

Oversight Policy Document

for

Payment and Settlement Systems



BANK ĊENTRALI TA' MALTA
EUROSISTEMA
CENTRAL BANK OF MALTA

Central Bank of Malta
January 2010

(Version 5.0)

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PAYMENT SYSTEMS OVERSIGHT POLICY DOCUMENT

1.0 Introduction

Payment systems provide channels through which funds may be transferred among credit institutions and other institutions to discharge the payment obligations arising in the financial markets and across the entire economy. Payment systems allow financial obligations to be settled securely and efficiently between debtors and creditors or between originators and beneficiaries of payments. This function makes payment systems critical to the effective functioning of financial systems worldwide.

In order to avoid that payment systems transmit disruptions within the domestic and international financial market, such systems must be sufficiently protected against credit, legal, operational and other risks. The Central Bank of Malta (“the Bank”), like other central banks worldwide exercises a specific form of supervision of payment systems called oversight. The Bank’s responsibility to oversee payment systems forms part of the Bank’s wider responsibilities for monetary and financial stability.

This oversight policy document outlines the principles and provides the guidelines on the basis of which the Central Bank of Malta will conduct payment systems oversight. This responsibility is assigned to the Central Bank of Malta by virtue of article 34 (1) of the Central Bank of Malta Act which empowers the Bank to regulate and to oversee domestic payment and securities settlement systems. This role stems from the oversight role of central banks forming part of the European System of Central Banks as enshrined in the Treaty establishing the European Community and the Statute of the European System of Central Banks and the European Central Bank. This function is recognised as an important task of the Eurosystem¹.

The purpose of this document is to give an overview of the oversight process while outlining the techniques used to fulfil the oversight requirements and objectives.

2.0 Objectives

The objectives pursued by the Bank in its oversight functions are the following:

1. Maintaining systemic stability in payment systems by reducing exposure to systemic risk for payment systems;

¹ Article 105 of the Treaty establishing the European Community and article 3.1 of the Statute of the European System of Central Banks and of the European Central Bank provide that one of the basic tasks to be carried out through the ESCB shall be – to promote the smooth operation of the payment systems.

2. Fostering safety and efficiency of payment systems through systems design which is relevant to the financial market;
3. Fostering security and efficiency of payment instruments used by the public, and associated clearing facilities;
4. Safeguarding an essential medium for the transmission of monetary policy through oversight; and
5. Encouraging fair access to payment systems for market participants.

3.0 Oversight Requirements

In order to fulfil its oversight responsibility, the Bank aims to ensure that there is:

- comprehensive and timely access to information concerning the payment system components, and any other information deemed relevant from a financial stability and/or systemic risk perspective;
- timely analysis of the above-mentioned information;
- transparency of the payment systems oversight policies and objectives;
- regular reporting of the oversight activities and findings to the Bank's management; and
- co-operating with other relevant overseers/supervisors to ensure the smooth functioning of the payment system.

4.0 Roles and Responsibilities of Overseers

To ensure and promote the efficient and smooth market operation of payment systems, the Bank, as overseer of payment systems, conducts periodic meetings with the payment system operator, especially during the initial stage leading to the approval of a payment system. Advice is given on the operation, maintenance, policy and oversight issues of the payment system. Furthermore, as part of the oversight function, the overseer has to report to the Bank's management on the compliance of the payment system's set-up and procedures against the Core Principles for Systemically Important Payment Systems², or other international standards as may be applicable from time to time. This applies to payment systems operated by the Bank, as well as other payment systems. In the case of payment systems operated by the Bank, there is a clear separation of the oversight function and the operational functions of payment systems. Thus, in the case of payment systems operated by the Bank, officers responsible for oversight are kept separate from officers responsible for the operation of the payment systems.

² Refer to Appendix I for the 10 Core Principles for Systemically Important Payment Systems

The Bank may, on a case by case basis, make enquiries, written or orally, whenever required to the operator of the payment or settlement system.

When it deems it is necessary, the Bank is also empowered to collect information and to undertake actions such as approval, issuing directives of compliance, directing changes to the rules and regulations of the system, and exacting financial penalties in the case of breach of directives relevant to payment systems³.

5.0 Oversight Function

The oversight function of payment systems is based on international oversight principles or standards, namely the Core Principles for Systemically Important Payment Systems⁴. Consequently, the Bank will first and foremost from among the main systems operating within the financial system, identify those systems which are systemically important payment systems⁵.

The criteria used to establish whether a system is one of the main systems within the financial system are:

- *Volume*: The total volume of traffic in a system, number of direct participants and number of clients being given a service by direct participants;
- *Value*: The total value being processed by the system and the total value of exposure of each participant; and
- *Risk*: Risks which should be considered refer to the lapse of time to final settlement of any order, and the information available to any participant regarding its exposure in the system⁶.

Once it is determined that a payment system is one of the main systems within the financial system, the Bank will assess whether a payment system may be classified as a systemically important payment system. The Bank here requires information and documentation, which will allow it to make a decision as to whether that system may be operated in such a manner as to pose systemic risk. Particular attention is given to systems which process significant volumes of large-value payments such that the failure of a participant could have substantial implications for the system or the financial markets in which it operates.

6.0 The Oversight Process

The oversight process can be divided into two separate activities:

- a) continuous oversight; and
- b) change driven oversight.

³ Refer to Appendix V for the Directives relevant to the payment system

⁴ Refer to Appendix I for the 10 Core Principles for Systemically Important Payment Systems

⁵ Refer to Appendices II & III for the definitions of systems and to Appendix IV for a list of the systems currently designated as systemically important payment systems in Malta.

⁶ Other specific risks which should be considered are described in Appendix II

6.1 Continuous Oversight Activities

Continuous oversight refers to the monitoring of the activity in, and evaluation of, the payment system. The oversight function should specify which information is required and at what frequency it should be collected. Continuous oversight information is collected from written sources (financial reports, statistics, rules and procedures, audit reports, etc) provided by the payment system operators, through discussions with relevant parties and on-site inspections. This information is mainly of a quantitative nature, and includes:

- Value and volume of payments processed
- Availability of the system
- Number and value of failed payments
- Incidents (minor and major)
- Statistics

Furthermore, continuous oversight involves a regular review of various ongoing aspects of the payment system, but does not imply an involvement in the actual operation of the system.

Continuous oversight activities aim to monitor the activity of the system, suggest any possible improvements, and ensure that the system runs smoothly. This will mainly include the following:

- a) Analysis and review of relevant statistical data (namely, trends in number and value of payments, availability of the system);
- b) Review of the impact of any legal changes on the payment systems rules;
- c) Review of audit reports (internal and external, risk management reports, and other independent reports conducted by IMF, World Bank, etc);
- d) Review of reports on incidents and follow-up to incidents;
- e) Review of any possible complaints by users of the payment system; and
- f) Periodical assessment of the payment system against the Core Principles for Systemically Important Payment Systems.

Analysis of the information should detect any positive or negative trends in the behaviour of the system and its participants, and what action, if any, should be taken. With regards to incidents, the Bank will investigate whether the incident was at the level of the payment system operator or participant, or whether it was due to a technical or financial failure.

Subsequently, an oversight report should be drawn up outlining suggestions for improvements, and any recommendations that are deemed necessary.

6.2 Change Driven Oversight Activities

Change driven oversight is the oversight of payment systems triggered by the occurrence of various events. This mainly involves:

- (i) the assessment of the changed payment system to ensure that it continues to comply with the Core Principles;

- (ii) recommendations of any possible improvement; and
- (iii) monitoring any new developments of the payment system.

Change driven oversight involves reviewing changes to:

- (i) The rules applicable to the payment system (eg. Access and exit criteria, operating hours, governance, etc);
- (ii) The design of the system (eg. Software changes);
- (iii) The risk management framework;
- (iv) Contingency arrangements;
- (v) Testing documentation;
- (vi) Contractual arrangements with infrastructure providers;
- (vii) Links with ancillary payment systems (both domestic and international); and
- (viii) Governance of the system.

It should be noted that any minor changes that do not involve significant alteration to the set-up of a payment system should be reported to the Bank, together with any documentation pertaining to this change.

Major changes, which will significantly alter the payment system, or which will introduce new features in the system, should be discussed with the Bank before their introduction, and any documentation should be forwarded for assessment. The documentation provided should include information on the change to be undertaken, the schedule for implementation, legal documents and procedures that have to be amended.

Change driven oversight is mostly of a qualitative nature and includes risk analysis review of the description of the new function and of the legal documentation. This function will be carried out every time the system rules and procedures are changed, and also when continuous oversight assessments lead to findings and results which require further analysis.

Furthermore, it is also useful to review the execution of technical, legal and organisational arrangements with external service providers (eg. SWIFT Service Level Agreement or the Service Level Agreement with local IT Support). The Bank should have the opportunity to review whether such technical, legal and organisational arrangements are properly set-up.

Apart from analysing the information submitted by the operator of a payment system, the Bank will also conduct meetings with the operator to discuss the details of the changes being affected. At this point the Bank already has an indication on whether the proposed alteration to the payment system still complies with the Core Principles. Subsequently, once the change becomes operative, the Bank will again assess the system to ensure compliance with the Core Principles. A report will be drawn up making suggestions and recommendations. Such assessments will on average be carried out at most once every 2 or 3 years, unless, as stated above, a significant change in the rules has taken place.

6.3 Initial Oversight Assessment

For any system proposed or identified, an initial oversight assessment will be carried out as part of the process leading to approval of the system. The international standards and guidelines on the basis of which assessments are carried out are:

Interbank payment systems	Core Principles for Systemically Important Payment Systems – Report of the Task Force on Payment System Principles and Practices, Bank for International Settlements.
Securities settlement systems	Recommendations for Securities Settlement Systems and Recommendations for Central Counterparties in the European Union

7.0 Co-operation Between Overseer and Regulator

The oversight of payment and settlement systems focuses on the stability and efficiency of each system, as opposed to the stability or efficiency of individual participants or of the financial markets that the systems serve. This is in contrast to the supervision of individual credit/financial institutions, which aim to promote the safe operation of these institutions. Nevertheless, it is essential that close co-operation exists between the payment systems overseers and the banking supervisor. Such co-operation should contribute to an overall strategy of risk reduction in the financial system and also helps to promote its stability. It is therefore a basic requirement that there is the possibility of exchange of information between the authority entrusted with the oversight function and the authority responsible for regulation and supervision in order to ensure the soundness and stability of payment and settlement systems and of their participant credit institutions.

In Malta, this requirement is satisfied through a Memorandum of Understanding that has been signed between the bank and the Malta Financial Services Authority. In this Memorandum the parties have extended their agreement to establish procedures to provide for the mutual exchange of information to ensure financial stability within the financial system in Malta to apply to the regulation, oversight and smooth running of payment and securities settlement systems.

Furthermore, the Bank and the Malta Financial Services Authority have with effect from 17 June 2004, together with the banking supervisory authorities and the central banks of the other new Member States of the European Union, also adhered to the Memorandum of Understanding on co-operation between payment systems overseers and banking supervisors in Stage Three of Economic and Monetary union, in force since 1 January 2001.

Reference

- Overseeing the Safety and Efficiency of Payment Instruments, Payment Systems and Securities Clearing and Settlement Systems – Banque de France
- Oversight of Payment Systems – Bank of England
- ECB - Role of the Eurosystem in the field of payment systems oversight
- ECB Target Oversight Guide (still in Draft form)

Core Principles for Systemically Important Payment Systems (CPSS)

The Committee on Payment and Settlement Systems (CPSS) of the Bank for International Settlements has issued Core Principles for Systemically Important Payment Systems as a means to maintain financial stability by strengthening the financial infrastructure. The Core Principles are expressed in a general way so that they can be useful for any country, and do not represent a design or operation of any individual system. In fact, they suggest, as a minimum, 10 key principles that all systemically important payment systems should satisfy.

- 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 risk they incur through participation in it.
- iii. The system should have clearly defined procedures for the management of credit risks and liquidity risks, which specify the respective responsibilities of the system operator and the participants and which provide appropriate incentives to manage and contain those risk.
- iv. The system should provide prompt final settlement on the day of value, preferably during the day and a minimum at the end of the day.
- v. A system in which multilateral netting takes place should, at a minimum, be capable of ensuring the timely completion of daily settlements in the event of an inability to settle by the participant with the largest single settlement obligation.
- vi. Assets used for settlement should preferably be a claim on the central bank, where other assets are used, they should carry little or not credit risk and little or nor liquidity risk.
- 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.

It should be noted that systems should seek to exceed the minima included in Core Principles IV and V.

The Core Principles are obligatory for systemically important payment systems and should also be observed by other payment systems in the euro area, even if they are not of systemic importance.

Further to the Core Principles, the CPSS also published responsibilities of central bank in applying the Core Principles:

- A. The central bank should define clearly its payment system objectives and should disclose publicly its role and major policies with respect to systemically important payment systems.
- B. The central bank should ensure that the systems it operates comply with the Core Principles.
- C. The central bank should oversee compliance with the Core Principles by systems it does not operate and it should have the ability to carry out this oversight.
- D. The central bank, in promoting payment system safety and efficiency through the Core Principles, should co-operate with other central banks and with any other relevant domestic or foreign authorities.

The Eurosystem has also identified a sub-set of the Core Principles with which euro retail payment systems should comply if they play a prominent role in the processing and settlement of various types of retail payments and if their failure could have major economic effects and undermine the confidence of the public in payment systems and in the currency in general.

Other relevant International Standards and Guidelines:

Real-time Cross Settlement Systems - CPSS

Report of the Committee on Interbank Netting Schemes of the Central Banks of the Group of Ten Countries (The Lamfalussy Report) – CPSS

Recommendations for Securities Settlement Systems – CPSS

Delivery versus Payment in Securities Settlement Systems – CPSS

Oversight Standards for Euro Retail Payment Systems – ECB

Report on Electronic Money – ECB

EU directives of relevance.

Systemically Important Payment Systems

Systemically important payment systems are an essential mechanism which supports the effectiveness of financial markets. It should be noted that poorly designed systems can contribute to systemic crises if risks are not adequately contained. This may result in financial shocks being passed from one participant to another, therefore systemically important payment systems are therefore crucial for the economy.

In order to safeguard the payment system, it is necessary to identify and understand how risk of various types may arise or be transmitted within the system. It is also essential to determine where these risks are borne. Once these risks are properly analysed and assessed, appropriate and effective mechanisms must be devised to monitor, manage and control them.

Risks: Systemic Risk

This is the risk that the failure of one participant to meet its obligations in the system will result in other participants being unable to meet their obligations, thus leading to a chain reaction.

Credit Risk

This is the risk that a party within the system will be unable to meet its financial obligations within the system in full, either when due or at any time in the future.

Liquidity Risk

A party within the system may have insufficient funds to meet financial obligations within the system as and when expected, but it may be able to do so at some time in the future.

Operational Risk

This is the risk that operational factors (eg. Technical malfunctions or operational mistakes will cause or exacerbate credit or liquidity risks)

Financial Market Risk

A malfunction of the payment system may have consequences for the financial markets. Disruption in one are of the market could spread quickly throughout the financial sector and put the whole system at risk. Furthermore, disruptions in the financial sector may also have an impact on the real economy.

Security of the System

This is important both to the confidence of the users of the payment systems and of the users of the payment instruments. These will ultimately lead to the maintenance of public confidence in the currency. Security Risk Analysis

- *Set or review the system's security objectives and policies*
- *Identify the system's functions, components, boundaries and areas of responsibility*
- *Identify possible threats, and their magnitude (impact and likelihood)*
- *Identify existing or potential safeguards (such as physical devices, security software and organisational or operational procedures)*
- *Identify any residual risks and vulnerabilities*
- *Repeat the last two steps until the residual risk and vulnerabilities are acceptable within the system's security objectives and policies*
- *Implement within the system the safeguards identified by the risk analysis process.*

Monetary Policy

The oversight of payment systems is aimed at safeguarding the transmission channel for monetary policy.

A systemically important payment system does not necessarily handle only high-value payments, but can relate to payments of various values which can also trigger or transmit systemic disruption by virtue of certain segments of its traffic.

A system is considered as a systemically important payment system if it has at least one of the following:

- It is the only payment system in the country, or the principal system in terms of the aggregate value of payments;
- It handles mainly payments of high individual value;
- It is used for the settlement of financial market transactions or for the settlement of other payment systems.

Non-Systematically Important Payment Systems

These types of payment systems handle large volumes of payments of relatively low value, and generally carry little, if any, systemic risk. Although a payment system can be designated as being a non-systematically important payment systems, it can still be appropriate to apply many of the Core Principles, especially if the system is widely used and users have no ready substitute methods of making the same payments.

Retail

The Eurosystem has issued a sub-set of the core principles that apply to retail payment systems.

See above mentioned Core Principles Nos: I, II, VII, VIII, IX and X. These are obligatory for non-systematically important payment systems. While the remaining Core Principles, i.e. Nos: III, IV, V and VI are not obligatory, the application of the entire set of the Core Principles by system operators is desirable.

E-Money (Report on Electronic Money published in 1998 by the ECB)

Systems designated as Systemically Important Payment and, or Securities Settlement Systems

Currently the systems designated as systemically important payment and, or securities settlement systems in Malta are:

- MaltaClear – Securities Settlement System
- TARGET2-Malta (T2MT)

Central Bank of Malta Directives related to Payment Systems

1. Directive 2: Payment and Securities Settlement System

This Directive seeks to reduce the legal and systemic risks that are associated with participation in payment and securities settlement systems. It also aims to minimise the disruption to a system that can be caused by insolvency proceedings against a participant in the system. Furthermore, this Directive applies to the operation of and the participation in, domestic payment and securities settlement systems, as well as to any other form of cash or security transactions, whether domestic or cross-border that may be involved therein.

2. Directive 3: Cross-border Credit Transfers

This Directive has been superseded by EC Regulation 924/2009.

3. Directive 4: Electronic Payment Services

This Directive seeks to ensure a high level of consumer protection in the field of electronic payment instruments and to promote customer confidence in, and retailer acceptance of, these instruments, and to set out the minimum requirements needed to ensure an adequate level of customer information upon conclusion of an electronic payment contract as well as subsequent to transactions effected by means of a payment instrument. It should be noted that this Directive does not apply to payments by cheques, and to the guarantee function of certain cards in relation to payments by cheques.

4. Directive 6: Harmonised Conditions for Participation in TARGET2-Malta

This Directive constitutes the legally binding contract that lays down the legal framework for participation in the TARGET2-Malta component system. It provides the access criteria for direct and indirect participation and the application procedure, together with the provision of details of obligations of the parties, the management activity of Payments Module accounts and the processing of payment orders in line with SWIFT standards. The

Directive also includes a description of optional liquidity management features outlining the payments within the scope of the system, and it establishes the security and contingency requirements.