paymentsnz

Financial Market Infrastructures Bill: Exposure Draft

Payments NZ Limited submission

26 September 2019

Introduction

1. Payments NZ Limited ("**Payments NZ**") welcomes the opportunity to submit on the exposure draft of the Financial Market Infrastructures Bill ("**FMI Bill**"). Payments NZ has considered the FMI Bill and has had the opportunity to meet with the Reserve Bank to discuss this in some detail. Payments NZ understands the Reserve Bank's need for stronger oversight and crisis management powers which are aligned with the CPSS-IOSCO Principles for Financial Markets Infrastructures ("**PFMIs"**). However, it is important that any oversight regime takes into account the specific characteristics of the financial system and the FMI landscape in New Zealand, and is effective at addressing any problems that could arise.

2. Payments NZ is of the view that what is being proposed may not provide the level of assurance and value that the Reserve Bank is wanting to achieve, certainly if Payments NZ is being asked primarily to provide that assurance. The FMI Bill endeavours to capture the entire FMI infrastructure under the same regime, but many of the matters in the FMI Bill are not relevant to Payments NZ because, unlike the other parties covered by the FMI Bill, Payments NZ does not own or operate infrastructure.

3. Payments NZ has made three submissions previously:

   (i) in May 2013 on the Consultation Document "Strengthening Statutory Payment Oversight Powers";

   (ii) in July 2015 on the Consultation Document "Oversight of Designated Financial Market Infrastructures"; and

   (iii) in May 2016 on the Consultation Document "Crisis Management Powers for Systemically Important Financial Market Infrastructures".

4. As the Reserve Bank will be aware, Payments NZ has separately submitted to the officials undertaking a review of the Reserve Bank of New Zealand Act 1989 (**"RBNZ Act")** as part of the "Safeguarding the future of our financial system" (**"Phase 2")** consultations. This pointed out the linkages with this work and the FMI Bill and, because of this, suggested that the two initiatives should be aligned.

5. The Reserve Bank cover note seeking submissions on the FMI Bill, states that:

   "*... as decisions on the overall structure of the new regulatory regime have already been made, the purpose of publishing the Exposure Draft is specifically to seek views on the more granular and technical detail reflected in the Bill.*"

6. It should be noted that Payments NZ still has concerns in relation to a number of policy matters and may seek to make a submission to the responsible Select Committee reiterating matters it has previously submitted on. However, as requested in the cover note, this submission focuses largely on the details of the FMI Bill as they apply to the circumstances of Payments NZ. In particular, as Payments NZ neither owns nor operates FMI, its position is very different from other parties covered by the FMI Bill.

7. There are a number of specific questions raised in the Reserve Bank's cover note, however, these are largely directed at matters not relevant to the activities of Payments NZ. Some general observations are offered in relation to penalties at the end of the submission.

8. This submission covers the following matters:

   (i) definitions;

   (ii) purpose and principles;

   (iii) powers;

   (iv) rule changes; and

   (v) directors.

Definitions

Operator

9. Payments NZ notes that the definition of "operator" is very broad in scope and includes someone responsible for "maintaining or administering the FMI's rules".

10. In a crisis, purely rule making bodies have little, if any, power to require the rectification of issues with the core FMI. Therefore, Payments NZ does not believe that the scope of the definition of "operator" is appropriate or consistent with the overall purpose of FMI regulation. Such a broad definition is not required to allow the Reserve Bank to effectively manage the risks that may arise in the financial system caused by problems with the FMI, particularly in a crisis.

11. Payments NZ suggests that the second limb of the definition of operator is deleted from the FMI Bill (that is, the second limb of paragraph (a)). Its inclusion appears to be at variance with what is contemplated in Annex D of the PFMIs and it is inconsistent with the approach in Australia and in the UK. Attention is also drawn to the definition of operator in section 2 of the RBNZ Act, which focuses on the party providing clearing, settlement or processing services - and does not cover rule making bodies.

FMI definition

12. The definition of FMI means a "multilateral system for the clearing, settling, or recording ....."

13. Both settlement before interchange ("**SBI**") and the high value clearing system ("**HVCS**") are, from an operational point of view, bilateral systems with participants settling directly with each other. However, it is understood that the Reserve Bank takes the view that these are multilateral systems. This is on the basis that the two systems are subject to the rules of Payments NZ which are, in effect, a multilateral contract. Ideally, this should be clarified in the FMI Bill given it is ultimately a matter of statutory interpretation.

14. Payments NZ believes that the definition of FMI should be split into 2 parts:

    (i) clearing and settlement facilities (following the approach used in Australia and the UK); and

    (ii) to the extent it is necessary, having a definition of payment system modelled on the UK definition of "interbank payment system".

15. This reflects the fact that the risks and issues between the two types of infrastructure are very different and as such should be managed quite differently.

16. The PFMIs apply to the five key types of FMI: payment systems, central securities depositories, securities settlement systems, central counterparties and trade depositories. The FMI Bill will apply to all of these (by virtue of the definition of FMI) and bring them under exactly the same regime[1]. This is in contrast to the approach in

[1] These other FMIs are ESAS, NZClear, CLS and NZCDC (which are designated settlement systems under Part 5C of the RBNZ Act).

Australia and the UK where we see a distinct difference in the nature of regulation between payment systems and that applying to the other FMIs. In this regard, the former has a relatively simpler regulatory model[2] compared to the latter which is far more comprehensive and involved.

Distressed

17. The main ground for the giving of directions or for declaring statutory management depends on the FMI being "distressed". It is noted that grounds (f) and (g) in the definition of this term appear to be drawn from the meaning of systemically important in clause 27. A wide discretion is thereby conferred for the exercise of such interventionary powers and it will be important that there are appropriate checks and balances in place when it comes to the exercise of the discretion on these grounds, in particular.

Rules

18. The definition of "rules" in relation to an FMI is very broad and includes rules "that are evidenced in writing…and whether contained in, or made under, a body's constitution, an agreement, a procedure, a contract, or any other document."

19. Including aspects of the constitution of an FMI as part of the rules of a designated FMI does pose a number of issues. For example, the constitution sets out clearly how any changes or amendments (to the constitution) can be made and it is not clear how directions from the Reserve Bank to make changes would be managed. Furthermore, the constitution is a contract between shareholders and the company and it does not cover all participants.

Participant/Indirect Participant

20. Payments NZ has not previously commented on the detail of the definition of participant and indirect participant, however, the issues will be very different between payment systems (where indirect participants will typically have an agency contract with a bank liable as principal) and clearing houses (where indirect participants will typically have a custodian or sub-custodian who may be a bare trustee).

21. As a more general observation, it is not all that clear how the proposed law will impact on indirect participants, in particular, how the operator is to deal with indirect participants.

[2] In both cases this is based on a definition of payments system which is fairly similar. The transfer of funds is at the heart of the definitions in the two jurisdictions (in Australia, Part 2 of the Payments Systems (Regulation) Act 1998 and in the UK, Part 5 of the Financial Services (Banking Reform) Act 2013). It is also central to the description of payments systems in the PFMIs.

Purpose and Principles

Purpose

22. Clause 3 of the FMI Bill includes as purposes of the Act to:

    (i) promote the maintenance of a sound and efficient financial system; and

    (ii) avoid significant damage to the financial system that could result from problems with an FMI, an operator of an FMI, or a participant of an FMI.

23. Payments NZ notes that these are based on the existing purposes in the RBNZ Act and the Non-bank Deposit Takers Act 2013 ("**NBDT Act**"), both of which are currently under review. In both cases it appears the expressed preference of officials is that the powers be replaced by a single objective of "financial stability". Payments NZ may need to reconsider its own objectives of safety and efficiency in light of this change as well.

24. Payments NZ believes that the soundness and efficiency objectives may still have relevance for the integrity of the payments ecosystem, even if financial stability is introduced as the key objective of banking supervision. As such, it would like to know whether the Reserve Bank will retain the proposed objectives in the FMI Bill and, if so, how it would reconcile those objectives when/if the new objective of financial stability is incorporated into its own core legislation.

Principles for Exercising Powers and Recommendations

25. Clause 13 of the FMI Bill sets out the purposes and principles that the regulator must use when exercising powers. In discussions with the Reserve Bank, Payments NZ has been reassured that the powers in the FMI Bill will not be used as an operational tool – rather they are a "back stop" to address any issues which have been identified by the regulator but which have not been adequately remedied by the designated FMI. In addition, the Reserve Bank has been clear that Payments NZ will not be asked to do something when it does not have the necessary authority to carry it out. In light of this, Payments NZ considers this should be recognised in the list of principles set out in clause 13 by wording, for example, like the following: "the ability or capability of an operator to carry out or comply with an action that is required by a regulator". Payments NZ regards this as vitally important given its limited capacity to compel third parties to undertake or initiate actions.

26. The Reserve Bank previously indicated it would consider the following matters in relation to its oversight powers :

    (i) avoiding duplication of requirements;

    (ii) the desirability of industry led solutions; and

    (iii) maintaining competitive neutrality.

    Payments NZ believes that these matters should be included in the FMI Bill.

27. In addition, the Reserve Bank may wish to consider some of the objectives in the NBDT Act (section 8) such as the importance of sound governance and effective risk management.

28. Payments NZ notes that clause 23 contains a number of matters which the regulator may have regard to when making a recommendation for designation. They include the capability and capacity of the FMI's operators and the FMI, and the financial resources of the operators of the FMI. Payments NZ is unclear as to how these matters would be taken into account when making recommendations in relation to it – given that it only has limited financial resources and it does not actually operate any infrastructure. Payments NZ believes the matters which regulators must have regard to in the FMI Bill should be qualified by the nature and scope of the activities required to be performed by the relevant operator.

29. In relation to matters which must be taken into account when recommending whether an FMI is systemically important, Payments NZ notes that the value or volume of transactions is not listed as a consideration. This does not appear to be consistent with previous statements of the Reserve Bank, nor indeed the PFMIs themselves.

30. As a general observation, it is difficult to discern from the FMI Bill how designation will actually be exercised and over whom. This is when you take into account the range of matters in clauses 23 and 24, and the overlay of the very wide meaning of "systemically important" in clause 27. It is understood also that this term will be clarified in policy guidance to be published by the Reserve Bank. However, it does seem to be a wide and reasonably complex framework on which to base the designation regime - potentially creating uncertainty as to how it will operate or be applied in practice e.g. will designation always follow notwithstanding the quality of the rules and the credentials of the operator?

31. The nature and scope of the designation notice under clause 28(1)(a) will assume critical importance. While the definition of "operator" in the FMI Bill is broad, Payments NZ is reassured that the designation notice will specify clearly who is subject to the regime, in particular, the FMI and its operators, the scope of the system which is being designated and the documentation which constitutes the rules for that system. Potentially it is possible to have more than one operator. Equally it is possible that critical service providers can be specified in the notice. It is noted, however, that there is no definition of critical service provider in the proposed legislation. Payments NZ regards this as an omission, in particular, when Annex F of the PFMIs outlines the oversight expectations for critical service providers in order to support an FMI's overall safety and efficiency.

32. Given the importance of designation, and the ramifications which flow from it, consideration should be given to the consultation in clause 26 being extended to participants (in addition to the operator). Although it is more of a practical matter, the expectation would be that all submissions would go onto the Minister in the interests of natural justice/fairness.

Powers

Previous Submissions

33. Payments NZ refers to its previous crisis management submission – particularly related to Payments NZ's unique position as an "operator" that is only involved in the setting of rules.

34. Payments NZ believes that the FMI Bill should recognise the very different scope and nature of powers needed depending on whether an operator is either:

    (i) providing or managing services under the FMI; or merely

    (ii) maintaining or administering the FMI's rules.

35. If the two categories of operators are to be maintained in the final version of the FMI Bill, it is essential that the FMI Bill addresses the differences in powers required depending on the nature of the operator, following the approach taken in Australia and the UK.

36. As Payments NZ pointed out in its crisis management submission, there are a substantial number of powers which could be exercised in respect of it that it would simply not be in a position to comply with because it does not actually control or manage the infrastructure.

37. Notwithstanding this, the FMI Bill in fact still contains a number of the provisions that apply to operators that Payments NZ simply cannot meet because it does not have the necessary power over either participants or the infrastructure used (including the infrastructure provided by the Reserve Bank).

Standards

38. As understood, the Reserve Bank is still working through the detail of the legally binding standards which will be issued and whether standards should be principles based or more prescriptive. Payments NZ strongly favours the principles based approach which is more fitting for the nature of a standard in any event, and enabling the necessary flexibility when it comes to their application. Payments NZ is reassured by the procedural protections set out in the Bill relating to the issuance of standards.

39. Standards that may be imposed on Payments NZ (if it is deemed to be an "operator"), for example, include standards relating to:

    (i) ***the relationship between operators and persons who provide services to operators for the purposes of the designated FMI*** - Payments NZ, as owner of the rules for the SBI system, has an arrangement with SWIFT as the administrator of a closed user group but has no capacity otherwise to impose requirements on SWIFT. Similarly, the Reserve Bank itself provides services to SBI and HVCS, namely, its exchange settlement account system. Payments NZ has no capacity to impose requirements on the Reserve Bank as a critical service provider;

    (ii) ***capital and liquidity*** - Payments NZ as owner of the rules has limited requirements for capital or liquidity and it is difficult to see the value in imposing

any such requirements on it, hence it is considered that any such standards should not apply to it. It is also not clear that the requirements for capital and liquidity are simply limited to the operator. If they also relate to participants in SBI and HVCS, then again Payments NZ has limited capacity to impose requirements for their capital or liquidity;

(iii) ***risk management*** - Payments NZ as a rules body is not in a position to manage any of the risks referred to in clause 34(1)(e) of the FMI Bill. Moreover it should not be put in the position where it is compelled to do so through a standard which it can only implement by imposing rules; and

(iv) ***FMI contingency plans*** - Payments NZ reiterates the comments made in its crisis management submission on contingency plans. While acknowledging the importance of contingency plans, Payments NZ stressed that it was only able to create contingency plans with the co-operation of participants, SWIFT and the Reserve Bank. Payments NZ cannot be in a position where it is required to have a contingency plan when it has no power to compel parties to produce, or to enter into, one.

40. Payments NZ submits that operators that are only rules bodies should only be subject to clause 34(2) of the FMI Bill and only required to impose standards through rules**,** provided (of course) that they can be implemented.

Directions, remedial plan, statutory management

41. The corollary of the fact that Payments NZ may become subject to standards it cannot comply with, is that there are other provisions in the FMI Bill which give the Reserve Bank powers to compel outcomes that Payments NZ (solely as a rules body) simply cannot fulfil, such as requirements to:

(i) give the regulator a remedial plan (and then comply with it);

(ii) comply with a direction in relation to the sorts of (indeterminate) things it could potentially be used for (as per the open ended nature of clause 78(2)(e)).

42. Ministerial approval is a pre-requisite for the giving of directions, however, Payments NZ notes that Ministerial involvement is currently under review in the Phase 2 consultations. Given the intrusive nature of direction powers, Payments NZ would be concerned if this led to the removal of Ministerial approval for FMI purposes. Payments NZ does, however, support the Reserve Bank's indication that giving directions will be a two-step process, where the regulator will, in the first instance, raise any concern with the operator and provide an opportunity for the issue to be resolved. Only if the response is inadequate, will the regulator then look to use its formal powers of direction. It will be self-evident, but directions should not be used to require an operator to act in breach of other law such as competition law. Otherwise there should be "safe harbour" protection as, Payments NZ understands, is being contemplated in the Phase 2 consultations.

43. Payments NZ believes that the FMI Bill must qualify the Reserve Bank's powers in respect of an operator whose sole responsibility is in relation to managing rules for an FMI, in

particular, to only giving a direction (a workable direction) to that operator in relation to its rules. The potential requirement for a remedial plan should not apply to Payments NZ or any other body solely responsible for rules.

44. Payments NZ reiterates the comments made in its crisis management submission that it is not appropriate to have separate powers in relation to FMI contingency plans. Under clause 34(1)(f) the Reserve Bank has powers to make standards relating to contingency plans. There is no need therefore for separate statutory provisions as contained in subpart 4 (clauses 47 to 52) to also deal with contingency plans and giving rise, as they do, with a somewhat prescriptive approach which Payments NZ has reservations about in terms of the specific requirements that arise. Payments NZ is reassured by the Reserve Bank's indication that contingency plans will remain primarily the domain of the operator with the regulator having back stop powers to require change.

45. It is submitted that contingency plans should be dealt with in standards only.

Other

46. One of the key operators for the New Zealand payments system is SWIFT. This is primarily overseen by the SWIFT Oversight Group of which the G10 central banks are members. The Reserve Bank of Australia is however a member of the SWIFT Oversight Forum which does have input into the oversight of SWIFT.

47. The Reserve Bank may need to consider the extent of its own engagement with SWIFT, given that SWIFT is best placed to resolve an operational crisis in the payments system. It may be possible for the Reserve Bank to join forces with what the Reserve Bank of Australia is doing, especially given the dominance of the big four banks in the New Zealand financial system. It does underscore too the value of the recognition approach that had been originally proposed and which was endorsed by Payments NZ at the time. This had the benefit of direct interaction with providers like SWIFT rather than the Reserve Bank endeavouring to work through someone like Payments NZ.

Rules changes

Overview

48. While noting it presumably is a policy decision, Payments NZ questions the value of requiring FMI rules to be designated. The designation regime in Part 5C of the RBNZ Act was introduced to provide legal certainty for those operating clearing and settlement systems in New Zealand (ESAS, NZClear, CLS Bank and New Zealand Clearing and Depository Corporation (i.e. NZX)) and is valuable for that purpose. It is hard, however, to see what value it adds to the regulation of FMI and particularly crisis management, when the original concept was designed for a totally different purpose.

49. This approach does not appear to have been adopted in any other comparable country. It is noted that the Bank of England has powers to require operators to establish rules, but it doesn't review or designate them.

50. Similarly in Australia payments rules are not designated. The Payments System Board of the Reserve Bank of Australia maintains oversight through its reserve power to impose access requirements or make standards. Regulatory intervention in payments in Australia appears to be very much viewed as last resort and only used where absolutely necessary.

Process for Changing Rules

51. In relation to clearing houses, rules do not tend to be changed particularly frequently and so are easier to designate.

52. On the other hand, given the highly technical nature of the payments system and the evolution of products and services for payments, the rules for payments can, and do, change significantly and much more frequently. They tend to be process focussed compared to standards which are static in nature. Certainty as to when a rule is to come into effect is also very important for payments participants, so that the necessary operational processes can be implemented in good time.

53. Payments NZ was incorporated in 2010. It is coming up to its 38th version of its rule book. Many of the changes that are made are quite technical and because of this they need to be regularly reviewed. The rules themselves are constantly evolving with the fast changing payments ecosystem. The process for updating rules has, in Payments NZ's experience, worked well over the last decade. That has involved including the Reserve Bank at all stages of the process, from the development of business requirements through to the drafting of rule changes. All significant rule changes are referred to the Reserve Bank for "no objection" letters. These letters are typically received reasonably promptly, given the nature of consultation which has occurred throughout.

54. This process is very different from the process for approving periodic changes which are made to other designated systems (two of which are owned by the Reserve Bank).

55. Payments NZ is concerned that introducing a level of formality to the process will make consultation and engagement more formal and legal, and the timeframe for effecting

rule changes more protracted. There are also cost considerations that will arise. Overall this may have a negative impact on the safety and efficiency of the payments system.

56. It is understood from the Reserve Bank that the rules approval process reflects the supervisory role of the regulator but it does not want to own the rule book of Payments NZ and it certainly does not want to concern itself with operational matters. It views the formal requirements in the legislation essentially as back stop measures. Notwithstanding this helpful indication, Payments NZ comments as follows :

(i) it is not clear exactly which of its rules Payments NZ would be required to have designated if, for example, SBI and HVCS were both designated. The current rule book runs to some 1550 pages. The rules for SBI are split between three clearing systems and are split between clearing and settlement requirements (20%) and what are essentially operational requirements for products (80%). Content which can be regarded as being systemically important is blended together with content that is not. In light of this, it is going to be extremely difficult to segregate rules into designated and non-designated sets for the purposes of having them specified under clause 28(1)(b) and as contemplated in the Cabinet Paper;

(ii) the FMI Bill contains a requirement for an operator to make rule changes within 40 working days of receiving the notice from the Reserve Bank requiring a change. There are many circumstances where this simply may not be achievable, when applied to Payments NZ. For example, the Reserve Bank worked with Payments NZ on rule changes to implement better contingency plans following the payments outage which occurred on ANZAC Day 2012[3]. Because of the complexity of the issues, that process took many months to complete and there were quite contentious issues that needed to be worked through with the Reserve Bank. It would not have been possible to determine exactly what changes were required at the outset of the process. In some cases, the Reserve Bank changed its views following discussion and the provision of more information. It would also have been unrealistic to expect Payments NZ to have put rules in place incorporating an updated contingency plan within 40 working days of the notice from the Reserve Bank. Even if it were possible, the process would have been rushed, with a significant risk of mistakes. The same issue applies if the Reserve Bank was not satisfied with the rule change proposed in response to a direction it gave – where the time limit is reduced to 20 working days. The FMI Bill should give operators a reasonable time to implement changes with a back stop power to prescribe a timeframe for completing changes if the Reserve Bank believes changes are being unreasonably delayed;

(iii) on the other hand, there are no time limits imposed on the Reserve Bank. While Payments NZ accepts that there are potential constraints on resources to approve rule changes, like other regulators, there should still nevertheless be a timeframe

[3] Found to be caused by a telco malfunction outside New Zealand.

required for response (even if that timeframe is able to be extended where the complexity or importance of issues require more detailed evaluation); and

(iv) minor and technical changes in the rules appear to be covered by the same approach. This would not be worthwhile or efficient. It is submitted that these changes should be excluded and left to the rules body.

57. While Payments NZ believes that it is unnecessary to designate rules, consideration needs to be given to what approach should be used for changing the rules if designation is to be proceeded with. Payments NZ considers the current approach has proven to have worked well over a number of years with all rule changes and, because of this, it should be retained. It is difficult to see what a prescriptive approach would add. If necessary, this could be backed up with a power to issue a direction if the Reserve Bank had reasonable grounds for being concerned about delays in implementing rule changes. Another approach is the disallowance approach that is evident in Part 5C of the RBNZ Act and, indeed, which was signalled in the Cabinet Paper.

58. In relation to the availability of the rules, it is noted that there is an obligation on an operator of a designated FMI to publish a copy of the FMI's rules on an internet site of the operator (clause 36). Payments NZ considers that there needs to be some scope for withholding aspects of the rules, as is done at present, to protect the integrity of the system.

Directors

Power to Remove

59. Payments NZ reiterates comments made previously that a power to remove or appoint directors of/to an operator of an FMI is of limited practical purpose. It achieves nothing that the Reserve Bank could not achieve through a power of direction. The same issues previously submitted on have not been addressed in the FMI Bill, namely:

    (i) how the Reserve Bank would stop a relevant shareholder simply removing the director which it had appointed;

    (ii) what one director could realistically achieve (given for Payments NZ at least that director would only have one vote out of 11); and

    (iii) how the Reserve Bank would deal with the moral hazard of having an appointed director (and indeed the risk it may be a deemed director itself).

Director Liability

60. In addition, Payments NZ notes that specific offences have been included in the FMI Bill for directors.

61. Payments NZ believes that the director liability provisions go significantly further than is reasonable. In particular, it is not reasonable to impose liability on directors for every offence that a company which is an operator commits.

62. The director liability provisions also go further than the current liability regime for directors of registered banks which is largely limited to liability in respect of disclosure statements. It appears to be modelled on the liability regime for non-bank deposit takers. However, both the liability regime for bank directors and non-bank deposit taker directors are being reviewed as part of the Phase 2 consultations.

63. Payments NZ believes clause 128 of the FMI Bill should be removed.

Criminal/Civil liability

64. More generally, Payments NZ is concerned with the nature and scale of the penalties that are proposed (criminal and civil). In this context it is considered that some of the offences should be re-thought. An example is clause 37 which creates an offence for intentionally or recklessly contravening the obligation to publish a copy of the rules.

65. Reference is made to the 2018 guidelines of the Legislation Design and Advisory Committee, in particular, as to whether a number of the offences actually warrant being created at all. This is so given the good relationship between the Reserve Bank and Payments NZ over the years and the self-governing approach that has proven to have worked well in the circumstances of New Zealand.