RESERVE BANK OF NEW ZEALAND
TE PŪTEA MATUA

Summary of submissions and final policy proposals on the Consultation Paper: Oversight of Designated Financial Market Infrastructures

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PART ONE: BACKGROUND

1. Financial market infrastructures (FMIs), such as payment and settlement systems, are the channels through which financial institutions, governments, businesses and individuals transmit money and financial instruments. They are generally sophisticated systems that centralise certain activities, handling significant transaction volumes and sizeable monetary values. By centralising activities, FMIs can concentrate risks and create interdependencies between and amongst FMIs and participating institutions. Some FMIs become systemically important when disruptions within them have the potential to trigger system-wide disruption among participating institutions and more broadly through the economy.

2. If operating safely and efficiently, such FMIs can play a crucial part in mitigating systemic risk and enhancing financial stability. For example, a real time gross settlement system enhances financial stability by providing settlement finality that minimises settlement risks and inter-bank contagion. This is also evidenced by how FMIs, by successfully performing their roles during the global financial crisis, helped the financial system to function continuously during a time of heightened stress.

3. A number of FMIs play a crucial role in supporting the effective and efficient functioning of New Zealand's financial system, by facilitating convenient, cost-effective, and low-risk financial transactions. As such, their sound and efficient operation is important to ensure the maintenance of a sound and efficient financial system. This in turn supports the sustainable performance of the New Zealand economy, for example by ensuring business can cheaply access the capital they need to grow.

4. The governance and risk management of such FMIs, however, may not always fully align with public policy considerations. In some cases, market failures could lead to FMIs not being as safe or efficient as socially optimal.

5. The Reserve Bank has statutory responsibility in respect of payment and settlement systems, and a key interest in the soundness and efficiency of other systemically important FMIs such as central counterparties. Currently, it oversees payment and settlement systems in New Zealand for the purposes of promoting the maintenance of a sound and efficient financial system, and avoiding significant damage to the financial system that could result from the failure of a participant in a settlement system. The Financial Markets Authority (FMA) jointly oversees designated settlement systems with the Reserve Bank, for the purpose of promoting the integrity and effectiveness of settlement systems and related markets in New Zealand, and enhancing the confidence of investors and other market participants in settlement systems and related markets in New Zealand.

6. The Reserve Bank conducted a review of the existing powers for the oversight of payment and settlement systems in 2013. The review concluded that the current regulatory framework left significant systemic risks unaddressed and that it did

not provide for sufficient regulatory oversight of a sector that is of critical importance to the New Zealand financial system. It was also noted that New Zealand's very light-handed regulatory powers seemed to be an outlier by international comparison and did not reflect the risk mitigation that had taken place at the international level. The consultation document[1] based on this review contained a first set of proposals for enhancing the current regime.

7. After an analysis of the consultation feedback, the Reserve Bank conducted a second round of consultation on a revised set of proposals[2]. Those proposals reflected the feedback received from the first round of consultation and the evolution in the Reserve Bank's thinking. In addition to the written responses received during this second round of consultation, the Reserve Bank also held a number of bilateral follow up meetings with key stakeholders to further discuss their submissions in August this year.

8. This paper summarises the feedback the Reserve Bank received in this second round of consultation. It discusses the Reserve Bank's responses to the points made by stakeholders and sets out the Reserve Bank's final policy proposals (except for crisis management which, as noted later in the paper, a separate consultation document would be issued in early 2016). Subject to approval by the Minister of Finance, these proposals will be presented to Cabinet and form the basis of concrete legislative proposals. A Regulatory Impact Statement (RIS) will be presented alongside the Cabinet Paper and published on the Reserve Bank's website.

9. The rest of this paper is structured as follows: Part Two provides a detailed problem definition and policy objectives; Part Three summarises the comments made by stakeholders, both in their written submissions and bilateral meetings, and the Reserve Bank's responses; Part Four outlines our final policy proposals; and Part Five outlines the next steps.

PART TWO: PROBLEM DEFINITION AND OBJECTIVES

Problem Definition and Status Quo

10. Our starting assumption is that markets, left to their own devices, generally produce an efficient outcome. Regulatory intervention may be appropriate if markets do not function as expected, for example, due to market failures, and if the intervention can improve on the outcome that would otherwise be obtained.

[1] http://www.rbnz.govt.nz/regulation_and_supervision/financial-market-infrastructure-oversight/5195423.pdf

[2] http://www.rbnz.govt.nz/regulation_and_supervision/payment_system_oversight/Oversight-of-Designated-Financial-Market-Infrastructures.pdf

11. For FMIs, market forces alone might not be sufficient to achieve the Reserve Bank's objectives of promoting the maintenance of a sound and efficient financial system.[3] FMIs are networks that may 1) display high levels of market concentration; 2) produce spillover effects and may be subject to negative externalities given their pervasive role in the economy; 3) be owned and therefore heavily influenced by the financial institutions that are also their largest participants; and 4) be prone to coordination issues.

12. FMIs can exhibit a number of specific market failures, such as:

Spillover effects and negative externalities

- By bringing together counterparties or acting as a counterparty themselves, FMIs have links to many financial institutions, processing significant transaction flows. Any operational or participant failure may impact not only on those that have direct linkages to the FMI but could affect third parties which might be other financial institutions or participants in the real economy. For example, the failure of a major participant of an FMI or a technical or operational failure of an FMI might mean that financial transactions between two counterparties in the real economy, e.g. two SMEs, do not get processed. The recipient of an invoice might not get paid, which might affect their liquidity and could have follow on implications for any bills they might have to pay, thus reverberating through the economy more widely. But owners and operators of FMIs make decisions on the basis of what they consider to be in the best interest of their firms and they do not necessarily consider these potential wider societal costs associated with their payments, clearing, settlement and recording activities. This can lead to a situation where the risk management decisions made by FMIs are misaligned with the wider public interest. System operators will generally manage impacts on their participants (such as liquidity) but they are less likely to take into account the costs associated with the flow-on effects that could lead to these wider disruptions.

  These externalities may also exist in New Zealand where we rely on a small number of FMIs that have direct linkages to one another or common participants. This increases the risk of disruptions being transmitted through systems and participants, and could potentially impact the wider economy. Although that has not yet happened in New Zealand, an overseas example was the unavailability of UK CHAPS for nine hours last year. During that episode, high value sterling payments, including the settlement of house purchase, could not proceed, causing gridlock of domestic house settlement. In addition, the settlement of foreign exchange transactions around the world was disrupted because the functioning of the CLS system depends on the ability to make and receive payments in all currencies in CLS, including sterling.

[3] See Section 68, the Reserve Bank of New Zealand Act 1989.

Regulatory intervention can help so that the public costs are better reflected in FMIs' risk management calibrations, subject to the expected costs of that intervention not being higher than the expected benefits.

Market concentration

- FMIs typically exhibit economies of scale as they have high fixed and upfront costs and relatively small marginal costs. This can contribute to the market being divided up between a small number of operators, each with significant market power. Market concentration can increase the risk of insufficient competition, which in turn can hamper the drive for improvement and innovation and lead to higher costs than necessary.

  In New Zealand, there is a high level of market concentration with participants relying on a few key systemically important FMIs. Apart from the impact this may have on innovation and efficiency already described above, market concentration also means that the external costs of a major disruption by any one player can be amplified due to a lack of substitutes and the wider ramifications of a bigger entity failing compared to a market with many small players. Although FMI failures are relatively low-probability events, they could be high cost and high impact events that happen very quickly. In addition to the wider economic effects a failure could produce, it could also lead to a significant loss of confidence in New Zealand markets, damaging New Zealand's reputation for financial stability and lead to reduced foreign investment in New Zealand, higher risk premia demanded by international investors and higher domestic interest rates, including for government bonds.

Ownership structure

- Related to market concentration, the institutional structure of systemically important FMIs (SIFMIs) could also pose problems. As many FMIs are owned by their largest participants, these large participants could exercise strong control and influence on the rules of the FMI to their advantage and against the interests of their competitors or new entrants. Large participants could also demonstrate "club behaviour" in terms of restricting access and governance to the existing network, frustrating competition within the network.

  A New Zealand example is the self-governance model within the retail payment industry, where large banks have the dual role of owning and operating the payment system, as well as participating in the system. This model is a legacy of how payment systems have evolved in New Zealand. While some progress on widening participation has been made recently, as previously observed, the current model may have to-date remained biased towards the incumbent banks[4]. In an environment where new payment instruments and non-bank payment service providers are emerging quickly, it

[4] http://www.rbnz.govt.nz/regulation_and_supervision/financial-market-infrastructure-oversight/5476599.pdf

is important that there is a level playing field and that non-contestable monopolies and unnecessary barriers to entry are removed.

Coordination issues

- FMIs are networks that benefit from coordinated planning and management to achieve optimal network size, efficiency and quality. Participants may be incentivised to only focus on their own private costs and benefits and may not take actions that improve the network as a whole. For example, an individual participant may not have sufficient incentives to support collective innovation as other participants may also benefit from the innovation. In a stress scenario, participants may focus primarily on minimising their own costs, and their actions might not align with the broader public interests and could lead to inefficiencies when handling a crisis.

13. Given the large (and growing) values of transactions cleared and settled, and the increasing centralisation of activity around a small number of key FMIs, there is a risk that the potential market failures described above could be exacerbated. The growing reliance on technology, including increased outsourcing of technical operations to third party infrastructure service providers, also increases the range of operational risks FMIs are exposed to, such as cyber-attacks.

14. From a public policy perspective, the Reserve Bank's foremost concern is that the above mentioned market imperfections are addressed in a way that better takes account of the potential social cost (negative externality), mitigates the adverse effects of market concentration and addresses the issues around institutional and ownership structure. The aim is to enhance the soundness and efficiency of the FMIs. In doing so, the regulator has to ensure that any intervention is measured, procures a net benefit and does not unnecessarily impede efficiency.

Current oversight arrangements

15. The current regulatory framework does not allow the Reserve Bank to adequately address the market imperfections identified above. At the moment, the Reserve Bank oversees payment and settlement systems whereby the objectives of promoting the maintenance of a sound and efficient financial system are promoted by monitoring the systems and, where necessary, inducing changes. This oversight is backed by an explicit power to require operators of systems, or participants in systems, to provide relevant information. However, the Reserve Bank has to rely on moral suasion to induce changes.

16. The Reserve Bank and FMA also jointly administer the Designation Regime for designated settlement systems. The Regime provides statutory backing for netting and finality of payments in a designated settlement system. It also provides the joint regulators stronger powers to oversee these systems, including the ability to induce changes by imposing conditions of designation and disallowing proposed rule changes.

17. Regulatory requirements currently only apply to settlement systems that opt in to the Designation Regime. There are certain benefits associated with being in the Designation Regime, such as legal protection of netting and settlement finality. Any systemically important FMI that does not consider that the private benefits of designation outweigh the costs may decide to stay outside the regime. That means that most of the current regulatory requirements would not apply to such an FMI.

18. Another significant gap in the current framework is the absence of a formal crisis management regime. In the extreme case that a systemically important FMI were to fail, for example due to a prolonged operational breakdown or a default from one or more participants, it could lead to severe systemic disruptions if it caused markets to cease to operate effectively. In such a scenario, the lack of formal crisis management powers would seriously limit the regulators' ability to facilitate an orderly recovery or resolution of the situation.

19. The current scope of the legislative framework also does not capture other types of FMIs such as central counterparties for over-the-counter derivatives and trade repositories, which are of growing systemic importance globally and to the New Zealand financial system.

20. SIFMIs should be designed, governed and operated in a way that mitigates the possibility that their failure, or their participants' failure, could cause broader financial and economic instability, and that supports financial system efficiency. The current regulatory powers make it difficult to address the market imperfections that might impede these. They are also out of step with the Reserve Bank's risk-based supervisory approach for other sectors and with international regulatory practice.

Objectives

21. The Reserve Bank's main objectives in the area of FMI oversight are to promote "the maintenance of a sound and efficient financial system" and "to avoid significant damage to the financial system from the failure of an FMI or the failure of a participant in the FMI". As argued above, the sector is characterised by market features that suggest that the current legislative framework may be sub-optimal with respect to soundness and efficiency, and also on the second count of avoiding significant damage to the financial system from the failure of a payment system participant.

22. The Reserve Bank's aim is to mitigate the market failures identified above, subject to the expected benefits outweighing the expected costs. This includes keeping any regulatory costs, including efficiency costs, as low as possible.

23. Concretely, there are four core oversight outcomes that the Reserve Bank wants to achieve in respect of FMIs. These are: clear and transparent governance; a sound risk management framework; continuity of service when in distress; and fair and open market access.

24. While the responsibility for managing an FMI lies with its management, clear and transparent governance arrangements support confidence that an FMI is being managed well. Given the linkages between FMIs and the financial system more generally and the resulting potential for negative externalities, good governance arrangements can contribute to a reduction in idiosyncratic as well as systemic risk.

25. FMIs generally have incentives to manage key risks such as legal, credit, operational or liquidity risks in the absence of any regulatory requirements. As explained above, the extent to which they would manage these risks, however, might not be optimal from a societal point of view. Regulatory requirements around a risk management framework can enhance risk management practices by taking into account potential social costs, thus reducing systemic risk. This, however, has to be balanced against the additional compliance costs that regulatory requirements may produce and the efficiency impact. Compliance costs may be viewed as the difference in cost between complying with the regulatory requirements and the risk management an entity would ordinarily choose.

26. As mentioned above, one of the objectives of the Reserve Bank is to avoid significant damage to the financial system from the failure of an FMI or the failure of a participant in the FMI. Continuity of service in a failure event is crucial for containing the impacts and avoiding widespread damage.

27. FMIs should have reasonable risk-based and publicly disclosed criteria for participation. Given that there is usually a limited number of FMIs for a particular market, participation in an FMI may significantly affect the competitive balance among participants and disadvantage those that could not access the FMI.

28. Fair and open access to FMI services generally facilitates competition among market participants and promotes innovation, which in turn supports efficiency. Open access may also reduce the concentration risk that may otherwise result from highly tiered arrangements that only allow a small number of direct participants.

29. The Reserve Bank consulted on a number of proposals aimed at achieving the objectives stated in this section. The proposals were in the areas of regulatory mandated designation of systemically important FMIs, enhanced oversight powers for Designated FMIs, including broader information gathering, standard setting and crisis management powers, and cooperative oversight of offshore FMIs. The Reserve Bank also requested information on the expected compliance costs of the proposed regulatory changes. The next section summarises the feedback the Reserve Bank has received from its stakeholders on each of the 13 questions asked in the consultation document, followed by Part Four which outlines the Reserve Bank's final policy proposals.

PART THREE: SUBMISSIONS AND FEEDBACK

30. Nineteen submissions from a wide spread of industry stakeholders were received, including banks, operators of potentially systemically important FMIs, smaller payment system operators, infrastructure providers, industry organisations, and international card schemes.[5]

31. The Reserve Bank would like to thank all submitters for their input into this round of consultation.

32. The following provides a summary of submissions in the sequence of the thirteen questions contained in the consultation document. Subsequent feedback received through bilateral meetings with submitters has also been included. The summary of the submission feedback is followed by the Reserve Bank's response to any issue raised, where relevant.

Question 1: Do you agree with the proposed scope for the new oversight regime focussing on systemically important FMIs only? If not, please provide more details.

33. The proposed scope is the same as our first consultation in 2013 which received strong support. The vast majority of submitters remained supportive of at least focussing on SIFMIs. Some submitters acknowledged that the Reserve Bank's focus mirrored international developments in this area.

34. Several submitters noted that there should also be some focus on non SIFMIs. Some responses suggested that all FMIs should be subject to increased oversight, for example through some minimum standards in relation to rules, transparency and operational robustness, or at least in the form of crisis management powers. Respondents argued that non-systemically important FMIs could become more systemically important over time and that their failure could nevertheless have wide impacts. This led some to propose that the Reserve Bank should contemplate a "tiered regime" to accommodate a wider range of FMIs than only SIFMIs.

35. The proposed focus on SIFMIs stems from the increasingly critical roles they play in maintaining financial stability. We acknowledge that while some FMIs might be considered important in the domestic context, and a disruption or failure of their operation could materially impact their users such as causing inconvenience, they pose a low level of systemic risk such as severe disruptions to the wider economy.

36. We also acknowledge that the FMI landscape is dynamic with new market entrants and new risks emerging. The proposed focus of the revised Designation Regime for systemically important FMIs reflects the risk-based approach that is a

[5] Submissions have been received from the following: ANZ, ASB, BNZ, Westpac, HSBC, CLS Bank International, ASX, LCH Clearnet Limited, Paymark Limited, Franks Oglive, EFTPOS NZ Limited, SWIFT, Payments NZ, INFINZ, Retail NZ, MasterCard, Visa, Progressive Enterprises Limited and Merco.

feature of the Reserve Bank's prudential supervision model in general. While the proposed revised Designation Regime would have a single focus on systemic importance, the overall oversight regime goes beyond designation, and allows the joint regulators to seek to designate any FMIs that have become systemically important. It would be incumbent on the regulators to monitor developments to identify new sources of systemic risk. This would be achieved through the power to require information to be provided by all FMIs. SIFMIs do not emerge overnight. New payment instruments might, with many being cleared or settled via existing FMIs, and it would take some time for any new way to make payments to become systemically important. While it might take time to designate a new SIFMI, the joint regulators could still influence their operations through moral suasion in the meantime.

37. A number of submitters also suggested that the Reserve Bank establish an FMI register. Instead of having a public list where entities are required to be registered, we plan to maintain a list of all of the FMIs that the joint regulators are aware of, using the information gathering power, which would serve as a useful tool for the regulators to monitor the FMI sector.

38. Some submitters also commented on the need for more focus on "efficiency-related" issues, such as pricing and fee levels in the domestic payment systems and card schemes. While we do acknowledge that there might be a gap in terms of how wider efficiency issues related to retail payment systems are currently being addressed, we note that the Reserve Bank's efficiency objective is to be understood in the context of prudential regulation. The Reserve Bank is not a market conduct or a regulatory competition authority. At this stage we do not think that the Reserve Bank, or the FMA, is best placed to address such efficiency questions, and that other regulators, such as the Commerce Commission, have a role to play, too. Most of these submitters accepted why the Reserve Bank would want to focus primarily on financial stability issues.

Question 2: Do you have any views on the Reserve Bank's proposal to strengthen the FMI oversight framework via modifying the existing Designation Regime? If so, please provide more details.

39. Views were evenly divided amongst submitters that responded to this question. Submitters who disagreed that new oversight powers for systemically important FMIs should be introduced by revising the current Designation Regime seem to favour the previous proposed Recognition Regime, which was perceived to be somewhat more light-handed, flexible, and future-proof. The revised Designation Regime, on the other hand, was considered heavy-handed and all-or-nothing.

40. The proposed revised Designation Regime is intended to be very similar to the previously proposed Recognition Regime. In our opinion, it would also have the benefit of simplicity as two regimes would be consolidated into one. It would not impose more costs on a designated FMI than the Recognition Regime as they would both be tailored to the circumstances of a particular FMI.

41. The main reason for submitters to favour a dual regime seems to be due to a misunderstanding of the difference between the Recognition Regime and the revised Designation Regime, and the degree of flexibility associated with the latter. It appears that some submitters thought that once an FMI was designated, it would be subject to all the proposed powers and obligations, irrespective of its size or level of systemic importance, whereas those that were not caught would be left entirely unregulated even if they gained in market share. These submitters went on to note that given the dynamic nature of the payments landscape, regulators may be powerless to oversee new emerging risks. They also thought the revised Designation Regime would no longer allow non SIFMIs to opt in for designation for protection of legal finality; and that even if they did opt in, they would have to comply with all the standards SIFMIs would be subject to.

42. In hindsight, we acknowledge that it would have been useful if we have been clearer on how the proposed regime would work for different types of systemically important FMIs. When we discussed this further with submitters that have voiced their preference for the previous proposal, they noted that they were much more comfortable with the proposed revised Designation Regime.

43. In summary, the proposed framework is expected to work as follows:

- Ongoing monitoring. We would be monitoring developments with the aim of identifying any new systemic risks (including through keeping and monitoring the FMI list). If another new SIFMI were to develop, the joint regulators would seek to designate it. There should not be coverage gaps given the broad definition of FMI. The joint regulators would continue to have the power to require non-designated FMIs to provide information.

- Tailoring requirements. The proposed powers are permissive in that the joint regulators would be able to impose requirements as appropriate, and some of the requirements will differ from one class of designated FMI to another, depending on the role the FMI plays, the nature of its operations, the risks inherent in the FMI, and in the case of offshore FMI, what types of oversight it is subject to in its home jurisdiction.

  The Reserve Bank has adopted the CPMI-IOSCO *Principles for Financial Market Infrastructures* (PFMIs) as the basis of its FMI oversight, and published its oversight approach in *Oversight of Financial Market Infrastructures in New Zealand (FMI1)*[6]. While FMI1 would be subject to some revisions to reflect the legislative changes (such as the revised Designation Regime) once they have become effective, the fundamental oversight approach remains the same, including the adoption of the PFMIs. Detailed analysis, followed by consultation, would be conducted before relevant standards were imposed on each of the designated FMI. Active reviews would be carried out to assess the appropriateness of standards based on

[6] http://www.rbnz.govt.nz/regulation_and_supervision/payment_system_oversight/Oversight-of-Financial-Market-Infrastructures-in-New-Zealand.pdf.

any change of circumstances for designated FMIs. In Appendix One, we provide a broad outline of what types of standards and powers might be applicable to different classes of FMIs.

The Reserve Bank and FMA are committed to conducting oversight via active stakeholder consultation – the approach they have adopted in recent years. Good working relationships are key to effective oversight. The proposed powers would provide oversight tools the joint regulators could exercise should the need arise, subject to a number of checks and balances. The oversight focus, however, would be to maintain an open and robust relationship with designated FMIs, which enables all stakeholders to have a clear understanding of the regulators' oversight expectations, and provide a channel for regulators to identify and resolve issues in a cooperative manner. Not all proposed powers would apply equally to all designated FMIs. Some powers, such as removal of directors or disallow rule changes, would not in practice be applicable to designated offshore FMIs.

- The proposed revised Designation Regime is no different from the previously proposed Recognition Regime in the March 2013 consultation, except that it consolidates the two separate regimes and that the legal protection would only apply when relevant. The new arrangements would continue to provide for voluntary designation for non-systemically important payment and settlement systems, as long as their rules meet the requirements for legal certainty. Designated non-SIFMIs would be subject to standards that are applicable and relevant based on the nature of their operations and the risks inherent in them, and not necessarily the requirements that SIFMIs are subject to.

Question 3: Do you agree with the proposed objectives of the revised regime? If not, please provide more detail.

44. In the consultation paper, it was proposed that the objectives of the revised regime would be to:

    - Promote the maintenance of a sound and efficient financial system;
    - Avoid significant damage to the financial system that could result from the failure of a financial market infrastructure or the failure of a participant in a financial market infrastructure;
    - Promote the integrity and effectiveness of financial market infrastructure and related markets in New Zealand; and
    - Enhance the confidence of investors and other market participants in financial market infrastructure and related markets in New Zealand.

45. Twelve of the thirteen responses to this question were supportive. Two submitters have noted that there could be more emphasis on efficiency, for example, on measuring how payment schemes are meeting end-users' needs. One submitter disagreed with the proposed objectives for the FMA around "promoting confidence".

46. The Reserve Bank has a mandate to promote the soundness and efficiency of the financial system. In exercising its powers for this purpose, there are, at times, trade-offs to be made between soundness and efficiency. Much of the regulatory proposals support the soundness leg of these objectives. However, the Reserve Bank takes its efficiency objective seriously and is keen to avoid unnecessary compliance costs to industry or barriers to entry, and to promote efficiency where possible subject to its effects on soundness. As mentioned in our response to Question 2, the Reserve Bank is not a market conduct or a regulatory competition authority. The latter is the domain of the Commerce Commission. Although the Reserve Bank acknowledges that some respondents perceive that there is scope for efficiency enhancements, the Reserve Bank may not be best placed to address those concerns and is satisfied that its efficiency objective is currently adequately reflected in the policy proposals.

47. The FMA's proposed objective of enhancing the confidence of investors and other market participants in FMIs and related markets broadly aligns with the purpose of the Financial Markets Conduct Act 2013, which includes promoting the confidence and informed participation of businesses, investors and consumers in financial markets. Enhancing or promoting confidence does not mean eliminating all risk for investors or market participants. Instead it means ensuring that investors and market participants can make use of FMIs, confident in the knowledge that they are operated to an acceptable minimum standard of governance, transparency, and risk management. This proposed objective also aligns with the purposes for which the FMA must exercise its powers under Part 5C of the Reserve Bank of New Zealand Act 1989, and we think it is sufficiently clear and measureable to help guide the exercise of the FMA's powers under the proposed regime.

Question 4: Do you agree with the proposed definition of financial market infrastructures (FMIs)? If not, please provide more details.

48. Twelve submitters have responded to this question, with nine agreeing to the proposed definition of FMI. The rest have either sought clarification for the meaning of the word "multilateral" or on which part of the FMI would be designated and subject to regulation, noting that the proposed powers could only be exercised on legal entities, whereas some FMIs are not legal entities. One submitter also commented that the definition of "operators" needs further clarification.

49. The proposed FMI definition refers to a multilateral system and is consistent with the definition of FMIs used by CPMI-ISOCO. A multilateral system can be either that clearing and/or settlement occurs via a multilateral agreement, or the system rules are agreed on a multilateral basis. As an example, the Settlement Before Interchange (SBI) system, where participants clear and settle bilaterally, would be considered as an FMI as the system rules are agreed on a multilateral basis.

50. We agree with submitters that FMIs are generally sets of system rules, procedures, and operational arrangements and might not be legal entities. Our proposal is that when an FMI is designated, the system itself would be designated, with the proposed standards and other obligations imposed on the operator of the designated FMI. The current Designation Regime works in the same way – a settlement system is designated and its operator or operators are subject to Conditions of Designation. Examples of how this might work are set out in Section 4.3 "Prescribing Standards" of the Consultation Document, where we refer to "operators are likely to be required to…" for each of the matters that standards may relate to.

51. With regards to the definition of an "operator", we note that there could be more than one operator for an FMI that has interconnected platforms managed by different entities. In some of these cases there could be a need to distinguish a central operator from all operators, who would be ultimately responsible for the operation and soundness of the FMI, whereas in other cases regulatory obligations may be placed on multiple operators. For further clarification, we would also like to amend the definition of operator by replacing the "and" to "or" in the previous version, as follows:

    "Operators would be defined as any persons who are legally responsible for carrying out or managing the services provided by the FMI, or maintaining and administering the rules of the FMI".

52. Finally, we note that while all of our proposed definitions reflect our policy intent, they may be subject to revisions during the legislative drafting process to ensure they are legally robust. Stakeholders will have the opportunity to comment on any revisions to the definitions when an exposure draft of the legislation is published for comment.

Question 5: Are there any additional factors that the Reserve Bank and FMA should take into account when making an assessment of systemic importance of an FMI? If so, what are those factors?

53. In the consultation paper, we outlined the following four key factors for identifying when an FMI would be systemically important:

    - The size, degree of market penetration and concentration of financial risks
    - The role of the FMI and the nature of the transactions processed
    - The degree of substitutability
    - Interdependencies with other FMIs or markets

54. General feedback from submitters was that the proposed factors for assessing systemic importance were reasonable. A couple of respondents did suggest additional considerations such as product innovation, or the confidence in financial markets, matters of efficiency and maintaining a level playing field. This

contrasts with some comments that there should not be any further expansion to other factors.

55. We are satisfied that the proposed list of factors is appropriate. It is based on the PFMIs and therefore consistent with international practice. We are aware many jurisdictions have adopted similar approaches in assessing whether an FMI is systemically important.

56. The main theme of the comments on this question is on the need for more clarity on how the key factors would be applied, especially to a payment system. We agree that this is one of the most important elements of the proposed framework, and more certainty on the thresholds would be desirable.

57. We have therefore provided more detail on two of the four key factors as below:

- The size, degree of market penetration and concentration of financial risks within the FMI. The key indicators here include:

  - The size of the system as reflected by the value of transactions settled. This provides an indication of the associated financial risk for its participants and for the financial system as a whole;

  - Degree of market penetration, such as the volume the FMI settles as a percentage of market share, which is a measure of the relative importance of a system within the domestic market.

  FMIs that settle large value transactions such as wholesale systems are generally classified as systemically important. Retail payment systems could also be considered as systemically important. The key indicators that would be considered include the average daily value the retail payment system processes, the percentage of the national RTGS by value, and its market share of the retail payments markets.

- The degree of substitutability. The systemic importance of a particular FMI will, all other things being equal, be reduced where its critical services are substitutable and readily available elsewhere in the market. For a payment system, the degree of substitutability refers to the extent other payment systems can provide the same services in the event of a failure, and how quickly the critical services can be substituted. An important consideration is the extent to which there is a viable alternative until a replacement is available. Whether an alternative is viable depends on how it might impact on the users and whether it would require the users to change their behaviour.

58. Many submitters have also commented on the list of FMIs that we have identified as potentially of systemic importance. In particular:

- A number of submitters questioned the inclusion of Paymark as a SIFMI.

- Submitters also questioned the exclusion of High Value Clearing System (HVCS) or Assured Value Payment (AVP) from the list. HVCS refers to a set of rules covering both bank to bank and customer to customer high value transactions via ESAS. AVP refers to the closed user group for accessing ESAS via SWIFT.
- Some submitters have also noted that SBI should not be considered as systemically important.

59. It is worth noting that the list in the consultation document was a preliminary assessment and intended to be indicative only. For each SIFMI that is proposed to be designated, there would be a robust process for designation, including detailed analysis and consultation with stakeholders. Respondents' feedback on this aspect of the consultation has been particularly helpful and the Reserve Bank has made a couple of changes to its proposed list of designated FMIs. Specifically:

    - *Paymark*. Our preliminary assessment put a lot of weight on the key role that Paymark plays in the retail sales and the degree of substitutability of Paymark as a switch. Because Paymark is a critical component of several payment types – proprietary debit card transactions, scheme debit and credit card transactions, we were of the view that if Paymark was unavailable for an extended period, there would be no real alternatives available for card transactions. A few submitters have made a compelling case on why Paymark should not be designated. Our follow up meetings with a number of stakeholders have also provided us additional information on the substitutability of Paymark. We have therefore come to the conclusion that at this stage, Paymark is probably not of systemic importance because of the existence of viable substitutes.

    - *HVCS.* HVCS currently processes an average of $21 billion per day. We agree that HVCS could also be considered as a SIFMI because of the size of the system. We do not consider it appropriate to add AVP to the list as there is not a separate set of rules that governs AVP. Instead, AVP refers to a group of ESAS participants that access that system in line with ESAS' Terms and Conditions.

    - *SBI.* During our follow up meetings with stakeholders, we noted that the concern with SBI being designated was not because it should not be considered as systemically important, but rather questioning the value of designation and what would happen during a crisis. There was a particular concern that as the operator of SBI, Payments NZ could be put into statutory management, and that this seemed to be inappropriate given Payments NZ does not operate SBI.

      We note that the revised Designation Regime is designed to provide a legislative framework for the oversight of SIFMIs. Legal protection for finality of netting and settlement would only apply if that is relevant. In SBI's case, given settlement occurs via ESAS, it might not require the legal protection –

but that does not mean it should not be designated. The test is on whether it meets the criteria of systemic importance or not. During a crisis, there are a number of crisis management powers that the regulators would be able to exercise, depending on the nature of the failure.

60. Based on the feedback received, we have updated the list of FMIs that are potentially of systemic importance (see Appendix Two).

Question 6: Do you have any comments about the proposed process for Designation and revoking Designation? If so, please provide more details.

61. Three submitters commented on the proposed process for Designation and revoking Designation not being flexible, arguing that it would not allow regulators to be pragmatic when assessing FMIs or identifying rule sets to be covered. Another comment was that the proposed process was a significant process for the regulators and might not be able to cope with relevant changes in the FMI itself or in the local or international regulatory frameworks applicable to it. The rest supported the proposed process.

62. We note that these are similar comments to Question 2. As discussed earlier, our follow-up stakeholder meetings suggested that this was mainly a misunderstanding, partly due to the fact that the consultation document did not expand on how the revised Designation Regime was expected to work. To clarify, the revised regime would provide flexibility for the joint regulators in assessing FMIs, including tailoring standards and rule sets to different classes of FMIs. These would be subject to change if there are changes to the FMI's circumstances or the legislative environment.

63. The proposed process for designation would require the joint regulators to consult with relevant stakeholders. After consultation, the Order in Council for recommending an FMI to be designated would be accompanied by a statement of the reasons for the recommendation, including a summary of feedback from consultation.

64. We recognise that an Order in Council process could take a considerable time from start to finish. However, we do not agree with the comments that such a process would be too slow for a dynamic landscape. The joint regulators would monitor emerging risks and exercise moral suasion as required – designating a SIFMI is a significant undertaking that, in our view, warrants a robust process that incorporates appropriate checks and balances, as well as providing sufficient scope for stakeholder consultation.

65. One submitter commented that participants should also be consulted if the regulators were considering to revoke the designation of an FMI that was no longer systemically important, as the loss of legal protection could impact on participants' business practice.

66. We would like to clarify that for designated FMIs that benefit from netting and settlement finality, if they are no longer considered as systemically important, the joint regulators would consult the FMI stakeholders, including participants, before recommending a revocation. If a designated FMI chooses to remain designated in order to receive legal protection for its netting and settlement, the joint regulators would not revoke its designation, as long as the FMI continues to meet the standards that it is subject to (which might differ from the standards the FMI would previously be subject to when it met the criteria of systemic importance).

Question 7: Do you have any views on the proposed process for setting standards, and the proposed matters that standards may relate to? If so, please provide more details.

67. On the whole, there was support for the need for the joint regulators to have standard setting powers. Some submissions acknowledged that the proposed standards would be consistent with the PFMIs and should already be covered by FMIs.

68. Nonetheless, several submitters also remained cautious about the potential regulatory burden, even though most recognised that the proposed minimum standards were reasonable. One particular area that a number of submitters expressed concerns about was how the regulators would exercise the power to require supply of information, noting that the reporting obligations should not be overly burdensome.

69. We acknowledge stakeholders' concerns over potential regulatory burden, and would like to emphasise that a number of matters, in particular minimising compliance costs, would be considered before the exercise of any of the proposed powers. Appendix Three outlines the legal constraints on the exercise of statutory powers under the proposed oversight framework for FMIs.

70. The power to require the supply of information already exists today in respect of payment and settlement systems, and there is no proposal to depart from how we currently exercise this power. This power also forms the cornerstone of our monitoring of non-designated FMIs under the proposed regime. As a result, it needs to be framed broadly in the legislation to ensure that it can be used to monitor the very diverse range of arrangements and entities that may be acting as FMIs. Finally, we note that the legislation is likely to only permit the joint regulators to exercise this power where they reasonably believe that this would be necessary or desirable to perform their functions and duties, or to decide whether to exercise other powers, under the legislation. This test ensures that the power could not be used arbitrarily.

71. We note that submitters were generally comfortable with the standards to be imposed as being consistent with the PFMIs, and represent fundamental areas that SIFMIs should be addressing already. Appendix One provides more clarity on applicable standards on different classes of FMIs and gives stakeholders comfort as regards the potential regulatory burden. Many of the proposed areas

in which the standards would apply are likely to already covered by FMIs. The process for making, amending or revoking standards would also include consultation with affected entities, further reducing the potential for unnecessary compliance costs. In addition, the regulators would be required to undertake an assessment of regulatory impacts where the changes to standards related to a policy that was more than just minor or technical (i.e. this regime will be linking into the obligation in section 162AB of the Reserve Bank of New Zealand Act 1989).

72. Several responses also commented on the need for the joint regulators to co-ordinate with home regulators when it comes to imposing standards on offshore FMIs. This has been our intention, and we provide more detail on how we envisage working with home regulators on offshore FMIs that are designated in New Zealand in Question 11.

Question 8: Do you agree with the proposal to oversee core technical infrastructure providers via their contractual arrangements with designated FMIs? If not, please elaborate further.

73. Views were divided as to how core technical infrastructure providers should be overseen.

74. Those that did not support indirect oversight noted that their preference would be that such entities be overseen directly by the regulators, with a graduated approach that included information gathering and crisis only powers. One of their main concerns about the contractual approach seemed to be the potential costs in negotiating (or re-negotiating) contracts with these entities.

75. The Reserve Bank accepts that the need to re-negotiate contracts with providers could lead to some compliance costs and that the consultation document could have been clearer on the regulators objectives for the oversight of core infrastructure providers to designated FMIs. Our concern here is that the operational reliability of a designated FMI may be dependent on the continuous and adequate function of core infrastructure providers that are critical to an FMI's operations. In particular, the regulators are interested in sound risk management, technology management, security management, resilience and communication with users. This is best reflected by having arrangements in place that meet the expectations as set out in Annex F Oversight Expectations Applicable to Critical Service Providers of the PFMIs[7].

76. Instead of insisting on certain terms to be reflected in their contractual arrangements, the joint regulators could achieve the same outcome by requiring the operator of the designated FMI to be reasonably satisfied that the FMI's core infrastructure provider meet certain principles based requirements in the areas set out in Annex F of the PFMIs; and, in line with Principle 17 Operational Risk of the PFMIs, identify, monitor and manage the risks its core infrastructure providers

[7] http://www.bis.org/cpmi/publ/d101a.pdf

might pose to the FMI's operations – for example, having a business continuity plan for a scenario where its core infrastructure provider is no longer able to provide the core service. It is most likely that FMIs relying on a core infrastructure provider to provide their core functions would already have put similar arrangements in place.

Question 9: Do you have any comments about the proposed process for requiring that an existing rule be changed or a new rule be adopted? If so, please provide more details.

77. Most submitters agreed that rules were a critical element for FMIs and there was acknowledgement that designated FMIs should be subject to rule-setting powers. Due to the wide-ranging nature of FMIs rules and the potential for compliance costs, it was suggested that the scope of the FMIs "rules" for the purpose of designation should be explicitly set out in the Order in Council designating the FMI. This would be particularly important for offshore FMIs.

78. We agree with all those comments and think that some further clarification of how the rule setting powers are to be used might allay stakeholders' concerns about the potential compliance costs. The regulators would follow a consultative process when exercising the powers to require rule changes and to disallow proposed rule changes. Requiring implementation of a new rule or a change to an existing rule is intended to be used infrequently and would require ministerial consent as it would constitute a form of direction.

79. At the time of designation, the Order in Council would specify the rules that would be within the scope of oversight powers. The range of rules that the regulators would be interested, and specify in the Order, would likely be limited to material aspects of the designated FMIs' functions. For example, if the designated FMI is a payment system, the relevant rules would likely include those related to access, governance, settlement, clearing and failure to settle. In determining which rules would be defined in the Order, the regulators would also consult with the operator and other key stakeholders of the designated FMI. Similar to the current Designation Regime, the joint regulators would also have the ability to define immaterial aspects out of the rules that would otherwise be subject to the oversight powers.

80. One submission suggested that the threshold for the regulators to require new rules or rule changes should be consistent with the rule disallowance process. In section 4.4 of the consultation paper, it was proposed that such a power could be exercised when the joint regulators identify any gaps or deficiencies in the existing FMI rules. We agree that the threshold should be consistent, and would like to amend that so the regulators would be able to require a rule change or a new rule when they consider there is "potential negative impact to the FMI's soundness and efficiency".

81. A couple of respondents also mentioned the 20 working days would be too short for drafting new rules. We note that this was based on the current Designation Regime, and the 20 working days is "at a minimum". Depending on the nature of

the rule and its complexity, it might take longer than 20 working days, and the regulators would work closely with the operators to determine what the appropriate timeframe for drafting a particular rule would be in each case.

82. Some submitters also noted the need to have appropriate arrangements for rule changes, where the FMI is subject to multi-jurisdictional oversight that includes New Zealand regulators.

83. We agree that there would be express limits for the process for rule changes related to offshore FMIs. It would not be appropriate for an offshore FMI to have different rules in New Zealand. We do not expect that the oversight powers with relation to rules would be applicable to offshore FMIs.

84. One submitter suggested that there should be a right of appeal from any direction to change an FMI's rules. We do not propose any appeal rights. This approach is consistent with similar legislation (for example, the Insurance (Prudential Supervision) Act 2010 and the Non-bank Deposit Takers Act 2013). It is adopted here (and under these other Acts) on the basis that:

    - Decisions on the merits of exercising specific powers under these regimes requires specialist regulatory and subject matter expertise, which means that the courts are not necessary always well placed to assess the decisions; and

    - Judicial review remains available where the regulator may have made an error of process or acted in an arbitrary or irrational manner.

Question 10: Do you agree with the proposed crisis management powers? If not, please provide more details.

85. There was strong support for the regulators to have crisis management powers to prevent any systemic damage as a result of the disorderly failure of a SIFMI or one of its participants.

86. There were a number of more specific comments on those powers though. Most significantly:

    - A number of submitters questioned whether the power to remove and appoint directors was appropriate, and noted that it was not included in overseas FMI regimes;

    - One respondent also questioned the appropriateness of statutory management framework for FMIs and whether more conventional approaches to recovery and resolution would be appropriate.

87. On the first of these points, we accept that given the differences between FMIs and other prudentially regulated entities (banks, insurers and NBDTs), an argument could be made that the power to remove and appoint directors is less

relevant or important here. However, we still base our regulatory and supervisory approach for FMIs on the three pillars of self, market and regulatory discipline. As a result, we subscribe to a less intrusive supervisory approach to FMIs than is common overseas, and place extra weight on the role of directors and senior management in this area. On balance, we consider that the power should be retained in light of this context.

88. On the second point, we have thought carefully about the structure of crisis management powers for FMIs, and the potential role of statutory management.

89. We see considerable merit in a graduated approach to crisis management, with the "first line of defence" being business continuity, recovery and resolution plans prepared by FMIs. To reinforce this approach, we think it is appropriate for joint regulators to be able to require these plans to be prepared where they do not already exist, and to be able to assess whether they are adequate.

90. The "second line of defence" here would be direct intervention powers for joint regulators. These powers would be used where FMI's business continuity, recovery and resolution plans are either not adequate to deal with the nature of the crisis, or are not implemented in a timely and effective manner.

91. The first of these powers would be the direction power set out in the consultation document.

92. Beyond that, in order to ensure the continuity of essential services, we consider that joint regulators also sometimes need the power to:

    - Appoint a person to take over the operation of the FMI and/or its operator(s);

    - Transfer some or all of the business of the FMI to a new operator(s)

93. At this stage, we still consider that both of these powers could be given effect through a form of statutory management regime. However, given the complexity of this area, and the need to ensure that the crisis management framework is appropriately tailored to the FMI sector, we plan to issue a separate consultation document at the beginning of 2016 on the detailed design of a crisis management regime for FMIs.

94. Similar to the previous questions, there were also a few responses that noted the need to have a co-operative cross-border solution when it comes to dealing with an offshore FMI that is subject to co-operative oversight arrangements. We agree that this would be a top priority for the New Zealand resolution authority when it comes to dealing with offshore FMIs that are designated in New Zealand.

Question 11: Do you agree that offshore FMIs should be included in the proposed revised Designation Regime? If not, please provide more details.

95. All respondents were either supportive of or comfortable with the proposal to include offshore FMIs in the revised Designation Regime subject to the need to ensure efficient cooperation between New Zealand regulators and home regulators to avoid duplicating or conflicting requirements.

96. Including offshore FMIs that are of systemic importance to New Zealand in the revised Designation Regime would provide the avenue for the New Zealand regulators to establish co-operative arrangements, as well as crisis management protocols, with the offshore regulators. Before designating any offshore-based FMIs, the joint regulators would conduct close consultation with the home regulatory authorities.

97. As part of the designation process, the regulators would need to determine whether the offshore FMI is subject to sufficiently equivalent oversight in its home jurisdiction. Sufficiently equivalent oversight, in this context, refers to whether the oversight is based on the PFMIs and other CPMI-ISOCO best practice guidance such as the PFMI Disclosure Framework and Assessment Methodology[8].

98. The legislation would require the joint regulators to take into account the existence of a co-operative oversight arrangement before exercising any of the proposed powers. In practice, it is unlikely that the New Zealand regulators would impose additional New Zealand specific requirements on offshore FMIs, unless there were material difference between the home regulator's requirement and New Zealand regulation. The joint regulators would continue to look to the key considerations in the PFMIs (Responsibility E: Cooperation with Other Authorities) in their oversight of designated offshore FMIs, such as actively seeking input from and sharing information with interested relevant international authorities, to avoid oversight overlaps and minimise the imposition of conflicting requirements.

Question 12: Do you have any views on how the additional costs for the proposed revised Designation Regime could be funded? If so, please elaborate.

99. Only six respondents provided some brief comments on this question, with half suggesting that the additional costs should be absorbed by the regulators. A couple of submitters noted more consultation should be undertaken, including identifying any material market benefits, before determining whether industry or public funding would be appropriate. There was some acknowledgement that the compliance cost should not be significant.

100. However, we note that a number of submitters did express their concern that the proposed regime could impose significant costs on regulated entities in their general comments.

[8] http://www.bis.org/cpmi/publ/d106.pdf

101. One submitter suggested that the most transparent approach to funding the revised designation regime would involve the designated FMIs paying a direct supervisory levy annually for the oversight arrangements by the regulators, and the designated FMIs could then pass the cost onto individual institutional members based on existing allocation methodologies.

102. Our preliminary assessment is that the proposed regime would require additional resources for the joint regulators, however these are unlikely to be significant. While we have not formed a view on how to recover such additional costs at this stage, we note the FMA may charge for performing its functions and exercising its powers under any enactment (section 67 of the Financial Markets Authority Act 2011). The Bank proposes that the new legislation provides for a similar ability for it to charge. Any decision for fees and charges for FMIs will be made at a later date and will be made in light of Auditor General and Treasury principles as to charging by public bodies.

Question 13: Could you provide some details on the likely costs that a designated FMI would incur?

103. Five respondents provided some comments on this question, with two noting that the costs were not expected to be material.

104. While we did not receive much detail on quantifying the likely costs, submitters mentioned designated FMIs may incur the following costs:

- costs of accreditation/designation
- an increase in governance costs
- increased risk and compliance resource costs as entities implement risk oversight infrastructure, including access to third party experts and consultants for independent reviews of the FMIs capabilities
- potentially cost relating to opening an ESAS account
- requirement for self-assessment
- economic opportunity costs
- costs to include certain matters in contracts with core infrastructure providers
- costs in relation to being required to provide or publish information such as additional periodic reporting, audits or investigation
- costs associated with rule changes

105. Overall, we understand why submitters would be concerned about compliance costs from a “new” regulatory regime. We acknowledge that a SIFMI is likely to incur some costs at the point of initial designation. Such costs would be low for four FMIs that are already designated under the current regime because the legislation would likely to deem those four FMIs as designated under the new regime. These four FMIs are already subject to equivalent requirements under the current regime in the form of Conditions of Designations, and we do not anticipate that they incur material additional costs when designated under the revised regime.

106. Designation of offshore FMIs would also unlikely to lead to material additional costs for those operators. Our proposal is centred on the establishment of co-operative oversight arrangements with the offshore regulatory authorities, which should not incur material additional costs for those FMIs.

107. For the remaining two domestic FMIs that might be designated, there is likely to be some cost associated with the initial designation process. These costs would likely be in relation to the provision of information concerning their operations, governance and risk management arrangements, and potentially because of rule changes in order to meet expected standards for a SIFMI. FMIs might also choose to seek legal advice during the designation process.

PART FOUR: FINAL POLICY PROPOSALS AND LIMITED SCOPE CONSULTATION

108. The formal submissions and the follow-up meetings with submitters have been useful for the Reserve Bank to refine its proposals. The key features of the final policy proposals remain as follows:

- An FMI is a multilateral system among participating institutions, including the operator of the system, used for the purposes of clearing, settling, or recording payments, securities, derivatives or other financial transactions. An FMI includes a payment system, securities settlement system, central securities depository, central counterparty, and trade repository.

- The Reserve Bank and FMA to have enhanced oversight powers for SIFMIs, including investigative and enforcement, standard-setting, rule setting and crisis management powers, via a revised Designation Regime.

- FMIs that meet the criterion of systemic importance would be required to be designated under the new Designation Regime. Regulators to assess an FMI's systemic importance based on its size, degree of market penetration, its role and nature of transactions processed, the degree of substitutability and its interdependencies with other FMIs or markets.

- Designated FMIs that are payment and settlement systems can continue to seek legal protection for netting and settlement as per the focus of the existing Designation Regime. Other non-systemically important payment and settlement systems are also able to opt in for designation.

109. As discussed in the previous section, we have made a number of key refinements to the proposals based on the feedback from the industry. Specifically:

- The preliminary list of FMIs that might be of systemic importance in or to New Zealand has been updated. Paymark is no longer on that list, and we have added the HVCS. The updated list is provided in Appendix Two.

- Core infrastructure providers. We previously suggested that the regulators would require designated FMIs to address certain matters in their contractual arrangements with their core technical infrastructure providers. After considering feedback from submitters, we consider it would be more appropriate that designated FMIs are required to be reasonably satisfied that their core infrastructure providers meet certain principles-based requirements (that will be closely based upon Annex F of the PFMIs). Please refer to Question 8 in Part Three for further detail.

- The threshold for requiring a rule change or a new rule is aligned with the rule disallowance process. In considering whether to disallow any rule changes, the regulators would need to take account of whether the rules would continue to adequately provide that the FMI complies with the standards applicable to it, and whether there would be any potential adverse impact on the soundness and efficiency of the FMI from adopting the rule. The regulators could also require a rule change or the establishment of a new rule if they consider the existing rule, or the lack of a rule in a given area, would have any potential adverse impact on the soundness and efficiency of the FMI. This is a change from the wording in the consultation paper which stated "the joint regulators could also require a rule change or the establishment of a new rule if any gaps or deficiencies are identified in the existing FMI rules".

- The definition of an operator has also been amended to recognise that an operator does not necessarily manage the services of the FMI and maintain the rules. An operator is now defined as "any persons who are legally responsible for carrying out or managing the services provided by the FMI, or maintaining and administering the rules of the FMI".

- The fit and proper requirements for directors and senior management are clarified. On page 10 of the consultation document, it was noted that there might be specific governance requirements for operators such as a minimum number of independent directors and fit and proper requirements for directors and senior management. We would like to clarify that this means the regulators would require the operator to have a policy in place for assessing the suitability of its director and senior management, instead of the regulators having direct influence in such suitability assessment.

110. These refinements are clarifications, or in a couple of cases, a more light-handed approach than what has been consulted on, and are made as a result of submitters' feedback. These will be included in the final policy proposals that form the basis of concrete legislative proposals.

111. Submitters have requested more details in a number of areas. These have been provided in various parts of this paper, as follows:

- Problem definition and objectives (Part Two)

- Factors for assessing the systemic importance of a payment system (Question 5);
- Oversight of offshore FMIs (Question 11);
- Types of oversight powers and standards applicable to different classes of FMIs' operators (Appendix One);
- Legislative constraints on the exercise of statutory powers (Appendix Three)

112. We have also added more detail on the crisis management framework (Question 10). However, we acknowledge that, due to its complexity, there are merits for this part of the proposal to be further developed before the legislative drafting process. It is a crucial element of our proposals and we would like to seek further stakeholder inputs into the more detailed design features of such a framework. We plan to issue a limited scope consultation on this topic shortly, and we look forward to receiving industry feedback on a tailored crisis management framework for FMIs.

113. We are also considering establishing a list of FMIs. Such a list would be for supervisory purposes only, and we believe the power to require information to be provided would be sufficient to enable the maintenance of such a list.

PART FIVE: NEXT STEPS

114. The Reserve Bank would like to thank all submitters again for their feedback, which has helped shape the final policy proposals for the oversight of designated FMIs. The next steps are as follows:

- The Reserve Bank will undertake a limited scope consultation on the detailed design of the crisis management framework for designated FMIs in early 2016 with a ten-week consultation period. Submissions received will feed into the final overall proposals

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

- Subsequently, the Reserve Bank plans to re-engage with the industry via an Exposure Draft of the proposed legislation, around Q3 of 2016

Appendix One: Powers and standards applicable for classes of FMIs

The following powers and standards may be applicable to all FMIs, except as noted in the following table:

- Governance – requirements to have clear and transparent governance arrangements and to have policies about appointing suitably qualified directors and senior managers.
- Risk management – requirements to identify key risks relevant to the FMI and to have a sound risk management framework for comprehensively managing those risks.
- Access criteria – requirement to have objective, risk-based and publicly disclosed criteria for participation.
- Reporting requirements and public disclosure
- Preparation of participant default management, recovery and resolution and business continuity plans.

	Systemically Important FMIs	**NZ FMIs in class**	**Comment**
1a	Reserve Bank operated payment and securities settlement systems	ESAS/NZClear	These FMIs are likely to be subject to different, or no, requirements in the following areas: • Governance (although there would probably be a requirement that management were suitably qualified) • Recovery and resolution planning • Holding ring-fenced liquid assets to cover business risk • Crisis management powers would not be relevant • Depository would be subject to depository-specific requirements (PFMI11)
1b	Reserve Bank operated central securities depository (CSD)	NZ CSD Limited	
2a	Domestic payment and securities settlement systems – with a central operator	BaNCs (NZCDC)	
2b	Domestic payment and securities settlement systems – arrangement/set of rules	HVCS; SBI	Settlement could continue in absence of an operator that only managed the rules (e.g. PNZ) The following requirements are unlikely to be relevant: • Recovery and resolution planning • Holding ring-fenced liquid assets to cover business risk

3a	Offshore payment and securities settlement systems – with a central operator	CLS system	Where an FMI is based in a jurisdiction assessed to be equivalent to NZ and where NZ regulators participate in a co-operative oversight arrangement, applicable standards could be limited to requirements to: • Comply with the requirements of the home regulator; and • To notify NZ regulators of material changes to the system and amendments to the rules.
3b	Offshore payment and securities settlement systems – arrangement/set of rules		
4	Domestic central counterparty (CCP)	NZ Clearing (NZCDC)	In addition to the requirements applying generally, CCPs could potentially be subject to requirements around: • Holding sufficient financial resources to cover largest credit exposure to participant(s) (PFMI4) and liquid resources to cover default of participant(s) that generates largest liquidity obligation (PFMI7) • Segregation and portability of client positions
5	Offshore CCP	LCH.Clearnet; ASXClear (Futures)	See comment on 3a/3b
6	Domestic CSD	NZ Depository (NZCDC)	Depository specific requirements (PFMI11)
7	Offshore CSD		See comment on 3a/3b
8	Domestic trade repository (TR)		TR specific requirements – but would only need to develop these if there were a TR located in NZ.
9	Offshore TR	DTCC Singapore	See comment on 3a/3b

Appendix Two: Updated list of FMIs that might be of systemic importance

Domestic	
1	ESAS
2	NZClear
3	NZCDC Settlement System
4	High Value Clearing System
5	Settlement Before Interchange
Offshore	
1	CLS system
2	LCH. Clearnet
3	ASX Clear (Futures)
4	DTCC Singapore

Appendix Three: Legal constraints on the exercise of statutory powers under the proposed oversight framework for financial market infrastructures

Introductory comments

The following table does not include general administrative law constraints that could form the basis for judicial review. It also does not cover the statutory constraints applying to the FMA's exercise of its powers under the Financial Markets Authority Act 2011, which it may also exercise in relation to financial market infrastructures covered by the proposed oversight regime.

All of the proposed powers in the table must be exercised: 1) by the Reserve Bank for the purpose of promoting the maintenance of a sound and efficient financial system and avoiding significant dames to the financial system that could result from the failure of an FMI or participant; 2) by the FMA for the purpose of promoting the integrity and effectiveness of FMIs and related markets in New Zealand, and enhancing the confidence of investors and other market participants in FMIs and related markets in New Zealand.

References to joint regulators in this table should be taken to mean the Reserve Bank and FMA, except in relation to designated FMIs that are payment systems, in which case references to joint regulators should be taken to mean the Reserve Bank alone. References in this table to joint Ministers should be taken to mean the Ministers of Finance and Commerce, except in relation to designated FMIs that are payment systems, in which case references to joint Ministers should be taken to mean the Minister of Finance alone.

It should also be noted that the table does not discuss the specific constraints that would apply in respect of the exercise of crisis management powers, such as:

- Requiring business continuity plans / recovery and resolution plans
- Removing or appointing directors
- Issuing directions
- Statutory management

The legal constraints on the exercise of these crisis management powers will be included in the separate limited scope consultation document on crisis management powers that is being prepared, and which will be consulted on separately.

Specific constraints on statutory powers

Statutory power	Who does the power apply to	Legal constraints on the exercise of the power
Requiring information be provided	Operators of FMIs / persons who are wholly or partly responsible for the operation of an FMI / Participants of an FMI / Critical Services Providers of an FMI	The power may only be exercised where joint regulators reasonably believe that this would be necessary or desirable to perform their functions and duties, or to decide whether to exercise other powers, under the legislation.
Requiring designation	Financial Market Infrastructures	An FMI is designated by an Order in Council made on the advice of joint Ministers given in accordance with a recommendation of joint regulators In considering whether an FMI should be designated, joint regulators must consider that it is systemic. In determining whether an FMI is systemic, joint regulators must have regard to matters prescribed in the legislation. Before recommending that an FMI be designated, and defining the nature and scope of the FMI for the purpose of the designation order, joint regulators must consult with relevant stakeholders (including persons responsible for the current management and administration of the FMI), and take into account submissions received.
Assessing applications to be designated (opt-in applications)	Financial Market Infrastructures	An FMI is designated by an Order in Council made on the advice of joint Ministers given in accordance with a recommendation of joint regulators In considering whether an FMI should be designated, joint regulators must have regard to matters prescribed in the legislation (it is expected that these matters will closely align with the matters currently listed in section 156Z of the Reserve Bank of New Zealand Act 198)
Issuing standards	Operators of designated Financial Market Infrastructures	Standards would be required to relate to certain matters prescribed in legislation.

		Before making, amending or revoking a standard, joint regulators would be required to consult with affected entities, and take into account submissions received. Standards would be legislative instruments for the purposes of the Legislation Act 2012, which means that they would be subject to scrutiny by the Regulations Review Committee9 and could be disallowed by Parliament. Joint regulators would be required to notify standards in the Gazette, make standards publicly available, and make standards available for purchase at a reasonable price on request. Joint regulators would be required to assess the regulatory impacts associated with applying particular standards to newly designated FMIs, making new standards, or amending standards that are already in place (unless the amendment to the standard was of a minor or technical nature).
Disallowing rules	Operators of designated Financial Market Infrastructures	Joint regulators must be notified of any proposed amendments to the rules of a designated FMI, and may disallow those amendments within 20 working days of receiving notification of the amendments. When considering whether to disallow an amendment to the rules of an FMI, joint regulators must have regard to: • Any implications the amendments may have for the FMI continuing to be operated in accordance with the standards imposed on its operator(s); • Any implications the amendments may have for the soundness and efficiency of the FMI; and • Where the FMI is a settlement system, whether the amendments are consistent with settlement finality protections continuing to apply

Requiring new rules	Operators of designated Financial Market Infrastructures	The process for requiring a change to an FMI's rules would operate as follows: • Where the Reserve Bank and FMA consider that it is necessary or desirable to achieve the objectives of the legislation, they may request that the operator(s) of an FMI prepare a draft rule change relating to a specified matter • If the Reserve Bank and FMA are not satisfied that the draft rule change prepared by the operator(s) is sufficient to achieve the objectives of the legislation, they could direct the operator(s) to make a specified change to the rules of the FMI in relation to the specified matter. Before directing that a rule change be made, they would have to consult with the affected FMI. This kind of direction could also only be given with the consent of the Ministers of Finance and Commerce (as with the other kinds of directions discussed below)
Entering and searching premises	Any person who may have breached obligations impose by or under the legislation	Before entering and searching premises, joint regulators would have to apply to court for a warrant, and there would be a threshold prescribed in legislation for when they could make this kind of application to the court. The relevant parts of the Search and Surveillance Act 2012 would also apply in order to ensure that the processes for seeking a warrant and searching premises are carried out in accordance with the standard requirements applying in other areas.
Requiring independent reports	Operators of designated Financial Market Infrastructures	This power would only be able to be exercised where joint regulators reasonably believe that this is necessary to carry out their functions or duties under the legislation, or to determine whether to exercise other powers joint regulators have under the legislation.