Financial Market Infrastructures Bill — Second reading

Financial Market Infrastructures (FMIs) are multilateral systems that provide clearing, settlement and reporting services in relation to payments, securities, derivatives and other financial transactions. FMIs include payment and settlement systems, central securities depositories, central counterparties, and trade repositories. The Financial Market Infrastructures Bill (the Bill) establishes a new regulatory regime for FMIs, and revokes Parts 5B and 5C of the Reserve Bank of New Zealand Act 1989 (Parts 5B and 5C).

The new regulatory regime has three main components:

- information gathering and investigative powers that allow for the ongoing oversight and monitoring of the FMI sector;
- a new designation regime that provides for the enhanced regulation and oversight of systemically important FMIs, and FMIs that opt-in to the regime;
- crisis management powers for designated FMIs that are systemically important (specifically, direction powers and a statutory management regime for FMI operators).

Background

FMIs play a critical role in the operation of financial markets and broader economy. All electronic payments, and most transactions involving the buying and selling of financial products, rely upon the sound and efficient operation of FMIs. Disruption to the services provided by an important FMI can make it difficult or impossible to make payments, or enter into other types of financial transaction. In turn, this can place market participants under severe solvency or liquidity stress. The disruption or failure of a significant payment system can also have serious implications for consumers and businesses in the real economy, by disrupting their ability to buy and sell goods and services.

However, FMIs can have characteristics which mean that they are not operated in a manner consistent with their importance and the risks they can raise. For example, most of the consequences of the disruption or failure of a systemically important FMI are borne by participants and the broader financial system or economy, rather than the FMI's operator. This can result in inadequate incentives on the operator to manage risks.

The current regulatory regime for FMIs is established by Parts 5B and 5C of the Reserve Bank Act. Part 5B provides the Reserve Bank with information gathering powers in respect of payment systems, and Part 5C establishes a designation regime for settlement systems wishing to access legal protections around settlement finality, netting, and the enforceability of their rules.

The designation regime established under Part 5C is opt-in, and does not cover FMIs other than settlement systems. It includes a very narrow range of supervisory powers, and does not include any provisions to deal with the distress or failure of an FMI (i.e. crisis management provisions). While this regime fulfils its original objective of providing a mechanism for settlement systems to access legal protections around settlement finality, netting, and the enforceability of their rules, it does not reflect international standards around the regulation of FMIs (or the significance of systemically important FMIs and the risks their disruption or failure can raise). This was recognised by the International Monetary Fund in its most recent Financial Sector Assessment Programme review of

New Zealand. The findings of this review were published in 2017,[1] and included a recommendation to adopt the basic regulatory framework now established by the Bill in order to broadly align with international standards and reduce the risks should an FMI not be operated in a prudent manner.

Key features of the Bill

The purposes of the Bill are to:

- promote the maintenance of a sound and efficient financial system;
- 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;
- promote the confident and informed participation of businesses, investors and consumers in financial markets; and
- promote and facilitate the development of fair, efficient, and transparent financial markets.

The role and functions of the regulator under the Bill are carried out jointly by the Reserve Bank and Financial Markets Authority (FMA), except in relation to designated payment systems, where the Reserve Bank is the role regulator.

Under the Bill all FMIs are subject to the regulators' information gathering powers, and the regulators' ability to require independent reports into aspects of an FMI's operations. These powers are important to allow the regulator to monitor risks within the sector, and to identify when an FMI may be systemically important.

Enhanced regulation applies to those FMIs that are designated. This reflects a proportionate approach to the regulation of FMIs that focuses on those that are more significant (as well as minimising compliance costs for smaller FMIs and new entrants to the FMI sector).

The regulators may recommend that an FMI be designated if it is systemically important, or if the FMI applies to be designated in order to access legal protections in the Bill around settlement finality, netting, and the enforceability of their rules (these legal protections are largely carried across from Part 5C). In assessing whether an FMI is systemically important for these purposes, the regulators are required to have regard to certain matters such as the nature and scope of the activities carried out under the FMI, and the concentration of financial risks within the FMI.

The Bill provides the regulators with the power to issue legally binding standards that designated FMIs must comply with. This power is designed to permit standards to be issued in any of the areas covered by international guidelines (in particular, the Committee on Payment and Market Infrastructures – International Organisation of Securities Commission (CPMI-IOSCO) Principles for Financial Market Infrastructures (PFMIs)). Standards may cover the management of various risks (e.g. operational, credit, liquidity, and cyber risks), and a variety of other matters such as governance, disclosure, and access to the FMI.

Under the Bill the regulators are responsible for approving any changes to the rules of designated FMIs, and can require that any deficiencies in the rules be remedied. The Bill also requires all designated FMIs to have comprehensive, adequate, and credible contingency plans for dealing with operational or financial failure. The regulators have powers to require that any deficiency in these

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[1] See the IMF technical note "Regulation and Oversight of Financial Market Infrastructures", which is available at: https://www.rbnz.govt.nz/-/media/ReserveBank/Files/regulation-and-supervision/FSAP/Technical-note-Regulation-and-oversight-of-financial-market-infrastructures.pdf?la=en&revision=4c342970-5c20-4a3d-acff-6f3d2a347bc3.

plans be remedied, and must be notified by the operator of the FMI when a contingency plan is activated.

The Bill provides two broad types of crisis management power for dealing with the disruption or failure of a designated FMI that is systemically important. These are direction powers and statutory management. In broad terms, these powers can only be used when an FMI is distressed (e.g. where a disruption in the operation of the FMI is affecting the stability of, or public confidence in, the financial system), and the FMI's contingency plan is not being properly implemented or is inadequate to deal with the situation.

The direction powers in the Bill may include directions to the operator of an FMI, directions to participants of an FMI to comply with the FMI's rules, and directions removing or appointing directors of an FMI operator.

The statutory management regime in the Bill is based upon the basic statutory management framework in other legislation (such as the Corporations (Investigation and Management) Act 1989), but tailored in a variety of ways to the special circumstances of FMIs. For example, by ensuring (subject to some limited exceptions) the continued application of the FMI's rules during statutory management in order to provide certainty for participants.

The Bill also provides for a variety of supervisory and enforcement tools, such as the ability to issue notices requiring entities to remedy non-compliance, the ability to enter into voluntary undertakings that are enforceable in the courts, civil pecuniary penalties, and criminal offences. This will help ensure that the regulators can respond to any breaches in a flexible and proportionate manner.

Amendments recommended by select committee

The Finance and Expenditure Committee (FEC) has recommended a variety of amendments to the Bill. These include adding a new principle the regulator will have to have regard to when exercising its powers under the Bill. Specifically, the importance of recognising the diversity of FMIs and the circumstances of different FMIs. This will help ensure that the approach taken to regulating different FMIs is proportionate and reflects the specific characteristics of that FMI.

To support the efficient operation of the regime FEC has also recommended a number of changes to decision making processes under the Bill. Specifically:

- Broadening the circumstances where the regulators may agree that one of them act as the sole regulator in a particular case;
- Simplifying the thresholds for when Ministers must grant approval or consent to decisions made by the regulator;
- Clarifying the relationship between the general purposes and principles of the Bill and the specific purposes and principles relating to crisis management powers;
- Removing the requirement for Ministerial consent before the regulators may issue a notice requiring a rule change;
- Removing the requirement for Ministerial consent to a new operator scheme (which is used in statutory management to transfer the business of the FMI to a new operator).

FEC has also recommended new arrangements for transitioning designated settlement systems under Part 5C across to the new designation regime in the Bill. These arrangements will ensure that these FMIs are not required to go through the full process of being re-designated.

Finally, FEC has also recommended a number of more technical amendments to the Bill. Specifically:

- Clarifying how the concept of "stability and confidence" referred to at various points in the Bill interrelates with the Bill's purposes;
- Bringing into force certain additional provisions of the Bill the day after the Royal assent;
- Adjusting the circumstances where derivatives counterparties can exercise certain "close-out" rights against an FMI operator in statutory management;
- Clarifying that security interests in the assets of an FMI operator in statutory management continue in existence if those assets are transferred to a new operator under a new operator scheme;
- Providing a Crown indemnity for the statutory manager of an FMI operator;
- Enhancing the rules around confidentiality notices issued by the regulator;
- Adjusting the rules around the confidentiality of information held by the regulator so that the relevant confidentiality rules in the Financial Markets Authority Act 2011 apply to the FMA; and
- Making a technical amendment to the Financial Markets Authority Act 2011 to ensure that the FMA can also make use of its powers under that Act in respect of FMIs.

The Government supports all of the changes to the Bill recommended by the Select Committee.