Proposed Criteria and Risk-management Standards for Prominent Payment Systems

Canadian Payments Association Submission in Response to Bank of Canada

August 21, 2015

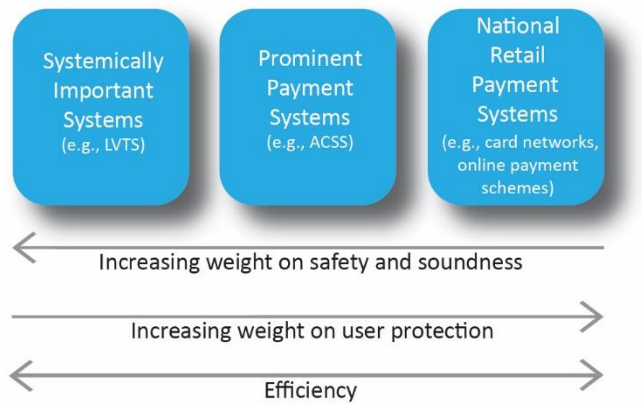
Note: This submission reflects the views of the Canadian Payments Association and not necessarily those of any one of its individual member institutions.

Contents

1. Introduction and Context

In its *Economic Action Plan 2014*, the Government committed to developing a comprehensive risk-based approach for the oversight of the Canadian payments system. The oversight framework was articulated in a Department of Finance consultation paper in April (Figure 1). [1]

Figure 1: The Government's Conceptual Oversight Framework



The Government oversees payment systems through stated policy objectives of 1) safety and soundness, 2) efficiency and 3) consideration of user interests. The conceptual oversight framework assigns each eligible payment system a place along a continuum according to the overall level of risk it poses to the economy. The weighting of public policy objectives changes accordingly. In particular, it is clear that safety and soundness are crucial for systemically important systems, while they are relatively less so for prominent and national retail payment systems. By the same token, protecting the needs of users is given more weight for national retail payment systems, and less for prominent payment systems, and less still for systemically important systems. The public policy objective of efficiency applies across the spectrum.

Amendments to the Payment Clearing and Settlement Act in 2015 give the Bank of Canada the responsibility to designate and oversee payment systems that have the potential to pose payment system risk[2]. These are referred to as prominent payment systems. The Bank of Canada has issued a consultation paper[3] on proposed criteria for identifying prominent payment systems; and proposed risk-management standards that would guide operators of these systems in the mitigation of payments system risk.

The Canadian Payments Association (CPA) has previously provided comments on the oversight framework for "national retail payment systems" proposed by the Department of Finance. [4] The CPA welcomes this opportunity to provide input on another key component of the overall oversight framework for Canadian payment systems.

1 Department of Finance (April 2015), Balancing Oversight and Innovation in the Ways We Pay: A Consultation Paper available at: http://www.fin.gc.ca/activty/consult/onps-ssnp-eng.asp

2 The Payment Clearing and Settlement Act defines payments system risk as the risk that a disruption to or failure of a clearing and settlement system could cause a significant adverse effect on economic activity in Canada.

3 Proposed Criteria and Risk-Management Standards for Prominent Payment Systems: A consultation paper by the Bank of Canada available at: http://www.bankofcanada.ca/wp-content/uploads/2015/06/proposed-criteria-risk-management-standards.pdf

4 CPA submission in response to Finance Canada consultation paper on oversight of national retail payments systems available at https://www.cdnpay.ca/imis15/pdf/pdfs_publications/CPA_submission_Finance_consultation_oversight_NPRS.pdf

Role of the CPA

The CPA underpins the Canadian financial system and economy by providing safe, efficient and effective clearing and settlement of payments. As a public-purpose organization, we act in the best interests of the Canadian payments system, our members and stakeholders.

The CPA's Automated Clearing Settlement System (ACSS) is Canada's main retail payment clearing system. The ACSS is used in the clearing and settlement of various payment instruments such as cheques, debit card payments and automated funds transfers. The Government and the Bank of Canada have indicated that the ACSS would likely qualify as a prominent payment system (PPS).

Part 2 of our submission provides a brief overview of the CPA views on proposed criteria and risk-management standards for PPS. Part 3 addresses the specific questions in the Bank of Canada's consultation paper.

2. High Level Summary of CPA views

The CPA supports the comprehensive risk-based approach to the overall oversight framework for Canadian payment systems developed by the Government. The CPA believes the oversight framework for systemic, prominent and national retail payment systems should come together in a way that efficiently promotes the public policy objectives and avoids undue duplication of oversight.

The CPA agrees with many of the key elements articulated in the Bank of Canada's consultation paper[5]. In particular, we agree with the approach to develop a comprehensive oversight regime focused on risk-management standards that are proportionate to the risk posed by PPS. The CPA offers the following high level views on where improvements can be made:

- **More clearly articulate what would constitute an "impact on economic activity" and a "general loss of confidence" in the Canadian payments system.** While the CPA agrees that a holistic approach to determining whether a system poses payment system risk is appropriate, additional clarity here (even if qualitatively) would better enable payment system operators to understand where their systems sit on the Government's oversight framework continuum, and the conditions under which they may move along the continuum.

- **The financial risk standards and operational risk standard are too stringent relative to the risks posed by prominent payment systems and are too prescriptive.** Overall, with very few exceptions, the proposed standards for PPS are largely the same as those for systemically important payment systems. Given that systemically important systems pose significantly more risk to the Canadian financial system, this approach seems inconsistent with the Government's oversight framework. We appreciate the Bank of Canada's intention to apply the standards in a manner proportionate to the risk; however, certain standards are prescriptive which could impede the Bank of Canada's intentions in this regard.

5 The CPA consulted broadly with members and stakeholders in developing its views.

- **The oversight regime should be implemented gradually**. The Bank of Canada indicates that it will work with the system operator to determine a reasonable timeline to meet the standards. This is appreciated. Internationally, the oversight of non-systemically important payments systems is in early stages relative to oversight of systemically important systems. A measured approach would allow Canada to leverage the international experience. As well, the Bank's proposed approach is a significant leap in expectations for systems that had previously not been subjected to risk management standards. The CPA's experience over the past three years in applying the Principles for Financial Market Infrastructures to the Large Value Transfer System (LVTS) (which was already well placed to meet the principles) suggests that a measured approach to observing the principles will be required.

  In particular with respect to the ACSS, meeting any potential gaps should be considered in the light of the CPA's initiative to modernize its system[6].

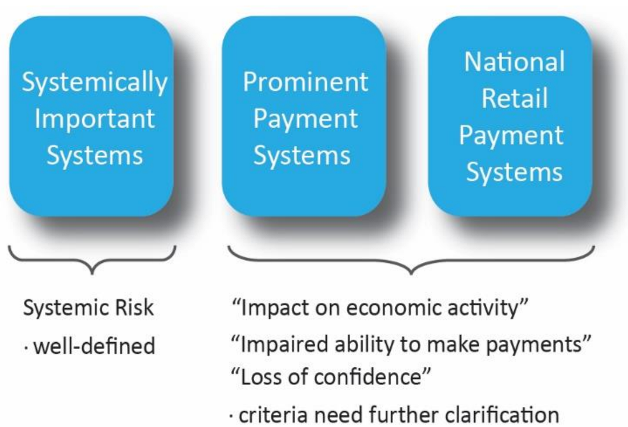
3. Detailed Response to the Consultation Questions

What other criteria or characteristics, if any, should the Bank consider? Why?

The proposed criteria for identifying prominent payment systems are consistent with the criteria typically used internationally and domestically to assess the importance of a financial market infrastructure (FMI). The CPA agrees with a holistic use of the criteria, as a principles-based approach.

Nevertheless, in the absence of quantitative metrics, the Bank of Canada should provide a qualitative sense of what may constitute an "impact on economic activity" and a "general loss of confidence" in the Canadian payments system. Strengthening this concept will better enable payment system operators to understand where their systems fit on the Government's oversight framework continuum; and thereby better understand Government expectations with respect to meeting the stated public policy objectives.

More explicitly, the CPA believes that the oversight framework for systemic, prominent and national retail payment systems should come together in a way that efficiently promotes the public policy objectives and avoids undue duplication of oversight. Therefore, the criteria to belong to one category or another, needs to be appropriately clear across the continuum.



For example, to be designated systemically important, a system must have the capacity to pose "systemic risk". This is clearly defined as the inability of a participant to meet its obligations as

6 See press release: "Canadian Payments Association Launches Initiatives to Support Modernization of Canada's Payments System" available at: https://www.cdnpay.ca/imis15/eng/Publications/News/eng/res/ns/CPA_Launches_Initiative_to_Support_Modernization_of_Canada_Payments_System.aspx

they become due or a disruption to an FMI could, by transmitting financial problems through the FMI, cause:

i. other participants to be unable to meet their obligations as they become due;
ii. financial institutions in other parts of the Canadian financial system to be unable to meet their obligations as they become due; or
iii. the FMI or another FMI in the Canadian financial system to be unable to meet their obligations as they become due.

Even without more explicit quantitative thresholds, this qualitative definition of "systemic risk" provides system operators an important degree of clarity.

Similar clarity for PPS would be very useful because, while the Government and the Bank of Canada have been clear that the ACSS would be considered prominent, it is less clear for other payment networks, operating systems or arrangements that facilitate exchange of payment items. These systems can play an important role in the payments ecosystem, and economy.

Are there other risks relevant to PPS that should be addressed in the standards? How could the standards help to mitigate them?

The CPA has no additional risks to suggest that have not already been presented in the consultation paper.

Do any of the proposed standards address risks that are not relevant or material for PPS? Please explain which standards and why.

The risks addressed by the proposed standards are relevant for PPS.

Are there any risks that, while addressed in the standards, are addressed at an inappropriate level (too stringent or too lenient)? Please explain which standards and why.

The consultation paper clearly articulates the need and intention for oversight to be proportionate to the risk. This is acknowledged and appreciated. Getting the balance right is a challenge; but it is essential to ensuring an efficient oversight regime across the entire payments landscape.

Stringent/Lenient

Given the Government's conceptual oversight framework, the definition of payment system risk, and the Bank of Canada's stated oversight objective, we would expect that the risk management standards for PPS would be less stringent, and/or more flexible than the standards for systemically important payments systems (SIPS).

However, the proposed standards and key considerations, with very few material exceptions, are the same as those applied to SIPS. That is, standards that were explicitly designed to address systemic risk are also being applied to address the risk of a potential "impact on economic activity". This is an issue because the magnitude and velocity of risk is very different for each and therefore different mitigations are appropriate. For example, whereas addressing operational risk in systemic systems requires acting very quickly, there may be a longer time horizon to deal with operational risks from PPS.

While the consultation paper clearly indicates that a principle-based approach is preferred, the wording of some of the proposed standards is quite prescriptive and rules-based. This is likely because the standards align closely with the Principles for Financial Market Infrastructures (PFMIs). The more prescriptive rule-based nature is appropriate for the PFMIs which were developed for all types of systemically important FMIs and designed to demonstrate some level of international consistency. However, the same need does not exist for PPS. Indeed, this is an opportunity for the Bank of Canada to articulate standards that are tailored to payment systems (as opposed to central counterparties or other types of FMIs) in a Canadian context (not international). As well, a less prescriptive approach (for certain standards) will better enable the Bank of Canada to meet its stated intention to be flexible in meeting standards and would encourage an appropriate balance between oversight of PPS and efficiency.

The standards that are most disproportionate to the risks posed, and are at the same time prescriptive, are:

- Standard 5: Liquidity risk
- Standard 4: Credit risk
- Standard 12: Operational risk

Proportionality in the context of overall financial system safeguards

Finally, when the Bank of Canada is considering how to implement the standards, it will be important to be proportionate not just with respect to the risks posed by PPS (as opposed to SIPS), but also in the context of the overall financial system safeguards. Considerable effort has been made to increase the ability of the financial system to perform under stress (e.g. Basel III capital rules, Liquidity rules, FSB Key Attributes of Effective Resolution Regimes, CPMI-IOSCO[7] Recovery of financial market infrastructures). It would be useful if the standards and their implementation were explicitly described within this broader context. What this means from a practical perspective is that, when the Bank of Canada considers different approaches to meeting the standards (as articulated in Box 1 of the consultation paper), we expect that the wider financial system safeguards would be a consideration.

Below we provide more detailed comments on specific standards and point to examples of where improvements could be made to address the issues discussed above.

<u>Standards 4 and 5: Credit and Liquidity Risk</u>

Individually, and as a set, the standards around credit risk and liquidity risk (standards 4 and 5) are disproportionate to the risks posed by PPS and are too prescriptive.

Credit risk

The proposed credit risk standard requires a PPS to cover the default of the participant, and its affiliates, that would generate the largest aggregate credit exposure in extreme but plausible conditions. This is less stringent then the PFMIs requirement which requires covering the simultaneous default of all participants. However, the way "extreme but plausible market conditions" is interpreted will influence how proportionate the standard is compared to the risk posed. The interpretation should be in line with the oversight objective for PPS. That is, "extreme but plausible market conditions" for a PPS should be different from "extreme but plausible market conditions" for a SIPS.

7 The Committee on Payments and Market Infrastructures (CPMI) and the International Organization of Securities Commissions (IOSCO).

Liquidity risk
Given a PPS does not pose systemic risk, and that an impact on economic activity is likely to unfold over a longer timeframe than systemic risk, we would expect that the liquidity risk standards would be significantly less stringent and less prescriptive than for SIPS. Recognizing adjustments to some key considerations, in our view, the proposed liquidity risk standard and key considerations are still prescriptive and are more stringent than the standard for systemically important systems in some case.

- As for SIPS, the PPS must fully cover the single largest credit exposure using collateral and/or other equivalent financial resources with a "high degree of confidence". As discussed for credit risk, we would expect to interpret "high degree of confidence" in the context of the lesser risk posed by PPS.

- There are fewer options for a PPS to meet the minimum liquid resource requirement which makes the overall standard more stringent than for SIPS. In particular, qualifying liquid resources in each currency for a PPS include cash at the central bank of issue. The following types of assets are not allowed for PPS, where they are for SIPS:
    - cash at creditworthy commercial banks
    - committed foreign exchange swaps and committed repos
    - committed lines of credit are generally accepted in the PFMIs but only committed lines of credit at creditworthy commercial banks are listed in the standard for PPS
    - key considerations 3 and 5 from the PFMIs have been combined and considerations about access to routine credit at the central bank of issue have been removed

The liquidity standard should be reconsidered with respect to the overall expectation, and it should be less prescriptive in how the standard should be met. This will provide flexibility to the Bank of Canada and the designated system to determine an appropriate approach to meeting the standard.

<u>Standard 7: Settlement Finality</u>

In standard 7 on Settlement Finality, a PPS is expected to clearly define the point after which unsettled payments, transfer instructions or other obligations may not be revoked by a participant. It would be helpful to stipulate that, when appropriate, a PPS framework can support extended recourse for some payment items needed in a debit-pull environment. Such mechanism should be established through explicit and transparent rules and procedures.

<u>Standard 12: Operational Risk</u>

The standard encompasses sound practices, however "key consideration vi" is too stringent and is not proportionate to risk posed by PPS.

In particular, given the time-critical nature of the payments, a system that poses systemic risk requires a two-hour recovery time[8] . However, the same degree of time-criticality does not apply to a PPS. Moreover, since system operators, participants and regulators are sometimes involved in both a SIPS and a PPS, efforts should be focused on ensuring the SIPS is running first since the public policy objective emphasizes

8 The standard requires the use of a secondary site which should be designed to ensure that critical information technology systems can resume operations within two hours following disruptive events.

safety and soundness; the recovery time requirement for a PPS should not put that objective at risk. More principle-based key considerations would also allow more flexibility in applying the standard to different types of PPS.

Standard 14: Tiered Participation

As for the standards for SIPS, more clarity is needed to understand the implications. However, we expect that this could be addressed through a graduated approach to implementation.

Consolidate recovery in standard 24

As in the original CPMI-IOSCO PFMIs, recovery and orderly wind-down are covered in both standard 3 (framework for the comprehensive management of risk) and standard 10 (general business risk).

However, when the Bank of Canada articulated its standards (based on the PFMIs), it removed these elements from standards 3 and 10 and consolidated them in a new standard 24 on Recovery Plans. The Bank of Canada supplied additional clarity regarding recovery and orderly wind-down plans for designated FMIs in the Canadian context. It would be optimal for the Bank of Canada to follow the same structure for PPS.

Next steps for the process - the oversight regime should be implemented gradually.

The Bank of Canada indicates that it will work with system operators to determine a reasonable timeline to meet the standards. This is appreciated.

Internationally, the oversight of non-systemically important payments systems is in early stages relative to oversight of systemically important systems. A measured approach would allow Canada to leverage the international experience.

Most jurisdictions have an oversight regime in place for systemically important systems, based on the relevant PFMIs. However, the oversight of non-systemically important systems is much less mature. Those jurisdictions that have begun to define oversight regimes have used the PFMIs as a starting point, making adjustments to reflect the lower risk that non-systemically important systems pose. The clearest retail payment oversight regimes are in the European Union and the United Kingdom (UK). The former applies most of the PFMIs with the important exception of the financial risk principles (credit risk, liquidity risk, collateral). While the UK applies all the relevant principles, there is flexibility in their approach to implementing oversight so that it is done so proportionate to the risk posed. The Bank of Canada's approach seems more similar to the UK approach. Therefore, there may be benefit in leveraging others' experiences.

As well, the Bank of Canada's proposed approach is a significant leap in expectations for systems that had previously not been subjected to risk management standards. The CPA's experience over the past three years in applying the PFMI to the LVTS (which was already well placed to meet the principles) suggests that a measured approach to observing the principles will be required.

In particular with respect to the ACSS, meeting any potential gaps should be considered in the light of the CPA's initiative to modernize its system.