BUDDLE FINDLAY

Financial Market Infrastructures Act

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Current status

The Financial Market Infrastructures Act 2021 (the FMI Act) established a new regulatory regime for financial markets infrastructures (FMIs) and set new rules to regulate and supervise payment and settlement systems. The FMI Act was enacted on 10 May 2021 and will be implemented over an 18 month period.

On 26 July 2021, the Reserve Bank of New Zealand (RBNZ) and the Financial Markets Authority (FMA), the joint regulators of FMIs under the FMI Act, jointly issued two consultation papers on which submissions could be made until 20 September 2021. These papers focused on:

- The framework for identifying which FMIs are 'systemically important'
- The design of regulatory requirements, in the form of 'standards', under the new regime for designated FMIs (ie systemically important FMIs that are deemed to be designated, and FMIs that apply to be designated, under the FMI Act).

On 20 January 2022, the RBNZ and FMA jointly published:

- A finalised framework for identifying which FMIs are 'systemically important'
- Their responses to stakeholder feedback on the finalised framework, as well as on standards for designated FMIs, with a view to release an exposure draft of the standards in 2022, which they will seek public submissions on.

Background

FMIs are multilateral systems among participating institutions that are used for clearing, settling or recording payments, securities, derivatives or other financial transactions.

Common types of FMIs include payment systems, securities settlement systems, and central counterparties. The participants of FMIs are usually banks and other types of financial institutions, but in respect of payment systems, can also include individuals, retailers, and other businesses.

FMIs were previously regulated under Parts 5B and 5C of the Reserve Bank of New Zealand Act 1989. The FMI Act replaces the old regime with new stand-alone legislation, so as to better reflect international practice.

Legislative history

Consultation stage

In April 2017, Cabinet agreed to adopt an enhanced legislative framework for the regulation of FMIs. On 4 May 2017, the RBNZ released an accompanying Cabinet Paper and Regulatory Impact Statement (RIS). In December 2018, Cabinet made a number of supplementary decisions on aspects of the proposed new oversight regime for FMIs.

Prior to this decision, the RBNZ carried out three rounds of public consultation on the reform of the legislative framework governing FMIs in New Zealand:

- In March 2013, the RBNZ began the first round of consultation by releasing a consultation paper proposing the establishment of a new legislative framework for the oversight of systemically important payment and settlement systems and asking for public submissions. In October 2013, the RBNZ released a summary of submissions with the RBNZ's responses.
- In April 2015, the RBNZ began the second round of consultation by releasing a consultation paper to modify the existing statutory framework and asking for public submissions. In December 2015, the RBNZ released a summary of submissions on this round of consultation.
- In March 2016, the RBNZ issued a consultation paper on proposed crisis management powers for systemically important FMIs. In August 2016, the RBNZ released a summary of submissions on this round of consultation.

Exposure draft

On 1 August 2019, the RBNZ published an exposure draft of the Financial Market Infrastructures Bill (Bill) with an accompanying cover note, proposing a new regulatory framework for FMIs intended to be consistent with international best practice. The RBNZ consulted on this exposure draft, seeking submissions until 26 September 2019. In December 2019, the RBNZ published a summary of the sixteen submissions it received on the exposure draft, with the feedback resulting in a number of technical changes.

Overview of the Bill

On 17 December 2019, the Bill was introduced to Parliament. The Bill's purposes include promoting the maintenance of a sound and efficient financial system, and avoiding significant damage to the financial system that could result from problems with an FMI, its operator, or its participants.

The RBNZ and the FMA will act jointly as the regulator of FMIs except in relation to designated payment systems (where the RBNZ will be the sole regulator).

The Bill distinguishes between designated and non-designated FMIs. FMIs that are identified as systemically important will be designated on the recommendation of the regulators and be subject to more intensive regulation. However, other FMIs may 'opt-in' to the designation regime by applying to the regulators.

The Bill allows for the regulation of designated FMIs in the following ways:

- Regulators will have the power to make legally binding standards that will apply to designated FMIs – this will cover several areas such as governance and liquidity and may apply to individuals FMIs or a class of FMIs
- Regulators will be granted monitoring powers and, if necessary, the power to appoint a person to investigate designated FMIs
- Regulators will be granted oversight powers over the rules of designated FMIs (other than overseas FMIs)
- Regulators will be granted crisis management powers, in particular, designated FMIs would be required to have contingency plans for how they would deal with operational disruption or financial failure
- The regulator may remove or appoint the directors of an FMI, or recommend that the operator of a designated FMI be placed into a tailored statutory management regime.

Introduction to Parliament, select committee report and royal assent

The Bill was referred to the Finance and Expenditure Committee (FEC) who produced their select committee report on 4 August 2020. In its report, the FEC recommended that the Bill be passed with certain amendments, including:

- Ensuring the regime was sufficiently flexible to manage different types of FMIs, noting international practice where different types of FMIs are subject to different regulatory regimes
- Amending the purpose clause of the Bill to make reference to responding to threats to the stability of, and confidence in, the financial system
- Broadening the circumstances in which either of the RBNZ and the FMA (as joint regulators) could agree that one regulator may act as sole regulator in a particular case
- Increasing the flexibility for ministerial approval or consent to decisions made by a regulator
- Establishing a transition process for settlement systems that have been designated under the Reserve Bank of New Zealand Act 1989.

The Bill had its second reading on 16 March 2021 and, following a debate by a committee of the whole House, attained royal assent on 10 May 2021.

Implementation plan

On 26 July 2021, the RBNZ and the FMA published the 'FMI Act Implementation Plan'. This document outlines how the regulators intend to implement the FMI Act over an 18 month period with an aim to completion by the end of 2022.

The implementation plan identifies five key work streams to implement the FMI Act:

1. Identifying and designating systemically important FMIs
2. Developing standards for designated FMIs
3. Defining the approach to supervision by the regulators and how the RBNZ and the FMA will work together
4. Planning the use of information gathering and investigative powers
5. Drafting commencement orders and fees.

Consultation papers

On 26 July 2021, the RBNZ and the FMA jointly issued two consultation papers and sought public submissions until 20 September 2021. A total of eight submissions were received. These papers focused on the first two workstreams identified in the implementation plan:

- The framework for identifying which FMIs are 'systemically important'
- The design of regulatory requirements, in the form of 'standards', under the new regime for designated FMIs (ie systemically important FMIs and FMIs that apply to be designated to access the FMI Act's legal protections).

On 20 January 2022, the regulators jointly published their responses to stakeholder submissions on both the finalised framework for identifying which FMIs are 'systemically important' as well as standards for designated FMIs.

In relation to the development of standards for designated FMIs, most submissions were in favour of the planned approach of incorporating the current regulatory requirements, as set out in conditions of designation, in a comprehensive set of standards, although some wanted flexibility to tailor standards to the particular requirements of an FMI. Accordingly, the regulators confirmed their intention to make general standards and only impose specific requirements where they identify "a clear need to do so" and "only after consulting the FMI concerned".

In this response document, regulators propose developing and enacting standards to support the implementation of the FMI Act "over an approximately 18-month period ending in late 2022 or early in 2023" and implementing these standards using a "one-time transition approach".

The regulators will release an exposure draft of the standards in 2022, which they will seek public submissions on.

FMI systemic importance framework

On 20 January 2022, the RBNZ and FMA jointly published a finalised framework for identifying which FMIs are 'systemically important'. The framework is "closely aligned with" the criteria set out in the Principles for Financial Market Infrastructures (PFMI). The PFMIs are widely followed in other jurisdictions and considered international best practice for regulating FMIs.

The framework "is intended to provide guidance on the factors that the [regulators] will consider when exercising [their] regulatory discretion in making an assessment of systemic importance". The framework is not prescriptive, allowing regulators to be flexible enough to account for circumstances unique to each FMI and be responsive to the emergence of new risks. During their consultation, the regulators mostly received positive feedback for the use of such a 'principles-based' approach.

However, the framework does set out five prescribed qualitative and quantitative factors that the regulators must take into account in a holistic manner when making an assessment of systemic importance in order to provide clarity about the decision making process. These factors are:

- **Size of the FMI**: factors considered include the average and historical peak gross volumes and values processed, cleared or settled by the FMI over the last five financial years as well as the number of direct and indirect participants of the FMI. The regulators may also consider the potential for future growth and consider estimated future transaction volumes in assessing the size of an FMI
- **Type of participants**: factors considered include whether the direct and indirect participants of the FMI are central banks, other FMIs, registered banks and large corporates. For example, if a central bank is a participant, the FMI may play a role in the operation of monetary policy settings or the provision of liquidity in the financial system
- **Nature and scope of activities**:
  - factors considered include whether the FMI is significant for the proper functioning of the market it supports and whether that market is significant for the proper functioning of the economy, whether the FMI plays a role in mitigating risks for participants or if FMIs have multiple functions
  - interconnectedness with other FMIs – this requires determining whether an FMI has either a vertical or horizontal "system-based interdependency" on another FMI ie whether it depends on the smooth functioning of another FMI, or whether it has an "institution-based interdependency" ie when FMIs have a common financial institution as a participant or rely on a service provided by a common financial institution
  - interconnectedness among participants – assessing whether indirect participants rely upon services provided by direct participants in order to use the FMI's services as overreliance on a few direct participants can adversely affect an FMI if a participant defaults or experiences operational disruption
- **Concentration of financial risk**: factors considered include an FMI's market share, the magnitude of its credit exposure and liquidity exposure as well as the proportion of transactions by the five largest participants. This assessment is vital in mitigating contagion risk
- **Substitutability**: factors considered include assessing whether the services provided by an FMI can be adequately substituted by alternatives, what the cost of such a substitution would be and how much notice is required in order to make such a substitution.

The framework also outlines a process for designation of an FMI as systemically important when the regulators make a designation recommendation on their own initiative as well as the process for when an FMI applies to be designated.

If you would like advice on the FMI Act, please contact a member of our financial services regulation team.

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