



EUROPEAN CENTRAL BANK

## “OVERSIGHT STANDARDS FOR EURO RETAIL PAYMENT SYSTEMS”

### Response to the comments received by public consultation

On 8 July 2002, the Eurosystem issued its new “Oversight standards for euro retail payment systems” for public consultation. In total, the Eurosystem received responses from thirteen institutions, with some 120 individual comments being made in total. All responses will be published on the ECB’s website.

There has been wide support for the Eurosystem’s new oversight standards for euro retail payments, and commentators have appreciated the Eurosystem’s transparency in consulting the public for the purpose of further developing its retail policy. Several comments are of an explanatory nature and describe the circumstances surrounding specific systems. The Eurosystem appreciates these contributions but will not comment on them. In the following, comments deemed to be of crucial significance are listed, together with the Eurosystem’s response.

***There is no need to apply different oversight standards to retail payment systems; the same set of standards (e.g. the Core Principles) should, for competitive neutrality reasons, apply to all euro retail payment systems.***

The Eurosystem feels that such an approach would not be appropriate and would appear to be out of line with the Core Principles Report which suggests that “... *the main factor in assessing the potential for a payment system to trigger or transmit systemic disruptions is the value of the payments that the system processes, either in aggregate or individually, relative to the resources of the system’s participants and in the context of the financial system more generally ...*”. Another relevant factor is the nature of the payments which a systemically important payment system (SIPS)<sup>1</sup> normally handles. Examples in this respect would be the settlement of financial market transactions and the settlement of ancillary systems. Such transactions are not normally processed via

retail systems but rather via large-value payment systems. For these reasons, the Core Principles should be applied to euro retail payment systems only if these retail systems have the potential to trigger systemic disruptions. The Eurosystem has pinpointed a set of indicators, which will help identify whether the failure of a specific retail payment system has the potential to cause systemic disruptions.

Applying the Core Principles to systemically important retail payment systems does not, in the view of the Eurosystem, put these systems at a competitive disadvantage vis-à-vis other retail payment systems. Retail systems deemed SIPSs would normally process a high overall value and, in particular, very high volumes of payments. It is true that these characteristics require a stricter application of oversight standards to address the increased risk inherent in these systems. While this may entail increased costs for the system operator on the one hand, on the other hand the very high volumes generally allow such systems to exploit economies of scale, thus reducing their costs per unit.

***There should not be an overregulation of retail payment systems. What standards do small retail payment systems have to comply with that are neither SIPSs nor systems of prominent importance?***

The Eurosystem has carefully weighed the risks stemming from retail payment systems against the costs that stricter oversight standards might entail for the respective system operators. For this reason, the new “Oversight standards for euro retail payment systems” (“Retail Standards”) issued by the Eurosystem for consultation encompass only those retail payment systems *that play a prominent role in the processing and settlement of various types of retail payment and whose*

<sup>1</sup> For a definition of SIPS please see “Core Principles for Systemically Important Payment Systems”, BIS, Basel, January 2001.

*failure could have major economic effects and undermine the confidence of the public in payment systems and the currency in general.*

Thus, three regulatory layers have been created for euro retail payment systems:

- retail payment systems that are of systemic importance have to comply with the full set of Core Principles, as outlined in the Core Principles Report;
- retail payment systems that play a prominent role in the economy have to comply with the sub-set of six Core Principles, as outlined in the Eurosystem's announcement on "Oversight standards for euro retail payment systems";
- retail payment systems that do not belong to one of the previous two categories and thus have a lesser impact on the stability of the financial infrastructure have to comply with the relevant oversight standards as and if defined for such systems. Examples in this respect are the oversight standards for e-money schemes and the retail standards defined at the national level by each NCB.

***Interpretation of the oversight standards should be proportionate to the type of system, i.e. less strict for retail payment systems than for SIPSs.***

As outlined in the response to the previous question in relation to the three-tier categorisation of retail payments, the strictness of the oversight standards has to be proportionate to the risk that the underlying systems pose to the financial system. In that vein, the Eurosystem explained in the consultative document on the new Retail Standards that the implementation of the relevant Core Principles does not require the same strict interpretation for retail payment systems of prominent importance to the economy as it does for SIPSs. The consultative document cites the implementation of Core Principle VII as an example. It is outlined that the level of security and

operational reliability of and contingency arrangements for retail systems of prominent importance to the economy do not necessarily have to be identical to those for SIPSs. This criterion of proportionality would similarly apply to other Core Principles of the sub-set to be applied. For example, for retail systems which are of prominent and not of systemic importance 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.

***The Eurosystem should establish and publish criteria for determining the importance of a euro retail payment system and it should use a homogenous methodology for the assessment of such systems to ensure a level playing field.***

The Eurosystem has discussed criteria that should help to identify the importance of retail payment systems and thus determine which set of oversight standards have to be applied. It concluded that the systemic importance of a payment system depends on the level of concentration within the respective payments market, financial risks pertinent to the system and the risk of domino effects. In this respect, the Eurosystem will take particular account of whether the respective system is the only retail system in a country or whether a substantial portion of retail transactions is concentrated in this system. In the event that such a system fails, banks might find it difficult to process retail payments in that country. In order to assess the financial risks, the Eurosystem will, in particular in netting systems, take account of the turnover of the system and the debit positions of the largest participants. Finally, the Eurosystem will also take account of the risk that the failure of one participant to fulfil its obligations in the system could spill over to other participants and cause these participants to fail too. In addition to these commonly agreed criteria, the central banks overseeing the respective 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 circumstances that justify an assessment diverging from the commonly agreed framework are expected to vanish over time.

The degree of financial risk posed by systems that are of prominent importance to the economy is not normally as high as that posed by systemically important payment systems. 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 take account of the concentration of the retail payments market and in particular the market penetration of the respective system, i.e. its overall market share.

***The assessment of euro retail payment systems should be co-ordinated by a single body.***

The Governing Council of the ECB has (now) adopted a definitive policy for euro retail payment systems, and all retail payment systems will have to be assessed in the light of this policy. Pursuant to the framework already in place within the Eurosystem for the implementation of oversight activities, both the NCBs and the ECB will conduct these assessments. The Payment and Settlement Systems Committee of the ESCB will co-ordinate and review these assessments to ensure that the common methodology is applied in a harmonised manner throughout the Eurosystem.

***Oversight standards should not entail additional costs.***

In fulfilling its task of ensuring the smooth operation of payment systems, the Eurosystem has to ensure that the respective risks are mitigated. The reason for this public function is that individual participants in the payment

system may not be sufficiently aware of the risk that they pose to other participants and to the financial system in general.

The degree of regulatory intervention on the part of the Eurosystem will be differentiated according to the risk to financial stability. Therefore, the higher the risk to the financial system, the higher will be the oversight standards that such a system has to comply with. In addition, efficiency standards will also have to keep pace with the importance of the respective system. This implies that an individual retail payment system will have to satisfy the relevant oversight standards. It will have to improve its safety and efficiency measures in order to comply with the required standards if it does not currently do so. Such improvements in the system design may entail costs for the individual system, but bearing this cost will lead to reduced risks, i.e. a reduction in potential future costs to the system itself, its participants or the entire economy. In addition, the increased efficiency of the system may result in a number of benefits to the economy as a whole. Therefore, from a macroprudential point of view, additional costs for individual payment systems may be warranted if they lead to an effective reduction of risks and/or an increase in efficiency.

***The scope of instruments and systems to be covered should be clearly defined. The Retail Standards should apply to any form of clearing and settlement, i.e. they should not only apply to settlement but also to clearing and they should cover correspondent banking or other arrangements which are similar to payment systems.***

The crucial factor determining whether or not the new Retail Standards are to be applied is whether or not the retail systems play a prominent role in the economy. The kinds of instrument processed via these systems are of a secondary nature and less relevant for determining the degree of importance of a system. A retail payment system is a funds transfer system which handles a large volume of payments of relatively low value in such

forms as cheques, credit transfers, direct debits, and ATM and EFTPOS transactions.

The Retail Standards will apply to clearing and settlement systems. The fact that the relevant systems *always provide settlement services* should not be interpreted in such a way that the clearing process would not be subject to the standards. In fact, clearing and settlement are integral parts of the payments infrastructure. The final version of the Retail Standards clarifies this issue.

The scope of application of the Eurosystem's Retail Standards has been limited to ACH-type systems and multilateral arrangements. "Hub and spoke" arrangements and bilateral arrangements have, for the time being, not been included. Hub and spoke arrangements consist of a multitude of bilateral agreements where the hub (i.e. the settlement institution) can negotiate different contracts with every spoke (i.e. the customer bank). The reason for excluding these arrangements is that some of the principles are too generic to be applied in a straightforward way. For example, how should fair and open access be applied in a bilateral relationship in which the terms and conditions are determined by the two parties to the agreement on the basis of bilateral negotiations?

Bilateral arrangements and hub and spoke arrangements are the typical forms of correspondent banking relationship. The Eurosystem is currently collecting data in order to analyse the importance of correspondent banking arrangements within the financial system. Depending on the results of this analysis, it is possible that the Eurosystem will establish oversight standards for such arrangements.

***Should the application of Core Principle IV become mandatory?***

The Retail Standards do not deem Core Principle IV mandatory, but rather highly desirable. The reason for qualifying it as "highly desirable" is that in the Eurosystem's view the application of Core Principle IV would reduce financial risk. In addition, the

cost of making the technical adjustments necessary for achieving settlement on the day of value would not be excessive. From a methodological point of view it would, however, 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. Since Core Principles III and V are not mandatory, it was felt that compliance with Principle IV should likewise not be mandatory, but rather highly desirable.

***Will the Retail Standards also apply to acceding countries?***

The new oversight standards will govern all euro retail payment systems, i.e. they will apply to any country operating a euro retail payment system. Once they have joined the European Union and adopted the euro, the current acceding countries will have to comply with any oversight standards applicable to the euro area. The Eurosystem is working closely with acceding countries to assist them in preparing for accession. In this respect, the Eurosystem has already outlined the content and importance of its oversight standards. Since many accession countries are in the process of restructuring and redesigning their payment systems, the Eurosystem has highlighted the advantages of choosing a set-up which will facilitate the adoption of Eurosystem standards.

***The scope of oversight with respect to efficiency is unclear and it is for the market to decide on matters of efficiency.***

According to Core Principle VIII, a system *should provide a means of making payments which is practical for its users and efficient for the economy*. It is the task of the system operator, in co-operation with users, to determine the most efficient approach, and the Eurosystem fully recognises the prime responsibility of the market in this regard. The assessment of efficiency aspects cannot, however, be confined to the payment systems perspective, but will also have to take into

consideration the effects on the economy as a whole. It is the role of central banks – such as those of the Eurosystem – as public authorities having the statutory task of overseeing payment systems to verify and ensure that payment systems' operators take adequate account of this broader perspective.

**Core Principle VIII: BIC/IBAN could only be implemented in the long run for reasons of cost; it is premature to ask for straight-through-processing (STP) standards in all retail payment systems and implementation should be a matter of national competence.**

In the discussion on the Single Euro Payments Area (SEPA), the Eurosystem has repeatedly urged banks to overcome the lack of standardisation and implement international standards (e.g. BIC, IBAN) and message formats (e.g. SWIFT MT 103+), which would allow fully automated STP of payments across national borders. These standards should be implemented as soon as possible. It is recognised that this implementation will generate additional costs in the short run, but in the long run banks will be able to process cross-border payments much more efficiently and realise the respective cost savings. In addition, in a true SEPA it is not acceptable for payments of the same kind to differ substantially in terms of efficiency. Thus it is in the general interest, i.e. also in the banks' interest, to implement STP standards and achieve a SEPA as soon as possible. Given its euro area dimension, the implementation of standards cannot be entrusted to national communities alone, but will have to be co-ordinated at the euro area level.

**Core Principle VIII: Efficiency can be achieved within the legislative framework of the EU.**

The Regulation on cross-border payments in euro<sup>2</sup> aims to eliminate price differences between domestic and cross-border payments. Equal fees for the two services do not, however, imply equal costs. On the contrary, banks incur significantly higher costs for cross-border payments than for domestic

payments, i.e. there is a clear deficit in the efficiency of cross-border payments. This needs to be tackled and cannot be solved by legislation.

**Core Principle X: oversight should not touch upon the efficiency of organisational structures.**

As is the case with all other Core Principles, the primary responsibility for the efficiency of governance arrangements lies with the respective system, its owners and users. The central bank must ensure that these governance arrangements are effective, accountable and transparent.

**National implementation of EC Directives (such as the SFD) could lead to competitive distortions.**

It is inherent in the construction of an EC Directive that national authorities can exercise a certain discretion when implementing them into national law. This discretion must remain within the boundaries of the Directive, but can take account of national specificities. Because of this national discretion, it is likely that a Directive will not be implemented in exactly the same way in all countries. To identify any inconsistencies that need to be remedied, EC Directives may contain a review clause. Should such inconsistencies lead to competitive distortions in the ESCB's field of responsibility, the ESCB will bring these issues to the attention of the European Commission for review.

**What is the time-frame for the implementation of the new retail oversight standards?**

The Governing Council of the ECB has approved the final Retail Standards and these standards will now be duly implemented. The Eurosystem will assess all euro retail payment systems by the end of 2004. Retail systems that do not comply with the new oversight

<sup>2</sup> Regulation (EC) No 2560/2001 of the European Parliament and of the Council of 19 December 2001 on cross-border payments in euro.

standards will have to improve their design in order to comply with the respective standards.

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

their infrastructure. The Eurosystem will take these structural changes into account when assessing a system. Thus, a system in the process of redesign will be required to fully comply with the Eurosystem's oversight standards only in the medium term. Systems that have reached the end of their life cycle may therefore be grandfathered until 2008.

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