

THE BANK OF FINLAND OVERSIGHT POLICY

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Introduction

The functioning of our society is based on a monetary economy. The smooth operation, reliability and efficiency of payment and settlement systems is a prerequisite for the fact that we can receive our wages and salaries, earn our daily living and invest in a home or in a business. The tasks of financial markets are to ensure that payments are transferred and savings are channelled from the economy's surplus sectors to borrowers, and to enable the spreading of risks. All these functions require that various parties are brought together: payer and payee, depositor and borrower or risk-taker and a party interested in risk-sharing.

Due to their critical role, payment and settlement systems are overseen and their operations are subject to certain requirements. The provision of services requires authorisation and regular reporting. Service providers' actions are driven by their own private interests, and this does not necessarily lead to optimal outcomes for the system as a whole or for society. The key task of central bank oversight is to ensure that infrastructures function so as to take into account the benefits for society as a whole.

Oversight of the financial infrastructure is part of central banks' macroprudential duties. Oversight of infrastructures plays a key role in improving the resilience of the financial system and safeguarding the continuity of functions that are critical for society.

1 What are financial market infrastructures

Financial market infrastructures, ie payment and settlement systems, refer to multilateral arrangements and systems that are applied and used for the clearing, settlement and recording of payments, securities, derivatives or other financial transactions (CPSS-IOSCO: PFMI 2012). In addition to payment systems, financial market infrastructures include central securities depositories, which are responsible for securities settlement and safekeeping, as well as central counterparties and trade repositories.

Infrastructure refers not only to IT systems; the concept also covers the agreements, rules, practices and procedures for the transfer of transaction data and the required funds. The rules define the criteria for system participation, risk management and the responsibilities of involved parties, and they play a key role in the assessment of systems.

The reliable and efficient operation of these systems supports financial stability and promotes growth. On the other hand, payment and settlement systems can also become channels through which the problems of one participant spread rapidly to other participants; or in the event of operational failure, system participants may have difficulties in meeting their obligations. Problems like these may arise for example as a result of a rapid decline in available liquidity or if the counterparties incur credit losses.

2 The basis of the oversight task

Under the Act on the Bank of Finland, the Bank's task is to participate in maintaining the reliability and efficiency of the payment system and overall financial system and participate in their development (section 3, subsection 1, clause 3 of the Act on the Bank of Finland 214/1998). Other provisions on the secrecy obligation notwithstanding, the Bank of Finland shall have the right to obtain from the authorities and credit and financial institutions and other financial market participants any notifications, reports and other information necessary for carrying out the Bank's statutory tasks (Section 26, subsection 1 of the Act on the Bank of Finland).

As a member of the European System of Central Banks (ESCB), the operations of the Bank of Finland are also based on the Treaty on the Functioning of the European Union (Protocol No 4), which states that the task of the central bank is to promote the smooth operation of payment systems. The Bank of Finland also observes the agreed practices and oversight principles of the ESCB.

As a member of the ESCB, the Bank of Finland is committed to complying with international oversight principles.¹ These principles define the criteria for assessment of the smooth operation and efficiency of payment and settlement systems as well the division of responsibilities and communication between the various authorities.

The application and timing of oversight principles are agreed within the Eurosystem, in connection with the assessment of critical payment systems. The Eurosystem prepares its own policies on the basis of the oversight principles. The Bank of Finland operates in accord with these policies.

The Bank of Finland's strategy includes the specification of the priority areas that underlie the oversight priorities and the allocation of resources.

3 International and domestic cooperation between authorities

EU legislation defines the role of overseers and central banks in the cooperative oversight of central counterparties and central securities depositories.

The oversight responsibility of international systems lies with the central bank of the system's home jurisdiction. If a system does not have a clear home jurisdiction, the lead overseer is the ECB. In the Eurosystem, the oversight of international systems is based on the principle of voluntary participation. The Bank of Finland participates actively in the cooperative oversight of payment and settlement systems that are important for Finnish society.

The oversight of national payment and settlement systems as well as the oversight of the national special features and needs of international systems is the responsibility of the national central bank. International oversight principles recognise the authority of national authorities.

In the domestic division of tasks, the Financial Supervisory Authority supervises primarily entities that are required to have authorisation.² The central bank, in turn, focuses on the system level; the arrangements, practices, rules and systems that link the individual participants and form payment networks and settlement systems. Cooperation between these two authorities is necessary to ensure the reliability and efficiency of payment and settlement systems.

¹ CPSS-IOSCO principles for financial markets infrastructures

² Credit institution or payment institution authorisation.

4 The objects of oversight

As a member of the Eurosystem, the Bank of Finland works as an overseer of the European financial market infrastructure within the committee structure of the European Central Bank. The Bank of Finland's statutory task to participate in maintaining the reliability and efficiency of the payment system and overall financial system and participate in their development refers primarily to infrastructure important for the Finnish economy and society.

In accordance with internationally accepted principles³, the purpose of oversight is to assess systemically important infrastructures. Disruptions in such an infrastructure can broadly paralyse the operation of financial markets. Similarly, the importance of the transactions transferred via these infrastructures is so great that the failure of one participant can spread to the other participants of the system. Systemically important systems include large-value interbank payment systems, and central counterparties and central securities depositories used for the clearing and settlement of securities trades.

Retail payments are based on electronic payment instruments, ie payment cards, bank connection software and online banking. Electronic payment is part of the automation of financial administration, and it can improve corporate efficiency. Although deficiencies in retail payments would not immediately cause severe disruptions in financial markets, they would hamper the day-to-day operation of society and undermine public confidence in the payment systems and financial system as a whole. For this reason, oversight also covers retail payment systems important for society.

Since 2012, the oversight principles have also included the assessment of the infrastructure's critical service providers, irrespective of whether they are subject to authorisation. A globally important critical service provider is SWIFT, a provider of telecommunication services to the financial sector. The oversight principles take into account current trends, ie that service providers that extensively utilise information technology enhance their operations by splitting up processes and outsourcing parts of them. Responsibility for these services however always remains with the original service provider. Overseers monitor and assess only systemically critical service providers, not the outsourcing partners of individual market operators.

³ CPSS-IOSCO principles for financial markets infrastructures and the ESCB oversight policy.

The character of an infrastructure as a function seeking economies of scale, technological advances and European integration have led to a situation in which an infrastructure like this is not necessarily located in Finland. For the performance of its statutory task, the Bank of Finland works actively to promote international cooperative oversight. Only if it obtains adequate information on the operation of international infrastructures and has the possibility of influencing the oversight assessments of these systems is the Bank of Finland able to carry out its statutory tasks. The Bank of Finland defines the system-specific criteria for assessing the reliability and efficiency of the important infrastructure and works with both domestic and international partners.

5 The objectives of oversight

The task of ensuring the reliability and efficiency of payment and settlement systems is realised through three interlinked objectives:

- smooth operation and reliability of systems
- efficiency of the systems for society as a whole
- a structure that supports the competitiveness of infrastructures

Reliability of operations is a requirement for the infrastructure involved in the transfer of payments or securities important for society. Reliability of operations refers first and foremost to operations free of errors and disruptions, and the ability to produce the promised service as agreed. Reliability of operations is also the basis for assessing the efficiency of a system. Safeguarding the reliable operation of payment and settlement systems is the primary objective of oversight. The Bank of Finland has fulfilled this objective for example by conducting an oversight assessment of the special domestic features of the new retail payment system and by issuing recommendations for responsive action. Payment and settlement systems' services critical for society must be able to function adequately even in the event of an exceptionally severe incident. The oversight function contributes to the secure functioning of the infrastructure in such situations and participates in crisis management as specified separately. Oversight supports the national objectives of the security of supply.

On the one hand, efficiency may refer to the production costs or processing speed of the transactions and other functions of the system. On the other hand, in terms of a private sector service, efficiency may also refer to profitability of production. Individual service providers seek to optimise the reliability and efficiency of their processes from their own perspective. Financial market infrastructure services are typical services of a network economy in which the solutions of individual entities have an impact on the operating conditions of the other parts of the network. A conflict may arise between a private entity and system or its social efficiency.

The efficiency goals of an individual entity may not take into account how the payment and/or settlement system in question serves all its participants, their customers and society. Oversight examines the efficiency of infrastructures based not only on production costs and processes but also from the perspective of how well they serve the needs of end customers. From the perspective of society, payment and settlement systems can support the enhancement of the customers' own operations, in which case the efficiency gains extend wider than the individual payment system or payment service provider. A good example is the standardisation of electronic payment transfer, which enables the automation of companies' financial administration. The efficiency of infrastructures for society as a whole is another important objective of oversight.

Infrastructure services are dependent on financial market structures, ie on market participants and services. Correspondingly, without an infrastructure that is efficient for society, the competitiveness of financial markets can be threatened. Infrastructure that is efficient in terms of the tasks of the financial market enables the operation and innovations of credit and payment institutions of different sizes and with various service concepts. Therefore a structure that supports the reliable operation, efficiency and competitiveness of infrastructure is also one of the objectives of oversight.

6 Oversight practices

To be able to promote the reliability and efficiency of the payment and financial system, oversight must entail close monitoring of infrastructure developments, both domestically and internationally, as well as analyse trends and their impacts. The analysis is both qualitative and quantitative. The analyses that are part of the oversight function utilises documents, data and statistics on the payment and settlement systems, meetings with system participants, and market information. Critical systems are subject to regular oversight assessments. Based on the analyses and the oversight assessments, oversight draws conclusions as to changes necessary in the infrastructure.

Using analyses and oversight assessments, the central bank seeks to ensure the reliable and efficient operation of payment and settlement systems for society as a whole. The Bank of Finland exercises influence on market participants and competent authorities to implement the desired changes and objectives. Oversight conclusions are communicated primarily in meetings with market participants, in Bank of Finland publications, other

articles, essays and presentations, and in cooperation with the Bank of Finland Board.

The Bank of Finland can also take more concrete steps in the development of payment and settlement systems. The maintaining of payment and settlement systems is often a private sector service, and a central bank's participation in their development must be considered carefully and case-by-case. The central bank's participation in system development is justified if such deficiencies are detected in the operation of the infrastructure that the system operator or participants do not have adequate incentives or means to mend them. Such deficiencies can lead to either weakness in risk management at system level and thereby to higher risks, or to inefficiency from the perspective of the end customer and society. When the central bank participates in infrastructure development, it takes into account the oversight requirements concerning the infrastructure.

Legislation creates the framework for the operation of payment and settlement systems. The oversight function participates in the drafting of legislation on financial market infrastructures, in cooperation with the Ministry of Finance and Ministry of Justice.

On the one hand, oversight is based on international oversight principles and jointly-agreed Eurosystem policies, and on the other hand, on the oversight policies approved by the Board of the Bank of Finland, and the Bank's strategic policy decisions. Oversight assessments as well as policies affecting the oversight activities are presented to the Board of the Bank of Finland for approval.

In its oversight work, the Bank's most important entities for cooperation are – in addition to infrastructure providers and users of infrastructures and the Federation of Finnish Financial Services – the Financial Supervisory Authority, the Ministry of Finance and the Ministry of Justice. Regarding critical continuity arrangements and contingency planning, the Bank works in the Finnish security of supply system. The oversight of international infrastructures is based on cooperation with the authorities of other countries. Within the Bank of Finland, the most important parties for cooperation are – in addition to the Macroprudential Analysis Division, the Macroprudential Policy Division and the Statistics unit – the Banking Operations Department and the Cash Department.

To promote the efficiency of payments, the Bank of Finland has arranged an annual Payments Forum, in which the trends and objectives of payments have been discussed together with the industry and the users of payment services. The Payments Council, chaired by the Bank of Finland, will provide a framework for dialogue between payment service providers and

users. The Payments Council is an important channel for exerting influence and ensuring that, as services and infrastructure solutions change, we will see an increase in the benefits of automated payments for end customers and for society as a whole.

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