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# Financial Market

# Infrastructures Bill –

Payments NZ Submission to Finance and  
Expenditure Select Committee

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**April 2020**

## Introduction

Payments NZ Limited (Payments NZ) welcomes the opportunity to make a submission to the Finance and Expenditure Select Committee on the Financial Market Infrastructures Bill (the FMI Bill). Payments NZ would also like to make an oral submission to the Select Committee.

Payments NZ is a key stakeholder in the governance of the New Zealand payments system. It creates and manages the rules (Rules) relevant to settlement before interchange (SBI) and to the high value clearing system (HVCS), both of which are likely to be designated under the FMI Bill. Further information on SBI and HVCS is attached as appendix 2 to this submission. These Rules facilitate the exchange of payments between financial institutions at an operational level, and this interoperability allows consumers, businesses and organisations that hold funds at different financial institutions to transfer funds to each other seamlessly. However, unlike many of its international counterparts, Payments NZ does not own or operate any infrastructure to enable payments to be made.

This submission will provide an overview of:

- the role of Payments NZ in promoting interoperable, innovative, safe, open and efficient payments systems;
- how the current regulation of the payments system is working; and
- Payments NZ's views on the proposed oversight regime set out in the FMI Bill in respect of pure payment systems.

## Executive summary

The effective functioning of the payments system is critical for the economy. Payments NZ is responsible for promoting interoperable, innovative, safe, open and efficient payments systems and the current self-governance of the New Zealand payments system works well.

The Reserve Bank of New Zealand (the Reserve Bank) has oversight powers in relation to the payment system for the purposes of promoting the maintenance of a sound and efficient financial system.<sup>1</sup> In exercising its strategic oversight of the payments system, the Reserve Bank has been very constructive and effective. It has engaged closely with Payments NZ and the industry and the current regime is "right sized" for New Zealand.

Payments NZ accepts that there has been a move internationally for payments regulators to have greater powers and supports the strengthening of the Reserve Bank's oversight of financial market infrastructures (FMIs) to ensure that it has:

- effective reserve powers should its current approach of working directly with the industry prove ineffective in the future; and
- the ability to directly manage the failure of any systemically important payments infrastructure.

However, while Payments NZ agrees that the Reserve Bank needs greater powers over the

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<sup>1</sup> This is likely to change to protecting and promoting the stability of New Zealand's financial system in future.

participants in, and operators of, pure payments systems in New Zealand, and providers of systemically important payments infrastructure, it does not believe the designation regime set out in the FMI Bill is appropriate in respect of pure payment systems.

Payments NZ's primary concerns are that:

- the designation process required for operators of pure payment systems could divert from what should be the key focus of the FMI Bill – how to ensure the security and efficiency of the payments system and to manage any crisis that may occur;
- the Payments NZ Rules are constantly evolving to deal with on-going changes to the way New Zealanders want to make payments and to deliver greater efficiencies and, if the Rules are designated, the formal approval process for rules changes outlined in the FMI Bill will add significant time to this process and could potentially slow down innovation;
- the FMI Bill does not recognise the different powers which are needed depending on whether an “operator” is providing services or maintaining rules; and
- the FMI Bill does not capture systemically important payments infrastructure directly – it requires Payments NZ to impose standards (e.g. in respect of business continuity) on providers of systemically important payments infrastructure (particularly global and domestic payment switches and gateways). However, Payments NZ is not in a position to compel providers of key infrastructure to comply with these standards because it does not have any regulatory powers.

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

- providing or managing services under the FMI; or
- maintaining or administering the FMI's rules.

Payments NZ also believes the Reserve Bank should have direct powers over providers of key infrastructure so that it can ensure that critical services continue to be provided in all circumstances.<sup>2</sup>

In respect of pure payment systems, Payments NZ is of the view that a sound and efficient payments system, with lower compliance costs, less duplication of effort and better industry engagement, could be achieved if the FMI Bill:

- operated a recognition regime in respect of systemically important pure payments systems (as opposed to the proposed designation regime), whereby systems considered to meet a pre-determined set of criteria for systemic importance would be formally recognised and subject to oversight; and
- instead of relying on Payments NZ to exercise indirect control over providers of key infrastructure, gave the Reserve Bank direct power over them to:
  - exercise certain information gathering powers;
  - impose standards consistent with the international standards in the Principles for Financial Market Infrastructures;

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<sup>2</sup> Consistent with the Reserve Bank's objectives for FMIs as set out in the Reserve Bank's 2015 policy statement “Oversight of Financial Markets Infrastructure in New Zealand” (FMI1).

- require their involvement in FMI contingency plans; and
- put distressed providers of key infrastructure into statutory management using the powers of the FMI Bill (as opposed to the Corporations (Investigations and Management) Act 1989).

The new regime has significant consequences for Payments NZ, both in terms of what has to be done for the purposes of embedding the regime and what has to be done in terms of its ongoing operation<sup>3</sup>. Payments NZ questions the value of the proposed changes in relation to its operational activities, especially given that the current arrangements are working well and all that is needed to meet international principles is for the Reserve Bank to have better crisis management powers and backstop regulatory powers if the current collaborative approach breaks down.

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<sup>3</sup> There will be regular self-assessments required every two years in accordance with the (extensive) CPSS-IOSCO Disclosure framework for financial market infrastructures and the CPSS-IOSCO Assessment methodology for the principles for FMIs prescribed by the Bank for International Settlements (BIS) and the International Organization of Securities Commissions (IOSCO)

## Role of Payments NZ

Payments NZ is a limited liability company owned by the eight banks who were the existing settlement banks at the time that Payments NZ was formed in 2010 (to take over the governance of the payments system from the New Zealand Bankers' Association). The shareholders are: ANZ Bank New Zealand Limited, ASB Bank Limited, Bank of New Zealand, Citibank, N.A., The Hongkong and Shanghai Banking Corporation Limited, Kiwibank Limited, TSB Bank Limited and Westpac New Zealand Limited.<sup>4</sup>

The establishment of Payments NZ followed a review of New Zealand's payment system arrangements and was shaped by the following priorities of the Reserve Bank:

- its objectives, as set out in its "Statement of principles: payment system oversight" (PS1), and
- its expectation that all payment systems operating in New Zealand should comply with the Committee on Payment and Settlement Systems (CPSS) Core Principles for Systemically Important Payment Systems<sup>5</sup>, unless there are compelling reasons for non-compliance in the particular circumstances (e.g. taking into account specific New Zealand conditions).

Payments NZ opened up direct access to the payments system to non-banks for the first time and, through improved transparency and governance arrangements, went a long way to ensuring that New Zealand's payments system complied with the relevant CPSS Core Principles for Systemically Important Payments Systems.

Since 2012, Payments NZ has continued to focus on compliance with the Principles for Financial Market Infrastructures and to ensure that it meets the Reserve Bank's objectives for FMIs<sup>6</sup>, in particular by providing:

- clear and transparent governance arrangements that promote soundness and efficiency;
- sound risk-management frameworks;
- clear and certain final settlement;
- appropriate failure to settle mechanisms to minimise disruptions associated with the failure of one or more participants;
- the ability to continue to provide critical services in all circumstances;<sup>7</sup>

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<sup>4</sup> The shareholding in Payments NZ is proportionate to the amount that each bank had contributed to the New Zealand Bankers' Association over the preceding three years – effectively a proxy for the value they had contributed to the development of the Rules at that time.

<sup>5</sup> CPSS is a committee of the Bank for International Settlements. It replaced the Core Principles for Systemically Important Payment Systems in 2012 when it released the Principles for Financial Market Infrastructures (PFMIs). In 2014 CPSS became the Committee on Payments and Market Infrastructures. The Committee sets international standards that promote the safety and efficiency of payment, clearing, settlement and related arrangements that are considered essential to strengthening and preserving financial stability. The Reserve Bank responded to the more stringent guidelines in the PFMIs in March 2015 by releasing the FMI1 policy statement to replace PS1.

<sup>6</sup> As set out in the Reserve Bank's 2015 policy statement "Oversight of Financial Market Infrastructure in New Zealand" (FMI1).

<sup>7</sup> Payments NZ requires participants to meet resilience requirements specified in the Rules (and conduct testing in relation to these requirements), however, because Payments NZ does not own or operate any infrastructure, it cannot ensure the continued provision of critical services by critical service providers that are not participants.

- objective, risk-based and publicly disclosed criteria for participation which promote fair and open access;
- efficiency and effectiveness in meeting the requirements of participants and the market they serve; and
- publication of relevant rules and key procedures with sufficient information to enable participants to understand risks, fees and other material costs incurred through participation.<sup>8</sup>

Payments NZ operates in accordance with its Constitution and its Rules. All participants in Payments NZ's clearing systems have agreed to be bound by the Rules which are, in effect, a multilateral contract between participants and between Payments NZ and its participants. The Rules set out the framework for access to, participation in and governance of each of the four clearing systems which Payments NZ oversees (described below). The Rules provide a clear, transparent, and enforceable legal basis for each material aspect of its activities, including:

- access to clearing systems;
- risk management;
- security and operational reliability;
- system resilience;
- participant default; and
- legal clarity in relation to end to end clearing and settlement of transactions and when debts are created and discharged.

Payments NZ's objectives, as set out in its Constitution are to:

- manage the Rules;
- promote interoperable, innovative, safe, open and efficient payments systems;
- encourage and facilitate new entities becoming participants in clearing systems based on fair and reasonable public access criteria; and
- facilitate interoperability of payments between participants on legally appropriate and fair and reasonable terms.

Payments NZ's participants are financial institutions<sup>9</sup> that have joined one or more of the following four payment clearing systems managed by Payments NZ which allows them to exchange payments directly with other participants efficiently and securely pursuant to the Rules:

- Bulk Electronic Clearing System (BECS) (direct debits, electronic credits, bill payments and automatic payments);
- Consumer Electronic Clearing System (CECS) (EFTPOS and ATM transactions);
- Paper Clearing System (PCS) (cheques); and

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<sup>8</sup> Payments NZ Rules clearly set out information to enable participants to understand the risks, fees and other material costs of participation. While it does not make all relevant rules publicly available, it provides copies to those with a genuine business need/interest. Its Access Rules are published on the website.

<sup>9</sup> The financial institutions are all regulated entities and mostly are registered banks prudentially regulated by the Reserve Bank.

- High Value Clearing System (HVCS) (same day cleared payments, NZD cross-border payments).

## **Governance arrangements**

In accordance with its Constitution, Payments NZ is governed by a board of directors. The board is made up of three independent directors and eight directors appointed by shareholders. Directors must act in the best interests of Payments NZ and resolutions (including changes to the Rules) can be passed by a majority of directors.

Payments NZ's Constitution also establishes management committees for each of its clearing systems. A range of matters have been delegated to management committees, including responsibility for the rules and standards relating to the clearing systems. Each participant in the clearing system is entitled to nominate a member for appointment to the management committee. This ensures that all participants in a clearing system can have direct input into, and voting rights in relation to, the development of rules and standards for the clearing system. In carrying out these responsibilities, management committees must act in the best interests of Payments NZ and with the principal objective of ensuring the efficient operation and management of the clearing system.

Good payment system governance requires that all affected stakeholder voices are heard, and Payments NZ has established a membership programme to engage with organisations who have an interest in the ongoing development and strategic direction of New Zealand's payments system. It is through this programme that effective and on-going stakeholder engagement is undertaken (in the context of the wider payments ecosystem).

## **Access to the payments system**

Payments NZ encourages and facilitates new entities becoming participants in its clearing systems in accordance with the access provisions in the Rules.

Since Payments NZ was formed, it has continued to review the provisions of the Rules relating to access (Access Rules) to ensure that they remain objective, fair and risk-based, without imposing any unwarranted barriers to access. The board has delegated authority for determining access applications to the independent directors.

The Access Rules require an applicant to satisfy one overarching access criterion, namely that an applicant will not, if it becomes a participant in a clearing system:

- adversely affect the integrity and reputation of the clearing system; or
- introduce significant risk into the clearing system.

The Access Rules specify prudential, operational and operational risk management requirements in relation to the clearing systems and provide that an applicant can satisfy the access criterion by demonstrating it complies with these requirements.

## Promoting interoperable, innovative, safe, open and efficient payment systems

As stated above, management committees are responsible for ensuring the efficient operation and management of the clearing systems. New Zealand's payments system allows customers to pay and receive money easily, safely and securely and in a timely manner. To enable payments, other than cash, the Payments NZ Rules cover the following steps:

<b>Initiation:</b>	the process by which the initiating customer requests a payment be made.
<b>Authorisation:</b>	approval by the initiating customer's financial institution of the payment request.
<b>Clearing:</b>	reconciliation of the payment data, transmission of the payment data between financial institutions, and calculation of potential settlement positions.
<b>Settlement:</b>	discharge of financial obligations between two or more parties (financial institutions, initiating and beneficiary customers, etc).
<b>Posting:</b>	the process of making the funds available to the beneficiary customer.
<b>Notification:</b>	the provision of information to the parties involved in the payment process (financial institutions, initiating and beneficiary customers, etc.) to confirm the status of the payment.

These mechanisms, together with the people and organisations that make and receive payments, comprise the payments ecosystem.

However, it should be noted that Payment NZ's jurisdiction is limited to the participants (who are party to the Payments NZ Rules). There is no legal or formal ability on the part of Payments NZ to take action in respect of, or to require things to be done by, organisations that are not participants, in particular, providers of key infrastructure. This presents a challenge because Payments NZ does not own or operate any payments infrastructure itself and therefore has limited ability to assist the Reserve Bank with one of its key objectives for FMIs, namely, to continue to provide critical services in all circumstances.<sup>10</sup>

## Payments Infrastructure in New Zealand

A diagrammatic overview of New Zealand's payments system is attached as appendix 1 to this submission.

The key infrastructure provider relied upon to operate both New Zealand's retail and wholesale payments systems is SWIFT<sup>11</sup>. This is a global cooperative of banks based in Brussels that transmits payment orders between financial institutions. It does not transmit funds, which happens on an interbank basis. SWIFT is regulated by a College of Regulators (being a number of the major central banks around the world, including the Reserve Bank of

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<sup>10</sup> As set out in the Reserve Bank's 2015 policy statement in FMI1 ("Oversight of Financial Market Infrastructures in New Zealand").

<sup>11</sup> The Society for Worldwide Interbank Financial Telecommunications.



Australia).

Domestically, New Zealand has two payment switches (Paymark and Eftpos NZ) that are responsible for running the country's fleet of Eftpos terminals, arranging for payments to be authorised and providing the data to enable settlement to occur. Both switches have in the last eight years been sold by New Zealand banks to international terminal providers.

Credit card transactions and, now a significant number of debit card transactions (i.e. contactless), are switched and settled through global credit card systems located offshore. Visa and Mastercard are the largest providers of infrastructure to support card transactions in New Zealand.

Many internet-based transactions are supported by specialist gateway providers – with the largest of these being Windcave. There are also a number of other providers of payment gateway (such as Paypal and Stripe) and switching services (for example, ACI in respect of ATM switching) and core applications for mobile payments such as Finzsoft.

All this infrastructure sits outside the control of Payments NZ.

## Payments NZ Rules

The Payments NZ Rules run to some 1550 pages and the 40<sup>th</sup> version of the Rules has recently come into effect. Since Payments NZ was established, the rule set has been steadily renovated and new rules and procedures have been regularly introduced to deliver greater efficiencies to, and improve the security of, the clearing systems, for example:

- settlement before interchange, which enables participants to settle payments before exchanging the payment information with other participants – BECS, CECS and PCS;
- common standards for clearing and settlement of EFTPOS and ATM transactions, including standards for contact chip cards and mobile devices – CECS;
- a notification process for same day cleared payments to enable migration from bank cheques by providing certainty of payment – HVCS;
- rules relating to default (including facilitating the implementation of the Reserve Bank's 'open bank resolution' policy in BS17);
- new rules to provide for cleared funds for electronic credits designed to reduce customer settlement risk and speed up customer access to cleared funds; and
- compliance rules requiring participants to: conduct testing, attest to resilience, attest to their ability to conduct payments in accordance with the Rules, and notify material information that may have an adverse effect on their ability to comply with the Rules.

The Rules change quite significantly and quite frequently. This is because of the fast changing and dynamic payments ecosystem<sup>12</sup> and the need for the Rules to keep pace with the market. This is a constant endeavour.

The rules relevant to SBI are split between the three clearing systems, and between clearing and settlement requirements (20%) and what are essentially operational requirements for products

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<sup>12</sup> As emphasised in the latest quarterly review of the Bank for International Settlements (BIS), published in March 2020.

(80%). Content which can be regarded as being systemically important is blended with content that is not. It is noted that if the Rules were to be designated under the FMI Bill, it will be a significant challenge to segregate them into designated and non-designated sets for the purposes of having the appropriate ones specified in the designation notice.

## Current oversight of payments systems

The Reserve Bank currently has oversight powers in relation to the payments system for the purposes of promoting the maintenance of a sound and efficient financial system.<sup>13</sup>

Notwithstanding that prudential regulation of the payments system is light-handed, and the Reserve Bank currently has limited statutory powers to prudentially supervise the payments system, New Zealand has developed one of the most secure and efficient payments systems in the world. The Reserve Bank's active engagement with the 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. New Zealand's reputation for efficient, competitive and effective payments systems is based on:

- the number of electronic transactions per person being amongst the highest in the world;
- New Zealand having one of the lowest unit cost per transaction rates in the world;
- a perception that New Zealand has one of the most resilient payments systems in the world;
- the high penetration in the market for point of sale services;
- the wide reach of the ATM network;
- the world leading SBI system which has substantially eliminated inter-participant settlement risk for retail payments (this had already happened with wholesale payments). Elimination of settlement risk is a key consideration under the international principles;
- the comparatively low levels of payments fraud;
- the relative ease and speed of bringing products to market;
- very low cash in circulation relative to GDP, with low usage of cash for payments;
- the rapid decline of cheque usage; and
- New Zealand's highly banked population.

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. Even the international principles acknowledge that there was no failure of payments systems during the global financial crisis. Certainly, payments systems in New Zealand did not fail.

Ultimately, Payments NZ believes that 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 proven to be effective.

Payments NZ works closely with the Reserve Bank in carrying out its functions. The Payments NZ Constitution expressly provides that a representative of the Reserve Bank:

- may be invited to attend meetings of the board (which has been a standing invitation); and

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<sup>13</sup> Part 5B Reserve Bank of New Zealand Act 1989.

- is entitled to attend meetings of its four management committees.

In addition, there are meetings between the Deputy Governor of the Reserve Bank and the Payments NZ board, the Reserve Bank and the independent directors of Payments NZ and quarterly meetings at the executive level. No rule changes have been introduced by Payments NZ without the Reserve Bank's knowledge and without obtaining confirmation from the Reserve Bank that it has no objection to the proposed amendments.

In many instances, changes have been made in response to concerns expressed by the Reserve Bank. Examples of this include:

- the development of a comprehensive industry incident management plan to deal with operational problems in the payments system;
- 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 the access criteria.

All of these changes have occurred in an efficient manner.

The changes and progress made by Payments NZ have underscored the value of the constructive relationship with the Reserve Bank and that 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 skills, operational and strategic expertise, and specialist thought leadership and legal expertise to deliver outcomes that are efficient and effective. The way in which the Reserve Bank has actually exercised its strategic oversight of the payments systems and its practice of widespread engagement has been very positive and effective. The current regime is, in fact, "right sized" for New Zealand and Payments NZ believes that it only needs relatively limited change to address the key concerns.

In short, Payments NZ does not believe that there is a major problem in the New Zealand payments systems. It does, however, accept that there are international trends for payments regulators to have greater powers. But for New Zealand these should only be used as a "backstop" if the existing collaborative approach were to break down.

In the New Zealand market, we believe there is a good 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 in order to comply with international principles, where appropriate. To reiterate, market led solutions and the Reserve Bank's current approach to oversight have a record of working well.

## FMI Bill

The international standards in the Principles for Financial Market Infrastructures apply to five key types of FMIs:

- systemically important pure payments systems;
- central securities depositories;
- securities settlement systems;
- central counterparties; and
- trade depositories.

The FMI Bill will apply to all five types and bring them under exactly the same regime. This is in contrast to the approach that is adopted in Australia and the United Kingdom<sup>14</sup> where there is a distinct difference in approach in the nature of regulation between (systemically important) payment systems and that applying to the other four types of FMIs. In this regard, the former has a relatively simpler regulatory model compared to the latter which is far more comprehensive and involved. This is explained because of the critical roles that these other FMIs have in the markets they serve, and the automatic assumption of their systemic importance and because they actually own the infrastructure used to clear and settle transactions.

Payments NZ agrees that New Zealand needs legislation, primarily to ensure that New Zealand complies with international principles and to address the matters raised by the International Monetary Fund (in the Financial Sector Assessment Programme of April 2017). However, Payments NZ believes New Zealand can be afforded a relatively high level of flexibility in meeting international principles because:

- the current self-governance of the New Zealand payments system is working well;
- the Reserve Bank has been able to effectively exercise regulatory oversight by working directly with the payments industry; and
- there has been no failure in the New Zealand payments system.

As such, all the legislation needs to do is ensure that the Reserve Bank has:

- effective reserve powers should its current approach of working directly with the industry prove ineffective in the future; and
- the ability to directly manage the failure of any systemically important payments infrastructure.

Specifically, Payments NZ believes that this legislation should focus on giving the Reserve Bank:

- greater powers over participants in and, operators of, pure payments systems as well as providers of key infrastructure – particularly with respect to investigations and the power to require information (but mainly as a “backstop”);
- a graduated range of enforcement powers;

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<sup>14</sup> 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 definition of payments systems in the international principles in the PFMIs.

- an ability through secondary legislation to impose the more prescriptive requirements of international principles and to do this directly on providers of key infrastructure; and
- appropriate crisis management powers.

Payments NZ supports the approach which the Reserve Bank articulated in its 2015 consultation<sup>15</sup> where it stated that it would consider the following objectives, when developing the FMI Bill:

- avoiding duplication of requirements;
- minimising compliance costs;
- desirability of industry-led solutions; and
- maintaining competitive neutrality.

Payments NZ believes that the FMI Bill does not achieve these objectives as well as it could in respect of the pure payments systems (of which Payments NZ would be an operator). In particular, it would not achieve the objective of minimising compliance costs. It also risks duplicating functions and risks moving away from the current industry led collaborative approach.

Payments NZ's two primary concerns are that:

- the designation process required for operators of FMIs could divert from what should be the key focus of the FMI Bill – how to ensure the security and efficiency of the payments system and to manage any crisis that may occur; and
- the FMI Bill requires Payments NZ to impose standards (e.g. in respect of business continuity) on systemically important payments infrastructure or providers of key infrastructure (particularly global and domestic payment switches and gateways). However, Payments NZ is not in a position to compel these providers of key infrastructure to comply with these standards because the providers of key infrastructure are not participants and Payments NZ does not have any regulatory powers. Accordingly, Payments NZ believes the Reserve Bank should have direct powers over providers of key infrastructure and not rely on Payments NZ to impose standards for the Reserve Bank.

## Designation

As Payments NZ understands, the designation regime which currently exists in the Reserve Bank of New Zealand Act 1989 (the Reserve Bank Act) was introduced to meet the conditions set by CLS Bank for its entry into the New Zealand market. CLS Bank is a New York-based bank owned by a number of world-leading financial institutions. It was designed to ensure that cross currency settlements occur simultaneously across the world to avoid the risks associated with a bank in one country making a payment before it receives a corresponding amount from a bank in another country. The designation regime was designed primarily to ensure that CLS Bank would have absolute legal certainty that its rules would be enforced in accordance with their terms in New Zealand – and in particular, there would be no New Zealand legislation which could

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<sup>15</sup> Reserve Bank of New Zealand “Oversight of Designated Financial Market Infrastructures” April 2015.

override its rules (e.g. provisions in New Zealand's insolvency regimes or the regimes governing the granting of security such as the Personal Properties Securities Act 1999).

Since then, NZX's system for trading and settling securities has been designated (NZCDC) and the Reserve Bank has designated both its security settlement system (NZClear) and its system that enables interbank payments to be cleared and settled (the Exchange Settlement Account System- ESAS). Given the volume of trading in those systems and the critical importance of legal certainty to participants about their trading, designation of those systems makes sense.

Payments NZ, however, decided that it was not necessary for its own Rules to be designated under Part 5C of the Reserve Bank Act. This was because they deal predominantly with the form of payment instruments that will be accepted and the file formats and processes for exchanging those files. The Rules provide that the actual settlement must effectively take place through ESAS (operated by the Reserve Bank). This is what gives legal certainty that transactions effected either in the HVCS or the retail payment system (SBI) can be settled without the risk of being unwound. Settlement finality is thus assured in any event through the designation of ESAS.

Furthermore, unlike those systems which are designated, the Payments NZ's Rules are constantly evolving to deal with rapid changes in the market. As noted above, since 2010 there have been 40 versions of Payments NZ's Rules. The more formal approval process proposed in the FMI Bill, compared to the previous no-objection approach, will add significant time, cost and effort to this process. This could be compounded by the Reserve Bank becoming "a more orthodox regulator"<sup>16</sup> and not having the same level of ongoing engagement as previously, in particular, not being involved from the outset and throughout in the development of rules. This risks duplicating work, adding compliance costs and moving away from an industry led approach (some of the core considerations relied on by the Reserve Bank when designing the regime).

If each new version has to be designated, the evolution of the Rules will slow down significantly and the costs associated with change are likely to be significantly greater. Payments NZ understands that, in contrast, changes to the rules of ESAS, NZClear and NZCDC are rare.

Payments NZ is not aware of any other jurisdiction which has adopted a similar approach to the regulation of systemically important payments infrastructure (i.e. which requires designation of the operators of payments systems and, with that, the designation of rules). Most other jurisdictions simply ensure that their regulator can exercise powers over payment systems (and settlement systems) that meet a statutory test of systemic importance. This is Payments NZ's preferred approach. It believes this approach is simpler and focuses on ensuring the Reserve Bank has powers to intervene where necessary – namely:

- reserve powers that are exercisable if its current approach of working directly with the industry proves ineffective in the future; and
- crisis management powers. In practice, these would be unlikely to apply to Payments NZ as it does not actually own or operate any payments infrastructure itself. However, crisis management powers should be available directly in respect of systemically important payments infrastructure and providers of that key infrastructure.

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<sup>16</sup> Per the letter dated 30 January 2020 from the Reserve Bank to Payments NZ.

## Providers of key infrastructure

One of the key objectives for FMIs is to ensure the ability to continue to provide critical services in all circumstances.<sup>17</sup> As noted already, Payments NZ does not operate any payments infrastructure at all (let alone systemically important payments infrastructure) and it has no jurisdiction beyond the participants who are party to the Rules. Much of New Zealand's systemically important payments infrastructure is provided by large global organisations that Payments NZ has little, if any, practical influence over (given the small size of the New Zealand market) e.g. SWIFT, Visa and Mastercard.

The FMI Bill contains a substantial number of powers which could be exercised in respect of Payments NZ that it would simply not be in a position to comply with because it does not actually control or manage systemically important payments infrastructure (including the infrastructure provided by the Reserve Bank).

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

- providing or managing services under the FMI; or merely
- maintaining or administering the FMI's rules.

Even if this indirect approach were adopted, there would still be a critical gap because there are no crisis management powers in respect of this payments infrastructure. Instead, the Reserve Bank (in respect of pure payment systems) will have to rely on general insolvency law and/or, if the appropriate threshold is reached, intervention by the Financial Markets Authority through the Corporations (Investigations and Management) Act 1989. This significant gap has not been caught by the tailored crisis management/statutory management provisions in the FMI Bill which are largely intended to deal with failure in the other four types of FMIs.

Payments NZ is therefore concerned about its ability both to deliver a contingency plan and to enforce standards over providers of key infrastructure that actually operate systemically important payments systems. The Reserve Bank has reassured Payments NZ that it will not be asked to do something when it does not have the necessary authority to carry it out. Payments NZ considers that 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.

Ultimately, Payments NZ is concerned about having obligations imposed on it to require compliance from providers of key infrastructure with which it has a limited relationship and over which it has limited influence.

In Payments NZ's experience, large global organisations (such as the providers of key infrastructure) will always ensure that they are compliant with the rules and regulations imposed by a regulator (such as the Reserve Bank) in the countries in which they operate. It can sometimes present challenges to secure voluntary submission to requirements when sought by a self-governing body like Payments NZ, particularly in a small country.

In summary, Payments NZ believes that the Reserve Bank should have direct powers over

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<sup>17</sup> Per the Reserve Bank's policy statement in 2015 (FMI1).



systemically important pure payment systems to require information, to impose standards and to have crisis management powers over the payments infrastructure that enables payments to be made. This could be achieved by including providers of key infrastructure in the definition of an operator of an FMI. This will be easier if the designation does not always need to specify rules. A definition of critical service provider would also be desirable, as was previously contemplated in the Reserve Bank's 2013 consultation. It needs to be kept in mind too, the importance attributed to providers of key infrastructure by the Principles for Financial Market Infrastructures in order to support the FMI's overall safety and efficiency (Annex F refers).

## **Other matters**

### *Definition of operator*

"Operator" is defined in the FMI Bill as a person who provides or manages services under the FMI or who maintains or administers the FMI's rules. Payments NZ does the latter but it does not do the former. It is purely a rules making body without involvement in payments infrastructure. Payments NZ thinks the definition of operator is somewhat unusual, if not artificial, by embracing a rules body. The framing of the definition is inconsistent with the approach in Australia and the UK and appears to be at variance with the Principles for Financial Market Infrastructures (at Annex D). The definition of operator in section 2 of the Reserve Bank Act also talks about providing clearing, settlement or processing services and, in contrast, does not endeavour to bring in rule making bodies.

### *Penalties*

In its submission to the Reserve Bank on the FMI Bill, Payments NZ made reference to the 2018 guidelines of the Legislation Design and Advisory Committee, in particular, concerning the number of offences and the severity of the penalties that had appeared in the Exposure Draft of the FMI Bill. Some of the offences have subsequently been turned into civil matters (liability for pecuniary penalties), in particular, where they relate to technical or minor procedural matters. Payments NZ does, however, continue to question the need for so many penalty provisions in the FMI Bill, in particular, in the context of the good relationship with the Reserve Bank over the years and the self-governing relationship that has proven to have worked well in the circumstances of New Zealand. It asks the Committee to have the officials further test the penalty provisions against the 2018 guidelines to ensure that they are limited only to those that are strictly necessary.

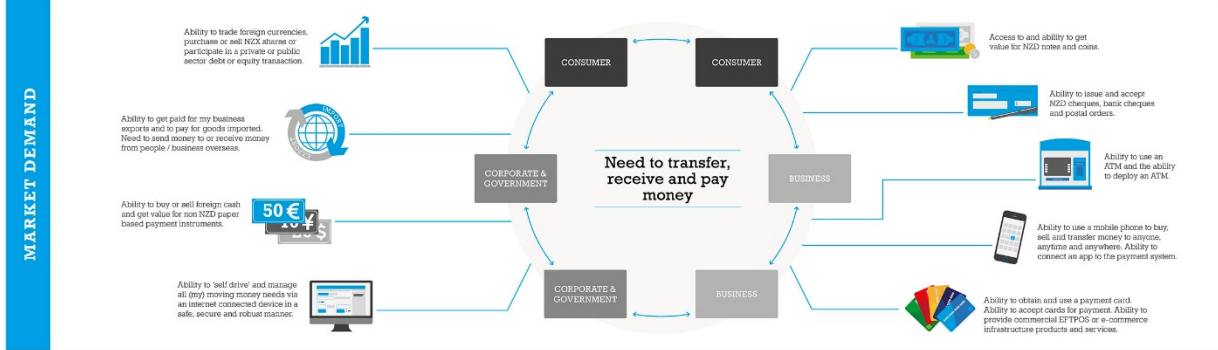
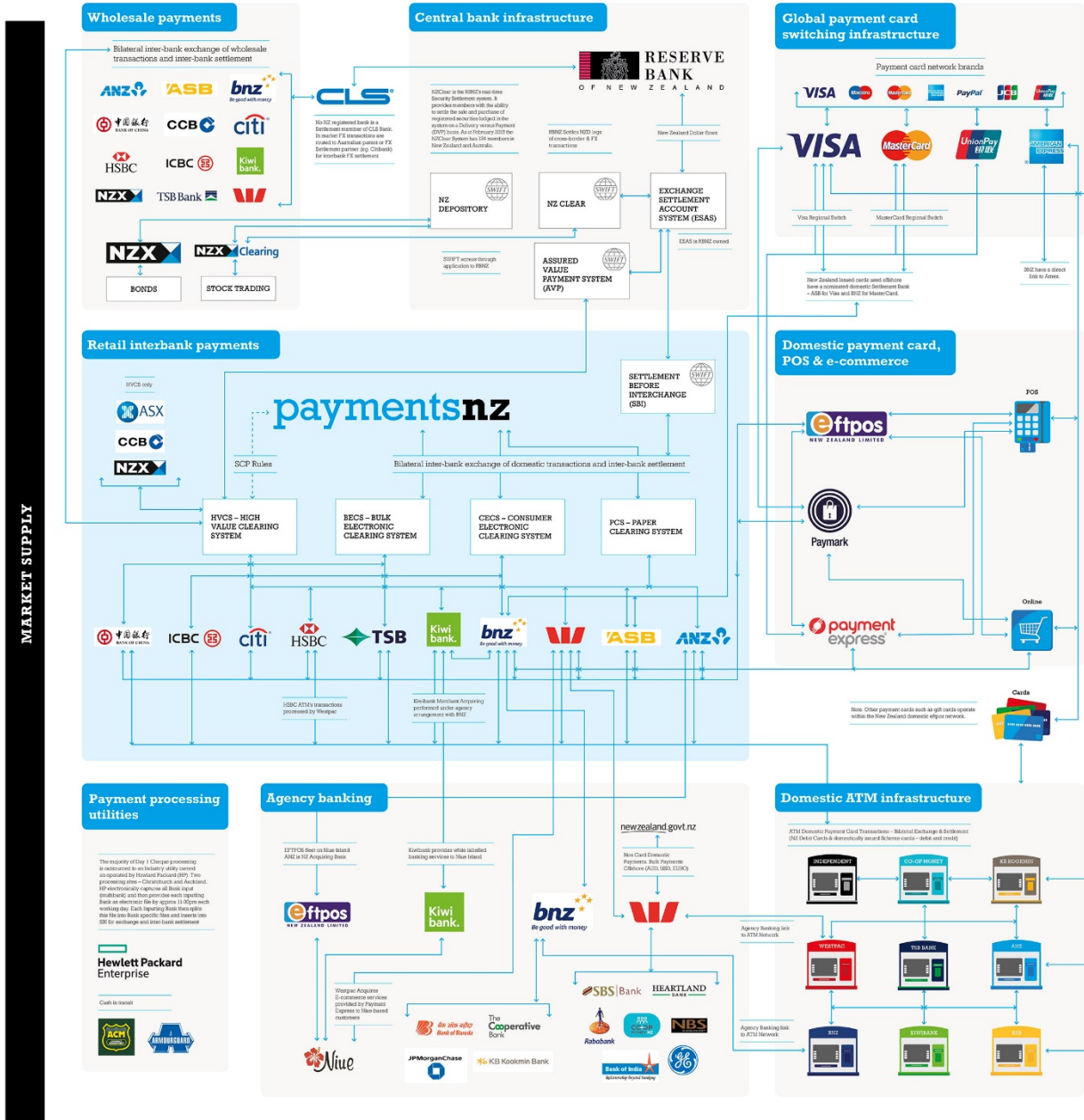
Thank you.



Steve Wiggins  
Chief Executive  
Payments NZ Limited

# APPENDIX 1 – OVERVIEW OF THE NEW ZEALAND PAYMENTS SYSTEM

## Payments Ecosystem Map



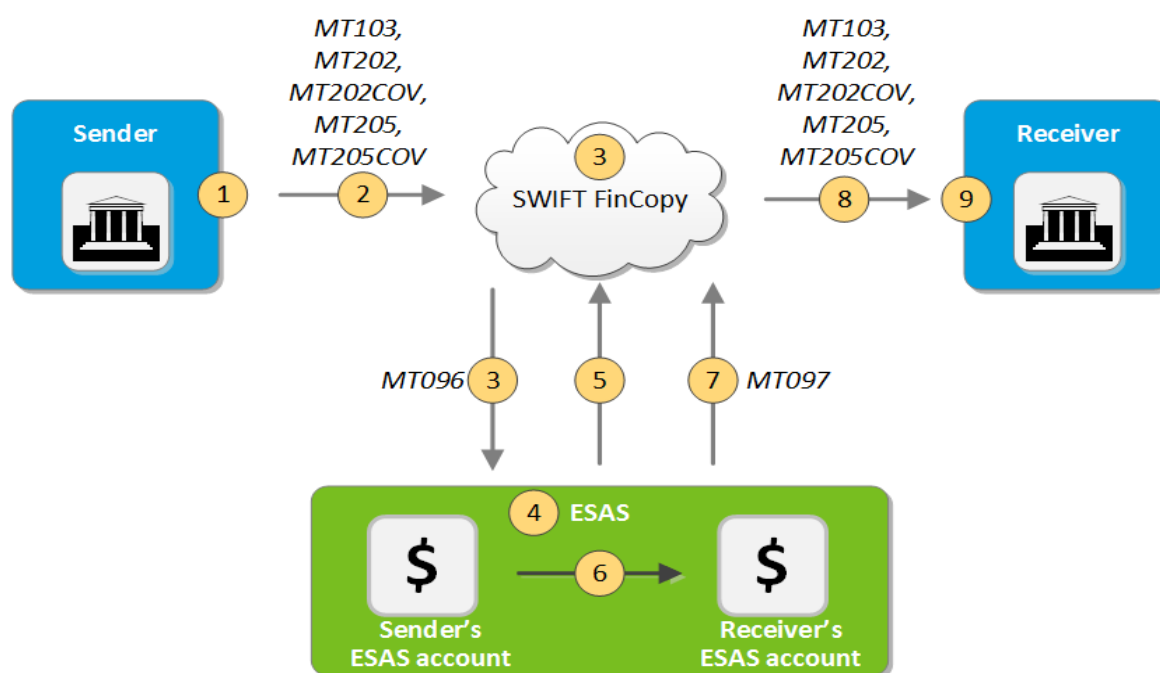
Disclaimer: This Payments Ecosystem map is a representation only of New Zealand's core payments ecosystem. While Payments NZ has made every effort to illustrate the ecosystem accurately, Payments NZ takes no responsibility for any errors or omissions and will not be liable for any loss sustained in reliance on this information. Map updated: October 2018

## APPENDIX 2 – EXPLANATION OF HVCS AND SBI

### High Value Clearing System

The high value clearing system is the system mainly used by banks to make payments to each other. It has a relatively low volume of often very high value settlements in it. One of its features is that all payments once made are irrevocable and cleared: For that reason it is also used for things like house settlements (instead of the traditional bank cheque).

### High Value Clearing System – diagram



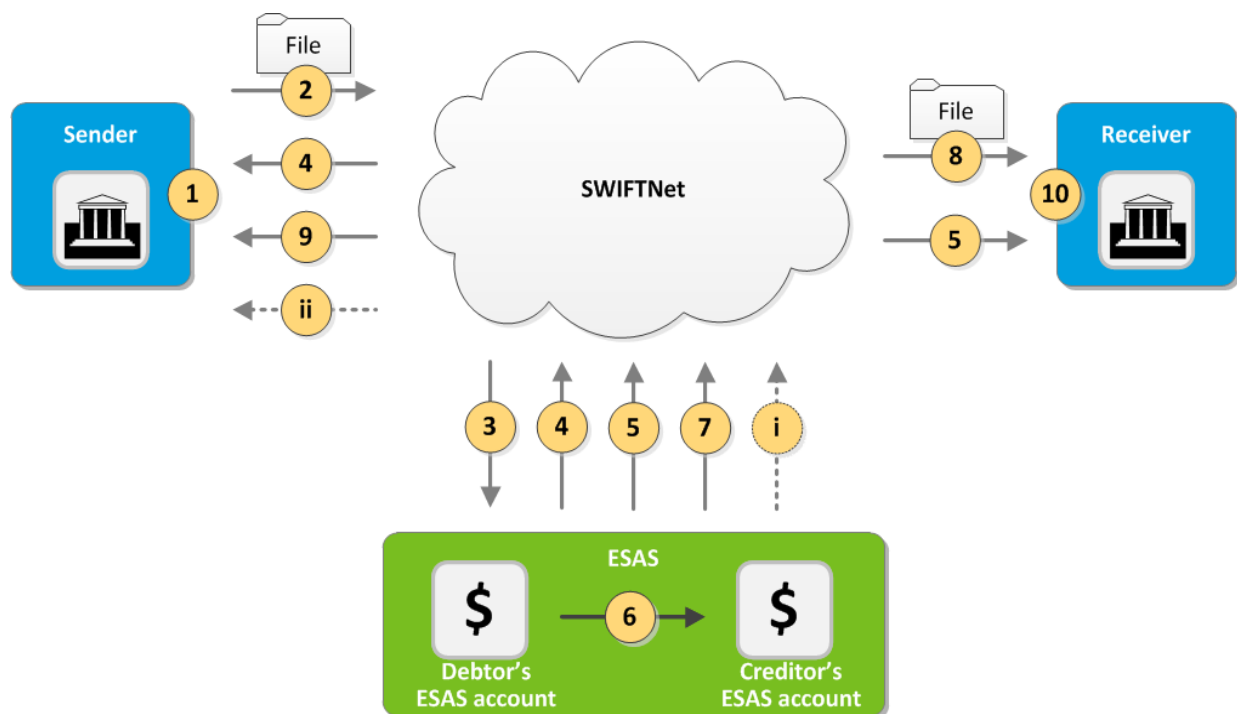
### How the system works

1. The sender prepares one of the listed payment messages and puts the service code AVP in field tag 103 of the message.
2. The sender sends the message for the receiver to SWIFT for FINCopy (in Y mode) processing.
3. SWIFT checks that the sender and the receiver are AVP CUG members, validates the message content and sends a settlement request to ESAS in the form of an MT096-FINCopy
4. ESAS validates the structure of the MT096 message, generates a transaction, and enters the transaction in the ESAS database.
5. Transaction flow if transaction fails validation
6. ESAS debits the sender's account and credits the receiver's account
7. ESAS sends an MT097 - FINCopy message authorisation/refusal notification message
8. SWIFT FINCopy releases the transaction to the receiver
9. SWIFT FINCopy sends an MT012 -sender notification message - to the sender confirming settlement

## Settlement Before Interchange (SBI)

SBI stands for settlement before interchange and is the system, unique to New Zealand, whereby retail payments, such as internet banking payments, social welfare payments, direct debits, automatic payments and cheques, are exchanged between banks. Under this system money is paid between banks before the file is exchanged and the receiving bank obliged to credit its customers. It is effectively a payment before delivery system designed to minimise the payment risk between banks. In effect a bank can't be liable to its customers until it gets the money from the payees bank.

### SBI - diagram



### How the system works

1. The sender prepares and validates the BACHO file, and creates a file transfer request (FTR)
2. The sender sends the BACHO file and FTR for the receiver to the SBI CUG transaction delivery system
3. SWIFT Bulk Payments Service holds the FTR and file in the receiver's store and forward queue, and copies information from the FTR and sends it to ESAS in the form of a settlement request
4. ESAS queues the settlement request for payment and sends a payment status report to the sender
5. ESAS sends a payment status report to the receiver
6. ESAS completes settlement - debits the debtor's account and credits the creditor's account with the net value of the file.
7. ESAS sends a message to SWIFT confirming settlement.
8. SWIFT releases the file transfer request and the file from the queue for the receiver.
9. SWIFT sends a message to the sender confirming settlement.
10. Receiver validates file and updates customer accounts.