PAYMENT SYSTEMS AND FINANCIAL STABILITY: A LEGAL ANALYSIS

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14 November, 2013
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FINANCIAL STABILITY AND PAYMENT SYSTEMS
Central banks’ functions in the area of payment systems are very closely related to their functions in the areas of monetary policy and financial stability.

Monetary stability supports sound investment and sustainable economic growth, which in turn are conducive to financial stability and support the smooth operation of payment systems.

A country’s payment system is the channel through which the central bank passes on its monetary policy.
Well-functioning payment systems ensure the efficient and safe execution of monetary policy operations and facilitate the smooth and homogenous transmission of monetary impulses.

The smooth functioning of payment systems is a precondition for users’ confidence in these systems and, ultimately, public confidence in the currency.

Central banks would extend their concern toward the safe and efficient use of payment instruments with a view to maintain public confidence in the currency and ensure its smooth circulation.
Central banks have a strong interest in promoting safety and improving efficiency in payment systems as part of their overall concern with financial stability.

The importance that central banks attach to the stability of financial markets derives from the possibility that financial institutions’ actual or perceived inability to settle their obligations in distressed market conditions could contribute to a loss of confidence and could also have a negative effect on the stability of financial markets and the economy as a whole.
In systemically important payment systems, disruption caused by one participant in the infrastructure can cause disruptions for other participants, propagate financial disturbances and possibly even amplify such disturbances by inducing chain reactions that might contaminate the whole financial system.

In that case, central banks decide on a case-by-case basis whether or not to inject liquidity into the market by means of extraordinary and/or non-conventional market operations, and whether and how to provide funding to individual banks that are illiquid but solvent.
A further issue facing systemically important payment infrastructures is the question of “moral hazard”. In some cases, markets may be convinced that some entities are “too big to fail”, which could lead to public intervention being expected in the event of any crisis.

To address such market failures and prevent them from occurring, central banks are involved in payment, clearing and settlement systems in different ways. In such systems, central banks aim mainly to:

- prevent systemic risk, thereby maintaining financial stability;
- promote the efficiency of payment systems and instruments;
- ensure the security of and public trust in the currency as the settlement asset; and
- safeguard the transmission channel for monetary policy.
To fulfill these objectives, the central bank typically acts in a variety of capacities as follows:

- As the operator or provider of a payment service, the central bank owns and operates facilities providing payment, clearing and/or settlement services.
- As a catalyst, the central bank plays an important role to create a supportive framework for system development.
- As a participant or a user of such systems, the central bank could participate in or use systems owned or operated by external parties.
- As the oversight authority, central banks oversee payment systems in order to ensure their smooth and efficient functioning, as well as their integrity and stability.
Over the last few decades, central banks have gained considerable expertise and knowledge regarding the functioning of payment systems and the risks involved. However, the continuous evolution of the handling of payments, securities and other financial instruments still poses a number of challenges to central banks.
THE ROLE OF THE LEGAL AND REGULATORY FRAMEWORK IN PAYMENT SYSTEMS
There exist no clearly defined standards for what kind of legislative or regulatory framework that should be in place.

Different models exist, from rather specific payment systems acts and laws on central bank oversight to more general laws, sometimes also including passages in the banking laws and in the central bank laws.

In some countries, the laws are very detailed, while in others, the authorities, like banking supervisor or the central bank has the power to decide upon the regulatory framework of the payment system.
Given the important role the payment system plays as key component of the financial system, many central banks have now received an exclusive mandate with respect to the stability or soundness of the financial system which includes also the payment system. The most prominent example is the European System of Central Banks (ESCB). One of the four basic tasks of the ESCB consists of "the promotion of the smooth operation of payment systems".

In many jurisdictions, laws on central banks expressly mention the central banks‘ crucial role in promoting sound and efficient payment and settlement infrastructures, which is linked to the tasks of maintaining confidence in the currency and providing sufficient liquidity to the financial system, both in normal circumstances and in cases of emergency.
The activities undertaken by the central bank in the execution of its mandate should be properly legally documented.

Consequently, the legal framework should define precisely the central bank's mandate (i.e. the power to establish payment systems, the power to make regulations, the power to arbitrate and bind parties), determine clearly its responsibilities and offer proper instruments.
A system, which is not legally robust or in which the legal issues are poorly understood could endanger its participants. As a result, it is no surprise that most internationally agreed safety and efficiency standards in the field of payments, clearing and settlement, including “Core Principles for Systemically Important Payment Systems” contain a standard on legal risk to the effect that “the system should have a sound legal basis in all relevant jurisdictions and the rules and procedures of a system should be enforceable and their consequences predictable”.
In the execution of its mandate, central banks’ legal framework alone may not be sufficient to offer a genuinely sound legal basis for the payment system. Other fields of the law, normally beyond the realm of central banks, might require specific intervention of the lawmakers to enhance the soundness and efficiency of the payment system (i.e. rules on insolvency, netting and financial collateral arrangements, legislation relating to contracts, relationships with debtors and creditors).
Now a relatively strong approach supports that explicit mandate of the central bank with respect to the payment system should be delineated in a specific payment system law.

The law should set out the scope of the central banks' mandate precisely.

Alternatively, the law could grant the central bank the power to determine the public policy objectives vis-à-vis the payment system, etc.

The law should provide an adequate legal basis for the oversight over the payment system by central banks. In that case, central banks should clearly separate the responsibilities of operating payment systems and overseeing payment systems.
In many jurisdictions the central banks’ competence in the field of the payment system is shared with other domestic institutions, namely, legislative authorities, ministries of finance, supervisors and competition authorities. In such cases, the law should delineate clearly the division of tasks between the central bank and other competent authorities. To that end, the legal framework should, at least under certain modalities, allow for the exchange of supervisory information between the authorities involved.

It is also important to clearly specify the jurisdiction under which law the payment system’s rules and procedures should be interpreted.
The law should set out “the existence of finality of payments”. In legal terms, finality may be defined as “the point or moment at which a transfer or settlement becomes irrevocable and unconditional”.

Between the time that transfer orders are accepted for settlement by the payment system and the time the order is actually settled, participants are subject to credit and liquidity risks, as the transfer order could be revoked or a system participant could become insolvent. Therefore, issues of finality require a legislative solution by adopting clear rules.

The provisions of the EU Settlement Finality Directive 96/26/EC on settlement finality in payment and securities settlement systems adopted in 1998 may lead the way to the relevant jurisdictions.
THE LAW ON PAYMENT AND SECURITIES SETTLEMENT SYSTEMS, PAYMENT SERVICES AND ELECTRONIC MONEY INSTITUTIONS (LAW NO. 6493)
Payment Systems Law

- The basic legal arrangements about payment and settlement infrastructure in Turkey

  - The Law on the Central Bank of the Republic of Turkey (Law No. 1211)
  - Payment Systems Operational Rules and participation agreement
  - The Banking Law (Law No. 5411)
  - The Capital Markets Law (Law No. 6362)
  - The Cheque Law (Law No. 5941)
  - The Bank Cards and Credit Cards Law (Law No. 5464)
  - The Public Finance and Debt Management Law (Law No. 4749)
  - The Turkish Commercial Code (Law No. 6102)
“Payment Systems Law” defines the objective and scope of the Law as regulating the principles and procedures of (a) payment and securities settlement systems, (b) payment services and (c) electronic money schemes. The activities of payment and securities settlement systems operators, as well as payment services providers and electronic money institutions shall be subject to provisions of the Law.
The Law includes the term “payment service”, which was not defined in the Turkish legislation before, and regulates the institutions providing payment service, which were not classified in any way, under the name of “payment service provider”.

The Law defines electronic money institutions and payment institutions established under this Law as well as the banks included in the Banking Law as “payment service providers”, stipulates that payment institutions willing to operate in the field of payment services under the Law shall need to obtain permission from the Banking Regulation and Supervision Agency.
The banks operating pursuant to the Banking Law and the electronic money institutions established by this Law are considered as institutions that are allowed to issue electronic money. The rest shall be prohibited from being engaged in electronic money issuing operations. The Law regulates that the electronic money institutions established for the first time by this Law shall need to take permission from BRSA; however, it is also settled that the banks shall be able to issue electronic money without the permission of BRSA.
Licensing and supervision of payment institutions and electronic money institutions shall be carried out by BRSA. Besides, the Law settles that the opinion of the Central Bank shall be sought for relevant arrangements and regulates that BRSA and the Central Bank shall exchange opinion and information in practice.

It is settled that principles and procedures regarding the operations and supervision of payment institutions and electronic money institutions shall be governed by a regulation to be issued by BRSA.
According to the Law, certain conditions and standards need to be fulfilled to operate a system. In this context, it is regulated that the Central Bank’s permission shall be sought to act as a system operator. In this regard, although the institution applying to act as a system operator fulfills all the required conditions and documents, the Central Bank shall be entitled to withhold permission to establish a new system in case it finds out that a new system may have negative implications for financial stability.

The Central Bank shall also have the authority to oversee the systems. For a smooth oversight, system operators shall be liable to submit all kinds of records, information and document, even if they are confidential, to the Central Bank in line with the principles and procedures to be set by the Central Bank and to make the system ready for the oversight of the Bank.
The Law also regulates the breaches which may be detected by the Central Bank and the measures to be applied. Depending on the severity of the breaches in system operation, the Bank shall have the authority to:

- grant a reasonable time period for the system operator to eliminate the cause of breach
- require the system operator to apply measures such as collateral pool and guarantee mechanism to provide settlement
- require certain participants to be banned from the system
- temporarily suspend operation licence until the problem is resolved
- revoke operation licence
- temporarily take over the management of the system operator to ensure smooth and uninterrupted execution of transactions in the system
The settlement provisions also constitutes an important part of the Law. The moment after which transfer orders will be irrevocable by participants or third parties has been clearly indicated and it has been stipulated that the transfer orders may not be revoked by any party after the prescribed time.

The system rules clearly define the moment of entry to the system. This allows the determination of the moment as of which payment orders entered into the system shall be affected by the measures and decisions taken by the relevant authorities.

In this context, the measures and decisions in question shall affect transfer orders entered into the system after the notification of such measures and decisions to the system operator.
In the event that the system operates according to the netting principle, it is settled that the netting transaction shall cover the transfer orders entered into system prior to the notification of such measures and decisions to the system operator. Within this framework, “zero-hour rule” principle, one of the standards designated by international institutions like BIS-CPSS is also regulated.
The Law regulates that the collaterals provided to the participant or the system operator in connection with the system as well as collaterals provided to the Central Bank shall be used to meet the obligations of the collateral provider arising from the system, and the measure and decision shall be applicable to the unused portion of the collateral after the fulfilment of collateral provider’s obligations.
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