



EUROPEAN CENTRAL BANK

OVERSIGHT STANDARDS FOR EURO RETAIL PAYMENT SYSTEMS

I Introduction

The oversight of payment systems is an essential function of central banks and aims to ensure the smooth functioning of payment systems and to contribute to financial stability. The oversight function of the Eurosystem¹ is recognised in the Treaty establishing the European Community (hereinafter referred to as the “Treaty”) and the Statute of the European System of Central Banks (ESCB) and of the European Central Bank (ECB) (hereinafter referred to as the “Statute”). Article 105(2) of the Treaty and Article 3 of the Statute state that “*the basic tasks to be carried out through the ESCB shall be [...] to promote the smooth operation of payment systems.*”

The Eurosystem’s task of promoting the smooth operation of payment systems consists of ensuring the safety and efficiency of payment systems and the security of payment instruments. The Eurosystem outlined its role in payment systems oversight in a public statement in 2000.² It has adopted various minimum standards for its oversight policy on payment systems which payment

system service providers are expected to meet. Examples of these standards are the 1998 report on electronic money³, and the G10 standards entitled “Core Principles for Systemically Important Payment Systems (Core Principles)”⁴, which were adopted by the Governing Council of the ECB in January 2001.

This note elaborates on the oversight standards that apply to euro retail payment systems, including national and pan-European systems. It explains the methodology that the Eurosystem uses to identify different categories of retail payment system and clarifies which oversight standards apply to each category. In particular, it outlines the new standards that apply to retail payment systems which play a prominent role in the functioning of the economy. In addition, the Eurosystem has reviewed the implications of Member States specifying and providing notification of retail payment systems under Article 10 of the Settlement Finality Directive (SFD).

2 Classification of euro retail payment systems

As part of their oversight function, the ECB and the NCBs have established a common methodology for classifying euro retail payment systems and applying the relevant standards. Euro retail payment systems will have to comply with a harmonised set of oversight standards depending on the degree of disruption that a malfunctioning of these systems could pose to the financial markets and/or the economy in general. Where the disruption to a retail payment system threatens the stability of financial markets, the Eurosystem requires the systems concerned to comply with the entire set of Core Principles. Where the disruption to a retail system does not have systemic

implications but could nonetheless have a severe impact on account of the fact that the retail system in question is of prominent importance for the functioning of the real economy, such a system has to observe a sub-set of the Core Principles (referred to herein as “Retail Standards”). Retail payment systems that do not belong to any of the two

1 The Eurosystem comprises the ECB and the national central banks (NCBs) of the Member States which have adopted the euro. The Eurosystem is governed by the Governing Council of the ECB and the Executive Board of the ECB.

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

3 “Report on electronic money”, ECB, Frankfurt, August 1998.

4 “Core Principles for Systemically Important Payment Systems” (also referred to as the “Core Principles Report”), Bank for International Settlements (www.bis.org), Basel, January 2001.

previous categories have to comply with the relevant oversight standards as and if defined for such systems.⁵

2.1 Retail systems of systemic importance

The Core Principles promote safe and efficient payment systems and set standards that apply to all systemically important payment systems (SIPSs) worldwide. According to the Core Principles report, a payment system is considered to be systemically important if it is capable of triggering disruptions or transmitting shocks across the financial system domestically or even internationally. The main determinants in this respect are the value and the nature of the payments that the system processes. A system is likely to be of systemic importance if at least one of the following is true: i) it is the only payment system in a country, or the principal system in terms of the aggregate value of payments; ii) it mainly handles payments of high individual value; or iii) it is used for the settlement of financial market transactions or the settlement of other payment systems. Each SIPS must comply with all ten Core Principles. While all large-value payment systems in the euro area are considered systemically important, some retail payment systems may also be of systemic importance and will thus have to fulfil the entire set of Core Principles. The central banks of the Eurosystem periodically review euro retail payment systems and may conclude that certain retail payment systems qualify as SIPSs on the basis of their systemic importance in a given context.

When assessing the systemic importance of a retail payment system, the ECB and the NCBs will take account of the market penetration within the respective retail payments market, the financial risks pertinent to the system and the risk of domino effects. They will be lead by the following indicators:

- *Market penetration:* In countries where there is no alternative system available to

handle retail payments there would generally be no alternative payment channel available to the public through which to effect retail payments, should this retail system fail. The volumes processed via such a system would normally be too high to be handled via the real-time gross settlement (RTGS) system. This is similarly true in cases where there are several retail payment systems but one system processes the bulk of the payments. In addition, the technical standards for the retail system in question may differ from those of the RTGS and other retail systems, meaning that it would be technically impossible to effect retail payments, even if the volumes could be dealt with. The failure of a sole or heavily used retail system in a given country could thus threaten the confidence of the general public in the payment system and in the currency. Thus, the fact that there is no alternative system or payment arrangement available to settle retail payments or that the respective system achieves a high degree of market penetration should warrant close attention. A high degree of market penetration is indicated by a market share of more than 75% of the respective retail payments market, i.e. the payments processed via interbank retail payment systems and via other payment arrangements.

- *Aggregate financial risks:* An important factor in evaluating whether a retail system is of systemic importance is the value of the payments that the system processes. The Core Principles Report therefore attaches considerable importance to the value of payments, since there is a positive correlation between the amounts processed and the degree of credit and liquidity risk: the higher the value processed in a system, the higher the systemic implications. Even if retail

⁵ As explained in the ECB statement on the "Role of the Eurosystem in the Field of Payment Systems Oversight" referred to above, NCBs may complement the common oversight policy described here with measures specifically tailored for such retail payment systems.

payment systems are not the principal systems in terms of aggregate value, they may process payments of considerable aggregate value that could be of decisive importance for the financial system. To assess the systemic implications of a retail system, it is helpful to relate the amounts processed in such a system to the amounts processed in the relevant RTGS system. All euro area RTGS systems are considered to be systemically important payment systems (SIPs). Extremely high nominal amounts may also be an indication of systemic importance. Particular attention should therefore be paid to retail payment systems processing more than 10% of the aggregate value of the respective RTGS system or processing payments with an average daily value of more than €10 billion.

- *Risk of a domino effect:* The failure of a participant to meet its obligations in a retail payment system may have serious repercussions for the non-failing participants, since individual problems may be transmitted to them. In the worst case scenario, such problems would be transmitted to all participants in a system. The risk of a domino effect is most evident in a netting system, but also in a gross system where the failure of one participant to fulfil its obligations may cause a liquidity shortage in the system. Elements that can contribute to a potential domino effect are the concentration ratio in or netting effect of a system, or the size of participants' net debit positions.

If the participant with the largest payment obligation in a payment system fails and the values processed in the system are highly concentrated among few participants, the financial consequences for the other participants may be substantial. A concentration ratio of 80% (i.e. the market share of the five largest participants) already appears to put significant strains on the remaining participants in a system. Additionally, in a netting system, the financial burden on

non-failing participants will be substantial if the system achieves a low netting ratio⁶ and participants have significant net debit positions. The financial consequences of such a failure will be particularly severe in the event of unwinding. Therefore, even if retail payment systems settle only relatively small values as compared with RTGS systems, they have to be assessed carefully if they achieve a substantial netting effect or the net debit position of a participant reaches a significant nominal amount. If a system's netting ratio is 10% or less or the net debit position of participants is at least €1 billion, this would appear to warrant careful attention.

If a euro retail payment system is characterised by a high degree of market penetration, high aggregate financial risks and a high risk of a domino effect, there is a strong indication that this system is of systemic importance. In addition to these commonly agreed indicators, central banks overseeing retail payment systems may take into account specificities that are peculiar to their respective payments market. With the integration of the euro payments market and the establishment of a Single Euro Payments Area (SEPA), national specificities that justify an assessment diverging from the commonly agreed Eurosystem framework are expected to vanish over time.

2.2 Retail systems of prominent importance

Some of the Core Principles are, in the view of the Eurosystem, so fundamental that they should not only be obligatory for SIPs but should also be observed by other payment systems of prominent importance in the euro area, even if they are not of systemic importance. Against this background, the Eurosystem has identified Retail Standards with which euro retail payment systems should comply if they play a prominent role in the processing and settlement of retail

⁶ Net settlement balance as a percentage of gross transaction value. A low netting ratio indicates a high netting effect.

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.

The degree of financial risk posed by systems that are of prominent importance to the economy is not similar to that posed by SIPS. For this reason, the Eurosystem has concluded that the Core Principles addressing financial risks (Core Principles III to VI) should not be obligatory for these systems. Consequently, the Eurosystem, when identifying such systems, will not direct its primary focus towards financial risks inherent in the system but rather take account of the concentration of the retail payments market and, in particular, the degree of market penetration of the respective system. A market share of more than 25% of payments processed in the respective retail payments market, i.e. the payments processed via interbank retail payment systems and via other payment arrangements, is an indication that a system is of prominent importance.

The euro retail payment systems that must observe the Retail Standards always provide clearing and settlement services and generally take the form of an automated clearing house (ACH). In these ACH-type systems, payment orders exchanged between financial institutions are sorted and cleared electronically by the ACH and settled by the respective settlement agent. In some countries such infrastructural arrangements do not necessarily take the form of an ACH but of multilateral interbank agreements. Such agreements are of a formal and standardised nature, are based on private contract or statutory law, are characterised by multiple membership and consist of one set of common rules.

The Eurosystem's oversight standards will apply to these ACH-type systems and multilateral arrangements. A distinction must be made between these arrangements on the one hand and "hub and spoke" and bilateral arrangements on the other. Hub and spoke arrangements are a collection of bilateral

agreements. The reason for excluding these and bilateral agreements from the Retail Standards is that some principles (in particular, on access and governance) are too generic to be applied in a straightforward way to such arrangements. It is, however, possible that the Eurosystem will establish specific oversight standards for such arrangements, including correspondent banking and quasi-systems, at a later stage.

2.3 Other retail payment systems

There are other retail payment systems that do not belong to either of the two previous categories. These systems have a lesser impact on the financial infrastructure and the real economy and therefore do not necessarily have to comply with the Core Principles or the Retail Standards. Such systems have to comply with the relevant oversight standards, as and if defined for them. Examples in this respect are the common oversight standards for e-money schemes and the standards defined at the national level by each NCB.

2.4 Follow-up

Once the ECB and the NCBs have evaluated the importance of a euro retail payment system they will assess it against the relevant standards. Systemically important retail payment systems will be assessed against the Core Principles. Retail systems of prominent importance for the economy will be assessed against the Retail Standards. Systems that belong to neither of these two categories will continue to be assessed against any applicable standards (e.g. on e-money).

The Eurosystem will make transparent which retail systems are to observe which oversight standards as well as the degree of compliance already achieved. Systems that do not fully comply with the respective standards will have to improve their design. Of course, the Eurosystem also welcomes any move on the part of system operators to exceed the

minimum standards and to apply additional, if not all, Core Principles if they consider this appropriate.

As a consequence of the move towards a Single Euro Payments Area many euro retail payment systems are currently in the process of, or are envisaging, consolidation or redesign of their infrastructure. The

Eurosystem will take these structural changes into account when assessing a system. It will therefore request any system that is in the process of change to fully comply with its oversight standards only in the medium term. A system that is in the process of re-design or about to reach the end of its life cycle may therefore be grandfathered until 2008.

3 Application of Retail Standards to euro retail payment systems of prominent importance

In the following, the Eurosystem briefly outlines why the different Core Principles should – or need not – be applied to retail payment systems that are of prominent importance to the economy. These elaborations do not explain the different Core Principles themselves. For a more detailed explanation and interpretation of the various Core Principles, please see the Core Principles report referred to above.

3.1 Core Principles to be complied with by retail payment systems

The formulation of the Core Principles is sufficiently broad in scope to apply to a wide range of circumstances. The application of some of the Core Principles to euro retail payment systems that are of prominent importance for the economy therefore does not necessarily require the same strict interpretation as for SIPSs. The interpretation of the respective Core Principle should be proportionate to the importance of the system. Two examples may illustrate this policy line:

- for non-SIPS retail systems to satisfy Core Principle I, it may not necessarily be obligatory to require external legal opinions to assess the legal soundness of a system. Such opinions could also be confined to investigations on an ad hoc basis;

- to satisfy Core Principle VII, the level of security and operational reliability of and the contingency arrangements for retail payment systems that are of prominent importance to the economy do not necessarily have to be identical to those of SIPSs.

The relevant overseer does, however, have to ensure that euro retail payment systems that are of prominent importance to the economy meet the requirements of the particular Core Principle in the respective circumstances in full. In this context, the Eurosystem reiterates one of the conclusions of the Core Principles Report, namely that the primary responsibility for the fulfilment of the respective standards lies with the operator of the payment system concerned. In its oversight assessment of the fulfilment of the relevant standards by the respective euro retail payment system, the Eurosystem takes a broader view than the operator, also encompassing the implications for the economy and the financial system as a whole.

- I *Legal basis: The system should have a well-founded legal basis under all relevant jurisdictions.*

Euro retail payment systems identified as being of prominent economic importance should have a well-founded legal basis. Participants could incur financial risks if the rules and procedures of a system are not clear and enforceable.

- II *Understanding financial risks: 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.*

Participants in euro retail payment systems deemed to be of prominent economic importance should understand the risks they incur through participation in such a system. It has to be clear to participants who will bear which risks and to what extent. This information should be largely provided by the rules and procedures of a system, which should define the rights and obligations of all the parties involved.

- VII *Security and operational reliability: The system should ensure a high degree of security and operational reliability and should have contingency arrangements for timely completion of daily processing.*

Just as the financial economy relies on large-value payment systems for the settlement of financial transactions, the real economy is heavily dependent on the availability of retail payment systems. The retail systems deemed to be of prominent importance should therefore be secure, operationally reliable and have contingency arrangements in place.

- VIII *Efficiency: The system should provide a means of making payments which is practical for its users and efficient for the economy.*

All systems deemed to be of prominent importance should be practical for their users and efficient for the economy. Resources should be used efficiently. A trade-off typically exists between minimising resource costs and achieving other objectives, e.g. safety. Designers of payment systems should economise on resource costs by being practical in the specific circumstances of the system and by taking account of its effects on the economy as a whole. Where this

can increase the overall efficiency of euro retail payment systems, particular consideration should be given to the implementation of international standards (e.g. SWIFT, BIC, IBAN, IPI) in national retail payment systems to allow for straight-through processing of domestic as well as cross-border transactions.

- IX *Access criteria: The system should have objective and publicly disclosed criteria for participation, which permit fair and open access.*

All systems deemed to be of prominent importance should have objective and publicly disclosed criteria for participation. Access criteria that encourage competition among participants promote efficient and low-cost payment services. Therefore, access should generally be free and open. However, imposing restrictions on access may be warranted in order to protect participants against undue risks resulting from the participation of other parties.

- X *Governance: The system's governance arrangements should be effective, accountable and transparent.*

The governance arrangements of systems deemed to be of prominent importance should be effective, accountable and transparent. The governance arrangements provide the structure through which the system's overall objectives are set and attained and through which performance is monitored. Such arrangements should provide proper incentives for management to pursue objectives that are in the interests of the system, its participants and the public more generally. Governance arrangements should ensure accountability to the relevant bodies and be transparent so that all affected parties have access to information applicable to them.

3.2 Other Core Principles

The following Core Principles are not obligatory for euro retail payment systems that are of prominent importance for the economy, but – as outlined above – the Eurosystem would welcome the application of the entire set of Core Principles by system operators, should they deem this appropriate.

IV *Prompt final settlement: The system should provide prompt final settlement on the day of value, preferably during the day and at a minimum at the end of the day.*

A highly desirable objective for euro retail payment systems.

In a SIPS, it is important that final settlement, i.e. debiting and crediting of the participants' accounts, occurs on the same day of value, preferably even during the day, so that participants do not incur undue credit risks. Since high-value payments or payments to settle financial market transactions are generally involved, participants urgently need to know, for risk management purposes, that such transactions have been finally settled during or at the end of the day of value. For retail payments, the amounts involved are smaller and, in most cases, the beneficiaries do not attribute similar importance to prompt final settlement. Since, as explained below, the Eurosystem does not require euro retail payment systems to comply with Core Principles III and V, it would be inconsistent to require settlement on the day of value while not requiring measures to ensure that timely settlement is also achieved in the event of the failure of a participant. Therefore, settlement on the day of value need not become mandatory for retail systems in the euro area.

However, if retail systems do not provide for final settlement on the day of value, the duration of participants' exposure could be several days (e.g. over a weekend). This risk can be avoided in euro retail systems deemed

to be of prominent importance if final settlement takes place on the day of value.⁷ Advances in technology suggest that such system features may be justifiable from a cost perspective. Settlement on the day of value should therefore be a highly desirable objective for euro retail payment systems deemed to be of prominent importance.

III *Management of financial risks: 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 risks.* Risk management features (e.g. collateral pools, debit caps) clearly add to the safety of a payment system. However, a balance has to be struck between safety and efficiency. It is therefore clear that safety requirements for retail systems should be different from those for large-value systems, on account of the different degree of risk involved. System operators should consider which risk management tools would be most appropriate for the system they operate.

V *Settlement in multilateral netting systems: 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.*

As already mentioned under Core Principle III above, a balance has to be struck between safety and efficiency for each retail payment system. If system providers consider it appropriate not to include risk management features in their retail systems, there is a clear risk that, in the event of a participant being

⁷ For retail payment systems, settlement on the day of value does not necessarily mean that settlement has to occur on the day the payment instruction is submitted to the system. This principle will also be satisfied if settlement occurs on some day shortly after submission, as long as final debiting and crediting take place on the same day and participants do not incur overnight credit exposure.

unable to settle, such systems might not be in a position to complete settlement for the day. System operators must consider how their systems can achieve timely settlement to the greatest possible extent in the event of failure.

- VI *Settlement assets: Assets used for settlement should preferably be a claim on the central bank; where other assets are used, they should carry little or no credit risk and little or no liquidity risk.*
Settlement in central bank money does not expose participants in payment

systems to credit risk involving default on the part of the settlement agent. Central bank money is therefore the safest asset for settlement. Since retail payment systems are not normally of systemic importance, the degree of risk involved in such systems does not seem to warrant obligatory settlement in central bank money. Such settlement should be optional, but if a system provider decides to use commercial bank money for settlement, the commercial bank should be of suitable standing.

4 Notification of retail payment systems under the Settlement Finality Directive

The SFD adds legal certainty with respect to the execution of transfer orders and netting in the event of insolvency proceedings against a participant. Therefore, the Eurosystem appreciates the fact that all SIPSs in the euro area have been subject to notification under the SFD. Furthermore, the Eurosystem holds the view that it would also be useful for notification to be given of non-SIPSs, in particular those of prominent importance, under the SFD. It acknowledges that the notifying authority may take account of national circumstances when deciding to designate a system as such.

The Eurosystem takes the view that the specific characteristics of retail payment systems would make it desirable to give notification of such systems under the SFD. Extensive foreign participation in payment systems may introduce particular legal risks, since the law of the foreign participant accessing the payment system via a branch or via remote access might not be fully

compatible with the law of the system. The laws governing, for example, collateral, netting, finality or insolvency in the country of a participant may differ from the laws applicable in the country where the payment system is incorporated. In the view of the Eurosystem, negative consequences for payment systems in the event of the insolvency of a foreign participant could be mitigated by giving notification of the relevant system under the SFD. In such cases, the rights and obligations arising from, or in connection with, the participation of that participant would be determined by the law governing that system. Another advantage of giving notification of a system is that, where a judicial or administrative authority (including a foreign authority) hands down a decision to open insolvency proceedings in respect of a particular participant, the system will be informed immediately of the opening of insolvency proceedings and can take immediate and appropriate action.

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