
Oversight of Designated Financial Market Infrastructures

Submission to the Reserve Bank of New Zealand

July 2015

Index

1. INTRODUCTION	3
2. EXECUTIVE SUMMARY	4
3. DEFINING THE PROBLEM	6
4. SOLVING THE PROBLEM	11
5. SCOPE OF OVERSIGHT	13
6. RECOGNITION OR DESIGNATION	15
7. WHAT ENTITIES SHOULD BE DESIGNATED?	16
8. WHICH FMIS ARE SYSTEMICALLY IMPORTANT?	19
9. THE PROPOSED POWERS	23
10. WHO PAYS	27
11. PAYMENT SERVICE PROVIDER REGISTER	28
12. HOW SHOULD THE CONSULTATION PROCESS BE STRUCTURED?	29
13. THE CONSULTATION DOCUMENT QUESTIONS	30

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1. INTRODUCTION

- 1.1 Payments NZ Limited ("**Payments NZ**") is a key stakeholder in the governance of New Zealand's payments systems, with primary responsibility for setting payment standards in New Zealand for "pure payment systems".
- 1.2 Payments NZ is made up of a team of industry specialists. It oversees most of the core payments systems in New Zealand and, in that capacity, provides thought leadership, change management and ensures compliance with relevant payment standards.
- 1.3 Payments NZ welcomes the opportunity for input into a regime to regulate Financial Market Infrastructures ("**FMI**s") given the important role it already has in the payments industry. Payments NZ particularly notes comments in the Reserve Bank's Consultation Document *Oversight of Designated Financial Market Infrastructures* ("**Consultation Document**") that the Reserve Bank of New Zealand ("**Reserve Bank**"), in developing its oversight powers, would take into consideration matters such as:
 - (a) avoiding duplication of requirements;
 - (b) minimising compliance costs;
 - (c) the desirability of industry-led solutions; and
 - (d) maintaining competitive neutrality.
- 1.4 Payments NZ believes that it can assist the Reserve Bank in addressing those considerations.
- 1.5 In responding to the Consultation Document, Payments NZ has set out its detailed comments in respect of the proposed oversight regime before answering the specific questions at the end of this submission.

2. EXECUTIVE SUMMARY

- 2.1 Payments NZ believes that the New Zealand payments systems are working efficiently and safely and historically they have always done so. The Reserve Bank has built good engagement with the payments industry, particularly over the last five years since the creation of Payments NZ, which has enabled it to work with the industry to make changes in the payments system in areas of concern to it. In short, there is not a compelling case for market intervention.
- 2.2 Payments NZ does not believe that the Reserve Bank has clearly defined the problem it is trying to address in the Consultation Document. Payments NZ believes that further work is required to adequately define the problem and that work should be accompanied by a Regulatory Impact Statement.
- 2.3 However, Payments NZ assumes that many of the problems identified in the previous consultation document remain issues for the Reserve Bank, such as the fact that the Reserve Bank's powers may not fully meet its obligations under the Principles for Financial Market Infrastructure ("**PFMIs**"), the absence of recovery and resolution powers over FMIs and the challenges of regulating fast changing payments systems with a new wave of payment operators.
- 2.4 Payments NZ acknowledges that internationally there has been a trend to greater regulation of payments systems and that there may be expectations for New Zealand to follow this trend. Nevertheless, New Zealand payments systems function with high levels of efficiency and soundness, and this has been achieved under comparatively light-handed regulatory conditions. Payments NZ believes that, irrespective of international trends, New Zealand should retain a relatively light-handed regulatory approach and only introduce new regulation to target specific problems. In effect, New Zealand is a small market and it is important that any regime is "right sized" for this market, something which means industry led self-regulation tends to work well in New Zealand.
- 2.5 While Payments NZ accepts that more countries now regard retail payments systems as systemically important than at the time of the previous consultation, Payments NZ does not believe that there will be any material benefits in designating the Settlement Before Interchange ("**SBI**") system in New Zealand.
- 2.6 Payments NZ does not believe there is a case for designating Paymark, or indeed the Consumer Electronic Clearing System ("**CECS**"), given the fragmentation in that market.
- 2.7 Given the Reserve Bank's stated concern about wholesale payments systems, Payments NZ would like more information to understand the Reserve Bank's conclusion that the High Value Clearing System ("**HVCS**") should not be designated.
- 2.8 Payments NZ is in favour of a single FMI oversight regime contained in a separate act that applies to all operators, infrastructure providers and participants. It believes designation should be retained for its current purpose only – to give legal certainty to those systems that need such certainty.

- 2.9 The payment oversight regime should focus on the key areas of concern – recovery and resolution over FMIs and the ability to get information from a new wave of payment operators and to intervene where there is a significant threat to the system as a whole.
- 2.10 In addition, Payments NZ is in favour of:
- (a) the Reserve Bank maintaining a register of payment service providers as a way of monitoring developments in a rapidly evolving market;
 - (b) the Reserve Bank and the Financial Markets Authority ("**FMA**") using their existing approach to publishing standards for FMIs, rather than seeking statutory powers to issue binding standards; and
 - (c) the Reserve Bank absorbing the compliance costs of regulation (i.e. no levy), particularly as Payments NZ does not believe there should be any significant incremental Reserve Bank costs associated with the implementation of the oversight regime (whereas there could be significant incremental costs to designated FMIs).
- 2.11 To the extent it is still considered necessary (and Payments NZ is not persuaded that it is), Payments NZ supports using a recognition regime as opposed to modifying the existing designation regime. The designation regime is focused on rules whereas there may be FMIs that do not have any rules and there seems little regulatory benefit in compelling FMIs to have rules designated.
- 2.12 If there is a recognition or designation regime, much clearer criteria for determining when to designate or recognise an FMI is required.
- 2.13 Given the number of questions that Payments NZ has on the Consultation Document and the reasonably substantive changes suggested, Payment NZ believes there should be a second round of consultation before the legislative drafting process begins. This second round of consultation should occur after the Regulatory Impact Statement has been prepared so that stakeholders can submit on the proposed regime once the cost benefit impact has been completed.

3. DEFINING THE PROBLEM

- 3.1 The Consultation Document does not contain any problem definition other than a statement that the Reserve Bank's "*foremost regulatory concern in the FMI sector is to ensure that large wholesale payment systems and other FMIs that give rise to systemic risks are operated in a sound and efficient manner, and positioned to enable the most efficient possible resolution if they fail.*"
- 3.2 The Reserve Bank notes that "*this is consistent with the Principles for Financial Market Infrastructures ("PFMIs") and international best practice published by the Committee on Payments and Market Infrastructure ("CPMI") and the technical committee of the International Organisation of Securities Commissions ("IOSCO").*"
- 3.3 The proposed powers and approach set out in the Consultation Document appear to go well beyond what is required to address the Reserve Bank's fundamental concern. For example, neither SBI nor Paymark are wholesale systems. In the case of SBI, settlement risk has largely been eliminated (because settlement occurs before files are interchanged) and, as Payments NZ understands it, Paymark does not have any settlement risk (because Paymark merely provides the infrastructure that facilitates the participants authorising transactions, settlement risk is actually between participants and part of the SBI process).
- 3.4 The Consultation Document simply states that wholesale systems running in a sound and efficient manner is one of the Reserve Bank's foremost concerns. However, it is not clear what the Reserve Bank's concerns are with large wholesale payments systems.
- 3.5 Payments NZ would like to see a much clearer problem definition and an analysis of how the proposed powers will address the problems identified. Payments NZ believes this should be accompanied by a Regulatory Impact Statement. A Regulatory Impact Statement would clearly identify:
- (a) the problem that needs to be addressed;
 - (b) the options for addressing the problem; and
 - (c) the costs and benefits of each option.
- 3.6 Following our request for more information, the Reserve Bank has advised us that the problem definition was defined in more detail in the 2013 consultation document. Payments NZ therefore assumes that the issues previously identified by the Reserve Bank with its current powers under Parts 5B and 5C of the Reserve Bank of New Zealand Act 1989 (the "**Act**") remain (although this may not be the case if the Reserve Bank's concerns are based solely on wholesale payments systems and systems with substantial settlement risk). In summary these were:
- (a) the absence of formal powers in Part 5B of the Act to induce changes in systemically important systems;

- (b) international developments that have led to increased reliance on certain types of infrastructure – such as the CLS system and SWIFT;
- (c) the fast changing payments landscape with a new wave of payment operators and a lack of the power to direct relevant payment operators and participants in payments systems to ensure consistent treatment between banks, non-bank deposit takers ("**NBDTs**") and other non-bank entities;
- (d) the lack of a specific statutory management regime for payment and settlement systems as well as a broader lack of crisis management powers in relation to payment and settlement systems;
- (e) the lack of any ability to initiate rule changes other than through moral suasion;
- (f) the fact that the Reserve Bank's current payment oversight powers were unlikely to fully meet the responsibilities set out in the PFMLs; and
- (g) the need for the Reserve Bank to be involved in co-operative oversight arrangements in relation to financial market infrastructure servicing the over the counter derivatives markets.

3.7 In short the Reserve Bank believed that its current payment oversight powers were rather "light" when compared to those of many other central banks. However, Payments NZ believes that the "light-handed" approach which the Reserve Bank has taken to payments oversight has, indeed, been positive for the New Zealand market.

3.8 New Zealand has developed one of the most secure and efficient payments systems in the world, largely without regulation. The Reserve Bank's active engagement with the payments market and regular disclosures in its Financial Stability Report has been an effective tool, along with the market incentives of participants in the payments systems, to create sound and efficient payments systems. This has been particularly the case following the formation of Payments NZ. New Zealand's reputation for efficient, competitive and effective payments systems is based on:

- (a) the number of electronic transactions per person being amongst the highest in the world;
- (b) New Zealand having one of the lowest unit cost per transaction rates in the world;
- (c) a perception that New Zealand has one of the most resilient systems in the world;
- (d) the high penetration in the market for point of sale services;
- (e) the wide reach of the ATM network,
- (f) the world leading SBI system which has substantially eliminated inter-participant settlement risk for retail payments (this had already happened with wholesale payments);
- (g) New Zealand being one of the quickest adopters of mobile payment technology and the first in the world to establish a credible trusted services manager;

- (h) the comparatively low levels of payments fraud;
 - (i) the relative ease and speed of bringing products to market;
 - (j) very low cash in circulation relative to GDP, with low usage of cash for payments;
 - (k) the rapid decline of cheque usage; and
 - (l) New Zealand's highly banked population.
- 3.9 Based on the research that Payments NZ has available to it, both consumers and merchants have a high level of satisfaction with the performance of, and a high degree of confidence in, the payments systems in New Zealand.
- 3.10 Even the PFMI's acknowledge that there was no failure of payments systems during the global financial crisis. Certainly, payments systems in New Zealand did not fail.
- 3.11 Ultimately, Payments NZ believes that the market and the Reserve Bank's approach of actively engaging with the industry and using moral suasion and disclosure (through publications such as its regular Financial Stability Report) have been effective.
- 3.12 Furthermore, the governance structure of Payments NZ has enabled much more rapid and effective industry led solutions. Payments NZ has been established with a board that includes three independent directors. The combination of those three independent directors with the ability of the board to make decisions by majority means Payments NZ can operate effectively in setting rules and standards for the payments industry. Similarly, its management committees, (where voting is based both on numbers and interchange volume), provide an effective opportunity for all participants in clearing systems to have a say..
- 3.13 Payments NZ believes that this has already resulted in a dramatic improvement in the time it takes to effect changes in the payments systems. Since Payments NZ has been established it has:
- (a) ensured the timely delivery of the SBI project after that project had languished for many years;
 - (b) introduced common standards for domestic EFTPOS transactions in New Zealand (including creating certainty for consumers and merchants by removing any rights for banks to reverse transactions which had been accepted at point of sale and by ensuring that the risk of the issuer bank failure is borne by the merchant's bank, not the merchant);
 - (c) introduced transparent access criteria for admission to the payments systems (including in relation to testing and technical requirements, the allocation of interchange numbers and providing for access decisions to be made by independent directors only). It is currently working through three applications to join the retail payments system (after a decade without any new entrants). There have also been two new entrants into the HVCS in the last five years;

- (d) worked with the Reserve Bank to develop standards that would enable the payments systems to implement the Reserve Bank's Open Bank Resolution Policy;
- (e) been the first body in the world to introduce mobile payment standards – followed quickly by amendments to provide for host card emulation. In both cases, the principle agreed by all parties (including banks and card schemes) was the customer had to be in control and select the primary payment method in their mobile wallet;
- (f) upgraded HVCS rules, in particular, providing certainty for customers about when same day cleared payments were irrevocable, irreversible and unable to be dishonoured;
- (g) commenced a project to introduce cleared funds for electronic credits designed to reduce customer settlement risk and speed up customer access to cleared funds;
- (h) introduced a membership program as part of an initiative to ensure that the company got wider industry engagement. As a result, Payments NZ now has, in addition to its participants:
 - (i) three infrastructure members;
 - (ii) one standards member; and
 - (iii) twelve industry members (which include infrastructure providers, cards schemes, vendors, resellers, merchants and non-participant banks);
- (i) undertaken work on creating a ten year vision for the New Zealand payments systems called "Payments Direction", which is the first time there has been a coordinated plan on improving payments systems and, in particular, making payments easier for all stakeholders.

3.14 In many instances changes have been made in response to concerns expressed by the Reserve Bank (for example, in relation to introducing CECS authorisation and settlement rules, providing for access decisions to be made by independent directors only and addressing the lack of transparency in relation to access criteria). All of these changes have occurred in an efficient manner. Payments NZ already has a substantial record of deliverables and its effectiveness is increasing as it becomes more experienced and integrated into the fabric of the payments systems.

3.15 The changes made by Payments NZ have underscored the value of industry led solutions. The payments systems in New Zealand are, like all payments systems, complex and technical. Payments NZ is able to bring together a range of project management, operational expertise, strategic expertise, and specialist thought leadership standards drafters and legal experts to deliver outcomes more efficiently and effectively than a regulator could unless that regulator substantially increased its resource. In the New Zealand market this would neither be sensible nor efficient. The way in which the Reserve Bank has exercised its strategic oversight of the payments systems and its practice of widespread engagement has been very effective. The

current regime is "right sized" for New Zealand and only needs relatively limited change to address key concerns.

- 3.16 In short, Payments NZ does not believe that there is a problem in the New Zealand payments systems. It does, however, accept that there are international trends, both in relation to payments systems and, more particularly, in relation to the over the counter derivatives market, for payments regulators to have greater powers.
- 3.17 In the New Zealand market we believe there is a case for the Reserve Bank to adopt the minimum powers necessary to address specific identified problems (such as recovery and resolution powers and an ability to deal with a rapidly changing payments landscape) and comply with international principles, as market led solutions and the Reserve Bank's current approach to oversight have a record of working effectively.

4. SOLVING THE PROBLEM

4.1 Payments NZ believes that the Reserve Bank can achieve its objectives in a much simpler manner than is proposed in the Consultation Document. In particular, Payments NZ is proposing a regime which does not need any form of designation. The legislation would apply to all entities involved in an FMI. However, there would be a threshold before powers could be exercised which would mean that, in practice, it is only likely to be the systemically important parties in the payments system that will be affected. Designation would not be a precondition to regulation.

4.2 The following is the proposed model for the legislation we are suggesting:

Financial Market Infrastructure Act

Application	The Act would apply to all FMIs and all operators, infrastructure providers and participants in FMIs.
Purpose	<p>The purposes of the powers granted in the Act would be for:</p> <ul style="list-style-type: none"> (a) promoting the maintenance of a sound and efficient financial system; and (b) avoiding significant disruption to FMIs where that disruption could cause significant damage to the financial system. <p>In effect, the purpose would be similar to the purpose the Reserve Bank has in relation to the supervision of banks.</p>
Powers	<p>The powers in the Act would include:</p> <ul style="list-style-type: none"> (a) the power to obtain information (similar to that already in the Reserve Bank of New Zealand Act 1989); (b) powers of investigation and/or audit (subject to checks and balances if an audit or investigation does not uncover any material concerns); (c) the power to issue directions (similar to the power that the Reserve Bank has in relation to registered banks); (d) the ability to obtain warrants from the court allowing the Reserve Bank to enter premises where the Reserve Bank is concerned about offences being committed; and (e) the power to appoint a statutory manager.
Grounds for Exercising Powers	Other than the information power, the Reserve Bank would be required to establish that the exercise of the power is reasonably necessary to prevent a material disruption or damage to the financial system as a whole.

Process for Exercising Powers	<p>Other than the information request power, Payments NZ believes that all powers should be subject to a process of independent review before they are exercised. Depending on the nature of the power, this could involve:</p> <ul style="list-style-type: none"> (a) ministerial consent; (b) an Order in Council; or (c) a Court Order. <p>The Reserve Bank would be required to consult before seeking to exercise any power (other than the information request power and the power to appoint a statutory manager).</p>
Statutory Manager	<p>A separate statutory management regime tailored for FMI participants, operators and infrastructure providers would be included in the legislation (which is likely to be a blend of the existing statutory management regimes in the Reserve Bank of New Zealand Act 1989 and the Corporations (Investigation and Management) Act 1989).</p>
Registration	<p>The Act could provide for an obligation for all operators, infrastructure providers and participants of FMIs to register, either with the Reserve Bank or in a separate section of the Financial Service Providers Register.</p>
Offences	<p>The Act could include civil and criminal penalties (based on the equivalent penalties in other legislation supervised by the Reserve Bank).</p>

4.3 If rules are not designated (and we see no benefit in this), there is no need for the Reserve Bank to have any powers in respect of rules. We similarly see no need for statutory backing for issuing standards, as we believe that a power to issue a direction combined with the current approach to setting guidelines and standards for FMIs should be sufficient and will mean the focus remains only on systemically important issues.

5. SCOPE OF OVERSIGHT

- 5.1 While payments systems internationally have appeared robust and demonstrated an ability to survive periods of global upheaval unscathed, Payments NZ acknowledges there has been a clear trend internationally in favour of giving regulators greater powers over payments systems, particularly crisis management powers to effectively deal with a failing FMI before that failure is able to spread through the wider financial system.
- 5.2 In its submission in May 2013, in response to the Reserve Bank's 2013 consultation document, Payments NZ noted its view that New Zealand was not lagging behind the rest of the world in terms of regulatory oversight in respect of payments systems. Payments NZ accepted that some strengthening of oversight powers of the Reserve Bank and FMA were warranted but called for a delay in the implementation of reform in order to give policy makers an opportunity to assess the outcome of reforms in other comparable jurisdictions. Since that submission, the United Kingdom, Hong Kong and Singapore (amongst others) have strengthened the powers of their respective payments systems regulators.
- 5.3 As Payments NZ believes the current self-regulatory approach is working, any reforms should be limited to those necessary to ensure that New Zealand is compliant with the responsibilities set for central banks in the PFMI. Payments NZ believes that these should be focused on:
- (a) crisis management – which seems to be the area with the biggest gap in relation to international practice (especially who should appoint the statutory manager) and an identified fundamental problem;
 - (b) the over the counter derivative market – given the substantial reform which has occurred over the last five years in that market both in the United States and Europe and the possible arrival in the New Zealand market of LCH Clearnet, ASX and DTCC Singapore;
 - (c) future proofing any regime to deal with the fast changing payments landscape such that current regulated entities such as banks and NBDTs are not disadvantaged as against unregulated entrants into the payments market (potentially such as Apple and Google). However, it should also be noted that existing substantial payments operators such as the credit card schemes are also not regulated in New Zealand.
- 5.4 Payments NZ does not believe that the current proposals set out in the Consultation Document particularly focus on two of the key problems. They do not, for example, deal with:
- (a) crisis management powers in relation to infrastructure providers, a key risk area in the payments systems; and
 - (b) new payment providers (or, indeed, significant existing payment operators such as the credit card schemes) unless they are formally caught as payments system operators of FMIs requiring designation. The proposal does not deal well with the oversight of a rapidly changing market place.

5.5 In short, Payments NZ accepts the need for greater oversight powers to meet international minimums but believes they should be focused on:

- (a) crisis management over all entities involved in an FMI; and
- (b) information powers relating to all payments system operators and infrastructure providers (so that the Reserve Bank can respond to a rapidly changing market).

5.6 A designation regime is not needed to address these issues and indeed using a regime designed for one purpose (legal certainty) for a completely different purpose (regulatory powers) is fraught because it will add compliance costs and not necessarily achieve the Reserve Bank's aims.

6. RECOGNITION OR DESIGNATION

- 6.1 Payments NZ does not believe either a designation or recognition regime is required. The comments below in paragraphs 6.2 to 6.7 are made in case the Reserve Bank decides to proceed with one of these options notwithstanding this submission.
- 6.2 The Reserve Bank's 2013 consultation document proposed that reform take place in the form of a 'recognition regime', which would sit alongside the already established voluntary designation regimes. The recognition regime would not impose regulation on the industry, such as the designation regime in the Consultation Paper purports to do.
- 6.3 The purpose of the dual regime was to acknowledge that only some systemically important settlement FMIs (such as the Exchange Settlement Account System ("**ESAS**")) absolutely required the benefits of designation (e.g. irrevocability of settlement and certainty in respect of rules). The recognition regime allowed the Reserve Bank to have oversight of other important FMIs which did not necessarily require all aspects of designation and, in particular, did not need rules to be designated to give legal certainty.
- 6.4 This approach gained widespread industry support compared to a designation regime over the course of the consultation process which took place in 2013 because it balanced regulatory oversight with the aim to keep compliance costs as low as possible (although we note that the preference was still for neither a designation nor recognition regime).
- 6.5 Payments NZ does not believe a compulsory designation regime is necessary – particularly given its focus on designating rules to give them legal certainty.
- 6.6 If any regime is required, Payments NZ believes that a recognition regime that does not require rules to be designated would be much simpler and have substantially lower compliance costs both for the regulator and the regulated. For example, it is difficult to see what rules would be designated if Paymark must be designated as it only has (we understand) individual contracts with merchants and banks. Where an FMI has rules that the Reserve Bank has an interest in, Payments NZ believes, if anything is required, it should simply be the formalisation of the existing 'no objections' process it has with the Reserve Bank (e.g. rules could only come into effect once a no objections letter was issued with the Reserve Bank having, say, 30 days to provide a letter or object).
- 6.7 The Consultation Document did not consider the possibility of the recognition regime as an alternative approach to the designation regime which is being proposed (notwithstanding widespread support for that option previously). If the Reserve Bank has particular reasons for not including the option of the recognition regime in the Consultation Document, it would be helpful to have those reasons disclosed in the interests of ensuring that the industry is able to engage with the Reserve Bank in a full and informed discussion as to the best approach to regulatory reform.

7. WHAT ENTITIES SHOULD BE DESIGNATED?

Definition of FMI

7.1 The comments in this section are made in the event that the Reserve Bank decides to proceed with designation (or recognition), even though Payments NZ does not support it. Most comments would apply equally if a 'light touch' recognition regime was adopted instead.

7.2 The Consultation Document has proposed to give the Reserve Bank powers to designate FMIs which present a systemic risk to the financial system. It proposes the following definition of an FMI:

"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."

7.3 If powers to designate or recognise are to be granted, the threshold for an FMI of systemic importance should be set out in clear and transparent criteria which draw on those principles set out in the PFMI.

7.4 Payments NZ agrees with the decision to remove the definition of a 'system', which was included in the 2013 consultation document. The definition proposed was too wide and lacked the appropriate detail to capture all of the necessary entities. The adoption of the PFMI definition of an FMI is a better approach. However, as stated earlier, Payments NZ believes that the Reserve Bank needs to be more specific as to the criteria it will use to decide if a system is or should be caught.

7.5 The Consultation Document sets out four key indicators in relation to the identification of systemically important FMIs:

- (a) the size, degree of market penetration and concentration of financial risks within the FMI;
- (b) the role of the FMI and the nature of the transactions processed;
- (c) the degree of substitutability; and
- (d) the interdependencies with other FMIs or markets.

7.6 Although these criteria provide a good starting point for making an assessment on whether an FMI is systemically important, there is significant uncertainty particularly in regard to the materiality threshold in respect of each key indicator which would trigger a recommendation for designation. Given the implications a designation could have, it is important that the criteria give as prescriptive a threshold as possible in order to maximise certainty.

7.7 At this stage, for example, there is considerable uncertainty as to how the Reserve Bank has identified those entities likely to be designated and those that are not and how it has applied criteria to come up with its conclusions. For example, it is unclear why:

- (a) Paymark is proposed as a designated entity but others, such as credit card schemes and other switches, are not; and
- (b) HVCS is not included but SBI is included (HVCS settles considerably more than the combined value of NZClear, which is currently designated, and SBI, which the Reserve Bank intends to designate).

7.8 Payments NZ suggests that a more robust discussion needs to take place in relation to finding an appropriate method of setting clearer criteria for systemically important FMIs. Payments NZ would like to work alongside the Reserve Bank in fine tuning these criteria to ensure that the definition is both wide enough for the Reserve Bank to act effectively as a regulator while ensuring that businesses are able to determine with a degree of certainty whether or not they are likely to be captured by the regulation. A partnership approach to solving this issue will allow for a workable and industry-led solution which will remain effective in the long term.

7.9 These are discussed in more detail later in this submission.

Who should a designation apply to?

7.10 Payments NZ has concerns with the lack of clarity in relation to which entities make up an FMI where the FMI is a 'system' rather than an entity itself. Based on the very broad definition of an operator, there are very few limits on how the Reserve Bank would interpret who makes up the FMI and this could lead to an inappropriate degree of 'reach through' to entities which did not expect to be covered by a designation.

7.11 The voluntary designation regime which is currently in place allows the applicant to determine the scope of the designation and clearly specify the entity that is the operator of the FMI. Given that an FMI can be a 'system' rather than being an entity, a regime in which the Reserve Bank has powers to impose a designation must provide some clear guidance as to which entity will be the operator of the FMI. For example, for domestic debit, is the operator of the FMI the rule maker, a switch or a participant? For HVCS, is the operator of the FMI the Closed User Group administrator who ultimately controls access (which is the Reserve Bank), SWIFT, the rule maker (Payments NZ), or a participant? For each of these examples, how far will 'reach through' extend and what will be the limitations on that 'reach through'?

7.12 The only logical entity to be covered by a designation is an operator of an FMI. The Consultation Document gives the following definition of an operator:

“any persons who are legally responsible for carrying out or managing the services provided by the FMI, and maintaining and administering the rules of the FMI. For the avoidance of doubt, an operator could also be the owner of an FMI, or a participant.”

7.13 The broad scope of this definition gives the Reserve Bank a great deal of discretion to decide which entities are covered by the designation. In deciding which entities to designate, the Reserve Bank should look to the purposes of the oversight regime and the problems it is trying to address. In particular, this is an area where there is a tension between the existing

designation regime, which focuses on certainty of rules, and what Payments NZ believes should be the focus of oversight powers – namely crisis management and information gathering. Indeed, there may be some payments systems that do not have rules or they comply with rules set by other parties, such as card schemes and Payments NZ in respect of CECS.

- 7.14 It is becoming increasingly common for payments systems to have no clear operator. For example, the consumer electronic payments market is highly fragmented, and SBI is a decentralised bilateral model that uses SWIFT messaging and ESAS settlement services. Cryptocurrency payments systems are even more decentralised and failure in these markets is highly unlikely to come from a failure by the rules body, if indeed formal rules exist. Certainly crisis management powers are likely to be of very limited value for a standards body as opposed to, say, a switch, exchange or trusted service manager. Even for bodies with expansive rules, such as the credit card schemes, the oversight of rules will be far less important than the oversight of switching and settlement.
- 7.15 For these reasons, Payments NZ believes that it is not an effective approach to designate rules bodies as an operator of an FMI. Instead Payments NZ believes that the Reserve Bank should look to a recognition regime that:
- (a) identifies all operators, infrastructure providers and standards bodies relevant in a system;
 - (b) has targeted and specialised crisis management powers;
 - (c) utilises the existing approach to setting policy for FMIs (jointly with the FMA where appropriate); and
 - (d) if appropriate, formalise the current no objections approach to rule changes (including potentially a no objections letter for existing rules at the time of recognition).

8. WHICH FMIS ARE SYSTEMICALLY IMPORTANT?

- 8.1 The Reserve Bank has made a preliminary assessment that nine FMIs would meet the systemic importance criteria which it has laid down in the Consultation Document. It is proposing to designate the four payments systems which are currently designated (with, implicitly, expanded powers in relation to them) and three offshore FMIs servicing the derivatives market systems, as well as Paymark and SBI.
- 8.2 Payments NZ understands the reasons the Reserve Bank's proposes to designate:
- (a) ESAS;
 - (b) CLS Bank;
 - (c) NZClear;
 - (d) New Zealand Clearing and Depository Corporation;
 - (e) LCH Clearnet;
 - (f) ASX Clear (Futures); and
 - (g) DTCC Singapore.
- 8.3 These FMIs are either already designated or are globally systemically important, such that it is important for the Reserve Bank to have relationships with the regulators that oversee them.
- 8.4 Payments NZ has reservations with the proposed designations of SBI and Paymark for the reasons set out below.

SBI

- 8.5 Payments NZ currently governs and oversees SBI. SBI is an example of self-governance driving and delivering market led initiatives. Payments NZ sets the rules and standards for SBI as well as being responsible for managing its resilience (which it does through processes such as industry incident management plans). It is constantly upgrading rules and standards relating to SBI.
- 8.6 Even though SBI is clearly an important system for the New Zealand payments market and a failure in it could cause significant disruption, Payments NZ questions what value there would be in designating the system, in particular:
- (a) Payments NZ has concluded that the SBI rules do not need the additional legal certainty created by designation – primarily because settlement actually occurs through the ESAS and because of the very robust process Payments NZ adopts in relation to its rules (including a review against the PFMI and, in particular, Principle 1 which requires rules to have a well-founded, clear, transparent, and enforceable basis);
 - (b) Payments NZ assumes that it would be regarded as the operator of the SBI system. However, given its role as predominantly setting rules and standards for the system, as well as being the Closed User Group administrator, it sees little, if any, value in the

Reserve Bank having crisis management powers in respect of it or powers in relation to investigation and enforcement. Furthermore, Payments NZ believes that the "rules supervision" power is not needed because of its close working relationship with the Reserve Bank both as rules are being developed and in the sign off process – where other than on minor or technical changes (e.g. to correct a manifest error) the Payments NZ Board seeks a Reserve Bank 'no objections' letter;

- (c) all of the existing participants in SBI are registered banks and subject to supervision by the Reserve Bank in any event;
- (d) any new participants in SBI will almost certainly either be banks or NBDTs and supervised by the Reserve Bank anyway – at very least they will require an ESAS account which must be provided by the Reserve Bank; and
- (e) SWIFT, as the key provider of infrastructure to the SBI system, has no presence in New Zealand and the Reserve Bank will be relying on (presumably) existing relationships with international regulators to supervise SWIFT.

8.7 In short, Payments NZ questions whether the compliance costs associated with designating SBI are justified and whether in practice the Reserve Bank would simply be duplicating powers that it already has. At best, Payments NZ believes that any regulation of SBI should be relatively light touch – for example, it sees little value in the compliance cost of getting the SBI rules designated.

Paymark

- 8.8 Payments NZ is not clear on why the Reserve Bank has indicated that Paymark should be designated.
- 8.9 Paymark does not set any rules and standards in relation to consumer electronic payments – it simply contracts with various banks and merchants to provide a switching service (much as SWIFT does for SBI and HVCS). There are certainly no rules to designate (unlike the other systems the Reserve Bank has identified).
- 8.10 The consumer electronic payments market is very fragmented and a market place in which there is intense competition. This is particularly so with the advent of mobile payments.
- 8.11 In addition to Paymark, there are two other substantial domestic switches, being EFTPOS New Zealand and DPS. Progressive Enterprises also provides switching services for its supermarkets in New Zealand through its Australian switch. Furthermore, increasingly debit transactions are being processed by credit card scheme switches as proprietary debit continues to decline in favour of card scheme contactless debit.
- 8.12 As technology has emerged which enables consumer electronic payments to be made using near field communication on cell phones, the consumer electronic payments market is only becoming more fragmented and competitive. To some extent, this has been coordinated by Semble, the trusted services manager, and Payments NZ has created the standards for

payments using mobile applications stored in secure elements on phones. However, some banks are exploring host card emulation technology which will avoid the need for a secure element on a phone and the coordination through Semble.

- 8.13 Finally, there are a number of global competitors such as Apple and Google, who may in the future enter the New Zealand payments market, along with other entities such as PayPal.
- 8.14 Payments NZ believes it would be counter to the principle of 'competitive neutrality' if only one participant in a very fragmented market was selected as an operator of an FMI, when there are numerous other participants in that market, some of whom are relatively significant (or could become significant).

HVCS

- 8.15 Payments NZ would like to understand the basis on which the Reserve Bank has concluded that HVCS should not be included on its preliminary list of designated entities in the Consultation Document. The Consultation Document stated in its introduction that its *"foremost regulatory concern in the FMI sector is to ensure that large wholesale payments systems... are operated in a sound and efficient manner."*
- 8.16 The value of transactions processed through HVCS, both as same day cleared payments and on an interbank basis, is many times higher than the value of payments processed each day in both SBI and NZClear. HVCS is a "large wholesale payment system".
- 8.17 Furthermore, the equivalent high value clearing systems in overseas jurisdictions have typically been designated by their respective regulators. For instance, the Payments System Regulator in the United Kingdom has recently proposed to regulate the clearing house automated payments system (and we believe this approach is consistent with a range of other jurisdictions such as Singapore and Hong Kong).

Critical infrastructure providers

- 8.18 Payments NZ is not convinced by the value of including outsourcing provisions in contracts with providers. These requirements will create more compliance costs through the need to renegotiate contracts, some of which may have existed for a long time. While the systemically important banks may already have some requirements included in their outsourced contracts under the Reserve Bank's BS11 outsourcing policy that may be relevant to their role as a participant in an FMI, many of the smaller banks might have to renegotiate contracts with infrastructure providers.
- 8.19 Under the proposal in the Consultation Document, the Reserve Bank would not have any direct recovery and resolution powers over the providers of critical infrastructure. Although this will not have a major impact for service providers largely based offshore (such as SWIFT), it could be important if a payment switch based in New Zealand were to fail. Payments NZ believes some limited direct powers over infrastructure providers is preferable to indirect outsourcing obligations.

8.20 If, however, the outsourcing approach continues to be pursued, Payments NZ would like greater clarity on the extent of the contractual requirements so that the likely cost of renegotiation of contracts with service providers for participants can be assessed. More specifically, Payments NZ would like clarification on:

- (a) who will be covered by any outsourcing requirements (i.e. will it just be operators, or just participants in FMIs or both)?
- (b) what substantive requirements will be required to be in contracts?
- (c) what value will contractual protections be on failure of the infrastructure provider?

8.21 Payments NZ believes a better approach would be to include infrastructure providers as part of a recognition order which would then give the Reserve Bank crisis management powers and information gathering rights in relation to them.

9. THE PROPOSED POWERS

9.1 Presently, the Reserve Bank's powers in respect of designated systems are largely limited to information gathering and information auditing powers. The Consultation Document proposes to expand on the current regime to include powers to:

- (a) set binding standards for FMIs;
- (b) investigate operators of FMIs;
- (c) impose civil and criminal penalties; and
- (d) use crisis management powers including the ability to:
 - (i) issue directives;
 - (ii) appoint a statutory manager; and
 - (iii) remove directors of FMI operators.

9.2 Payments NZ noted in its submission for the 2013 consultation that it does not think that a replication of the supervision model for banks and insurers (both of which have substantial balance sheet obligations to customers) is entirely appropriate in the case of payments systems.

9.3 Payments NZ accepts the proposals to give the Reserve Bank powers (or maintain the status quo) to:

- (a) collect information on designated FMIs;
- (b) set standards relating to FMIs provided they are limited to high level policy; and
- (c) appoint a statutory manager for a failing entity which operates or provides key infrastructure to an FMI.

Standard setting powers

9.4 The Reserve Bank currently issues non-binding standards for FMIs in order to achieve its statutory purposes set out in the Act. These standards (for example, the FMI1 guidance) are usually issued to promote compliance with internationally developed guidelines. Payments NZ believes the approach is working effectively now and is not aware of any problems the Reserve Bank has had with compliance with the non-binding standards.

9.5 The Consultation Document proposes to give the Reserve Bank formal powers to issue binding minimum standards over the FMIs subject to its regulation. The standards would be designed to limit systemic risk and enhance the soundness and efficiency of the financial system. Payments NZ does not believe these powers are necessary as they will inevitably add cost and complexity for FMIs and the Reserve Bank will potentially still be able to intervene in other ways if a matter is a threat to financial stability or is likely to cause significant disruption to a payments system. The following comments in paragraph 9.6 are made in the event that the Reserve Bank does not accept this submission.

9.6 Payments NZ notes that the Consultation Document states that standards would only be able to relate to certain matters prescribed in legislation. It will be important that those guidelines are clear and subject to checks and balances, potentially including Ministerial approval (given the limited powers of the Reserve Bank board to perform this function unlike, say, the board of the FMA).

Investigative powers

9.7 The Consultation Document proposes to give two new investigative powers to the Reserve Bank to increase the information gathering powers which already exist. They are the power to require independent reports on designated FMIs, and the power to enter and search FMIs with a warrant.

9.8 Payments NZ disagrees with the proposed power to require independent reports on FMIs relating to any aspect of its business. This has the potential to impose substantial compliance costs for FMIs for limited value, if any, to the Reserve Bank, particularly given the high level of engagement the Reserve Bank already has with the payments industry.

9.9 This concern is exacerbated by the seemingly low and subjective threshold the regulators would need to meet in order to exercise these powers.

9.10 If the power to require independent reports is retained after the consultation process, Payments NZ would only be in favour of a regime whereby the Reserve Bank would pay for the costs of the independent report if, in fact, the report shows that the FMI has reasonably complied with its obligations under the Act. For example, the Electricity Authority is subject to this restriction under Clause 9.33 of the Electricity Industry Participation Code 2010 to provide a check and balance against this power being exercised against retailers without caution. Payments NZ sees a closer analogy for payments to a utilities regulator, such as the Electricity Authority, than to supervision of banks and insurance companies.

9.11 If this is not acceptable, the requirement for independent reports should at least require Ministerial approval.

9.12 Payments NZ is satisfied that the power to enter and search the premises of an operator of an FMI is subject to the appropriate checks and balances through the judicial system and the Search and Surveillance Act 2012.

Rules Supervision

9.13 Many FMIs will not have discrete rules (or indeed any party with overall responsibility for system rules), they will simply be a series of commercial contracts. Payments NZ believes having power over rules will only create incentives for parties not to develop system wide rules – i.e. create regulatory arbitrage. For these reason, Payments NZ does not support rules supervision powers.

9.14 Where systems operate with rules, Payments NZ believes that it is most efficient if those rules are industry led and, if necessary, subject to the requirement for a no objections letter from the

Reserve Bank (similar to the existing process). To the extent that the Reserve Bank wishes to impose a rule on the market, this is akin to a regulatory power and so should only be exercised by Order in Council.

Enforcement Powers

- 9.15 Payments NZ does not see a need to give the Reserve Bank powers of enforcement, including the powers to issue public warnings and to enter into enforceable undertakings.
- 9.16 Many of the key FMI entities that the Reserve Bank is targeting through this power are already regulated through other forms of prudential regulation. There is no evidence that the lack of such powers has ever prevented an issue in the payments system being resolved. The close working relationship the Reserve Bank has built with the industry has always been effective.

Crisis management powers

- 9.17 Payments NZ believes that crisis management powers are the key powers that the Reserve Bank should obtain from any reform of the oversight of payments systems. It is consistent with international practice, and the PFMI for the payments systems regulator, to have some form of recovery and resolution powers of systemically important FMIs. However, crisis management powers do not need a designation regime to be effective. Indeed, linking these powers to designation will reduce the flexibility that may be needed to intervene (e.g. the Reserve Bank may want to intervene in relation to an entity in a non-designated FMI that could still create a major contagion effect).
- 9.18 However, the crisis management powers proposed in the Consultation Document are more extensive than those in the regimes of comparable jurisdictions. The ability to remove directors of FMI operators without any limitation (other than the requirement for Ministerial consent) is one such example.
- 9.19 Payments NZ agrees that the Reserve Bank should have the power to issue directives to FMI operators subject to the triggering of one of the four crisis management conditions in the Consultation Document and Ministerial approval.
- 9.20 Payments NZ agrees with the proposal for the Reserve Bank to have statutory management powers over operators (and key infrastructure providers) of an FMI. Payments NZ believes that it is important for the regulator to be able to step into and control a situation where an operator or infrastructure provider of an FMI is failing.
- 9.21 Another concern that Payments NZ has, which was also raised during the 2013 consultation, is that the Reserve Bank has a conflict of interest in acting as an operator of ESAS and NZClear and also as the enforcement agency. While this conflict exists currently, it will become more of a concern as the Reserve Bank's powers as an enforcement agency are increased and the Consultation Document does not address this. This issue is particularly acute in respect of ESAS because the FMA does not have co-regulatory power of it as it is a 'pure payment system'.

9.22 Payments NZ also questions whether there is any need to retain the co-regulatory model with the FMA, particularly in light of the Reserve Bank's current plans with respect to NZClear. The co-regulatory model leads to additional compliance costs for designated systems that need to obtain approval from two separate regulators. This approval process is further complicated due to the competing objectives of the Reserve Bank and the FMA, as follows:

- (a) Reserve Bank – "promoting the maintenance of a sound and efficient financial system" (section 1A of the Act); and
- (b) FMA – "promote and facilitate the development of fair, efficient, and transparent financial markets" (section 8 of the Financial Markets Authority Act 2011).

9.23 In our view, the FMI oversight regime should be focused more on prudential supervision (consistent with the Reserve Bank's current objectives under its Act), than on market conduct.

9.24 The Consultation Document is proposing a separate statutory management regime for payments system operators with the potential for separate legislation. Payments NZ supports this approach, but believes it should be extended to all entities involved in the payments systems.

10. WHO PAYS

- 10.1 Payments NZ opposes levying participants of FMIs to cover the Reserve Bank's cost of supervision. It seems particularly difficult to justify the imposition of a levy without a Regulatory Impact Statement outlining the cost benefit analysis of the proposals put forward in the Consultation Document.
- 10.2 Furthermore Payments NZ believes the incremental costs of this regime should not be significant (other than the possibility of some costs for FMIs servicing "over the counter derivatives" market that could be paid for out of the fee for designation). Payments NZ would be concerned if there were to be significant extra regulatory costs associated with this proposal or that the right to charge regulatory costs created any incentive to increase resources.
- 10.3 Payments NZ notes that no other regulated entities under any of the Reserve Bank's prudential supervision activities are levied (although the Reserve Bank has the ability to prescribe fees for insurers and NBDTs under their respective regulatory regimes, it has not yet prescribed any such fees). There is no clear reason why the prudential supervision of payments systems should be treated any differently to other industries regulated by the Reserve Bank, especially given that there should be limited, if any, extra costs of regulation for the Reserve Bank.

11. PAYMENT SERVICE PROVIDER REGISTER

- 11.1 It is important that greater clarity is provided regarding which entities would be considered part of an FMI, particularly where that FMI is a 'system' rather than an entity itself.
- 11.2 A partial solution to this problem, which Payments NZ believes could have some value, would be the creation of a payments service providers register. Although many FMIs will already be listed on the Financial Service Providers ("FSP") register created under the Financial Service Providers (Registration and Dispute Resolution) Act 2008, Payments NZ believes that there could be some merit in having a consolidated list of entities which are regulated under any new regulatory regime – including transferring those entities that are registered as payments providers under the FSP register to a new register.
- 11.3 The register would require that any entity providing a payments focused financial service, such as managing a means of payment, be registered either with the Reserve Bank or on a separate register with the FMA (as a separate section of its existing register) as a payments service provider (for example, card schemes, payment switches, payment gateway providers, payment providers, cloud based token providers, trusted service managers, bill presentment service providers and direct debit bureaus). It would allow the Reserve Bank to monitor developments in the payments market including any fragmentation risks or entities taking advantage of regulatory arbitrage. This register would be made publicly available. A statutory obligation to register would apply to all entities which fall within the criteria.

12. HOW SHOULD THE CONSULTATION PROCESS BE STRUCTURED?

- 12.1 Payments NZ suggests that once the Reserve Bank has considered the responses it receives to this Consultation Document it should produce a second consultation document with more detailed propositions in relation to reform. The second consultation document should be accompanied by a Regulatory Impact Statement, outlining the cost benefit trade-offs of the reform. A slower consultation process will allow for more opinions and ideas to be heard and help to ensure that the final product is as effective and efficient as possible.
- 12.2 Payments NZ is willing to facilitate a dialogue between the Reserve Bank and the wider industry on how to best proceed with reform. During the 2013 consultation process, Payments NZ led a number of workshops to help to facilitate engagement in the process and produce an industry led response to reform, particularly on elements of detail. Payments NZ would be happy to repeat this process and bring the key relevant parties together.
- 12.3 After the second consultation has taken place, Payments NZ is willing to work with the Reserve Bank to provide industry expertise and assist the Reserve Bank in the legislative drafting process.

13. THE CONSULTATION DOCUMENT QUESTIONS

Set out below are Payments NZ's responses to the questions set out in the Consultation Document. For more information, see the body of the submission or feel free to contact us directly.

1) Do you agree with the Reserve Bank's proposed scope for the new oversight regime focusing on systemically important FMIs only? If not, please provide more details.

No. We believe the Reserve Bank should have powers over all payment service providers particularly information and recovery and resolution powers should apply to all entities in the payment system.

See Sections 4 (Solving the Problem) and 5 (Scope of Oversight) for more information.

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.

Payments NZ does not think that there is any need for a Designation Regime. It believes in a single regime applicable to all payment services providers (as there is one statutory regime for all banks irrespective of size).

See Section 6 (Recognition or Designation) for more information.

3) Do you agree with the proposed objectives of the revised regime? If not, please provide more details.

We agree with the proposed objectives – which we note largely replicate existing objectives of the Reserve Bank in respect of payments systems.

See Section 3 (Defining the Problem) for more information.

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

We agree with the inclusion of a definition of FMI based on the international definition in the PFMIs.

See Section 7 (What Entities Should be Designated?) for more information.

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?

We do not believe there is any need to define systemic importance. Powers should apply to all entities but only when an issue:

- (a) affects the soundness of the financial system as a whole; or*
- (b) could cause substantial disruption to the payments systems as a whole.*

See Section 8 (Which FMIs are Systemically Important?) for more information.

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

We don't support the designation approach.

See Section 6 (Recognition or Designation) for more information.

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.

We do not believe there is any need to change the existing process for setting standards in relation to FMIs.

See Section 9 (The Proposed Powers) for more information.

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.

No. We do not agree with the proposal for core technical infrastructure providers to be overseen through their contractual arrangements. We believe that core infrastructure providers should be subject to crisis management and information gathering powers directly under legislation.

See Sections 8 (Which FMIs are Systemically Important?) and 9 (The Proposed Powers) for more information.

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.

We do not believe that rules should be required to be the subject of designation. We do not believe the Reserve Bank should be able to intervene in the rules setting process. This is akin to making regulation and should only be permitted by Order in Council. If any process is to be formalised in respect of rules of FMIs, we believe this should merely be a formalisation of the existing no objections process.

See Sections 6 (Recognition or Designation) and 9 (The Proposed Powers) for more information.

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

We do not agree with all of the proposed crisis management powers.

We agree with the proposal to include separate powers in relation to the appointment of a statutory manager and to adopt new legislation to do this.

We also accept that, in extreme circumstances, the Reserve Bank may need to give a direction to an operator. The fact that this direction must be given with Ministerial consent is a helpful constraint provided there is an obligation to notify the operator in sufficient time for the operator to make a submission to the Minister at the same time.

However, we do not agree with the power to appoint, remove or replace a director of an operator

See Section 9 (The Proposed Powers) for more information.

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

We agree that offshore FMIs should be covered by a regime but do not believe designation is the appropriate mechanism.

See Sections 6 (Recognition or Designation) and 8 (Which FMIs are systemically important?) for more information.

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

We believe that there is a way to create a very cost efficient oversight regime which we have outlined in some detail in this paper. In this light, we do not believe that the costs of the regime for the regulator should be significant and therefore believe they should be borne within existing operating budgets.

See Section 10 (Who Pays?) for more information.

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

The primary costs that a designated FMI would incur are in relation to matters such as the requirement for a self-assessment and the costs associated with the original designation. To the extent there are other costs, it will depend largely on the nature of any conditions imposed through the designation process.