

Legal update - The Financial Markets Infrastructure Bill

Simon Jensen

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On 4 May 2017 the Reserve Bank of New Zealand (RBNZ) released a Cabinet Paper and Regulatory Impact Statement (RIS) for the legislation to put in place a new oversight regime for Financial Market Infrastructures (FMIs), which Cabinet has now approved.

An FMI is a multilateral system used for the purposes of clearing or settling payments, securities, derivatives or other financial transactions. Currently the RBNZ and the Financial Markets Authority (FMA) jointly regulate FMIs that voluntarily seek designation (designation is typically sought to give the FMI's rules legal certainty).

The new regime will give the RBNZ and FMA enhanced powers to regulate FMIs, particularly those that are systemically important, and to compel those FMIs to be designated.

There were no particular surprises in the Cabinet Paper and it now seems clear that the New Zealand regime will:

- Require systemically important FMIs to be designated by Order in Council
- Give the joint regulators information gathering powers over all FMIs
- Give the joint regulators powers to set standards and require rule changes in respect of designated FMIs
- Set up a crisis management regime for designated FMIs which:
 - requires them to prepare business continuity plans and recovery and resolution plans
 - gives the joint regulators the power to remove directors and recommend statutory management.

Of the nine FMIs that are likely to be designated following the reform, the four that are already designated under the current voluntary regime will have an easier path to compliance. Payments NZ is likely to be impacted the most by the reform, with its Settlement Before Interchange System (the retail payment system) and High Value Clearing System (the wholesale payment system), both likely to be newly designated.

It is less clear how the reform will impact on offshore FMIs likely to be designated, being:

- LCH Clearnet
- ASX Clear (Futures)
- DTCC Singapore.

While the Cabinet Paper indicates more of a light touch regime for these offshore FMIs, they are still likely to be required to identify rules to be designated and create business continuity and recovery and resolution plans for New Zealand (or at least address resolution in New Zealand in their international plans). The RBNZ states these offshore FMIs expose New Zealand to avoidable systems risks and reductions in efficiency and so will therefore need to impose key elements of the regime on them to address those risks. The management of the "risks related to the use of overseas FMIs" was also specifically mentioned as a factor that is relevant for financial stability in the International Monetary Fund's Financial System Stability Assessment on New Zealand dated 10 April 2017 (FSAP Report).

It is also not clear what the extent of any additional impact as a result of the new regime will be on NZX, given it is already voluntarily designated. Disruption in the equity markets and contagion effects of it are specifically mentioned as risks in the RIS, as are the adequacy of "loss waterfalls" in central counterparty systems like New Zealand Clearing and Depository Corporation (NZCDC). It is therefore possible that, in time, this could see greater intervention in the NZCDC system.

Another approach for oversight that was discussed during the consultation process was a more light handed, industry-wide but graduated licensing approach to FMI supervision. Some of the potential benefits of such a regime could be that:

- Licensing helps the regulator engage with, and understand, the industry which in turn can help a regulator to manage risk
- The graduated nature of a licensing regime would give the joint regulators more flexibility to deal with fintech companies, which can start small but can quickly grow to be big and systemically important (the "too small to care" to "too big to fail" scenario)
- It would give the joint regulators industry-wide resolution powers that could be applied more broadly to important FMIs that do

not meet the designation threshold (for example, switches).

The RIS also looked at the benefits and costs of such a light-handed approach, but concluded that the proposed designation regime was preferable.

Ultimately, most parties seem to agree that an FMI oversight regime is required to comply with international best practice. This was reinforced by the FSAP Report which stated that the "proposed reforms to the regulatory and oversight framework for Financial Market Infrastructures (FMIs) will get New Zealand broadly on par with international standards". However, it is important to recognise that New Zealand FMIs have actually worked well and New Zealand has a particularly sound and efficient payments system.

Auckland

**188 Quay Street
Auckland 1010**

**PO Box 1433
Auckland 1140
New Zealand**

P: +64 9 358 2555

F: +64 9 358 2055

Wellington

**Aon Centre
1 Willis Street
Wellington 6011**

**PO Box 2694
Wellington 6140
New Zealand**

P: +64 4 499 4242

F: +64 4 499 4141

Christchurch

**83 Victoria Street
Christchurch 8013**

**PO Box 322
Christchurch 8140
New Zealand**

P: +64 3 379 1747

F: +64 3 379 5659