for oversight will be to apply policy requirements in a consistent way that does not prejudice certain institutions, or create inappropriate competitive distortions between comparable systems.
32. Alternatively, the Reserve Bank could adopt the term “FMI” used by CPSS/IOSCO, although as discussed in footnote 9, it does not include critical service providers.

*Question 2: Do you agree with the proposed definition of “systems”? If not, please provide more details. Alternatively, do you think the term “FMI” should be adopted, if so, why?*

### **B. Systemically Important Systems – Criteria and the Recognition Process**

33. The legislation does not currently differentiate between systems that are systemically important and other systems, even though the Reserve Bank has historically applied a risk-based approach by paying more attention to systems that are considered systemically important and prioritising and addressing what it sees as the most significant payment system issues.
34. In order to have a robust and transparent oversight framework, it is important to set out in legislation that the Reserve Bank oversees all systems, with increased oversight on systems that it has identified as systemically important. These systems will be formally “recognised”.
35. Parts 5B and 5C give the Reserve Bank exclusive responsibility for pure payment systems. For other settlement systems, Part 5C powers are to be exercised jointly with the FMA. Under the proposed regulatory framework the Reserve Bank will apply formal oversight over recognised systemically important systems, and it is also proposed that the FMA be the joint regulator for recognised systems that are not pure payment systems<sup>11</sup>. A more detailed discussion of the FMA’s role is provided in Section 3.C.
36. In terms of the assessment of the systemic importance of a system, CPSS and IOSCO have defined a systemically important system as one where:
  - Disruption within it could trigger or transmit further disruptions amongst participants or disrupt the domestic financial system more widely; or
  - If it is a securities settlement system, securities depository or a central counterparty, it plays a critical role in the markets that it serves.
37. To determine the systemic importance of a system, the following aspects are relevant:

---

<sup>11</sup> For the rest of the paper, when referring to exercising system oversight powers, if a system is not a pure payment system, the Reserve Bank and FMA will act jointly – i.e. reach agreement on a course of action and then issue a single communication to a recognised system.

- *The size and concentration of financial risks within the system.* The value of transactions settled in the system in aggregate and/or individually provides an indication of the size of those risks. Systems that settle large value transactions such as wholesale systems are generally classified as systemically important, because of the greater credit and liquidity risk exposures that are likely to be associated with the larger value transactions;
  - *The role of the system and the nature of the transactions processed.* Where a system is used to settle payments of other systems or make payments in settlement of financial market transactions, that system is likely to be systemically important. Infrastructure such as central securities depositories and central counterparties, because of their central role in the operation of key financial markets, will also generally be systemically important;
  - *The degree of substitutability.* The systemic importance of a particular system will, all other things equal, be reduced where there are other systems that can process the transactions or systems that can process similar instruments; and
  - *Interdependencies with other systems or markets.* The greater the interdependencies, the greater the potential for a problem in one system to affect other systems. Interdependencies may be system-based (direct linkages between systems), institution-based (common participants or an institution that provides services to two or more systems) and environmental (broader, less direct factors like reliance on a common service provider)<sup>12</sup>.
38. The Reserve Bank has recently applied the above criteria and concluded that there are five systemically important systems in New Zealand. These are: ESAS, the CLS system, NZClear, the NZCDC settlement system and the SBI arrangements (see Appendix 4 for a brief description of these five systems).
39. The Reserve Bank suggests that the legislation should clearly state that the Reserve Bank, in deciding whether or not to recognise a system, must be satisfied that the system is systemically important. Such assessment will be determined on a framework derived from international best practice and international standard setting bodies' recommendation. The legislation should further specify that the Reserve Bank applies a set of criteria to assess the systemic importance of the system – such as the volume and value of transactions, the availability of alternatives etc., including any other matters it considers relevant.
40. While CPSS and IOSCO presume that all SSSs, CSDs, CCPs and TRs are systemically important, at least in the jurisdiction where they are located (and typically because of their critical roles in the markets they serve), they also allow an authority flexibility to depart from that approach and instead assess such systems as not systemically important, as long as the authority provides a clear and comprehensive rationale for the determination. It is proposed that the legislation includes flexibility to take into account matters specific to the New Zealand domestic environment.
41. The criteria need to be objective and applied consistently. Transparency enables payment and settlement system operators to understand and observe applicable policy requirements and standards. In addition, transparency also provides a basis for others to judge the effectiveness of the Reserve Bank's policy, and therefore hold

---

<sup>12</sup> See more detailed discussion on these issues in a report by the CPSS in 2008, "*The interdependencies of payment and settlement systems*".

the Reserve Bank accountable for effective oversight and appropriate exercise of its oversight powers.

*Question 3: Do you agree with adopting the CPSS/IOSCO definition of “systemically important systems”? If not, please provide more details. Are there any additional factors that the Reserve Bank should take into account when making an assessment of the systemic importance of a system? If so, what are those factors?*

42. Recognition of a system would be done by Order In Council. Transparency will also be enhanced if the Reserve Bank is required to consult the affected entity and publish the reasons behind the recognition of the system. This also provides checks and balances for the recognition process.
43. The Reserve Bank should publish on its website a Recognition Notice once a system is considered to have met the conditions for increased oversight. Accordingly, it would be appropriate that the Reserve Bank maintains on its website a list of recognised systems. It should be noted that, unlike designation, recognition itself would not convey any special status.
44. It is proposed that the recognition process be separated from the designation regime. “Designation” is primarily about providing legal certainty to the settlement and netting of transactions of a system, whereas “recognition” would be about applying increased oversight on systemically important systems. Section Five discusses in more detail how the Reserve Bank envisages it would exercise its oversight and designation roles, and explains why the Reserve Bank prefers to separate the two regimes.
45. Lastly, there will need to be a process where a system that has previously been, but is no longer, considered systemically important could be “de-recognised”.

### **C. Co-regulatory Arrangement**

46. The FMA oversees market infrastructure and securities markets activity. It has responsibilities for promoting the integrity and effectiveness of settlement systems and related markets, and enhancing the confidence of investors and other market participants in settlement systems and related markets<sup>13</sup>. While these responsibilities differ from the Reserve Bank’s mandates, both regulators have a valid interest in the operations of settlement systems. Similar to the Reserve Bank, the FMA has an interest in the oversight of systems that are systemically important.
47. Under Part 5C, the Reserve Bank and FMA are already joint regulators for designated systems that are not pure payment systems. The Reserve Bank considers it appropriate that the same arrangement be extended to recognised systems that are not pure payment systems.
48. Under the proposed regulatory framework, this would mean the Reserve Bank continues to have general oversight responsibility and information-gathering powers for all payment and settlement systems. For CCP, CSD, SSS and TR, the Reserve Bank would work with the FMA to assess whether or not to such systems should be recognised. The FMA would also be involved in the on-going oversight of these systems, including information gathering, disallowance of rules etc.

<sup>13</sup> *Memorandum of Understanding between RBNZ and FMA*

[http://www.fma.govt.nz/media/513740/memorandum\\_of\\_understanding\\_.pdf](http://www.fma.govt.nz/media/513740/memorandum_of_understanding_.pdf)

49. On a practical level, the proposed recognition regime would not have much impact on the existing arrangements between the two regulators. For the five systems that are assessed as systemically important, four of them are already designated, and the Reserve Bank and FMA are the joint regulators for two of these systems<sup>14</sup>. The only systemically important system that is not designated is SBI, which is a pure payment system. Regardless of whether SBI is designated or recognised, or both, the Reserve Bank will be its sole regulator.

*Question 4: Do you agree with the proposed co-regulatory model? If not, how should oversight responsibility be shared between the Reserve Bank and the FMA?*

#### **D. Co-operative oversight with overseas bodies**

50. Given the increasing reliance on payment and settlement systems operating across borders, there is a greater need for co-operation between central banks for oversight, helping to avoid gaps and duplication of activity and to minimise the risk that different central banks impose conflicting requirements on a system. When exercising its powers, the Reserve Bank should be mindful of the reporting and disclosure requirements already imposed by the home regulator. The Reserve Bank should also ensure that it optimises international collaborative oversight arrangements (e.g. CLS, SWIFT, LCH) wherever possible. We suggest that this is made explicit in the updated PS1.
51. Responsibility E of the PFMI highlights the importance of co-operation with other authorities. The Reserve Bank is committed to the effective supervision of overseas systems operating in New Zealand, and will continue to contribute to the co-operative arrangements set up by other authorities for the systems in their jurisdictions.

## **SECTION FOUR: OVERSIGHT POWERS**

52. In articulating the range and nature of powers that the Reserve Bank should seek for effective oversight of systems, the Reserve Bank has had regard to the following principles:
- Consistency with the purposes stated in the Act, with a focus on systems that are systemically important;
  - Alignment, where appropriate, between the oversight of recognised systems and the supervisory functions the Reserve Bank has in other sectors, such as banks, NBDTs and insurance companies;
  - The delivery of appropriate powers to deal with negative externalities, to ensure the Reserve Bank can induce changes in an effective and efficient manner, including being able to enforce corrective action;
  - The adoption of recognised international standards unless there are good reasons not to; and

---

<sup>14</sup> ESAS, CLS, NZClear and NZCDC are designated under Part 5C. ESAS and CLS are pure payment systems and the Bank is the sole regulator for them.

- International comparability and consistency to the extent this is practical (i.e. reference to other central banks' payment oversight powers and the recent international regulatory focus).

53. It should be noted that the proposed powers referred to in the paper apply to both the Reserve Bank and FMA, unless in respect of a pure payment system, and that it is intended that both regulators would exercise the powers jointly, as it is currently the case under Part 5C.

54. The Reserve Bank has broadly classified the powers into four categories: obtaining information, imposing requirements, enforcement and crisis management. Combining these with its current oversight approach that emphasises cooperative and constructive engagement with the industry, the Reserve Bank will have an effective mix of oversight tools with positive motivators, compliance monitoring and deterrents.

#### **A. *Monitoring and assessing - Information obtaining powers***

55. To carry out effective oversight, the Reserve Bank requires a good understanding of how key systems operate, how the risks are borne or created by a system or its participants, how they interconnect as part of the overall financial system, and whether they adhere to relevant regulations and policies.

56. The power for requesting general information relating to a system therefore should be fairly wide, and should be applied to all systems, recognised or otherwise. Information on non-recognised systems will help inform the Reserve Bank whether a system may become systemic and how it interconnects with recognised systems, as well as being useful for efficiency considerations.

##### **a) General information gathering power (all systems) – amendment needed**

Section 156C of the Act gives the Reserve Bank the power to require information relating to payment systems from the operator, a person that is partly or wholly responsible for the operation of the system, or a participant.

There are other parties in systems that are not being covered by this provision, such as potential operators of a new system. 156C is also limited to only payment systems. To avoid doubt, it should be widened to all systems.

##### **b) Power to require information to be audited (all systems) – unchanged**

Section 156E already allows the Reserve Bank to require the information to be audited if it has sufficient grounds to believe the information is inadequate or inaccurate. No change is needed for this provision.

##### **c) Power to require independent reports (recognised systems only) – new**

While audited information is useful in many cases, there are alternative channels for obtaining information. One such channel is to require an independent report from an expert in a particular field (other than an auditor). This is a power the Reserve Bank has in other areas (such as Section 95 of the Act), and it would serve as a useful power, reserved for certain specific situations.

In this case, the Reserve Bank should be able to specify the nature of the expert to be appointed, the timing and scope of the report, and the subsequent treatment of the report regarding disclosure or publication.

d) Power for onsite inspection (recognised systems only) - new

Another type of verification activity is the power to appoint a qualified person to enter and search premises and inspect. The Reserve Bank would need to ensure certain conditions are met (such as obtaining the agreement of the occupier of the premises or an inspector obtaining an appropriate warrant) before proceeding with the onsite inspection. This is expected to be a reserved power in most cases.

e) Power to require disclosure (recognised systems only) - new

The Reserve Bank has always emphasised the importance of reinforcing market discipline to support market participants' ability to make informed choices about risks. An example of this is the Reserve Bank's imposition of disclosure requirements on banks, and these disclosure requirements contributing to improved transparency in the sector.

Principle 23 in the *PFMIs* requires an FMI to disclose rules, key procedures and market data. As noted earlier, the Reserve Bank is in the process of preparing specific proposals on how to adopt the new *PFMIs*. As part of that process, it is important that the Reserve Bank is able to require recognised systems to conduct self-assessments as well as requiring that the self-assessments be published.

In addition, the Reserve Bank should have the ability to prescribe public disclosure of other information if it is satisfied that such disclosure is in the public interest and will improve market discipline. For any new disclosure requirements, the Reserve Bank should be required to consult with the affected systems (similar to Section 81A).

It is noted that this power could potentially be covered by a generic power to impose conditions (see power g).

f) Requirement for confidentiality/limits of disclosure – unchanged

For all the information the Reserve Bank obtains via exercising its powers, there should be appropriate legal safeguards to protect all confidential and non-public information obtained from a system, as set out in Section 156G and 156ZN.

In addition to requiring systems to conduct and publish self-assessments, the Reserve Bank (along with the FMA) may consider conducting its own assessments of systems under certain situations. Where appropriate and legally permissible, it may also consider publicly disclosing these assessments as a means to induce change at those systems and promote transparency.

The Reserve Bank will support the principle of co-operative oversight based on robust procedures for information sharing and consultation between authorities. This means the Reserve Bank needs to be able to share relevant confidential or non-public information with other authorities, as appropriate. The Reserve Bank considers that the existing provisions for the Reserve Bank to disclose information to foreign regulators, the FMA and other regulators are appropriate and no change is proposed.

**B. Inducing changes - Powers to impose requirements**

57. After the Reserve Bank has obtained the information through its monitoring, it could then make an assessment of:

- Whether to subject the system to its increased oversight based on the risk and efficiency issues that arise, and which policies/standards would be applicable
- For those that are recognised, assess whether they meet the relevant policy requirements/standards

58. On the basis of the assessment results, the Reserve Bank may take action and induce changes when it finds that a particular system does not have a sufficient degree of soundness or efficiency. The Reserve Bank attaches utmost importance to good cooperation with the entities it oversees, as such constructive cooperation helps to ensure effective oversight and to minimise any burden for the overseen entities.

59. The effectiveness of moral suasion however, will be strengthened by the possibility that, if needed, the Reserve Bank could use various other tools to induce necessary changes in systems. This is the area where its current powers are considered particularly light. All the powers proposed below are therefore “new” and only apply to recognised systems.

g) Power to impose conditions on the operation of recognised systems - new

A generic power to impose conditions on the operations of recognised systems, including the individual components such as participants, operators, CCPs, is recommended. The Reserve Bank envisages that these conditions on the operation of recognised systems could take several forms:

- Complying with certain standards
- Event-based reporting
- Designation
- Disclosure (as described in power e)
- Governance

*Compliance with standards*

One tool the Reserve Bank has used is publishing a public statement of its oversight policy (PS1). *PS1* is primarily for increasing transparency and accountability, but it could also be a useful influence on a system, as it clearly states the Reserve Bank’s oversight objectives and any specific policy requirements. In *PS1*, the Reserve Bank outlines its expectation that all systems should comply with the CPSS *Core Principles*. However, it currently has no actual power to require compliance with these principles.

The Reserve Bank’s formal oversight of recognised systems (which are, by definition systemically important) will be based on accepted international standards, and in this case, the CPSS “*Core Principles for Systemically Important Payment Systems*”, and IOSCO’s “*Recommendations for Securities Settlement Systems*”.<sup>15</sup> This aligns with the focus of most other central banks that oversee payment and settlement systems.

The *Core Principles* and the *PFMIs* are designed specifically to address market failures in systemically important systems, acknowledging the intensity of intervention should be proportional to the systemic importance of the system. Given that the

---

<sup>15</sup> As mentioned earlier, the Bank plans to adopt the new CPSS-IOSCO *PFMIs* and is currently developing specific proposals, which are to be released for public consultation later this year.



principles are expressed broadly to apply to a range of different FMIs, there are circumstances where the principles incorporate a specific minimum requirement to ensure a common base level of risk management across systems and countries. It is envisaged that the Reserve Bank might consider imposing additional requirements in these areas, or other standards outside of *Core Principles/PFMs*. It is proposed that the Act include a generic requirement for the Reserve Bank to consult affected parties prior to imposing new condition(s).

#### *Event-based reporting*

It is intended that the Reserve Bank could, under this power, prescribe event-based reporting for recognised systems, such as notification of outages, material changes to risk management and proposed changes in system operator (i.e. ownership changes). Currently under Part 5C, it imposes these requirements by way of conditions of designation and the Reserve Bank expects this power will be exercised in a similar way.

#### *Require designation*

Designation is about providing statutory backing for finality of settlement and netting. Benefits of designation include providing a high degree of legal certainty to participants in a designated system, and reliance on the validity of the settlements they receive. In turn, this contributes to the on-going 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<sup>16</sup>.

Rather than an opt-in regime as is currently the case, should the Reserve Bank consider that designation is desirable for a particular recognised system, it is important that the Reserve Bank can require it to be designated after appropriate consultative process.

#### *Governance requirements*

Similar to the banking, NBDT and insurance sectors, the Reserve Bank has always emphasised the importance of good governance in its payment oversight framework. Appropriate governance arrangements make it more likely that risks are adequately identified and are appropriately priced, allocated and managed, resulting in a more sound and efficient payment system. Appropriate governance arrangements can also add to the dynamic efficiency of the payment system over time by ensuring that interested voices are heard, and, as appropriate, taken into account in strategic planning<sup>17</sup>.

For the payment industry, checks and balances are particularly necessary as the natural monopoly and network characteristics of many payment systems mean that payments systems tend to have significant degree of market power – which tends to dull the incentives to accommodate the interests of non-owners which, in turn, may erode payment system soundness and efficiency. It is therefore important the Reserve Bank has the power to impose requirements on the governance structure of a recognised system.

---

<sup>16</sup> “*The Designation and Oversight of Designated Settlement Systems*” (DSS1)

[http://www.rbnz.govt.nz/regulation\\_and\\_supervision/payment\\_system\\_oversight/4414164.pdf](http://www.rbnz.govt.nz/regulation_and_supervision/payment_system_oversight/4414164.pdf)

<sup>17</sup> “*Payment System Governance* (PS2)”

[http://www.rbnz.govt.nz/regulation\\_and\\_supervision/payment\\_system\\_oversight/2641543.pdf](http://www.rbnz.govt.nz/regulation_and_supervision/payment_system_oversight/2641543.pdf)

h) Power in relation to system rules - new

Typically, systems establish a set of common rules and procedures for their participants, a technical infrastructure or platform, and a specialised risk-management framework appropriate to the risks they incur. In many cases, the most important aspects of how a system operates are encapsulated in the rules that the system and its participants have agreed to follow. It is therefore an important power for the Reserve Bank to be able to instruct the system operator to take certain actions in respect of the system's rules.

In particular, this power deals with the scenarios where a weakness or issue has been identified in a recognised system's rules, and as a consequence, the Reserve Bank may require the operator of the system to either establish a new rule or change an existing rule in a specified way to achieve a specified purpose.

This power should also enable the Reserve Bank to require that it be notified of any proposed change to the rules, and that it is able to disallow proposed changes. This will align the oversight of recognised systems with that of designated systems under Part 5C. Many of the to-be-recognised systems are likely to also be designated systems under Part 5C of the Act, and therefore already under an obligation to notify the joint regulators of proposed amendments to rules (Section 156ZB) with the regulators empowered to disallow the proposed amendments (Section 156ZC).

It is anticipated that in most instances the Reserve Bank will continue its current practice of engaging closely with system operators to discuss improvements that should be made, and it will consider whether to exercise its powers only if such a process has failed, or the changes create unforeseen problems.

**C. Inducing changes – Powers to enforce**

60. As part of the assessment process, the Reserve Bank will be aware of whether or not a system adheres to relevant standards or policies. The Reserve Bank's oversight duty means that it should have the powers to induce change or enforce corrective action in a system that is not complying with relevant regulations or policies.
61. Moral suasion, such as discussions with the systems and their participants, plays, and will continue to play, an important part for the Reserve Bank in achieving its oversight objectives. However, previous experience with the industry has suggested that solely relying on moral suasion may neither be an efficient nor effective method in bringing about change. Moral suasion has been proven to work best when there are credible regulatory or other remedies available to the authorities.
62. The Reserve Bank has recently adopted a set of enforcement policies for potential and actual non-compliance of regulatory requirements in the sectors regulated and supervised by the Reserve Bank, including payment and settlement systems oversight<sup>18</sup>. Enforcement is considered in a very general sense that includes private warning or public notices, to civil or criminal prosecutions.
63. Based on the powers proposed in this document, the Reserve Bank notes that there are a number of cases where non-compliance or offence could occur, as part of the Reserve Bank's oversight of a system:

---

<sup>18</sup> [http://www.rbnz.govt.nz/regulation\\_and\\_supervision/banks/overview/5014438.html](http://www.rbnz.govt.nz/regulation_and_supervision/banks/overview/5014438.html)

- Failure to supply information requested (unchanged)
- Failure to have information audited (unchanged)
- Failure to comply with a requirement for independent reports (new)
- Failure to comply with conditions of recognitions (new)
- Failure to comply with directions on system rules (new)
- Failure to comply with other directions (new)

64. The Act currently only provides for imposing a penalty as an enforcement power. The Reserve Bank believes a range of options should be available.

*i) Power to publish warning and potential non-compliance/offence – new*

Once a potential non-compliance or breach has been identified, and judgement has been made that an enforcement process should be considered, publication of information on the non-compliance is one of the first steps the Reserve Bank could take.

If the Reserve Bank has issued a warning prior to imposing the sanction, it could also publish the warning notice, although it must have regard to the protection given to confidential information under Sections 156G and 156ZN when doing so.

Sections 162AA(c)(ii) and 165A(2)(b) of the Act require the Reserve Bank to publish relevant information in the FSR to allow assessments to be made of the activities of the Reserve Bank's achievement of its statutory prudential purposes, and effectiveness of the Reserve Bank's exercise of its powers.

Publishing information regarding the nature and outcome of the non-compliance serves as a deterrent of further non-compliance of the entity and encourages compliance for the sector.

*j) Power to impose penalties – amendment needed*

Currently, Section 156J stipulates the penalties for offences under Part 5B being:

- For an individual, imprisonment for a term not exceeding three months or a fine not exceeding \$50,000; and
- For a body corporate, a fine not exceeding \$500,000.

Given the wider ranges of offences that could occur, and the more serious nature of the offences, the Reserve Bank believes it appropriate to amend the penalties accordingly, ideally aligning them with those under the penalties for bank supervision (Section 156AC). This will result in increased maximum fines and longer jail time if convicted (e.g. for an individual, the penalty for offences will rise to imprisonment for a term not exceeding 18 months or a fine not exceeding \$200,000, and for a body corporate, a fine not exceeding \$2,000,000).

**D. Crisis management powers**

*k) Power to direct - new*

The Reserve Bank is of the view that a general power to issue directions to both the operators and participants of recognised systems would be of significant value as part of the Reserve Bank's crisis management toolkit, in cases where the payment and settlement systems would be likely to play a key role in the crisis.

The direction power should be exercised in relation to the Reserve Bank's oversight of the recognised systems. The Reserve Bank suggests that prior to giving a direction, it would need to be satisfied of the following:

- that the system operator or participant is insolvent, or likely to become so; or
- that the system operator has failed to comply with the Act and any conditions applying to it as a recognised system; or
- that the system operator has acted in a manner that is detrimental to the soundness and efficiency of the financial system; or
- that the participant has failed to comply with the rules of the system.

The direction may:

- Require or prohibit the taking of specified action in the operation or participation of the system; or
- Set standards to be met in the operation of the system.

l) *Power to remove, replace or appoint directors - new*

We expect that this power would be exercised on similar grounds to situations where the Reserve Bank issues a direction.

m) *Power to appoint a statutory manager – new*

Given the Reserve Bank's oversight role for all systems, we believe it should have a role in the statutory management of these systems (and the FMA accordingly if the system is not a pure payment system). Systemically important systems play an essential role in the financial system, and the disorderly failure of such a system could lead to severe disruptions and damage to the financial system as a whole. The Reserve Bank therefore has a proper interest in ensuring that it has a key role in managing that situation.

If a systemically important system fails for whatever reason, maintaining critical operations will be paramount. Given the critical nature of the functions of these systems, it is essential that an effective and tailored resolution regime can be applied so that the choice is not simply between taxpayer support and liquidation. This is recognised in the *Key Attributes* by FSB and the *Recovery and resolution of financial market infrastructures* by CPSS/IOSCO<sup>19</sup>.

Both of the papers mention that relevant authorities should have powers for activation and enforcement of recovery plans. These include: issuing orders, imposing fines or penalties and forcing a change of management as appropriate. These powers are already proposed in an earlier section.

The papers also note that because the traditional bankruptcy process does not have the preservation of financial stability as an objective and could cause a systemic

---

<sup>19</sup> See footnote 5.

disruption through delays or cessation of an FMI's critical functions, it is necessary to also have a resolution regime available for use on FMIs.

The Reserve Bank's starting point is that the basic framework for statutory management in other sectors, such as the banking sector, will be effective in respect of the payment and settlement systems. There may need to be some minor technical adjustments to some of the detail of the statutory management provisions to apply them to systems, and more detailed work is planned on that front.

This is a relatively new area where many central banks and other authorities are in a process of developing detailed regulations. At this stage the Reserve Bank suggests that it continues to monitor international developments, and should in principle seek to set up a tailored statutory management regime for recognised systems. Such regime will be aligned to the banks' statutory management regime to the extent that is appropriate, taking into account the differences between a system and other financial institutions.

*Question 5: Are there any powers that are proposed in this paper not appropriate in your view? If yes, please explain which one(s) and why. Are there any other powers should the Reserve Bank seek and why?*

## SECTION FIVE: RECOGNITION VS DESIGNATION

### A. *Recommended model - Separating recognition from designation*

65. Under Part 5C, the Reserve Bank and FMA jointly designate payment and settlement systems. It is currently an opt-in regime. As mentioned in paragraph 44, "designation"<sup>20</sup> provides a well-defined legal environment for a stable and secure system. The Reserve Bank and FMA oversee designated systems and have a number of powers in this regard.

66. This paper has emphasised the need for the Reserve Bank to oversee systemically important systems because of the systemic risks inherent in these systems. It is generally desirable for a systemically important system to also be designated, because that underpins the legal efficacy of their settlements and netting arrangements. But this is only one aspect (albeit a very important one) of a well-functioning system; the Reserve Bank has a wider interest in systems' other rules including matters relating to access, system design and operation, interconnection with other systems and participants, business continuity arrangements and governance structure .

67. In addition, the "settlement system" as defined under Part 5C<sup>21</sup> does not cover infrastructure providers (such as critical service providers), participants (except for

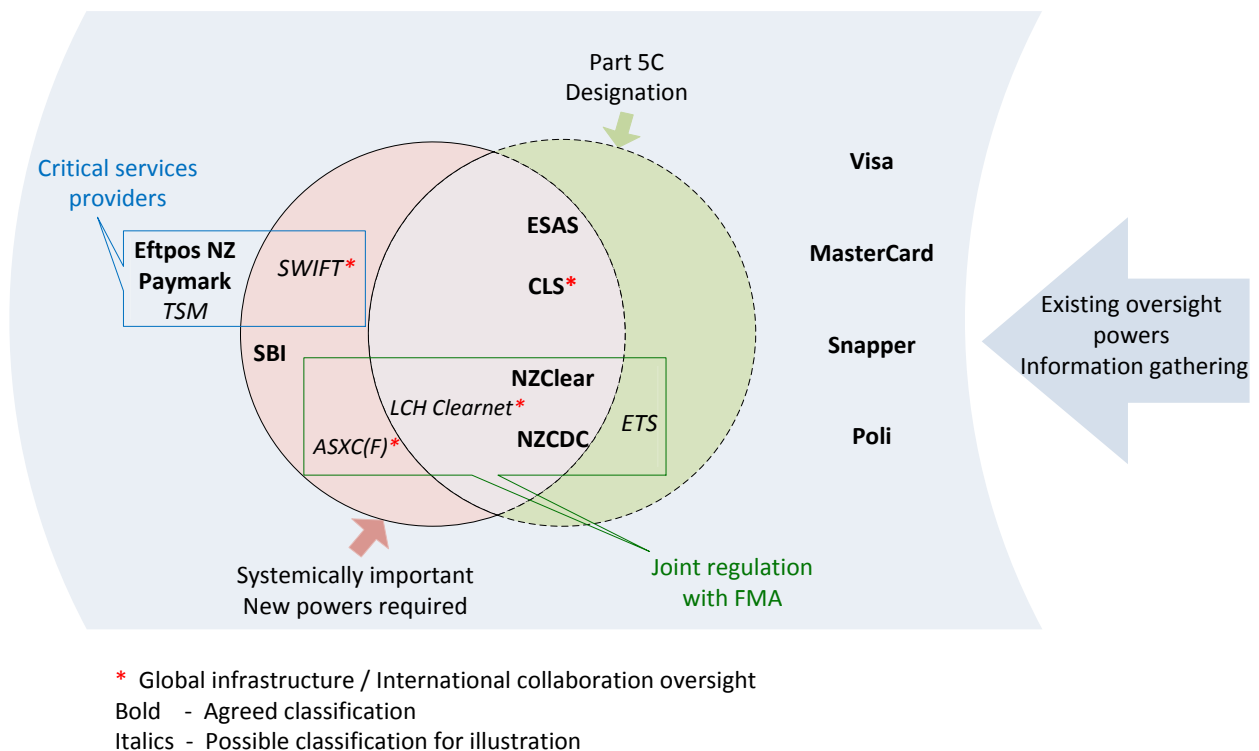
---

<sup>20</sup> Reserve Bank research shows central banks use "designation" to mean different things. There are currently three different meanings for designation: 1) brings the system into regulatory oversight if the system is systemically important (CPSS, HK, Canada, Singapore); 2) brings the system into regulatory control so the authority can impose access regime or other standards (Australia); 3) provides legal certainty (NZ, UK, Singapore). In this paper, unless the use of "designation" is in relation to other countries, "designation" means legal certainty as defined under Part 5C.

<sup>21</sup> Part 5C defines a "settlement system" as "a system or arrangement for effecting settlements or processing settlement instructions in accordance with the rules" and "includes a payment system".

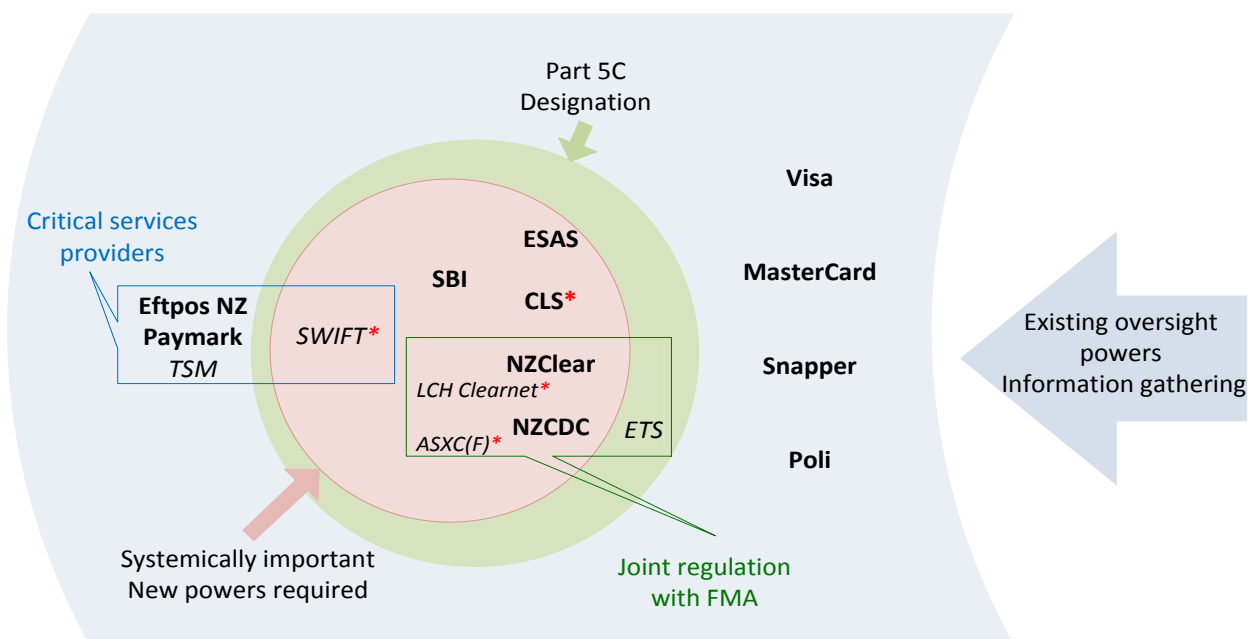
requiring information) or instruments. These are within the scope of the Reserve Bank’s proposed oversight powers, for the purposes of soundness and efficiency.

68. The Reserve Bank envisages its decision on whether or not to designate a system will be independent from its assessment of systemic importance of the system.
69. The opt-in feature of Part 5C also allows smaller system operators to apply for designation. While one of the criteria the Reserve Bank and FMA will consider in approving the application is the importance of the system to the financial system, the Reserve Bank considers it to be a lower threshold than “systemic importance”. It is unlikely that the Reserve Bank will be exercising increased oversight on a non-systemically important system (albeit the Reserve Bank still has a narrower interest in the oversight of designated systems).
70. While it adds complexity at the margin, the Reserve Bank considers that a separate recognition regime is warranted because it preserves the current meaning of “designation” (i.e. legal certainty) and is built on the assumption that not all systemically important systems should be designated. The current design of “de-designation” for example, also does not fit well with the recognition regime. The following diagram shows how the two regimes would overlap (note that the diagrams are illustrative only; Appendix 4 provides a brief summary of these systems):



### ***B. The alternative – Merging recognition with designation***

71. An alternative model is to merge these two regimes, where the Reserve Bank recognises systems that are systemically important and subjects them to increased oversight, and all recognised systems are required to be designated. This maintains the existing opt-in feature. See the following diagram on how the two regimes merge:



\* Global infrastructure / International collaboration oversight

Bold - Agreed classification

Italics - Possible classification for illustration

72. This would be a simpler model, and most of the additional powers sought in this paper would be more of a “back filling” nature given that the Reserve Bank already has the power to disapprove rules, review and even revoke the designation. It would still need to seek power to impose conditions on participants, and crisis management powers, such as power to appoint a statutory manager. However, as mentioned above, critical service providers such as SWIFT are not a system under the definition of Part 5C, so will not fit well into the designation scheme. A CCP may not have a settlement system embedded in it, and therefore would not be a settlement system under Part 5C. It might also be argued that SBI does not need to be designated. To be able to designate all of them, the Reserve Bank would need to change the meanings of “settlement systems” and “designation”.

### **B. Recommendation – separating recognition from designation**

73. On balance the Reserve Bank considers that separating the two regimes, while recognising the overlaps between them, is more desirable. Having the same joint regulatory framework for both would simplify the overall arrangement. Bank of England, Reserve Bank of Australia, Hong Kong Monetary Authority and Monetary Authority of Singapore, for example, all operate both regimes. Bank of Canada operates one scheme only – it designates systemically important systems and all designated systems are given legal certainty backing.

*Question 6: Do you agree that separating the two regimes would represent a better framework overall? Please provide more details to your answer. Do you have any comments about how these two regimes would work?*

## SECTION SIX: EFFICIENCY CONSIDERATIONS AND MONITORING THE WIDER ECONOMY

### A. Efficiency considerations

74. While the main objective of oversight is to assess and, if necessary, manage and mitigate systemic risk in systems, efficiency aspects also need to be considered. These are in principle similar to efficiency considerations in other sectors regulated by the Reserve Bank (banking, insurance, NBDTs) where in all cases its legal mandate encompasses both “soundness and efficiency”. Considerations should therefore be similar – the preliminary thinking outlined below is broadly consistent with preliminary thinking on banking efficiency in 2011<sup>22</sup>.

#### *Specifying efficiency objectives*

75. Part 5B gives the Reserve Bank responsibility for promoting the soundness and efficiency of the payment systems in its oversight role. While this part of the Act does not define efficiency, *PS1* does provide more details relating to the meaning of efficiency in this context. The statement makes reference to ensuring:

- the payment services are efficient and reliable, and are responsive to customer needs, and;
- the payment systems are open, flexible and competitive with no unwarranted barriers to entry.

76. As shown in *PS1*, the Reserve Bank’s focus has been primarily on encouraging greater competition between institutions that offer payment services. The *Access and Governance* project with the industry was an example where the Reserve Bank pushed for easier access to the payment system by a wider range of entities, including non-banks. The outcome of this project was the establishment of Payments New Zealand, whose constitution states that one of its primary objectives is to encourage and facilitate new entities to become participants in the New Zealand payment systems.

77. In practice, the Reserve Bank has tended to view the pursuit of soundness through prudential regulation as the key objective, while viewing the efficiency mandate mainly in terms of minimising or avoiding excessive compliance costs. This is consistent with many other central banks’ mandates, where priority is given to soundness<sup>23</sup>.

78. Tackling any potentially significant systemic risk is always a priority because of the serious consequences that can arise if the risk is realised. But where systemic risk is not an immediate issue then inadequate market infrastructure may mean that the priority for the Reserve Bank at a particular time is to promote efficient payment arrangements within the constraints of broad safety parameters<sup>24</sup>.

79. Over the last two years, the Reserve Bank has been developing a more systematic framework for analysing and reporting on efficiency-related issues across the

---

<sup>22</sup> Bloor, C and Hunt, C (2011), “*Understanding financial system efficiency in New Zealand*”, Reserve Bank of New Zealand *Bulletin*, 74(2), June

<sup>23</sup> *Ibid*

<sup>24</sup> CPSS – Oversight report – May 2005



financial system<sup>25</sup>. As part of the redesigning of its payment oversight framework, the Reserve Bank has also started to review the extent of its interest in efficiency.

80. A conceptual framework for measuring financial system efficiency has noted that analysis must be undertaken across a number of different levels – from the economic system as a whole, right down to the level of individual financial products or services<sup>26</sup>. This includes looking at “allocative efficiency” (i.e. whether the financial system is helping to allocate resources to their best use), “technical efficiency” (i.e. performing functions or provision of financial products and services at least cost), and “dynamic efficiency” (i.e. responding to changing consumer preferences and uncertainty through the developments of new financial services and products).

81. With these criteria in mind and adapting them to payment and settlement systems, we outline below a number of aspects where the Reserve Bank believes efficiency is relevant and should be reflected in its oversight framework:

- Ensuring fair and open access and foster competition. This includes removing legal obstacles and entry barriers and therefore enhancing the competitive environment. It has generally been acknowledged that a more competitive environment will produce the preconditions necessary for efficiency<sup>27</sup>. This is also linked to Principle 18 of the *PFMs*, where “*a FMI should have objective, risk-based, and publically disclosed criteria for participation, which permit fair and open access*”.
- Ensuring clear and transparent governance in a system. This is linked to the *PFMs* Principle 2, where clear and transparent governance in a FMI would “*promote the safety and efficiency of the FMI, and support the stability of the broader financial system, other relevant public interest considerations, and the objectives of relevant stakeholders*”.
- The efficiency of the system: In the *PFMs* Principle 21 states that “*an FMI should be efficient and effective in meeting the requirements of its participants and the market it serves*”. The system should provide a means of making payments that is practical for its users and efficient for the economy.
- Efficiency consideration is a “check and balance” for soundness and trade-offs between soundness and efficiency may need to be considered in certain situations – e.g. not creating a risk-proof payment system that is so expensive that no one is prepared to use it, or encourage flow to other, perhaps riskier alternatives.

82. It should be noted that efficiency considerations would be relevant to all systems overseen by the Reserve Bank, not just the recognised systems.

#### *Other public policy objectives - contributor*

83. In addition to soundness and efficiency, other public policy objectives such as control of money laundering, price regulation, consumer protection and the avoidance of anti-competitive practices must also be addressed in the design and operation of a payment and settlement system.

---

<sup>25</sup> Bloor, C and Hunt, C (2011)

<sup>26</sup> Ibid

<sup>27</sup> Ibid

84. A variety of other public sector agencies, including the Reserve Bank, have a role in achieving these objectives. The Commerce Commission, for example, enforces the Commerce Act 1986. That Act prohibits anti-competitive behaviour and structure in markets. The FMA also contributes to financial system efficiency by enforcing clear and transparent rules for financial market conduct.
85. It should be noted that these areas are not the Reserve Bank's focus. However, given its oversight role, it would contribute to the work of other public authorities with regard to these policy objectives. In some instances, it would be beneficial to set up a basic Memorandum of Understanding that provides a basic framework for dealing with these issues.

### *Next Steps*

86. This is a high level discussion of Reserve Bank current thinking in respect of efficiency considerations. For the purpose of the review, the Reserve Bank believes these considerations will be adequately addressed by the range of powers discussed in this paper. For example, the enhanced powers proposed in Section Four would help us achieve efficiency related goals such as ensuring system rules allow fair and open access.
87. The Reserve Bank will continue to refine its view on efficiency while monitoring industry developments, taking into consideration broader thinking on how it should consider "efficiency" across all the sectors it regulates.

*Question 7: Do you agree with the efficiency considerations discussed in this paper? If not, please explain why. Are there any other efficiency-related areas that you consider the Reserve Bank should look into? If so, please provide further details on those areas.*

### **B. Monitoring the wider landscape**

88. The existing general information-gathering power is important for the Reserve Bank to monitor the wider payments landscape, both to understand the potential risk to recognised systems themselves and to help identify any systems that have become (or seem likely to become) sufficiently important to merit recognition.
89. In addition, for systems that might not meet the criteria, the Reserve Bank might still have an interest in the implications for financial system efficiency. It will therefore maintain a dialogue with these systems and entities, including through informal meetings and by reviewing information received from them.
90. At this stage the Reserve Bank has not proposed a registration regime for all systems because its focus is on systems that are systemically important. The Reserve Bank uses the term "register" differently for the banking sector. The Reserve Bank also notes that the Financial Service Providers (FSP) register seems to include payment systems<sup>28</sup>.
91. However, the Reserve Bank acknowledges that the FSP register might not serve its purpose. The Reserve Bank plans to assess the pros and cons of maintaining some

---

<sup>28</sup> Section 11 of Financial Service Providers (Registration and Disputes Resolution) Act 2008 states that a financial service involves both: operating a money or value transfer service; and issuing and managing means of payment (e.g. credit and debit cards, cheques, travellers' cheques, money orders, bankers' drafts, and electronic money). This is administered by Ministry of Business, Innovation, and Employment.

sort of list for all the payment and settlement systems operating in New Zealand at the next stage, and would welcome any comments on this.

*Question 8: What are the pros and cons for the Reserve Bank to maintain a list of all the payment and settlement systems in New Zealand? Are you supportive of the Reserve Bank having such a list? If not, please provide detailed comments.*

## Appendix 1: Industry projects: Failure to Settle and Access and Governance

### Failure to Settle

After some years of discussion, the New Zealand Bankers Association's (NZBA) *Failure to Settle (FTS)* Project formally commenced in 2001.<sup>29</sup> It was about promoting changes to failure-to-settle rules in the retail payment systems (ISL Rules), which continued to be settled on a deferred net basis, and as a result, a considerable amount of intra-day risk existed.

The NZBA adopted revised Interchange and Settlement Rules in 2005.<sup>30</sup> Under these Rules, participants were better placed to manage the risks they faced in using the ISL Switch (a focal point for the domestic retail payment system before 2012) because the risks have been more clearly identified and allocated. The revised rules provided more certainty and clarity than was previously the case, regarding, for example, the point at which interbank credit exposures arose in the retail payment system as a result of customer transactions, and the point at which payment instructions became unconditional and irrevocable between banks.

One other important aspect of the *FTS* project was the containment of the systemic damage that could arise from the failure of a registered bank. In the Reserve Bank's view, it was important that the bank in statutory management could have immediate and continued access to the retail payment system. Additional changes to the rules were agreed to in 2008.

The Reserve Bank also aimed at reducing settlement risk in the retail payment system and this formed another part of the *FTS* project. The Reserve Bank's engagement with the NZBA in this regard was focused on the scope for increasing the frequency of settlement (i.e. from one to several settlement cycles per day), which would reduce the length of time settlement risk persists, and reducing the volume of high value transactions being settled through the deferred retail payment system.<sup>31</sup> The NZBA set up the *Settlement Before Interchange (SBI)* project in relation to this, but the progress of SBI model adoption was extremely slow,<sup>32</sup> with the proposed implementation date postponed numerous times from 2006 until finally implemented in early 2012 (Payments New Zealand (PNZ), established in 2010, took over the responsibility to manage the SBI implementation project from the NZBA).

SBI represents a significant change to the way that retail payments were exchanged between banks and settled. It was designed to address key risks in the retail payment system. In particular, SBI reduces settlement risk between banks<sup>33</sup>. However, the SBI model adopted by the industry does not address two significant long-standing (related) issues: high value transactions settled through SBI and the underlying counterparty risks between customers.<sup>34</sup>

### Access and Governance

In 2001, the Reserve Bank raised access and governance issues with NZBA<sup>35</sup>. Appropriate access and governance arrangements are particularly relevant to payment system efficiency and the Reserve Bank was actively engaged with the NZBA on NZBA's *Access and Governance (A&G)* project<sup>36</sup>.

---

<sup>29</sup> *FSR*, RBNZ, May 2005

<sup>30</sup> *FSR*, RBNZ, May 2006

<sup>31</sup> *FSRs*, RBNZ, May 2006, November 2007, May 2008

<sup>32</sup> *FSRs*, RBNZ November 2008, May 2009

<sup>33</sup> *FRS*, RBNZ, May 2012

<sup>34</sup> *FSRs*, RBNZ, May 2009, November 2009, May 2012, November 2012

<sup>35</sup> *FSRs*, RBNZ, May 2005

<sup>36</sup> *FSRs*, RBNZ, May 2006, May 2007

The Reserve Bank had two key objectives in the A&G project:

- In terms of access, the Reserve Bank is interested in seeing objective and publicly disclosed criteria for participation, which permit fair and open access. More specifically the Reserve Bank is interested in seeing access being possible for non-banks.
- In terms of governance, the Reserve Bank is interested in seeing governance arrangements that are effective, accountable and transparent with respect to the payment system's owners and users, and which take into account the public interest.

The NZBA had stated that having more open access to the ISL switch (which was owned by eight banks) depended on whether settlement risk issues in the *FTS* Project could be successfully resolved. Hence, the resolution of settlement risk issues would need to be prioritised and properly coordinated between both projects to ensure that project timelines in relation to more open access were met<sup>37</sup>. The introduction of SBI in 2012 has supported the A&G Project, as existing participants no longer have to be as concerned about the potential settlement risk involved in letting new participants into the system<sup>38</sup>.

It took a significant period of time for the access rules and governance arrangements to be agreed. This took place in 2008, and after a number of delays<sup>39</sup>, PNZ was established in October 2010, assuming responsibility from the NZBA for managing current payment system rules relating to the clearing and settlement of four types of payments: paper-based instruments, bulk direct entry electronic transactions, EFTPOS transactions and high value transactions. PNZ was established to ensure that there are objective and publicly disclosed criteria for participation in the clearing and settlement of each of the four payment types with the criteria permitting fair and open access. All participants should also have a role in the ongoing administration and development of the rules relating to the types of payments that they can clear and settle<sup>40</sup>.

In respect of ensuring fair and open access, one long-standing issue the Reserve Bank had was on access fees. The range of fees proposed over the course of the A&G project could have been substantial and could have provided a barrier to entry. In general, access fees need to be transparent and fair. The Reserve Bank will watch developments in this regard with interest, in particular, that the costs involved in accessing the payment system are reasonable for new participants.

No new participant has joined PNZ to date. The Reserve Bank continues to monitor developments and engage with relevant stakeholders, and will respond appropriately if it becomes evident that significant barriers to entry exist.<sup>41</sup>

---

<sup>37</sup> *FSR*, RBNZ, May 2007

<sup>38</sup> *FSR*, RBNZ, May 2012

<sup>39</sup> *FSRs*, RBNZ, November 2008, May 2009

<sup>40</sup> *FSR*, RBNZ November 2010

<sup>41</sup> *FSRs*, RBNZ, May 2012, November 2012

**Appendix 2: Central banks and other relevant regulators' statutory powers on oversight of payment and settlement systems**

	Australia	Canada	ECB	HK	New Zealand	Norway	Singapore	Switzerland	UK	United States
Legal backing for oversight responsibility	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
Information gathering power from systems/participants	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
Ability to designate a system or subject it to central bank's regulatory control	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
Ability to approve, disallow or impose systems' operational rules	✓	✓	✓	✓		✓	✓	✓	✓	✓
Power to make regulation or issue direction	✓	✓	✓	✓		✓	✓	✓	✓	✓
Power to inspect		✓		✓			✓	✓	✓	✓
Power to impose sanctions (fines, sanctions, suspension)	✓			✓	✓	✓	✓	✓	✓	✓

### Appendix 3: Meeting the responsibilities set for central banks in the *PFMIs*

The new *PFMIs* have set out five responsibilities for central banks, market regulators and other relevant authorities for financial market infrastructures. Preliminary assessments for the Reserve Bank on each responsibility are as follows, based on the proposals in this paper:

- *Responsibility A: FIMs should be subject to appropriate and effective regulation, supervision, and oversight by a central bank, market regulator or other relevant authorities*

The framework of subjecting systemically important systems to the Reserve Bank's increased oversight will meet Responsibility A.

- *Responsibility B: Central banks, market regulators, and other relevant authorities should have the powers and resources to carry out effectively their responsibilities in regulating, supervising and overseeing FIMs*

The Reserve Bank considers the powers proposed in the paper will provide it with sufficient powers to oversee systems effectively.

- *Responsibility C: Central banks, market regulators and other relevant authorities should clearly define and disclose their regulatory, supervisory, and oversight policies with respect to FIMs*

The Reserve Bank believes the criteria, if set out in legislation will provide sufficient transparency for how the Reserve Bank identifies systems on which it would exercise increased oversight. The Reserve Bank also considers continued usage of *PS1* to illustrate its oversight approach in more detail, which will further enhance transparency.

- *Responsibility D: Central banks, market regulators and other relevant authorities should adopt the CPSS-IOSCO Principles for Financial Market Infrastructures and apply them consistently.*

The Reserve Bank is planning to adopt the new *PFMIs* and will consult on the detailed proposals later in 2013. The proposed power of imposing conditions will enable the Reserve Bank to require compliance of the new *PFMIs*. The Reserve Bank plans to work closely with the FMA on systems that are not pure payment systems to ensure a consistent approach is adopted.

- *Responsibility E: Central banks, market regulators and other relevant authorities should cooperate with each other, both domestically and internationally, as appropriate, in promoting the safety and efficiency of FIMs.*

The Reserve Bank will continue to participate in cooperative oversight arrangements for cross-border systems, and support other regulators where possible. The current provision for information disclosure is sufficient for the information sharing and consultation with other regulators. The Reserve Bank will also continue to work closely with the FMA on recognised systems that are not pure payment systems.

#### Appendix 4: New Zealand Payment and Settlement Systems

System	Description	Owner/operator
<i>High Value</i>		
<b>Exchange Settlement Account System (ESAS)</b>	Provides real time gross settlement of interbank transactions across the exchange settlement accounts held with the Reserve Bank	Reserve Bank
<b>Continuous Linked Settlement (CLS)</b>	Provides payment versus payment settlement of foreign exchange transactions	CLS Bank International
<i>Retail</i>		
<b>Settlement Before Interchange (SBI)</b>	Arrangements for the progressive exchange during the day of retail payment instructions (cheques, direct debits and credits, automatic payments, ATM settlement transactions, internet banking and telephone banking). Payments are exchanged using SWIFT and settlement of net interbank positions occurs in ESAS	Arrangements are governed by rules administered by PNZ, a company owned by eight registered banks
<b>Paymark Limited</b>	Provides a network for the interchange of point of sale debit, credit, charge and proprietary card transactions	Four major registered banks
<b>EFTPOS NZ Limited</b>	Provides a network for the interchange of point of sale card transactions	Recently sold by ANZ to Verifone
<b>Visa</b>	A global payment technology company. It facilitates electronic funds transfers most commonly through Visa-branded credit cards and debit cards.	Visa Inc
<b>MasterCard</b>	A global payment company that provides payment products, such as credit cards and debit cards, and payment processing.	MasterCard Incorporated
<b>Poli</b>	An online payment option which facilitates a 'Pay Anyone' internet banking payment from a customer's bank account to a merchant.	Centricom Pty Ltd
<b>Snapper</b>	A contactless smart card used for transport and other everyday items, such as taxis, food and coffee	Snapper Services Limited (wholly owned subsidiary of



		Infratil Limited)
<i>Securities Settlement</i>		
<b>NZClear</b>	Allows members to settle fixed interest and equity transactions and make cash transfers. Interbank payments occur directly in ESAS	Reserve Bank
<b>NZCDC Settlement System</b>	Used to clear and settle trades on NZX markets. The system includes a central counterparty and securities depository	NZ Clearing and Depository Corporation Limited (wholly owned subsidiary of NZX)
<b>LCH.Clearnet SwapClear</b>	Global clearing service for interest rate swaps (including New Zealand dollar products)	LCH.Clearnet Group Limited
<b>ASX Clear (Futures)</b>	Central counterparty for derivatives (including NZD interest rate futures) traded on the ASX 24 market	ASX Limited
<b>New Zealand Emissions Trading Scheme (ETS)</b>	The system in which New Zealand Units (the right to emit carbon dioxide) is traded. It is linked to international carbon markets.	New Zealand Government
<i>Critical Service Provider</i>		
<b>SWIFT</b>	Provides secure global financial messaging services	Co-operative owned by over 8300 financial institutions
<b>Trusted Service Manager (TSM)</b>	A company that acts as a neutral broker that sets up business agreements and technical connections with mobile network operators, phone manufacturers, or other entities controlling the secure element on mobile phones.	Joint venture owned by Paymark, Vodafone, Telecom and 2 Degrees