EUROPEAN CENTRAL BANK

EUROSYSTEM

HARMONISED OVERSIGHT APPROACH AND OVERSIGHT STANDARDS FOR PAYMENT INSTRUMENTS

1 BACKGROUND

Central banks generally have the explicit objective of fostering financial stability and promoting the soundness of payment and settlement systems. As a rule, the extent of the oversight efforts that should be invested to ensure the compliance of the overseen entity should be in proportion to the systemic importance of that entity from a risk perspective. In line with this risk-based approach, the Eurosystem's common oversight started with those payment systems that could, under certain circumstances, undermine the stability of financial institutions and markets; thus, it developed standards for large value systems, and thereafter standards for retail payment systems. The risks in the provision of payment instruments (such as e-money, card schemes, direct debits and credit transfers) have not generally been considered to be of systemic concern, but the safety and efficiency of payment instruments are important for both maintaining confidence in the currency and promoting an efficient economy. The smooth functioning of payment instruments facilitates commercial activities and, thereby, welfare.

2 SETTING COMMON OVERSIGHT STANDARDS FOR PAYMENT INSTRUMENTS

The creation of the Single Euro Payments Area (SEPA) is changing the retail payment landscape significantly, increasing the importance of having a consistent approach in the oversight of payment instruments.

In the light of this, the Eurosystem developed oversight standards for card payment schemes in 2006/07, which were finalised after a public consultation in 2007 and approved by the Governing Council in January 2008. On the basis of these standards, the Eurosystem has developed a generalised approach and a minimum set of common oversight standards for payment instruments. The standards will create the common ground for all payment instrument frameworks, while leaving enough flexibility for the specificities of the individual instruments involved. Instead of elaborating frameworks in response to market developments on a case-by-case basis, the common oversight standards represent foundations on which oversight of payment instruments in general can be built.

Hence, the common standards will be used as a basis for the development of oversight frameworks for SEPA direct debits and SEPA credit transfers, as well as for new payment instruments that are used SEPA-wide. Each national central bank (NCB) may decide to apply the common standards also for the oversight of remaining national (non-SEPA) payment instruments if they deem this to be appropriate.

3 EUROSYSTEM APPROACH TO THE OVERSIGHT OF PAYMENT INSTRUMENTS

The Eurosystem approach is based on the following steps:

1. *fact-finding* on each payment instrument, including the development of a common Eurosystem approach to identifying when existing or new payment instruments reach market significance;

2. *risk analysis*;

3. development of the *oversight standards* and consideration, under each standard, of key issues;

4. public *consultation* or consultation of relevant players;

5. development of an *assessment methodology* to serve as a guide for a comprehensible and efficient assessment of each payment instrument against the oversight standards;

6. collection of *statistics* – aggregated business and/or fraud data – relevant to each payment instrument;

7. adoption of a common procedure for the practical *implementation of oversight* activity relating to payment instrument schemes.

4 SCOPE

4.1 CONSIDERATION OF THE INSTRUMENT-SPECIFIC DIVERSITY OF PAYMENT INSTRUMENTS

The common oversight standards for payment instruments issued by the Eurosystem cover SEPA direct debits, SEPA credit transfers and cards, as well as any other new payment instruments that are used SEPA-wide. With respect to both card and e-money schemes, the common standards rely on policies that the Eurosystem has adopted separately. Each NCB may decide to apply the common standards also for the oversight of remaining national (non-SEPA) payment instruments if they deem this to be appropriate. Since the goal of the SEPA initiative is a migration to common standards, the introduction of oversight for national payment instruments in countries where there is thus far no such oversight should only be envisaged if there is sufficient evidence that the national systems will not be phased out within the applicable SEPA deadlines.

Obviously, in order to take into account the specificities of each of the payment instruments, apart from the standards, the specific content of each of these steps (for instance, the relevant key issues identified per standard and their corresponding explanatory memorandum, the assessment questions, the assessment guide and the statistical reporting) will differ from payment instrument to payment instrument on account of the diversified nature of their operation.

4.2 OVERLAPS BETWEEN THE OVERSIGHT STANDARDS FOR PAYMENT INSTRUMENTS AND OTHER OVERSIGHT ACTIVITIES OR REGULATIONS

The oversight frameworks will, in order to avoid overlaps and duplication of work, clearly state specifically for each instrument which parts might also be subject to other Eurosystem oversight frameworks (e.g. those for large-value and retail payment systems) or to those of other regulatory authorities (e.g. banking supervisors). In the field of, or with respect to, critical functions of payment instruments that are subject to Eurosystem oversight, the results thereof will be used in the assessments of the relevant payment instruments. The overseer may also consider relevant assessments or activities of banking supervisory bodies. In addition, if certain payment instruments use correspondent banking arrangements, their operation will be reflected in the regular monitoring of correspondent banking activities.

In general, if some of the functions are of potential interest to other regulatory authorities, the Eurosystem will highlight these parts and should consider developing a framework for cooperation with those authorities that emphasises the specific fields of competence and intervention on payment instruments. The Eurosystem acknowledges that these boundaries are quite heterogenic within the euro area, and that these provisions do not, therefore, overrule any national legal obligations or mandates that an NCB might have for payment instruments operating in its national jurisdiction.

5 ADDRESSEE OF THE FRAMEWORK

From an oversight perspective, payment instruments are often offered by schemes that can, in turn, be broken down into main components or functions. One of the actors present in each scheme is the governance authority. For oversight purposes, the Eurosystem will consider the governance authority to be accountable for the overall functioning of the scheme that promotes the payment instrument in question, for ensuring that all the actors involved in the scheme comply with the rules. In agreement with the overseer, however, the governance authority may appoint other specific actor(s) to be responsible for certain scheme functions. In such cases, the boundaries set for the responsibility of these actors must be clearly defined, transparent and documented.

6 THE COMMON OVERSIGHT STANDARDS

The oversight of payment instruments should be aimed at ensuring the soundness and efficiency of payments made with such instruments. The soundness of payment instruments may be exposed to various risks, as is any payment system. Risk analyses carried out by the Eurosystem (involving card payment schemes, direct debits and credit transfers) have revealed that the risks can be legal, operational and financial in nature. Consequently, payment instruments should be protected against all those risks that would have an overall impact on the confidence of users in the instrument. A clear distinction should be made between issues with a scheme-wide impact (e.g. a breach of common rules or security standards, which would place all or a huge proportion of actors in jeopardy) and issues relating to individual actors (e.g. the insolvency of one actor, which would be handled by banking supervision) or issues that need to be mitigated by the individual actor concerned. In addition, it is particularly important to put in place efficient and effective governance arrangements, as well as to emphasise the prevention of any loss of the instrument's reputational standing.

The Eurosystem's oversight approach for payment instruments is focused on issues of scheme-wide importance that are under the control of the governance authority of the scheme providing the payment instrument. Although this is a common Eurosystem approach, it would be possible for each NCB to go further, and to adopt an approach that also encompasses other actors of the scheme, for instance, if this is required by national law.

Therefore it would be proposed that all schemes offering payment instruments covered by the scope of the oversight activity should comply with the following standards:

Standard 1: The scheme should have a sound *legal basis* under all relevant jurisdictions

The governance authority should establish rules and contractual arrangements for governing the payment instrument scheme in such a way that they provide a complete, unambiguous and enforceable legal framework for the proper functioning of the scheme. The rules and contractual arrangements should be compliant, in all circumstances (also over time and, where relevant, across borders), with applicable national and EU legislation. If this is not the case, appropriate action should be taken to eliminate or mitigate non-compliance.

Standard 2: The scheme should ensure that *comprehensive information*, including appropriate information on financial risks, is available for all actors

Clear, comprehensive and up-to-date documentation is essential for the smooth functioning of a payment instrument scheme. This documentation should be readily available in order to enable all actors to take appropriate action in all circumstances. In particular, actors should have access to relevant information in order to enable them to evaluate and mitigate financial risks; this will reduce the risk of a loss of confidence in the payment instrument through unexpected financial losses, including fraud. However, sensitive information should only be disclosed to the relevant actors on a need-to-know basis.

Standard 3: The scheme should ensure an adequate degree of *security, operational reliability and business continuity*

Operational risks, including fraud, could have a serious impact on the schemes offering the payment instrument. Operational risk results from inadequate and/or the failure of internal processes and systems as a result of human error or external events. This could lead to a financial loss for one or more of the parties using the payment instrument, thereby undermining the users' confidence in it. Thus, adequate security controls should be in place to mitigate operational risks. In this regard, the governance authority should ensure that all relevant actors in the scheme focus on risk and security management, business continuity and outsourcing by ensuring that adequate technical standards and procedures are in place.

Standard 4: The scheme should implement effective, accountable and transparent *governance* arrangements

Poor governance may have an adverse effect on the schemes operating the payment instrument and can cause serious financial losses to its actors. Efficient decision-making bodies and processes are needed in order to prevent, detect and respond promptly to disruptions. An updated and comprehensive security policy is needed to establish and maintain the trustworthiness of the scheme. Effective internal control processes are also essential in order to prevent any loss of confidence in the scheme, including an adequate and independent audit function.

Standard 5: The scheme should manage and contain *financial risks* in relation to the clearing and settlement process

The governance authority of the scheme operating a payment instrument should ensure that clearing and settlement providers are fit to perform their role in the scheme by identifying the financial risks involved in this process and by having the appropriate measure defined in order to address these risks. Any procedures to complete settlement in the event of default should not undermine the solvency of the actors committing resources to complete settlement.

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