In Confidence

Office of the Minister of Finance

Chair, Cabinet Economic Development Committee

Financial Market Infrastructures Bill: Additional Policy Issues

Proposal

1. The purpose of this paper is to:

   - Brief Cabinet on the background to, and content of, the Financial Market Infrastructures Bill (FMI Bill); and

   - Seek Cabinet agreement to a number of issues relating to the design of the FMI Bill.

Executive Summary

2. Financial Market Infrastructures (FMIs) are multilateral systems among participating institutions that are used for clearing, settling or recording payments, securities, derivatives or other financial transactions. Common types of FMIs include payment systems, securities settlement systems, and central counterparties. The participants of FMIs are usually banks and other types of financial institution, but in respect of payment systems can also include individuals, retailers, and other businesses.

3. The FMI Bill will establish a new regulatory regime for the oversight of FMIs. It arises out of policy work that has been undertaken since 2013, and which has included three rounds of public consultation. The previous Cabinet agreed to the adoption of the regime in April 2017 (EGI-17-MIN-0073, CAB-17-MIN-0164 refer), and the drafting of the FMI Bill has been underway since that time.

4. The enhanced regulation of FMIs is necessary for a number of reasons. Most importantly, FMIs play a key role in the operation of the financial system as they provide the essential services needed to clear, settle, and report electronic payments and transactions involving financial products. The disruption or failure of an FMI could affect the financial system as a whole, and create major solvency and liquidity problems for market participants (as well as disruption for consumers and businesses). This makes some FMIs systemically important.

5. In addition, FMIs can be subject to market failures resulting in, amongst other things, an insufficient focus on risk management or inadequate investment in underlying infrastructure. The existing legislative regime in New Zealand also has significant deficiencies and is not consistent with international best practice (for example, it is an

opt-in rather than mandatory regime, and does not cover all types of FMI, and lacks crisis management powers).

6. The FMI Bill will establish a standalone Act that will replace the current regime, which is contained in Parts 5B and 5C of the Reserve Bank of New Zealand Act 1989. The regime established under the FMI Bill will:

- Make the Reserve Bank and Financial Markets Authority (FMA) the joint regulators of FMIs (except payment systems, where the Reserve Bank would be the sole regulator);

- Provide the joint regulators with information gathering and investigative powers in respect of all FMIs, to enable monitoring of the wider sector;

- Provide for a category of designated FMIs that will be subject to enhanced regulation by the joint regulators. In particular, joint regulators will have the power to set regulatory requirements for designated FMIs and oversee their rules, and will have investigative and enforcement powers, and crisis management powers, in respect of designated FMIs.

- Provide that FMIs may either be required to be designated where they are identified as systemically important, or may opt in to the designation regime where they wish to access legal protections around settlement finality and netting.[1]

7. When the previous Cabinet agreed to adopt the new regulatory regime, they also requested reports back to Cabinet on a number of matters. The drafting of the FMI Bill has also raised a small number of additional issues. There are potential overlaps between some of the outstanding matters relating to the FMI Bill and phase 2 of the Review of the Reserve Bank Act (phase 2), although the FMI Bill is likely to be enacted before phase 2 is completed.

8. With this in mind, there are six remaining policy issues relating to the FMI Bill.[2] Specifically:

   i. Whether the joint regulators should use standards or conditions of designation to set regulatory requirements for designated FMIs. I recommend that the FMI Bill provide this be done using standards;

   ii. Whether Ministerial consent should be required before the joint regulators may issue a direction to the operator of an FMI. I recommend that on an

---

[1] These legal protections currently apply to designated settlement systems under Part 5C of the Reserve Bank of New Zealand Act 1989, and would be carried across into the FMI Bill.

[2] The reports back sought by the previous Cabinet relate to points i., ii., iv. and v. in this paragraph. Points iii. and vi. are issues that have arisen during the drafting of the FMI Bill.

interim basis Ministerial consent should be required pending the outcomes of phase 2;

iii. Whether the proposed statutory management provisions in the FMI Bill should be retained in light of the forthcoming work on crisis management in phase 2. I recommend that on an interim basis the statutory management provisions in the FMI Bill should be retained pending the outcomes of phase 2;

iv. Whether the FMI Bill should include a provision staying (preventing) the exercise of contractual termination rights against the operator of an FMI solely on the grounds that statutory management powers have been exercised in relation to the operator. I recommend that the FMI Bill include this kind of stay on the exercise of termination rights.

v. Whether changes should be made to the statutory manager's powers under the FMI Bill to act contrary to the interests of creditors on financial stability grounds. I recommend that on an interim basis this power be aligned in substance with the approach taken in the Reserve Bank of New Zealand Act 1989, pending the outcomes of phase 2.

vi. How the ability of Ministers/the Government to give general policy direction to the regulators and how this role is best captured in legislative drafting. I recommend that The Minister of Finance and the Minister of Commerce and Consumer Affairs have the power to direct the regulators to have regards to a government policy (consistent with the existing power in respect of the Reserve Bank, and the power which applies to Autonomous Crown Entities under the Crown Entities Act 2004).

9. Immediately following the conclusion of phase 2, I propose to report back to Cabinet on whether changes are necessary to any of the 'interim' approaches recommended in bullet points ii., iii., and v. Any changes of this nature will probably require legislative amendments, given that the FMI Bill is likely to be enacted by this time. However, this will provide an opportunity to take a consistent approach to these issues across banks and FMIs over the medium term, without delaying the progress of the FMI Bill. I consider it is important not to delay the progress of the FMI Bill given the key role of FMIs in the financial system, and the recommendations of the International Monetary Fund's 2016 Financial Sector Assessment Programme review of New Zealand (which recommended adopting all of the fundamental features of the proposed regime as a short term priority).

Background

What are FMIs?

10. FMIs are multilateral systems among participating institutions, including the operator(s) of the system, used for clearing, settling or recording of payments, securities, derivatives or other financial transactions. The participants of FMIs are

usually banks and other types of financial institution, but in respect of payment systems can also include individuals, retailers, and other types of non-financial institution.

11. FMIs generally come in five basic types:

- **"Payment systems"** are systems that transfer funds (i.e. make payments) between participants. Payment systems may have a retail or wholesale focus. An example of a retail payment system is EFTPOS. An example of a wholesale payment system is the Reserve Bank operated Exchange Settlement Account System (ESAS), which is the main interbank payment system in New Zealand. Payment systems can handle very large volumes of transactions – for example, ESAS handles on average transactions worth $30 billion per day, and Settlement Before Interchange (SBI), which settles retail payments, handles on average transactions worth $3.5-4 billion per day.

- **"Settlement systems"** are systems or arrangements for effecting settlements or processing settlement instructions. Settlement is the process of making a payment or transferring title to, or an interest in, personal property in accordance with a settlement instruction.[3] Payment systems are a subset of the broader category of settlement system, which also includes securities settlement systems (i.e. multilateral infrastructure used for transferring securities from sellers to buyers).[4] The largest securities settlement system in New Zealand is NZClear (owned by the Reserve Bank). The average daily value of transactions settled through NZClear is $7 billion. New Zealand based financial institutions also make use of overseas settlement systems – primarily Continuous Linked Settlement (CLS) which is a US based system that settles a major proportion of global foreign exchange transactions.

- **"Central counterparties"** (CCPs) are entities that interpose between counterparties to contracts traded in one or more financial markets, becoming the buyer to every seller and the seller to every buyer. The purpose of a CCP is to eliminate the credit risk to both parties in the event the other party defaults (the two parties are no longer exposed to each other, but only to the CCP which essentially provides insurance against bilateral default). New Zealand's one CCP is the New Zealand Clearing and Depository Corporation (NZCDC) which acts as the central counterparty for markets operated by the NZX, and clears several hundred million dollars worth of transactions per day.[5] New

[3] By contrast, "clearing" is the process of transmitting or reconciling transactions that are meant to result in settlements.

[4] It is important to distinguish securities settlement systems from stock exchanges like NZX. A stock exchange provides a market for buying and selling securities, but the transactions on a stock exchange are usually implemented through a securities settlement system (e.g. a party agrees to buy securities on a stock exchange, and the exchange of ownership of those securities is carried out through the settlement system). The sale and purchase of securities that are not exchange traded is often also implemented through a settlement system.

[5] Calculating the exact transaction values for NZCDC is complicated by the different methodologies that can be used to value derivatives trades. In addition, if the value of derivatives trades is included the total daily value of transactions can also vary significantly.

Zealand financial institutions also rely upon foreign CCPs such as the UK based London Clearing House (LCH).[6]

- **“Central securities depositories”** (CSDs) are entities that provide securities accounts,[7] central safekeeping services and custodial services, and play an important role in helping to ensure the integrity of securities issues (by ensuring securities are not accidently or fraudulently created or destroyed or their details changed). They support the operation of securities settlement systems. The Reserve Bank and NZX each operate a CSD in connection with the securities settlement systems they operate.

- **“Trade Repositories”** (TRs) are entities that maintain centralised electronic records (i.e. a database) of transaction data. Most commonly this relates to transactions involving Over-the-Counter (OTC) derivatives (i.e. derivatives which instead of being traded on an exchange, are bought and sold through standalone bilateral agreements). The big-4 New Zealand banks are part of banking groups that are subject to Australian requirements to report OTC derivatives transaction data to a trade repository (“trade reporting”). These banking groups report the relevant data to the Depository Trust & Clearing Corporation (DTCC), a Singapore based trade repository. A particular benefit of trade reporting is that it makes it transparent where the risks lie in OTC derivatives markets.

Why enhanced regulation of FMIs is necessary

12. Some FMIs are systemically important due to their high degree of interconnectedness with the rest of the financial system. More specifically, the disruption or failure of these FMIs can result in widespread disruption to transactions and impose serious solvency or liquidity pressures on financial market participants. FMIs can also act as the mechanism for transmitting contagion from the failure of a systemically important financial institution such as a large bank.

13. The disruption or failure of payment systems in particular can also adversely impact on consumers and other businesses, making it difficult or impossible to buy or sell goods and services (except where cash is a feasible payment option).

14. Furthermore, FMIs can be subject to market failures such as:

    - negative externalities (where most of the consequences of an FMI failure are born by the wider financial system rather than the FMI itself, leading to an underinvestment in risk management), and

    - monopolistic or quasi-monopolistic behaviour (which can influence decisions on who can access to the system, or decisions on investment in system infrastructure).

[6] Although generally as indirect participants (i.e. they contract full participants to execute transactions through LCH on their behalf).
[7] That is, an account showing the securities held by the account holder.

15. Finally, the current regulatory regime in Parts 5B and 5C of the Reserve Bank of New Zealand Act 1989 is very light handed, and inadequate for various reasons. For example:

- It only provides information gathering powers in respect of payment systems, and an opt-in "designation" regime for settlement systems (which allows them to access the legal protections around settlement finality and netting that are currently contained in Part 5C).

- Under the designation regime for settlement systems moral suasion or the revocation of designation are the only means of addressing breaches of conditions of designation (such as the requirement to periodically publish self-assessments against the CPMI-IOSCO (Committee on Payments and Market Infrastructures – International Organisation of Securities Commissions) *Principles for Financial Market Infrastructures* (PFMIs), which are the main international standard that FMIs are expected to observe).

- There is no regulation for the other types of Financial Market Infrastructures.

Process for developing the Financial Market Infrastructures Bill

16. The FMI Bill will establish an enhanced regulatory regime for FMIs. It arises out of policy work that began in 2013, and involved three rounds of public consultation. The first two public consultations (on the framework as a whole) were undertaken in 2013 and 2015, and the third public consultation (on the crisis management framework) was undertaken in 2016. During this period consultation was also undertaken on a bilateral basis with important industry stakeholders such as Payments New Zealand (operator of a number of important payment systems).

17. In the second half of 2016 the IMF's 2016 Financial Sector Assessment Programme (FSAP) review of the New Zealand financial system assessed the proposed framework. As a short-term priority, the IMF recommended adopting all of the fundamental features of the framework. A full list of the IMF's recommendations in relation to FMIs are set out in Appendix 1 (along with a description of how these recommendations relate to the FMI Bill).

18. In April 2017 the previous Cabinet agreed to the adoption of the proposed framework (EGI-17-MIN-0073, CAB-17-MIN-0164 refer). At the same time, it also agreed that there would be reports back on four specific issues.

19. Since that time, work has been underway on the drafting of the FMI Bill. A small number of additional matters requiring policy decisions have also arisen during the drafting process.

Outline of the Financial Market Infrastructures Bill

20. The FMI Bill has the following key features:

- The Reserve Bank and FMA (joint regulators) would have information gathering powers for all FMIs (not just payment systems), in order to monitor the broader sector and to identify potential systemic risks;

- An FMI that is identified as being systemically important can be required to be designated under a revised designation regime;

- Joint regulators would have enhanced oversight powers for designated FMIs, including powers to set regulatory requirements, oversee FMIs' rules, investigative and enforcement powers, and crisis management powers;

- Where relevant, designated FMIs would be able to access the legal protections around settlement finality and netting that are currently set out in Part 5C (and will be carried over into the FMI Bill). Designated FMIs will include systemically important FMIs, and any non-systemic FMIs that choose to opt-in to the regime to access these legal protections.[8]

21. A more detailed description of the FMI Bill is set out in Appendix 2.

Comment

22. The remaining policy issues in relation to the FMI Bill are as follows:

- The choice of legal instrument for imposing regulatory requirements on designated FMIs (this is one of the four reports back agreed by the previous Cabinet);

- Whether Ministerial consent should be required before the joint regulators may issue a direction to a designated FMI (this is one of the four reports back requested by the previous Cabinet);

- Whether the proposed statutory management regime requires further work; and

- If the statutory management provisions are retained:

  - Whether the FMI Bill should contain a stay on the exercise of contractual termination rights solely on the grounds that crisis management powers have been exercised in respect of the FMI. (this is one of the four reports back requested by the previous Cabinet); and

  - How the provisions relating to creditor rankings should operate under the FMI Bill (this is one of the four reports back requested by the previous Cabinet).

- The role and ability of Ministers/the Government to give general policy direction to the regulators and how this role is best captured in legislative drafting

[8] The four settlement systems that are currently designated under Part 5C are likely to be systemically important.

23. Some of these issues can be resolved permanently now. However, others relate to matters that are equally relevant to the regulation of banks, and will be reviewed in that context as part of phase 2 of the Review of the Reserve Bank of New Zealand Act 1989 (phase 2). A consistent approach to these issues across the banking and FMI regimes is likely to be appropriate, but I do not consider that this should delay the progress of the FMI Bill given the importance of FMIs to the operation of the financial system, and the IMF's recommendations in the 2016 FSAP.

24. I expect that the FMI Bill will be enacted before phase 2 is complete. As discussed in more detail below, I propose that an interim approach be taken to address the outstanding issues that will be considered in more detail in phase 2. Once the conclusions of the phase 2 are clear, I will provide a report back to Cabinet on any changes to the FMI regime that will be necessary in light of the conclusions of phase 2 on these issues (because the FMI Bill is likely to be enacted before phase 2 is complete, an amendment Bill will probably be required to implement any changes recommended by these reports back).

Choice of regulatory instrument

25. This issue relates to whether standards or conditions of designation should be used to impose regulatory requirements on designated FMIs. While these instruments have different legal forms, in both cases the instruments would be made by the joint regulators and only relate to matters that are specified in the FMI Bill. The main substantive difference between the two instruments is that standards would be subject to the Parliamentary disallowance procedure and conditions may not be.

26. I recommend that the joint regulators use standards rather than conditions for setting regulatory requirements under the FMI Bill. This provides an additional level of oversight without unduly constraining joint regulators' ability to independently set regulatory requirements that will often be very technical and specialist in nature. It also better aligns with the fact that these requirements are likely to be more legislative than administrative in character (i.e. be more akin to regulations rather than licencing conditions).

Ministerial consent for directions

Direction powers in the FMI Bill

27. Under the FMI Bill joint regulators have the power to direct FMIs when certain thresholds are met (e.g. insolvency of the operator, business being carried on in a manner that is prejudicial to the soundness of the financial system, breaches of regulatory requirements).

28. Joint regulators would have the power to direct designated FMIs on a number of matters, for example to:

- direct an operator to change its rules in order to align with requirements in standards;
- direct an operator to consult with the regulator;

- direct an operator to ensure that a specified person does not take part in activities relating to the management of the FMI;
- direct an operator to take action to remedy a breach;[9]
- direct an operator to take action under any FMI contingency plan;
- direct an operator to carry out or to cease to carry out any activities;
- direct a participant to comply with an FMI's rules;
- remove and appoint directors of an operator.

29. Joint regulators would be required to provide affected parties with their reasons for issuing a direction.

Comment

30. Whether or not Ministerial consent should be required before directions may be issued depends on a number of considerations:

31. The effectiveness of other governance and accountability arrangements: Issuing directions is a key part of the regulator's supervisory powers and, as such, needs to be considered in the context of the broader governance and accountability framework of the regulator (and vice-versa). In general terms, I would expect that an effective governance and accountability framework would include:

    - clearly defining objectives;
    - clearly defining the roles and responsibilities of the regulator(s) and of the responsible Minister(s), and
    - appropriate tailoring to the required powers being conferred.

32. The current governance and accountability framework in the FMI Bill is broadly aligned with that in the Reserve Bank of New Zealand Act 1989. Phase 2 will assess the effectiveness of that framework (and by implication also the framework in the FMI Bill).

33. The need for fast responses in crisis situations: The need for rapid resumption of an FMI's essential services is recognised in international guidance. For example, principle 17 of the PFMIs embeds a 2 hour recovery time objective ('2hr-RTO') for an FMI's essential operations (while 2 hours is still somewhat of an 'aspirational' objective for most FMIs, a fulfilment of end-of-day settlement obligations is a minimum expected requirement).

34. The potential benefits of having decisions made at arm's length by an independent expert body: Assessing the merits of issuing a direction may often require technical

[9] The ability to issue this type of direction may be removed from the FMI Bill. This is because it overlaps with a separate power in the FMI Bill for the joint regulators to issue corrective notices requiring action to be taken to address a breach.

knowledge or expertise. It is also likely to require a good understanding of the distressed FMI. In this respect, the regulators are likely to have the next best understanding of the distressed FMI after the operator itself.

35. The Crown's broader interest in the conduct of the resolution: The Crown has an interest in the conduct of a resolution where it could have potential fiscal risks, and also potentially when the way that the resolution is conducted could have impacts on the broader financial system and economy.

36. The approach taken in other regimes: The requirement for Ministerial consent for directions is included in the Reserve Bank Act of New Zealand Act 1989, but not in other broadly comparable legislation.

37. The FMA is an independent Crown entity and it would therefore be exceptional for its decisions to be subject to Ministerial consent. On the other hand, under its existing legislation, the FMA does have discretionary direction powers but not of the same magnitude as some of those it would gain under the FMI Bill.

38. Stakeholder views: In their feedback on earlier consultations, a number of stakeholders (NZX, Payments NZ, Paymark) noted that the proposed powers should be subject to appropriate checks and balances such as Ministerial consent.

Conclusion

39. The considerations discussed above suggests there may be grounds for not including requirements for Ministerial consent for directions within the regime, so long as the broader governance and accountability framework in the FMI Bill is appropriately robust.

40. However, this regime is based upon that in the Reserve Bank of New Zealand Act 1989, which is currently being reviewed as part of phase 2. Under the circumstances, I recommend that the FMI Bill include Ministerial consent for directions as an interim measure, pending the outcomes of the phase 2. Once the outcomes of phase 2 are clear, I will report back to Cabinet on whether any changes should be made to the requirement in the FMI regime for Ministerial consent for directions.

Statutory management

Crisis management powers under the FMI Bill

41. Statutory management is one component of the broader crisis management regime currently included in the FMI Bill. More specifically:

- FMIs will be required to have contingency plans to deal with operational or financial failure (these plans will need to include loss allocation provisions, which set out how any losses suffered by the FMI will be allocated across the operator and participants of the FMI).

- If contingency plans are not adequate to deal with the situation, or are not being properly implemented, joint regulators may use direction powers or recommend statutory management.

- Statutory management is a tool of last resort, when other crisis management tools are or are likely to be unsuccessful.

42. Statutory management involves the appointment of a third party (the statutory manager) to take over the management of the FMI. A statutory manager would have power to replace the operator of an FMI (if that is necessary to ensure the continuity of essential services). Statutory management could also be used to deviate from the ordinary implementation of loss allocation rules where this might create systemic risks (e.g. might result in the immediate allocation of losses to already financially strained participants).

43. The design of the statutory management regime is discussed in paragraphs 17-22 of Appendix 2.

Comment

44. Statutory management is an essential part of the crisis management framework, as it is the only mechanism available under the FMI Bill for replacing the operator of a distressed FMI if that is necessary to ensure the continuity of essential services. Circumstances where it may be necessary to replace the operator include:

    - Where the operator fails to comply with a direction;
    - Where the operator is insolvent;
    - Where the operator is carrying on the business of the FMI fraudulently or recklessly, or otherwise in a manner that is prejudicial to the soundness of the financial system.

45. The crisis management regime (including statutory management) was the subject of a standalone public consultation in 2016. The previous Cabinet agreed to the basic structure of the statutory management regime in 2017.

46. Statutory management of systemically important entities potentially involves the Crown taking on significant risk, incursions into property rights, and interaction with wider insolvency laws. The governance and accountability framework within which statutory management sits needs to ensure that the Crown's and other interests are adequately protected.

47. The statutory management provisions in the FMI Bill are modelled on the existing statutory management regime for banks contained in the Reserve Bank of New Zealand Act 1989 (with appropriate tailoring to reflect the particular characteristics of FMIs). The statutory management regime for banks will be reviewed and potentially reformed through phase 2. The following factors – all of which may be relevant to an FMI regime – are expected to be considered in phase 2:

    - Specification of **clear resolution objectives** for the resolution authority as recommended by the G20's Financial Stability Board's *Key Attributes of Effective Resolution Regimes*

- Clarification of **roles** of all relevant parties including the Minister, the regulator(s), and the statutory manager

- Clarification of **who is responsible for managing the Crown's interest in a resolution,** given these institutions are systemic and government fiscal exposures may be required

- **Ensuring sufficient powers** are available to the statutory manager to achieve the purposes of statutory management

- **Legal clarity as to how losses will be allocated** or provision for compensation where creditors are unduly impacted to protect the system as a whole (international standards define a '*No Creditor Worse-Off than in liquidation*" (NWCO) safeguard to provide legal certainty around property rights)

- Consideration of the **risks around existing creditor safeguards and interactions with wider insolvency law**, such as voidable transaction provisions of the Companies Act.

48. The materiality of some of these matters, and the extent to which the existing framework adequately addresses them, is not yet clear. However, they are being considered as part of phase 2, and in principle that the broad approach taken to these issues should be consistent across banks and FMIs.

49. Crisis management frameworks for FMIs are also evolving internationally. Therefore, there is merit in considering whether further tailoring of the proposed statutory management regime for FMIs is appropriate.

Conclusion

50. I have considered the options of either:

    - Leaving the statutory management provisions in the FMI Bill unchanged; or

    - Removing the statutory management provisions altogether pending the outcome of phase 2, having no FMI-specific statutory management regime in the meantime, and relying instead on the existing regime for corporations[10] (with amendments as required).

51. However, I recommend instead that the existing statutory management provisions be retained on an interim basis. I will then report back to Cabinet immediately following the completion of phase 2 on what changes to the statutory management regime may be required to align it with the approach that will be taken to crisis management for banks, and whether any further tailoring of the regime to FMIs is appropriate. Alignment with the approach taken to banks would likely help to ensure a consistent

[10] This is set out in the Corporations (Investigation and Management) Act 1989.

set of governance and accountability arrangements across the two crisis management regimes.

Stays on termination rights

52. Under existing law, joint regulators' exercise of resolution powers in relation to a designated FMI could provide grounds for third parties to exercise contractual termination rights against the operator of the FMI (i.e. to cease to perform obligations they owe to the FMI under one or more contracts).

53. Exercise of termination rights on this basis could disrupt the effective resolution of an FMI in various ways:

- It could provide a ground for critical service providers (utility providers, IT firms, etc.) to cease to provide essential services to the FMI;
- It could provide a ground for another FMI to terminate the FMI's rights of participation in that other FMI (this was a particular risk identified as part of the FSAP);
- It could provide a ground for parties to centrally cleared derivatives to close out their option positions with a central counterparty.

54. Possible consequences of any of the above outcomes materialising could be that:

- The FMI is no longer be able to continue to provide essential services to the market; and
- The FMI may fail in a disorderly manner (potentially causing financial system wide disruption).

55. I therefore recommend that the FMI Bill include a stay on the exercise of termination rights that could otherwise be triggered solely on the basis that:

- The joint regulators have issued a direction to the operator of the FMI;
- The FMI has been placed into statutory management; or
- The statutory manager has exercised any other powers under the Act.

56. The purpose of this stay on termination rights would be to provide a "cooling-off" period while it is determined whether the FMI can be restored to viability.

Creditor hierarchy

57. As with the Reserve Bank of New Zealand Act 1989, the statutory management provisions in the FMI Bill include provisions that enable the statutory manager to act in a way contrary to preserving the position of creditors and maintaining the ranking of creditors, in certain circumstances (broadly speaking where this is necessary to ensure financial stability outcomes). The issue here is whether the scope of this power is appropriate and whether it should be subject to additional safeguards.

58. Unless compensation is provided, this ability to treat creditors inconsistently does not align with the “no creditor worse off” (NCWO) principle found in international guidance on resolution regimes for financial institutions. This principle is that no creditor should be allocated greater losses as a result of statutory management than they would be if the failing entity was liquidated.

59. In the banking context, the scope of this power and safeguards it should be subject to will be considered as part of phase 2 (it relates to both of the last two bullet points in paragraph 47).

60. As a result, I recommend that:

- On an interim basis the FMI Bill align in substance with the comparable provisions of the Reserve Bank of New Zealand Act 1989 (while retaining the provision agreed by Cabinet last year that any departure from the equal treatment of creditors would require a direction by the Reserve Bank and notification to Parliament of the reasons for issuing that direction); and

- The regime then be updated to reflect the conclusions of phase 2 on these issues.

<u>Ability and role of Ministers/Government to give general policy directions</u>

61. The FMI Bill is currently drafted so that the Minister of Finance may direct the Reserve Bank to have regard to a government policy (consistent with the Reserve Bank of New Zealand Act 1989, and the Crown Entities Act 2004 in respect of Autonomous Crown Entities).

62. I consider that this power should apply to both the regulators (i.e. that the Minister of Finance and the Minister of Commerce and Consumer Affairs should be able to jointly direct the Reserve Bank and FMA) when they are carrying out their functions under the FMI Bill, as they will be exercising powers jointly in this context. However, it is important to stress that this power is not intended to cut across the operational independence of the regulators, and cannot require the regulators to take actions in relation to individual FMIs.[11]

Next steps

63. Subject to Cabinet’s agreement to the recommendations in this paper, I currently expect that an exposure draft of the FMI Bill will be released for public consultation around the beginning of November. It is likely that the FMI Bill will be ready for consideration by the Cabinet Legislation Committee and introduction into the House sometime in the second quarter of 2019.

Consultation

64. The Treasury, Ministry of Business, Innovation and Employment, Ministry of Justice, Department of Prime Minister and Cabinet (Policy Advice Group), Financial Markets

[11] In the FMI context, the direction power may, for example, affect the matters regulators take into account when setting standards but not how they are applied to an individual FMI.

Authority, and Parliamentary Counsel Office have been consulted on the contents of this paper. No concerns were raised.

65. Three rounds of public consultations on the overall regulatory regime being implemented by the FMI Bill have been carried out since March 2013. A wider range of stakeholders have also been engaged either via the formal consultation process, industry forums or informal bilateral discussions. Overall, there has been a high level of stakeholders' support for the regime.

66. While no public consultation has been undertaken on the specific recommendations in this paper, they either:

- relate to narrowly focused and highly technical matters (e.g. stays on termination rights),
- maintain the status quo approach under other regulatory regimes administered by the Reserve Bank (e.g. in respect of statutory management), or
- are likely to be unobjectionable to industry (e.g. requiring Ministerial consent for directions pending the outcome of phase 2).

67. As noted, an exposure draft of the FMI Bill will also be released for public consultation later this year, prior to Cabinet approval being sought to introduce the FMI Bill into the House.

Financial Implications

68. There are no financial implications arising out of the proposals in this paper.

69. The submission to the previous Cabinet (EGI-17-SUB-0073) seeking agreement to the overall regime noted that the additional resource costs of the regime could be met within the Reserve Bank's and FMA's existing baselines (but that consideration of whether additional funding may be appropriate in the longer term will be factored into the negotiation of the Reserve Bank's next 5 year funding agreement).[12]

Legislative Implications

70. The proposals in this paper will be implemented as part of the FMI Bill. [redacted] Information withheld under section 9(2)(f)(iv) of the Official Information Act 1982 [redacted]

Impact Analysis

71. An adviser from the Reserve Banks Prudential Supervision Department has reviewed the attached Impact Summary. They considers that the information and analysis summarised in the Impact Summary meets the criteria necessary for Ministers to fairly compare the available policy options and take informed decisions on the proposals in this paper.

[12] The Reserve Bank's next 5 year funding agreement is due to be in place by mid-2020.

Human Rights

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

Publicity

73. I do not propose to issue a press release regarding the decisions in this paper, but the Reserve Bank will inform key stakeholders as appropriate. A press release will be published when the exposure draft of the FMI Bill is released for public consultation later this year.

Proactive Release

74. I propose that, subject to Cabinet's agreement to the proposals in this paper, it be proactively released on the Reserve Bank's website (with appropriate redactions).

Recommendations

The Minister of Finance recommends that the Committee:

1. **note** that the previous Cabinet agreed to the adoption of a new regulatory regime for financial market infrastructures (FMIs) (EGI-17-MIN-0073, CAB-17-MIN-0164 refer), and that the adoption of this regime was also recommended by the IMF's 2016 Financial Sector Assessment Programme (FSAP) review of New Zealand.

2. **note** that the Financial Market Infrastructures Bill (FMI Bill), which is currently being drafted, implements the regulatory regime noted in recommendation 1.

3. **note** that the regime established by the FMI Bill will:

    3.1 Make the Reserve Bank and Financial Markets Authority (FMA) the joint regulators of FMIs (except payment systems, where the Reserve Bank would be the sole regulator);

    3.2 Provide the joint regulators with information gathering and investigative powers in respect of all FMIs, to enable monitoring of the wider sector;

    3.3 Provide for a category of designated FMIs that will be subject to enhanced regulation by the joint regulators.

    3.4 In respect of designated FMIs, provide joint regulators with the power to set regulatory requirements, oversee their rules, investigative and enforcement powers, and crisis management powers.

    3.5 Provide that FMIs may either be required to be designated where they are identified as systemically important, or may opt in to the designation regime where they wish to access certain legal protections around settlement finality and netting.

4. **note** that there are a number of outstanding issues relating to specific parts of the FMI Bill.

5. **agree** that, in respect of the matters noted in recommendation 4:

5.1 Standards made by the joint regulators be used to set regulatory requirements;

5.2 On an interim basis Ministerial consent be required before joint regulators may issue a direction;

5.3 On an interim basis the proposed statutory management provisions in the Bill be retained;

5.4 The FMI Bill include a provision staying the exercise of contractual termination rights against the operator of an FMI that are exercised solely on the grounds that crisis management powers have been exercised in relation to the operator;

5.5 On an interim basis the statutory manager’s powers under the FMI Bill to act contrary to the interests of creditors on financial stability grounds align in substance with the equivalent powers in the Reserve Bank of New Zealand Act 1989;

5.6 The power in the FMI Bill for the Minister to direct the regulators to have regard to a government policy will apply to both the Reserve Bank and FMA when carrying out their functions under the FMI Bill.

6. **note** that the Bill is likely to be enacted prior to the completion of phase 2.

7. **agree** that immediately following the conclusion of phase 2, reports back to Cabinet be made on whether there is a need to make any amendments to the FMI Bill relating to:

7.1. The requirement for Ministerial consent before directions may be issued;

7.2. Aspects of the statutory management regime described in paragraph 47, including creditor safeguards in statutory management and the statutory manager’s powers to act contrary to the interests of creditors on financial stability grounds;

7.3. Whether the statutory management regime could be better tailored to FMIs and whether any other aspects of crisis planning could be improved based on any implementation experience to date.

8. **note** that an exposure draft of the FMI Bill is likely to be released for public consultation later this year.

Authorised for lodgement

Hon Grant Robertson
Minister of Finance

Appendix 1: Financial Sector Assessment Programme recommendations on Financial Market Infrastructures[13]

Recommendation	Response
Recommendations for the oversight of FMIs	
Pursue the adoption and implementation of the proposed legislation to improve the regulation and oversight of FMIs in New Zealand.	Agreed. Recommendation being implemented by the Financial Markets Infrastructure Bill.
Adopt the PFMI through detailed requirements in secondary legislation.	Under consideration. Recommendation can be implemented using the standard setting power in the Financial Markets Infrastructure Bill.
Formalize supervisory practices, in particular by conducting standard assessments, and regular monitoring of the FMI landscape.	Under consideration. Recommendation can be implemented using the information gathering powers in the Financial Market Infrastructure Bill.
Increase resources significantly.	Under consideration. The Financial Market Infrastructure Bill can accommodate different supervisory approaches.
Adapt the existing memorandum of understanding (MOU) between the RBNZ and Treasury by including FMIs, clearly stating the roles of each organization, and harmonizing cooperation between the authorities for the different types of supervised entities.	Agreed. Recommendation has no impact on the Financial Market Infrastructure Bill.
Change, in the proposed regime, the frequency of FMI self-assessments from three to two years.	Under consideration. Recommendation can be implemented using the standard-setting power in the Financial Markets Infrastructure Bill.
Publicly disclose oversight responsibilities and policies.	Agreed. Recommendation has no impact on the Financial Markets Infrastructure Bill.
Enhance compliance of designated FMIs with PFMI requirements.	Agreed. Recommendation can be implemented using the standard setting power, supervisory and enforcement tools in the Financial Markets Infrastructure Bill.
Translate mandates into day to day oversight responsibilities.	Agreed. Recommendation has no impact on the Financial Markets Infrastructure Bill.

[13] These are drawn from the technical note completed by the IMF "Regulation and Oversight of Financial Market Infrastructures".

Streamline cooperation arrangements with Australian authorities.	Agreed. Recommendation has no impact on the Financial Markets Infrastructure Bill.
Develop and publish formal policy for oversight of foreign FMIs.	Agreed. Recommendation has no impact on the Financial Markets Infrastructure Bill.
Recommendations for crisis management and interdependences	
Broaden the use of crisis management powers beyond a failure in business continuity plans / recovery and orderly winding down plans.	Agreed in principle. The threshold for when crisis management powers may be exercised is when contingency plans are not being implemented, or are inadequate to deal with the situation.
Reflect specific features of FMI resolution in the proposed legislation for FMI crisis management.	Agreed in principle. Crisis management powers in the Financial Market Infrastructures Bill largely reflect the Financial Stability Board's Key Attributes for the Resolution of Systemically Important Financial Institutions. The limited number of departures from the Key Attributes (such as the lack of a 'no creditor worse off' safeguard in resolution) are common to the existing resolution regime for banks, and may be updated here at a later point if they are also changed in respect of banks as a result of phase 2.
Pursue protection for assets of FMIs in bank accounts during crisis.	Agreed. Recommendation has no impact on the Financial Markets Infrastructure Bill.
Establish and test an operational crisis management framework.	Agreed. Recommendation has no impact on the Financial Markets Infrastructure Bill.
Analyze exposures to OTC derivatives market and foreign CCPs.	Agreed. Recommendation has no impact on the Financial Markets Infrastructure Bill.

Appendix 2: Outline of the Financial Markets Infrastructures Bill

Objectives of the FMI Bill

1 The FMI Bill is intended to promote financial stability, which is best served by ensuring the continuity of essential services provided by systemically important FMIs. The FMI Bill will support the continuity of essential services through regulatory requirements for sound risk management, FMI rules for addressing participant default and robust FMI contingency plans. Where preventative measures for ensuring continuity of essential services do not work, the FMI Bill includes crisis management powers consisting of directions and statutory management. These preventative and crisis measures are designed to avoid the serious disruption to the financial system that would be caused by an FMI failure.

2 Except in relation to pure payment systems, under the Bill regulatory powers would be exercised jointly by the Reserve Bank and Financial Markets Authority (joint regulators), and Ministerial powers would be exercised jointly by the Minister of Finance and Minister of Commerce and Consumer Affairs (joint Ministers). In respect of pure payment systems, regulatory and Ministerial powers would be exercised by the Reserve Bank and Minister of Finance respectively. This reflects the approach currently taken under Part 5C of the RBNZ Act.

Content of the FMI Bill

3 The FMI Bill provides for different treatment of non-designated and designated FMIs. Designated FMIs are those that:

- Are identified as systemically important and deemed into the regime (as discussed further below); or
- Have opted into the regime to access the settlement finality and netting protections that are currently included in Part 5C and that will be carried across into the FMI Bill.

4 Designated FMIs will be subject to a range of regulatory powers, whereas non-designated FMIs will only be subject to information gathering powers (which are designed to facilitate monitoring of the broader FMI sector, and the identification of any new systemic risks).

5 The division between designated and non-designated FMIs is designed to reflect a risk based approach to regulation (where systemically important FMIs, or those with access to settlement finality and related legal protections, are subject to more scrutiny than other FMIs). Importantly, this also reduces compliance costs and barriers to entry for non-designated FMIs. Minimising barriers to entry in this context is especially important, as technological innovation is creating scope for new more efficient and customer friendly ways of carrying out FMI business (especially making payments).

i. <u>Accountability</u>

6 The FMI Bill will include purposes to guide the regulators when exercising supervisory or crisis management powers (e.g. promoting the maintenance of a sound and efficient financial system, promoting and facilitating fair, efficient and transparent financial markets). A separate set of principles will also provide the joint regulators with additional guidance (e.g. avoiding unnecessary compliance costs, ensuring an FMI's rules provide certainty and predictability to participants).

ii. <u>Regulation of designated FMIs under the FMI Bill</u>

7 Under the FMI Bill, joint regulators may recommend to Joint Ministers that an FMI be designated. Before making this recommendation the joint regulators must be satisfied that the FMI is systemically important. An FMI may also apply to the joint regulators to be designated to access the legal protections for designated systems that will be carried across from Part 5C.

Regulatory standards

8 Designated FMIs would be regulated by requirements in standards made by the joint regulators under the FMI Bill. Standards will relate to matters covered in the PFMIs (e.g. capital, governance and risk management) allowing the joint regulators to set expectations and requirements for the sound design and operation of FMIs, FMI rules addressing participant default, and FMI contingency plans. The IMF agreed that the framework would allow joint regulators to impose the PFMIs on all systemically important FMIs.

9 As well as promoting the soundness of designated FMIs, standards will also support the efficient operation of designated FMIs is certain ways. For example, the Bill will provide the scope for setting standards about access to an FMI's services, and about an FMI's governance. The Reserve Bank has had a longstanding focus on these areas when supervising FMIs. Being able to set standards in these areas will help ensure fair and transparent rules for entities seeking to participate in designated FMIs.

Participant default rules

10 Where an FMI is exposed to credit risk on the default of a participant (as is the case for CCPs, for example) the FMI's rules would be required to provide default management processes, including mechanisms for efficiently allocating losses amongst participants and the FMI. Losses would be apportioned according to some type of loss allocation 'waterfall'. Generally, the first loss under the waterfall would be allocated to the defaulting participant. If that participant's contribution is not sufficient to cover the entire exposure then losses would be allocated to other participant's and/or the FMI itself according to the waterfall. Loss allocation waterfalls are usually restricted to losses arising from participant default. Losses arising from other sources (e.g. operational losses, losses on investments) should accrue to the FMI itself and be absorbed by the FMI's capital (standards would be used to set capital requirements).

11 The FMI's rules must be transparent about loss allocation and allow participants to measure, manage and control their potential exposures. In addition, the rules should create incentives for the owners of the FMI and participants to control the amount of risk in the FMI, monitor the FMI's risk management activities and assist in the FMI's default management process.

FMI contingency plans

12 Designated FMIs will be required to have credible contingency plans (with regular testing to address deficiencies) for how they will manage their risks and continue to provide, or promptly restore, essential services in the face of operational (e.g. technology) disruptions or financial losses. The plans must demonstrate how the FMI will be able to continue operations if participants fail or critical service providers fail to perform services. Amongst other things, the plans might set out how the transfer of FMI functions to another operator or different FMI could be implemented. Detailed requirements for contingency plans would be set in standards.

Supervisory powers

13 For the purposes of day to day supervision, joint regulators will have information gathering powers in relation to FMIs, and powers to oversee the rules of designated FMIs (for example, joint regulators will administer a disallowance regime or an approval regime for changes to the rules of a designated FMI, and there will be a power to require rules changes where existing rules fail to comply with standards issued under the Bill).

14 Regulatory standards, FMI rules and contingency plans and supervisory powers are designed to lower the risk of the failure of an FMI and ensure failures that do occur can be managed with the least amount of disruption. As a backstop to these measures, the FMI Bill provides crisis management powers.

Crisis management powers

15 The crisis management powers in the FMI Bill would be directions and statutory management. They would only be used where contingency plans are not being appropriately implemented or are inadequate to deal with the situation.

16 The threshold for issuing directions under the FMI Bill is that the FMI is in distress (for example, actual or potential insolvency, carrying on business in a manner that is prejudicial to the soundness of the financial system, or carrying on business fraudulently or recklessly). Directions may require the FMI to take a range of actions to address the circumstances giving rise to the distress (e.g. cease to carry on activities, take action under a contingency plan). Participants may also be directed to comply with the FMI's rules.

17 Placing an operator into statutory management is a crisis management power of last resort. As indicated above, it will only be employed if an FMI's contingency plans are not being appropriately implemented or have failed to return the FMI to viability (or are unlikely to return the FMI to viability in a timely manner). Normal insolvency processes (i.e. liquidation) will not be satisfactory for managing the failure of a systemically important FMI. Liquidation is likely to increase uncertainty for participants negatively affecting market confidence, disrupt the provision of essential services, and, being oriented towards satisfying creditors, is not well suited for preserving financial stability in the short timeframes necessary for resolving a distressed FMI.

18 The proposed statutory management regime has the following features:

- An FMI would be placed into statutory management by an Order in Council made on the advice of joint Ministers given in accordance with a recommendation of joint regulators;

- The statutory manager would be required to take into account certain considerations to guide the statutory manager's actions. These considerations would be ranked, making it clear that in extreme cases where there was a conflict, certain considerations would be given priority over others (for example, maintaining public confidence in the financial system, and avoiding significant damage to the financial system would ultimately be given priority over preserving the position of creditors and maintaining the ranking of creditors).

- The statutory manager would stand in the place of the operator and be able to enforce the rules against participants, such as loss allocation rules. The statutory manager could also refrain from enforcing the FMI's rules if necessary to preserve continuity of services or on financial stability grounds.

- The statutory manager would be able to transfer the property and contracts (including licences and other intellectual property such as the FMI's rules) of a distressed FMI operator to a successor FMI operator or establish a new entity to take over the essential functions of the distressed operator, potentially using the technological infrastructure and specialist staff of the distressed operator.

- A moratorium would apply to payments to unsecured general creditors of the entity in statutory management. Payments and property transfers arising directly from payment and settlement processes will be excluded from the moratorium. This partial moratorium is designed to provide the FMI operator temporary relief, from its general debts for a period sufficient to stabilise the FMI.

- The joint regulators would supervise the statutory management.

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

Tailoring statutory management to the circumstances of FMIs

20 Internationally, there is ongoing work on the design and implementation of resolution regimes for FMIs.[14] This is because international guidance has only recently been developed.

21 The design of the statutory management regime takes into account recent international guidance, which reflects the fact that the resolution of an FMI differs from the resolution of a bank in important ways. The resolution strategy for a bank in statutory management involves resolving the bank's liabilities, by haircutting the liabilities and/or realising assets in an orderly manner to pay liabilities. The overriding objective for the statutory management of an FMI is to ensure continuity of essential services. Differences between banks and FMIs relevant to statutory management include:

[14] FMI resolution regimes have been implemented in a number of jurisdictions, including the US (systemically important FMIs) and the UK where CCPs were brought into the special resolution regime for banks in 2012 and a special administration regime for payment and settlement system was enacted in 2017. A number of EU countries have adopted their own resolution regimes and at the EU level a regulation on a framework for recovery and resolution of CCPs was published in November 2016. Australia and Canada have consulted or are still consulting on FMI resolution regimes.

- FMIs have much smaller and different balance sheets than banks. For example, New Zealand's one domestic CCP, NZCDC, has a balance sheet of around $80 million, and the operators of FMIs that do not take on credit risk can often be very small (for example, the operator of SBI, Payments NZ, has a balance sheet of under $10 million). In contrast to banks, core assets of FMIs will generally be its technical infrastructure and know-how. The size and composition of FMI balance sheets (and ex ante loss mechanisms) very significantly reduces the potential fiscal risks of an FMI failure;

- Compared to banks, FMIs issue very little, if any, debt. This means that bailing in an FMI's creditors will often not be an effective resolution tool;

- To allow transactions (e.g. payments and settlements) to continue to be processed through the FMI, the moratorium in a statutory management of an FMI will only be applicable to payments to general creditors (e.g. utility and IT service providers). An FMI moratorium is therefore of much lesser importance compared to the general moratorium on all outgoing payments that applies under the statutory management of a bank;

- Unlike banks, FMIs will be expected to have ex ante loss allocation rules agreed with their participants (which sets the default mechanism by which the FMI would be restored to financial health);

- Essential services of an FMI are less easily replaceable than the services provided by a bank. The resolution of an FMI must therefore take place particularly quickly, given the importance of ensuring the continuity of essential services and the fact that manual processing of transactions (the ultimate fall-back position if all other contingencies fail) cannot usually be sustained for more than a few days or weeks. By comparison, it could take years for a failed bank to be completely resolved;

- Because of an FMI's integration within the financial system, and the potential for transmitting contagion, the resolution of an FMI will often need to be worked out in coordination with resolution actions relating to defaulting financial institution(s). For example, the immediate imposition by an FMI of losses to a defaulting participant under loss allocation rules could adversely affect the capital and liquidity of that participant. However, failing to impose losses could prevent a distressed FMI from paying out to non-defaulting participants, potentially adversely affecting the capital and liquidity of those participants. Coordination is needed to take account of systemic consequences of enforcing loss allocation to limit potential adverse effects on the viability of participants.

22 As a consequence, some refinements are necessary to traditional statutory management for it to be effectively applied to FMIs. For example, provisions in the statutory management regime for banks that anticipate a potentially lengthy period of statutory management will be unnecessary for FMI statutory management. A statutory management of an FMI is used to provide the time needed to find the ideal solution for restoring or replacing the essential services of the FMI. Ensuring the continuity of services does not necessarily mean preserving the entity but rather the services provided. Where an FMI operator in statutory management ceases to be systemically important or the market no longer requires its services then the statutory management may end and liquidation of the FMI operator could be appropriate with usual creditor priorities applying.

iii. Regulation of non-designated FMIs under the FMI Bill

23 In respect of non-designated FMIs, the joint regulators would have a much more limited set of powers. This reflects the fact that these FMIs would neither be systemic, nor have access to the statutory protections transactions afforded to designated FMIs.

24 These powers are limited to:

- Requiring operators or participants of these FMIs to provide information; and

- Requiring operators of these FMIs to obtain an independent report in respect of the business or operation of the FMI

25 These powers are intended to be used mainly for the purpose of monitoring the broader sector, and identifying whether an FMI has become systemic (and so may need to be designated under the regime). No licensing or authorisation regime is proposed for non-designated FMIs.

iv. Enforcement and penalties

26 The regime will provide a graduated range of remedies. Specifically:

- Breaches of the Act will result in criminal offences when the breach is intentional or reckless, and civil pecuniary penalties in other cases;

- Joint regulators may accept enforceable undertakings with entities in breach of the Act.

27 We note that as a by-product of further work undertaken during the drafting of the FMI Bill, we:

- no longer see a need to include in the regime administrative penalties giving the regulators the power to issue infringement notices carrying low level fines; and

- see merit in including in the regime a power to issue corrective notices requiring a designated FMI to take steps to remedy breaches of the Act.

28 As a check on the power to issue corrective notices we propose that it be integrated with a power to require entities to prepare their own action plan to deal with breaches. Under this approach:

- The joint regulators would have the power to either require an action plan to be prepared, or issue a remedial notice requiring the operator to take actions to address the breach; and

- If the action plan is inadequate, issue a remedial notice requiring steps to be taken to remedy the breach.