

European Payments Council Observations On the European Central Bank Consultation on "Oversight Standards for Euro Retail Payment Systems"

The European Payments Council (EPC) considers that market consultation is an essential process of the European Central Bank in progressing towards the common objective of building SEPA - the Single Euro Payments Area. The EPC welcomes the publication of this consultation document and values the possibility to comment on it at an early stage.

While all large-value payment systems in the euro area are considered to be systemically important, the Eurosystem considers that some retail payment systems may also be of systemic importance and thus have to fulfil the entire set of Core Principles (10). However, some of the Core Principles (6) are in the view of the Eurosystem so fundamental that they should also be observed by payment systems in the euro area which are not of systemic importance.

This note is intended to reflect on the following key issues raised by the consultation document in this regard:

- The application of a subset of the Core Principles (6) to certain types of euro retail payment systems, even if they are not systemically important.
- The proposed selection of Core Principles to be observed for certain types of retail payment systems.
- Issues or difficulties expected to encounter as these principles are implemented.

I. General observations

Baseline guiding principles and observations

The EPC community shares the view that financial stability and smooth functioning payment systems are essential components of a sound economy, that in particular smooth functioning retail payment systems are essential for social stability, and that the oversight of payment systems is an essential function of central banks. These objectives are pursued in the context of free market principles, which i.a. demand that:

- A level playing field be created and maintained for all participants engaging in payment systems activity within the European Union. This means that the oversight approach must be consistent and coherent throughout
- Meaningful yet responsible competition between systems, and participants is fostered and maintained, also to achieve efficiency. Oversight impacts alone should not drive consolidation in this field.
- This implies non only that regulatory arbitrage should be avoided, but also that the overall costs of new obligations set by overseers and regulators on market participants,

where they cannot be recouped from the market, be commensurate to the objectives pursued.

- The above objectives will also be implemented more effectively when the overseer role of the Eurosystem is clearly and continuously segregated from its role as provider of payment services.

Regarding the proposals contained in the Consultation there is a majority view that:

- The criteria for identifying the payment systems subject to oversight, as well as the principles and standards for system operators, should be defined at a pan-European level, ideally in a dialogue between the Eurosystem and market participants. Such a definition would also specify the payment instruments (credit and debit transfers, cheques, card-based instruments...) to be covered. These objective criteria, principles and standards should then apply in the same way to all operators and participants that provide or use similar services.
- In this respect the publication of lists by (National) Central Bank(s) would not seem to qualify as an objective criteria.

However no majority view has emerged as to whether some of the core Principles should apply to non-systemic retail payment systems. Some would consider that such a disparity would create a non-level playing field, having observed that the notion of systemic risk should be dissociated from the notion of retail clearing system i.e. the risk linked to the operation of a payment system, and the risk linked to the settlement of the transactions exchanged). Acknowledging these 2 components also leads to observe that some large banking network in Europe play a pre-clearing role for second-tier banks: systemic risk is present through that activity as well.

Furthermore one would note that the Consultation document follows from the work done by the G10 Central Banks' Committee on Payments and Settlement Systems Task Force on "Payment and Settlement System Principles and Practices". Its aim is to take a detailed look at how the principles are to be interpreted in different contexts from an ECB perspective. This would suggest that the focus of this Consultation is as much the role of the ECB, than the principles themselves.

The rationale of the G10 Task Force in developing the 10 original principles was that:

- Principles should not apply to every system, irrespective of size and impact, otherwise this would detract from the process,
- "Systematically Important Payment systems" (SIPs) were regarded as systems that can trigger or transmit shocks across domestic and international financial systems and markets.

Finally it should be noted that all current observations are not meant to cover correspondent banking arrangements or similar "closed systems", which, according to the Consultation document, could also at a later stage fall within the scope of the proposed oversight standards. This environment should be the subject of a specific dialogue.

General policy stance

The Eurosystem defines its task of promoting the smooth operation of payments systems as “[...] *ensuring the safety and efficiency of payment systems and the security of payment instruments*”. It outlined its role in payment systems oversight as follows¹:

1. *defining, implementing and ensuring compliance with principles and standards which are established to promote safe, sound and efficient payment and settlement systems, whether these are operated by the central banks or by private operators; and*
2. *monitoring developments in the field of payment and settlement systems in order to assess the nature and scale of the risks inherent in these and ensuring the transparency of the arrangements concerning payment instruments and services.*

The ECB has herewith defined a broad role for itself. Its objectives include besides maintaining systemic stability and establishing a level-playing field among market participants also the efficiency of payment systems and the security of payment instruments in order to foster the achievement of a single euro payments area. Consequently, the ECB derives its mandate to promote the adoption of oversight standards for cross-border retail payment systems from its general policy stance. **This being said, we would caution against an “over-adoption” of standards in this field, in order to minimise the overall impact on bank participants.**

It is essential that the relationship between the ECB, the NCBs and the other various governance bodies are clearly defined to ensure that there is no conflict, duplication or uncertainty. The extent to which the ECB’s proposal changes the current situation should be laid open.

Oversight responsibility

In line with the principle of *decentralisation*, the enforcement of the ECB’s policy stance is, as a rule, entrusted to the NCB of the country where the retail payment system is legally incorporated. In view of the increasing cross-border participation in payment systems within the euro area, the Eurosystem fosters a co-operative approach towards the enforcement of its policy stance, with the local NCB acting as lead overseer. In theory, this could at times lead to a not fully consistent application of policy by the respective NCB, at least from a single euro payment area point of view. **Therefore, clear guidelines must be defined that on one side assist in identifying a systemically important payment system, with a relative classification based on its importance within its economic environment (e.g. in terms of daily turnover) and the risk and consequence of systemic failure (as broadly defined), and on the other the scope of application (e.g. in terms of payment instruments)**².

In line with the principle of *subsidiarity*, in areas not specifically covered by common oversight policy, the Governing Council can always take an initiative, where deemed necessary³. For systems which have no clear domestic anchorage (e.g. EBA), the ECB can become the body entrusted with oversight responsibility (acknowledging that the EBA is

¹ “Role of the Eurosystem in the field of payment system oversight”, ECB, Frankfurt, June 2000.

² see Federal Reserve Policy Statement on Payments System Risk, U.S. Federal Reserve Bank, December 2001.

³ provided for in Article 4 of the ECB Statute.

already supervised by the ECB). This approach could also be considered for retail payment systems which are pre-dominantly used for cross-border transactions in euro.

As mentioned previously, the definition of the oversight of retail payment systems falls in the first instance to the relevant central bank, which determines the need at national level.

The ECB should therefore ensure consistency in the enforcement of the oversight policy stance and, in particular, that standards are applied in the same way for all payment systems concerned. It is not advisable to create a multitude of oversight standards for various types of retail payment systems. With the continuing existence of predominantly national retail payment systems for a while, a level playing field in the euro area can only be achieved, if regulatory arbitrage is minimised.

Retail vs. wholesale

What makes retail different from wholesale from a risk perspective? As opposed to wholesale payment systems, retail systems handle domestically large volumes of payments of relatively low value and generally carry little, if any, systemic risk. Where retail schemes would have potential implications beyond the traditional domestic market, **general policy lines for oversight should be defined at pan-European level.**

Oversight standards for retail payment systems

Presently, central banks have differing views and ambitions with regard to oversight in retail payment systems. This may lead to whether the proposed 6 standards are really adequate for non-systemic retail systems? Would the same hold true for the 4 optional standards? If so, who should administer these standards?

The following principles (6) are proposed by the ECB for the observance of payment systems in the euro area which are not of systemic importance:

- I. The system should have a well-founded legal basis under all relevant jurisdictions.
- II. The system's rules and procedures should enable participants to have a clear understanding of the system's impact on each of the financial risks they incur through participation in it.
- VII. The system should ensure a high degree of security and operational reliability and should have contingency arrangements for timely completion of daily processing.
- VIII. The system should provide a means of making payments which is practical for its users and efficient for the economy.
- IX. The system should have objective and publicly disclosed criteria for participation, which permit fair and open access.
- X. The system's governance arrangements should be effective, accountable and transparent.

II. Specific remarks

The majority view is that the 6 Principles chosen are adequate. However the following remarks are made:

I. Legal basis

“[...] participants could incur financial risks if the rules and procedures of a system are not clear and enforceable [...]”

This principle requires the participants in and the provider of a retail payment system to carry out an assessment of the system’s legal characteristics in order to determine their enforceability and consequences. In particular, participants should examine all of the system’s legal documentation in order to identify the respective rights and obligations that they would assume as a result of their participation.

However, in order to enable the participants and the system provider to determine the legal enforceability and consequences of the arrangements in question, and their respective rights and obligations thereunder, an assessment would be necessary on the basis of reasoned and periodically reviewed legal opinions in respect of all relevant jurisdictions. This is particularly important for banks that take advantage of remote access to a system. **It is our understanding that such periodic assessments would be costly to the system provider and/or to participating banks.** For non-relevant retail payment systems a simple assessment of the legal situation should also prove sufficient.

In general, working towards an actual harmonization of this legal basis (also with respect to the accession countries) would greatly assist in this matter, by generally enhancing legal security, and making the assessment obligation less onerous.

II. Understanding financial risks

“[...] it has to be clear to participants who will bear which risks and to what extent [...]”.

This principle requires that participants should be fully aware of the extent of their liquidity and credit risk, if any, and of the impact that any unforeseen event adversely affecting the daily settlement may have on them and on the system as a whole. The potential impact of the liquidity default of one institution participating in several systems within a country, or in several countries, should be assessed as well.

Overall this information obligation of participants should be focused on the practically relevant financial risks. **Much of this information is provided by the rules and regulations of a system.**

VII. Security and operational reliability

(extended to principle IV. on prompt final settlement)

“[...] the specified retail systems should therefore be secure, operationally reliable and have contingency arrangements in place [...]”

This principle requires that retail payment systems should ensure the operational reliability of technical systems and the availability of backup facilities capable of completing daily processing requirements. This requires that hardware, software and communication facilities supporting the retail payment system have a high degree of reliability and integrity. It also may require that contingency plans and backup facilities be in place.

As an extension, this principle may also call for clearly defined procedures for the management of credit risks and liquidity risks, if any, which specify the respective responsibilities of the provider and the participants. These procedures may also proclaim that all parties have both the incentives and the capabilities to manage and contain each of the risks they bear. In addition, the definition of uniform standards for revocation and uniform rules for cancellation of credit transfers would further strengthen the security of the overall system.

As a further extension, this principle may call for the establishment of daily settlement and failure-to-settle procedures to ensure the timely completion of daily settlement. To this end, liquidity resources should always be available, taking full account of the sizes of positions, the resources available to complete settlement and the time needed to adjust positions and to mobilise available resources.

The documentation of a system's mode of operations should provide the supporting evidence. **In our view, only retail payment systems which are actually identified as systemically important systems should comply with the extended scope of this standard, whereas a reduced scope could become applicable to all other retail payment systems.**

Two areas that are inherently covered within Principle 7, yet may require some specific attention, are:

- the expansion to accession countries, and its consequences,
- the increased threats from cyberterrorism.

VIII. Efficiency

Efficiency has to be seen not only in terms of processing costs of the system, but also in terms of processing and liquidity cost of the participant. Whereas oversight should concern itself with the security of payment systems, i.e. efficiency from a macroeconomic perspective, **efficiency as defined here should result from the application of the free market principles highlighted above, unless there is proven market failure.**

In particular the payment industry will continue its work on standardisation, notably with a view of basing national projects on Europe-wide standards.

IX. Access criteria

“[...] access criteria that encourage competition among participants promote efficient and low-cost payment services. Therefore, access should generally be free and open [...]”.

This principle stipulates that retail payment systems should have objective and publicly disclosed criteria for admission which permit fair and open access. The admission criteria should address the financial and managerial capacity of an institution to satisfy its obligations and to manage the associated credit and liquidity risks, while a somewhat more restrictive

approach to membership may be justified for those systems with decentralised risk management procedures. **We believe consideration should also be given to whether participants (e.g. non-banks) are subject to effective supervision; access to central bank facilities could be an important factor in determining the appropriateness of participation.**

Finally some wonder whether access can be “free” in view of the investments undertaken by system’s owners; it is suggested that access should not be priced with a discriminatory objective.

X. Governance

“[...]the system’s governance arrangements should be effective, accountable and transparent [...]”.

This notion is supported. However it would not be expected that it translates into an oversight of the efficiency of organizational structures.

Applicability of additional principles

Currently no majority view emerges on the applicability of additional principles (Principles 3, 4, 5, 6). Some consider that the related costs are a deterrent as they could negatively impact the conditions for competition. Some suggest the inclusion of Principle 5. Some suggest that after a thorough analysis of the mechanisms the 4 additional Principles should be implemented as well.