

Oversight Function in Practice: How To Conduct Oversight

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**MEFMI Workshop on Practical Application of Payment
Systems Oversight
, October 2017**

Agenda: The Ws and H of Oversight Activities and Processes



What

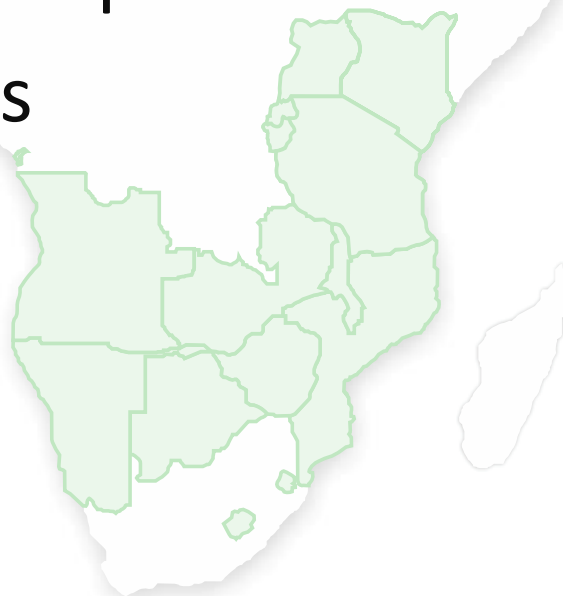
Why

Who

How

OUTLINE

- Scene Setting
- Rationale for Oversight
- Key Activities
- Roles and Responsibilities
- The Process
- Conclusion





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Scene setting: Payment System and the Economy

PS as the
economy's
plumbing
network

**Economic
Efficiency**

- Reduces transaction costs in the economy
- Promotes the efficient use of financial resources

**Monetary
Stability**

- Helps in efficient conduct of monetary policy
- Facilitates credit intermediation

**Financial
Stability**

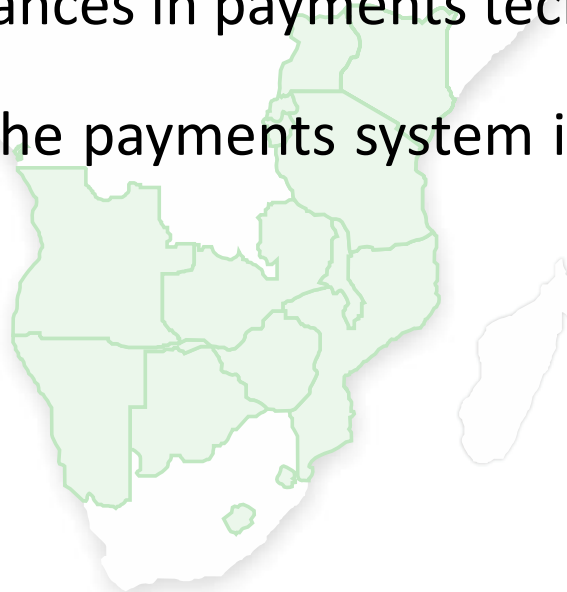
- Strengthens confidence in the financial system
- Contributes to the effective functioning of financial markets



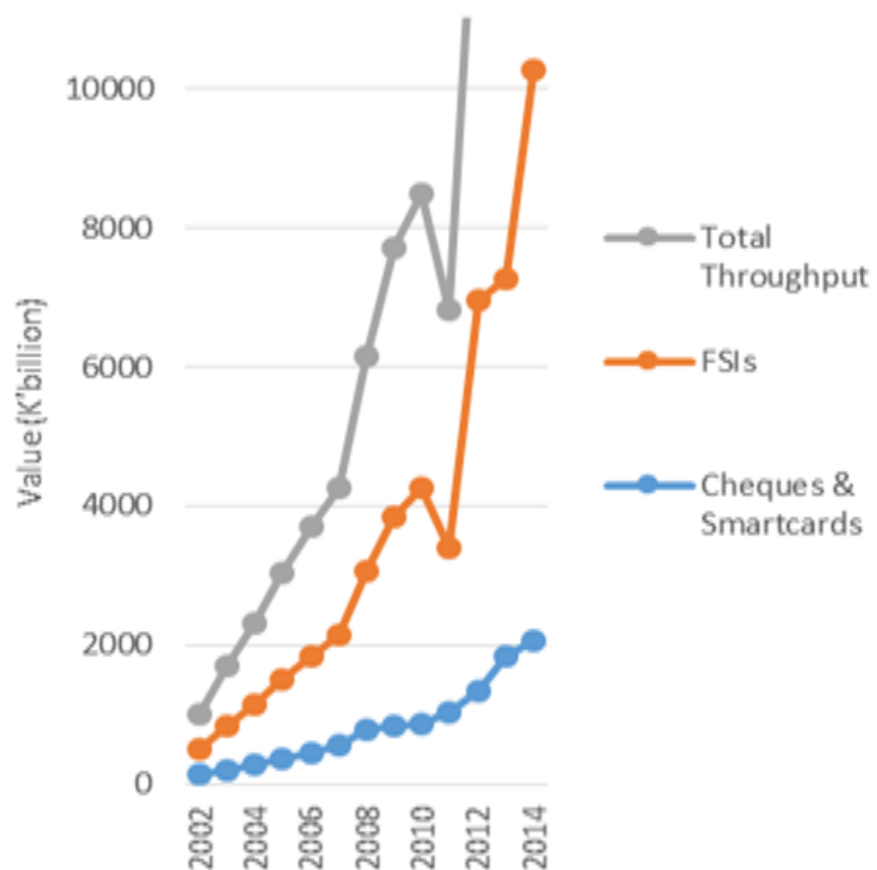
Scene setting:

Payment System and Economy Activity

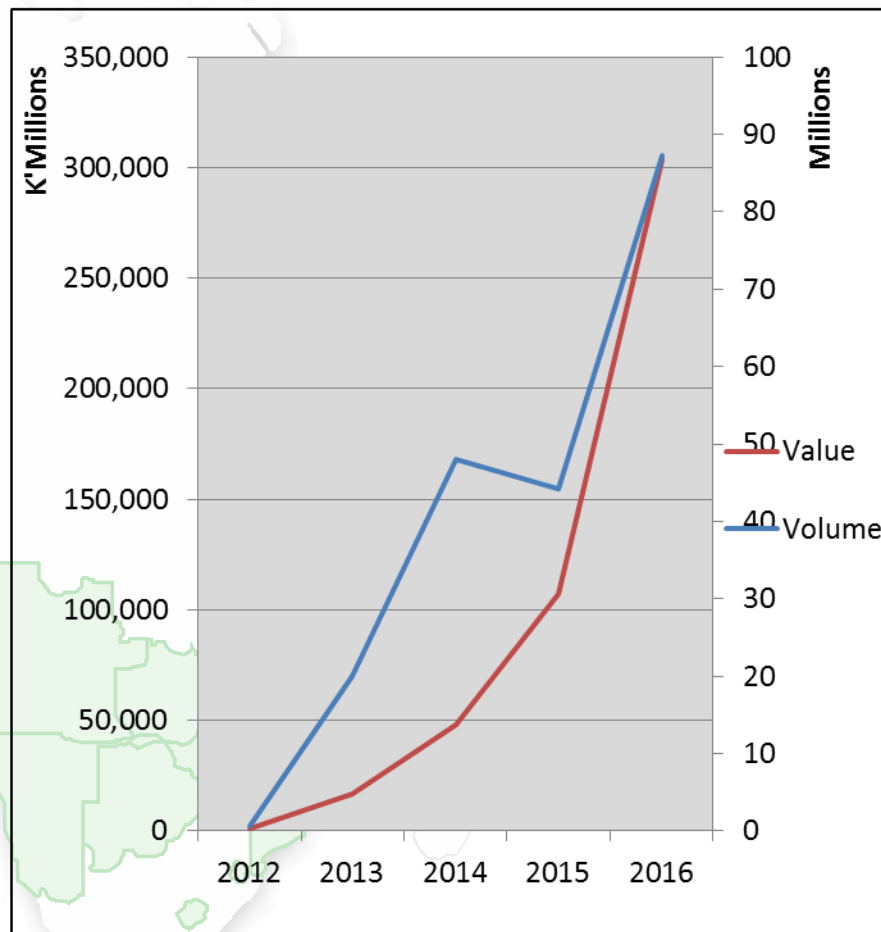
- As our economies are growing, the resultant changes in economic activity are reflected in increased volume and values (throughput) of payment system transactions
- This is further buoyed by advances in payments technology
- The safety and efficiency of the payments system is therefore a priority to regulators



MITASS STATISTICS

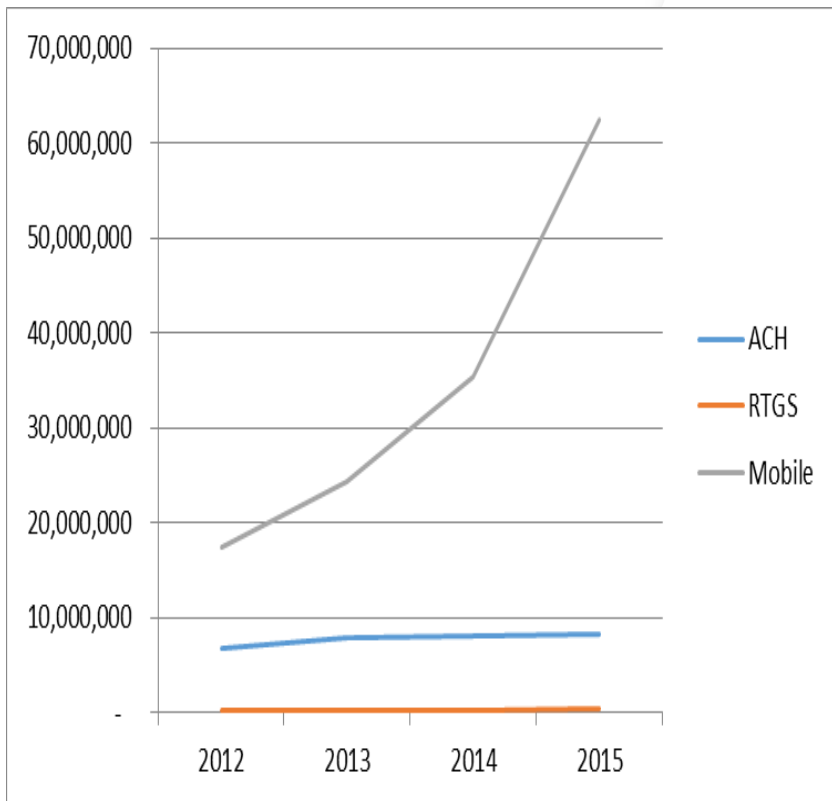


MOBILE PAYMENTS

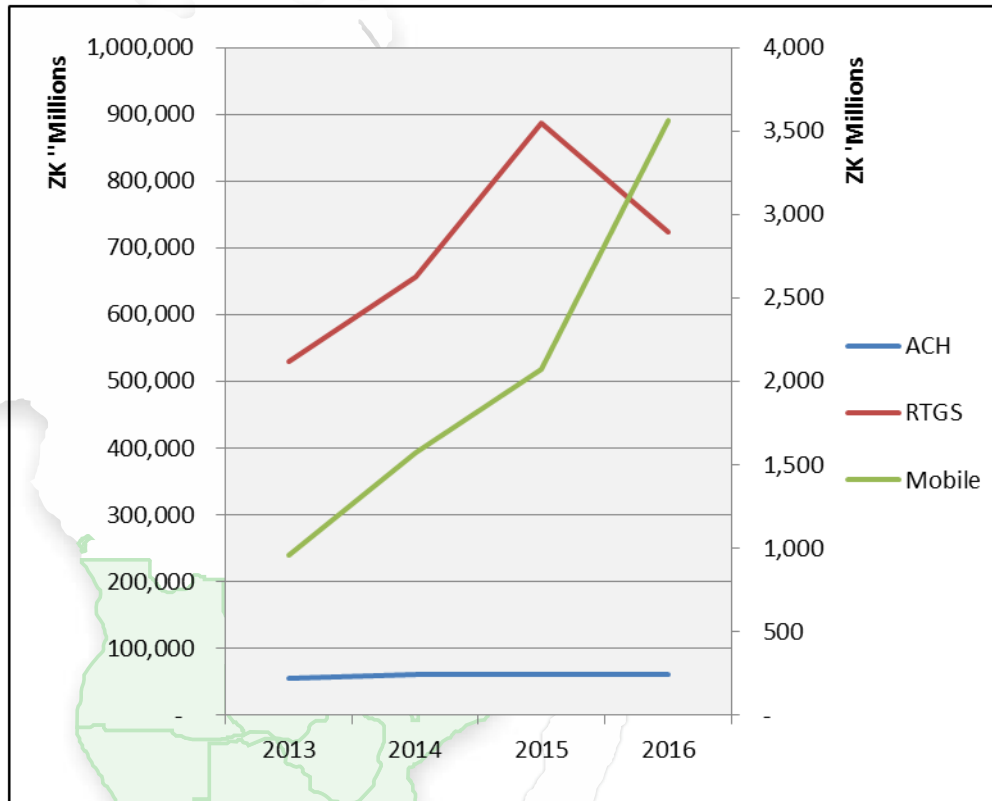


ZAMBIA

Volume

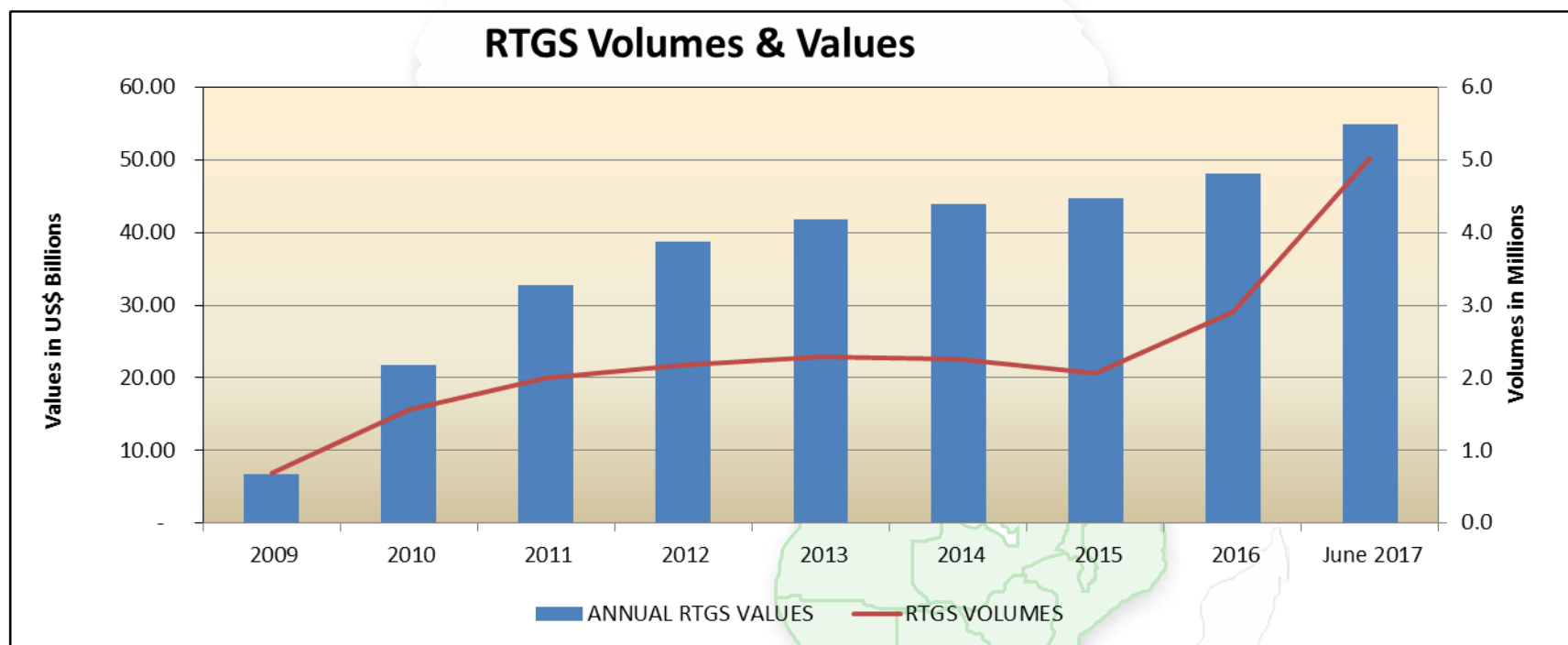


Values



Source: Bank of Zambia

ZETSS Statistics



Source: Reserve Bank of Zimbabwe

Rationale for Oversight

- So why bother with oversight if everything is going on well?
- Much ado about nothing?
 - waste of time and resources?
- What then are the key drivers?





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Objectives / Key Oversight Drivers



Risk concerns due to increased payments activity



Consumer protection issues



Other social welfare maximizing concerns

Key Oversight Drivers: **Risk Minimization**

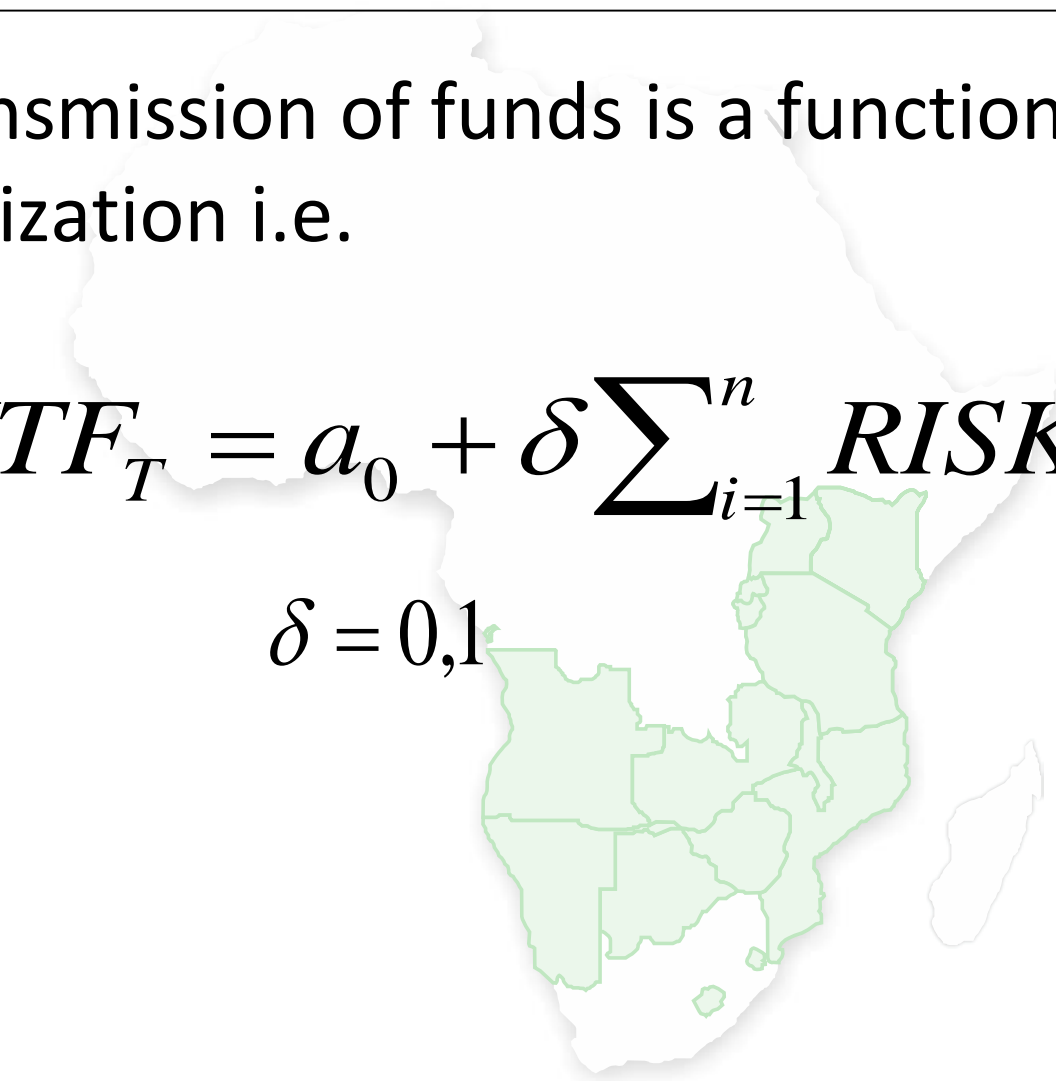
- **Reality:** Despite their importance to the overall economy, the ability to payment systems is riddled with numerous risks
- There is always the possibility that effective transfer of monetary value from a payer to a payee may not take place due to a variety of factors
- Thus, risk is the major reason why we need to oversee payment systems if safety and efficiency are to be guaranteed



Key Oversight Drivers: **Risk**

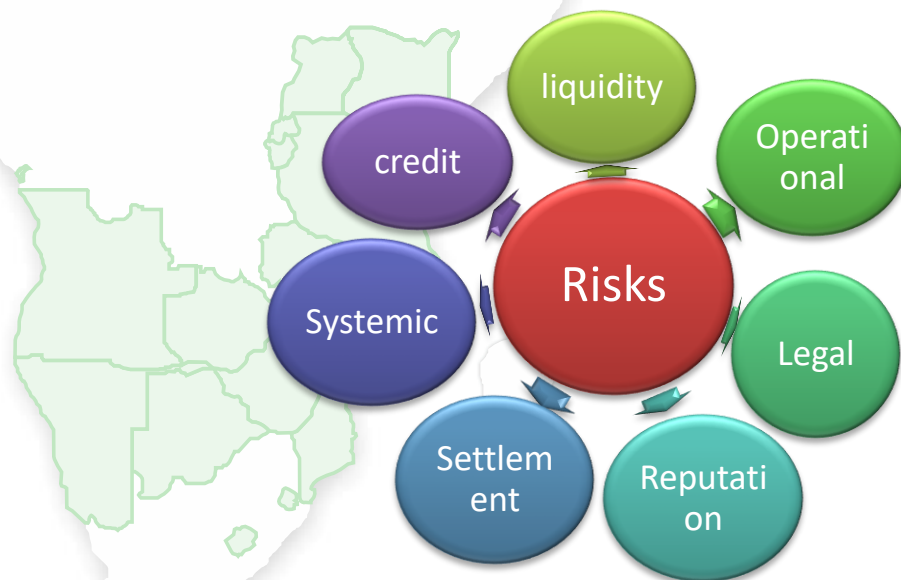
- Non-transmission of funds is a function of risk materialization i.e.

$$NTF_T = a_0 + \delta \sum_{i=1}^n RISK + u$$

$$\delta = 0,1$$


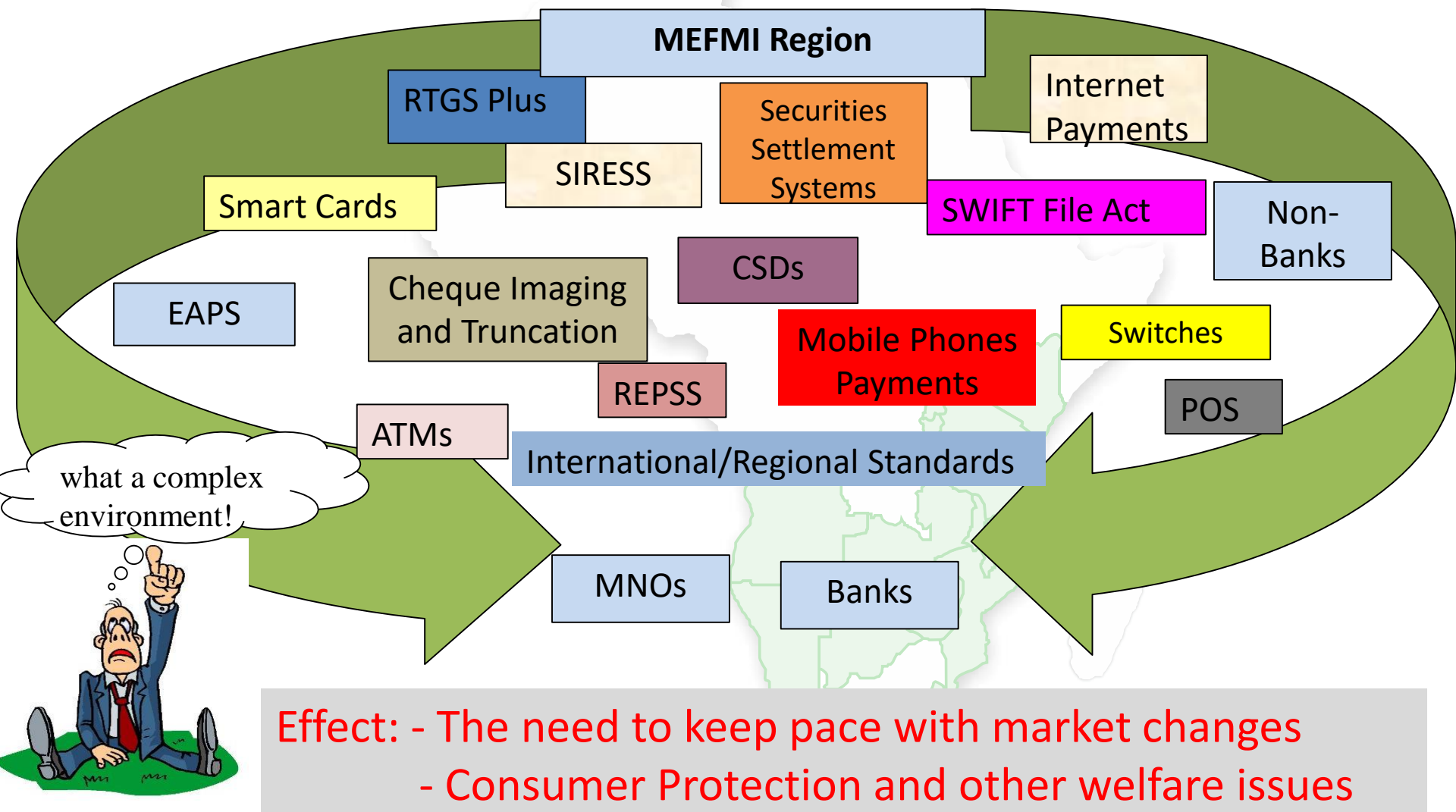
Key Oversight Drivers: Risk Minimization

- Therefore, in carrying out oversight, the principal motivation is to **maximise** transmission (and settlement) of funds **subject to the cost** of risk mitigation!



Examples of PS risks

Key Oversight Drivers: **Fulfilment of other PS Requirements**

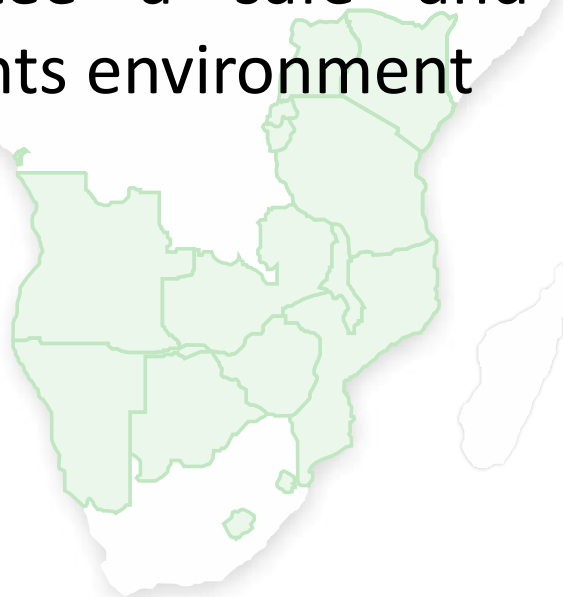


1. Keeping Pace with Market Developments

- Innovation affects market dynamics
- It encourages entry of new players, channels and instruments in response to consumer needs
- There is increased demand for standards to cater for speed, certainty, convenience, interoperability and straight through processing
- The level of security from these new players, channels and instruments may be **compromised in relation to what is offered by** traditional players such as banks
- As a result safety, efficiency and reliability **may not always be guaranteed**

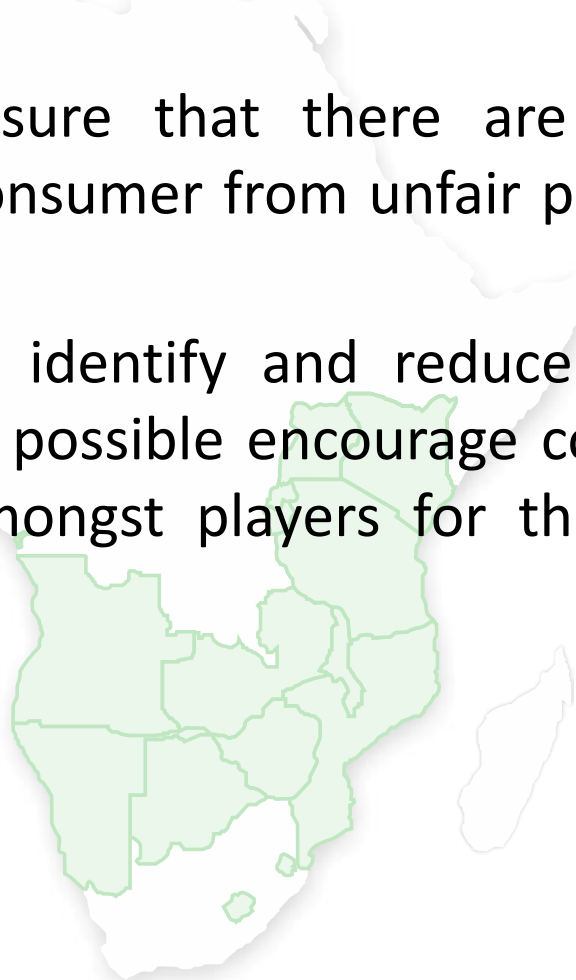
Market Developments/...

- Overseers (for payments infrastructure and communications sector) therefore need to **constantly review and adjust the legal and regulatory framework** to guarantee a safe and efficient payments environment

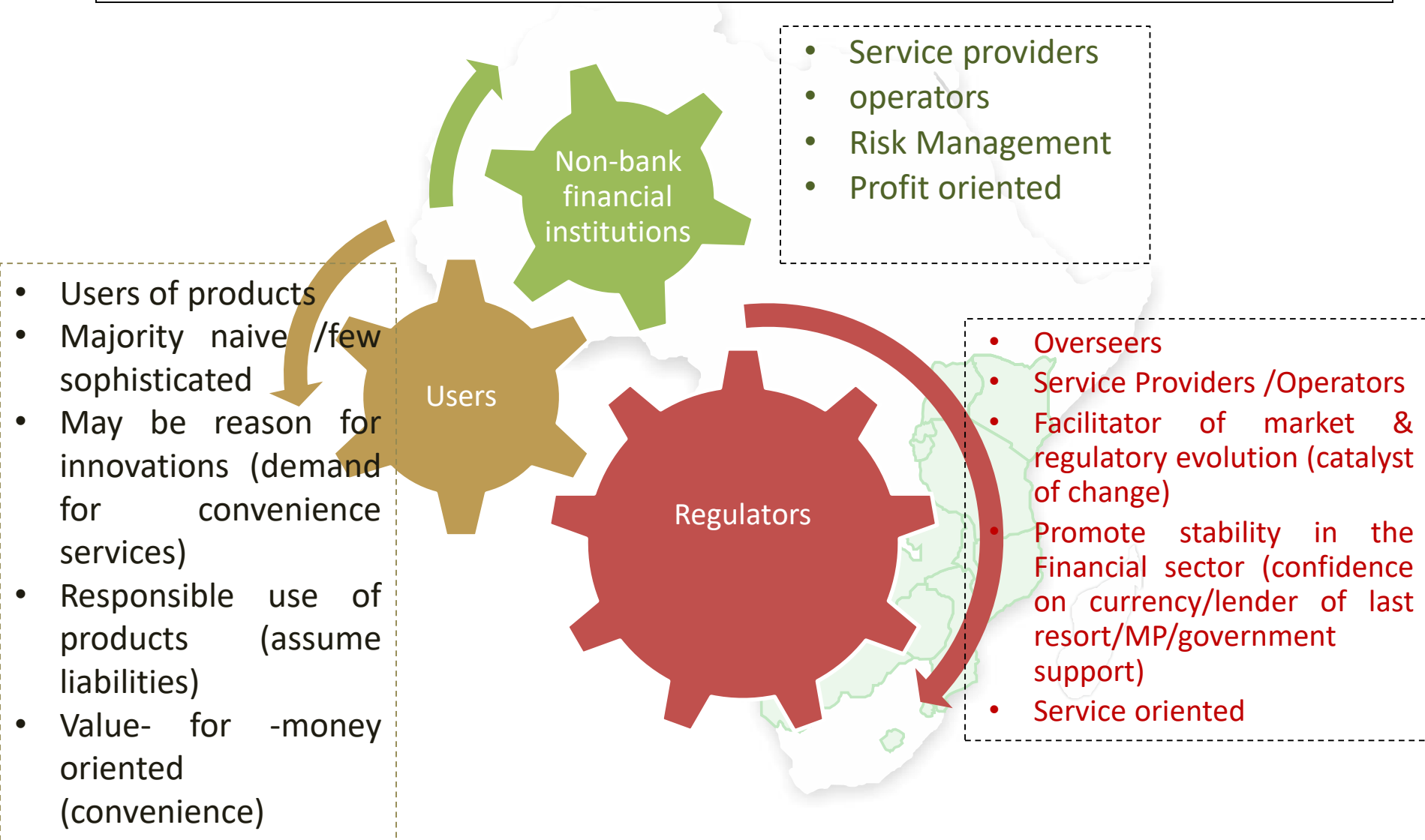


2. Consumer Protection and other Social Welfare considerations

- The overseer needs to ensure that there are adequate safeguards to protect the consumer from unfair practices by the consumer
- The Central Bank needs to identify and reduce areas for potential conflict and where possible encourage cooperation and healthy competition amongst players for the ultimate benefit of the consumer.



Roles and Responsibilities



Key Oversight Activities

Monitoring

- **Obtaining relevant information**
 - on system design and operation in order to understand its functioning

Assessment

A SWOT analysis on the payment arrangements in view of applicable standards, rules and regulations

Inducing Change

- **Influencing change to address shortfalls, consolidate gains and achieve higher levels of safety and efficiency**

Activities not mutually exclusive

Monitoring

Key issue: How do we obtain information on system design and operation to understand its functioning?

sources of information

- system documentation
- regular or ad hoc reporting on system activity
- internal reports of the board/internal auditors
- self assessments if any on compliance with CB policies
- bilateral contacts with operators and participants
- multilateral meetings with industry bodies
- on-site inspections
- expert opinion from legal advisers & external auditors
- information from other regulators
- feedback from customers

Assessment

Key issue: How do we obtain information on system design and operation to understand its functioning

sources of information

- ✓ Understanding the payment arrangements
- ✓ Formulate appropriate policies (and standards)
- ✓ Determining which systems come within the scope of such policies
- ✓ Information obtained on individual systems is used to assess whether they meet relevant policies and standards
- ✓ use self assessment and, if necessary, assessments by external parties in making relevant conclusions.

Key issue: How do we influence change?

Moral Suasion

- ✓ discussions with participants and other system operators
- ✓ quality of moral suasion depends on the strength of monitoring and assessment

Public Statements

- ✓ some Central Banks publish the oversight assessment reports of individual systems (transparency and accountability);
- ✓ others deem this as confidential

Voluntary agreements and contracts

- ✓ Memorandum of Understanding
- ✓ settlement account arrangements,
- ✓ Service Level Agreements (can be used to lay out the requirements and standards of the system)

Inducing Change

Participation in systems

- ✓ formal role in governance by the Central Bank

Cooperation with other authorities

- ✓ banking supervisors, SSS regulators

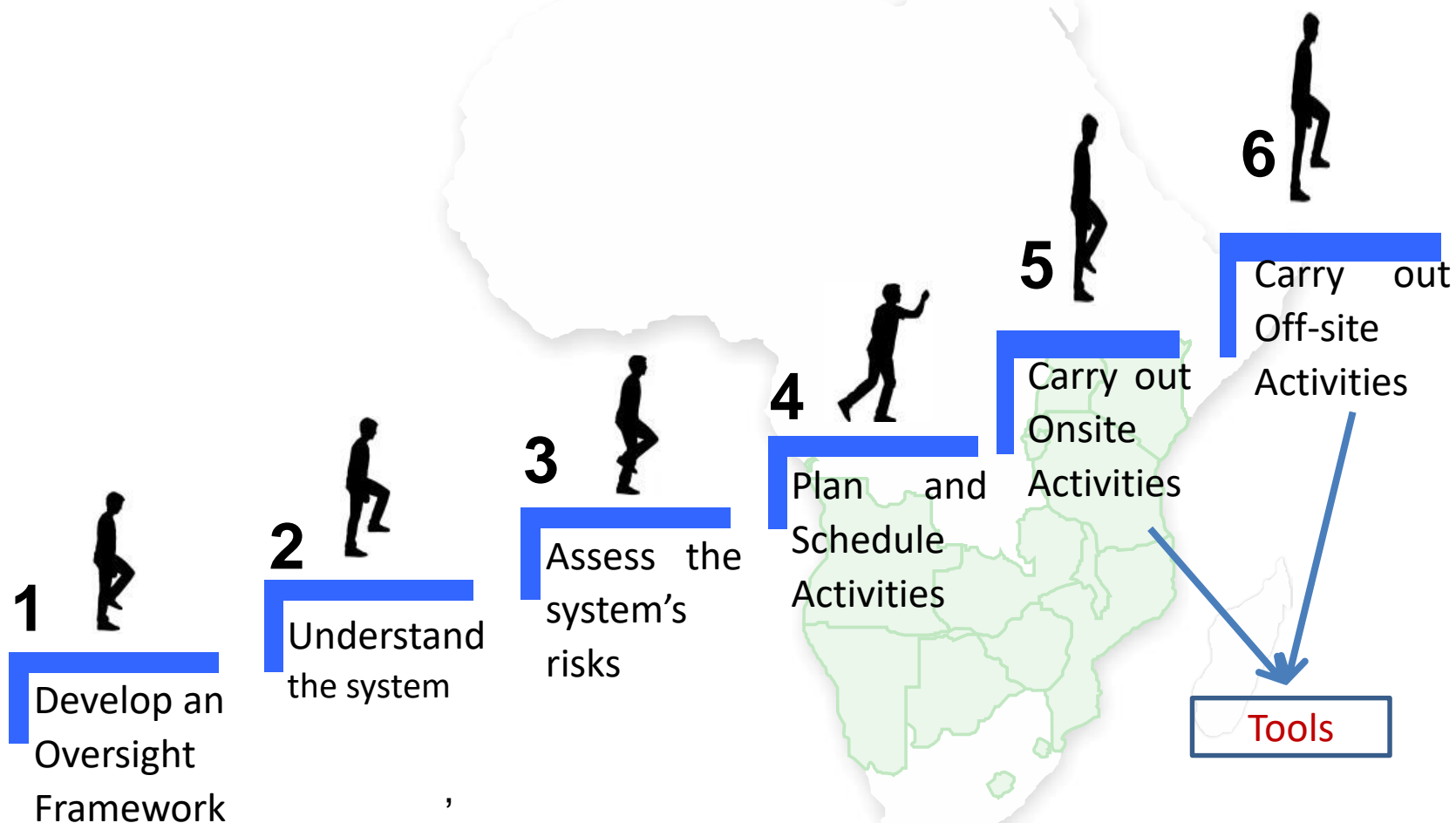
Statutory power to require change

- ✓ obtain data and carry out on-site inspections
- ✓ grant initial approvals
- ✓ approve changes to rules and procedures
- ✓ suspend and revoke membership

Enforcement and sanctions

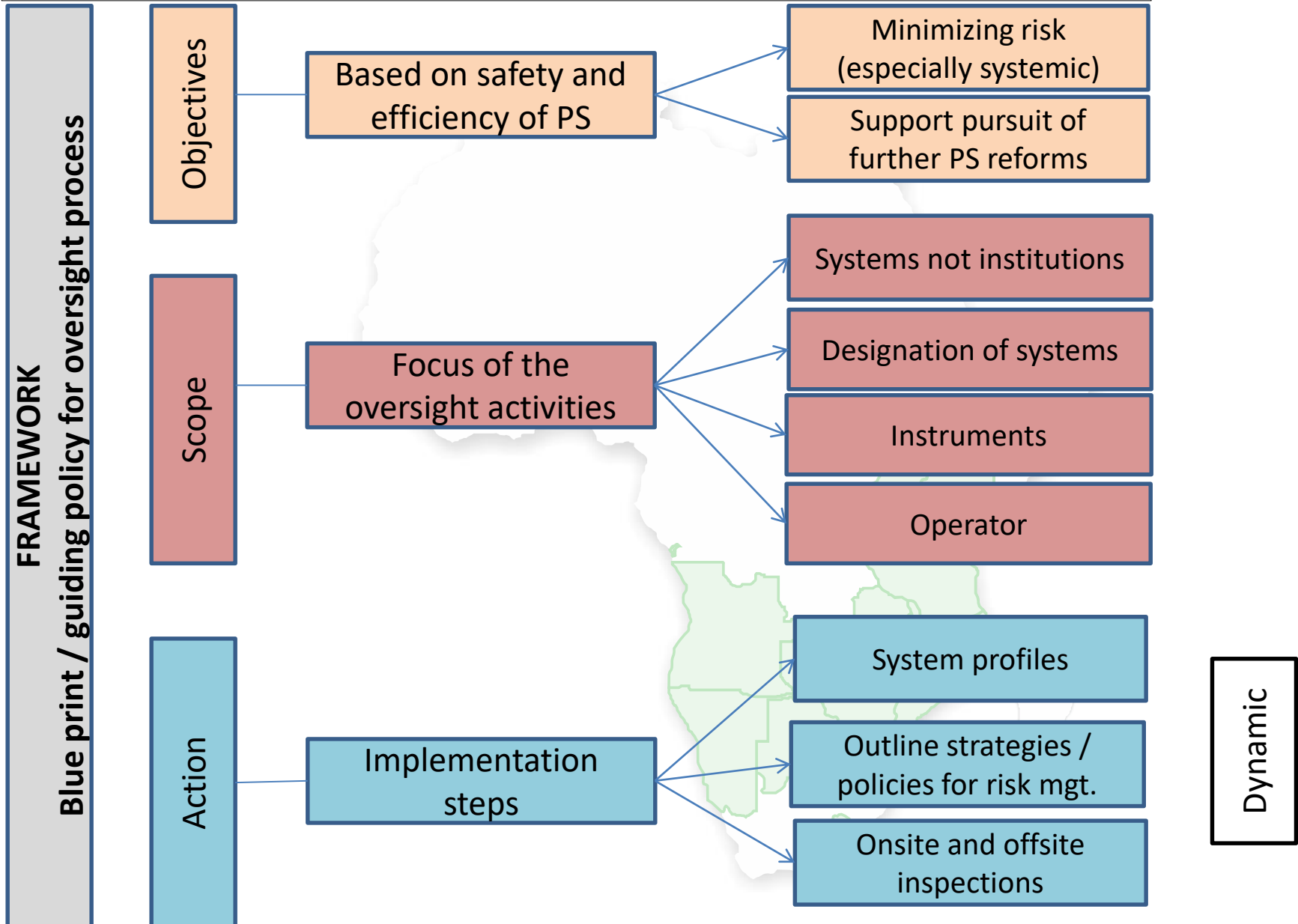
- ✓ threaten to use its powers, impose fines and/or imprisonment

Summarized Steps in Conducting Oversight

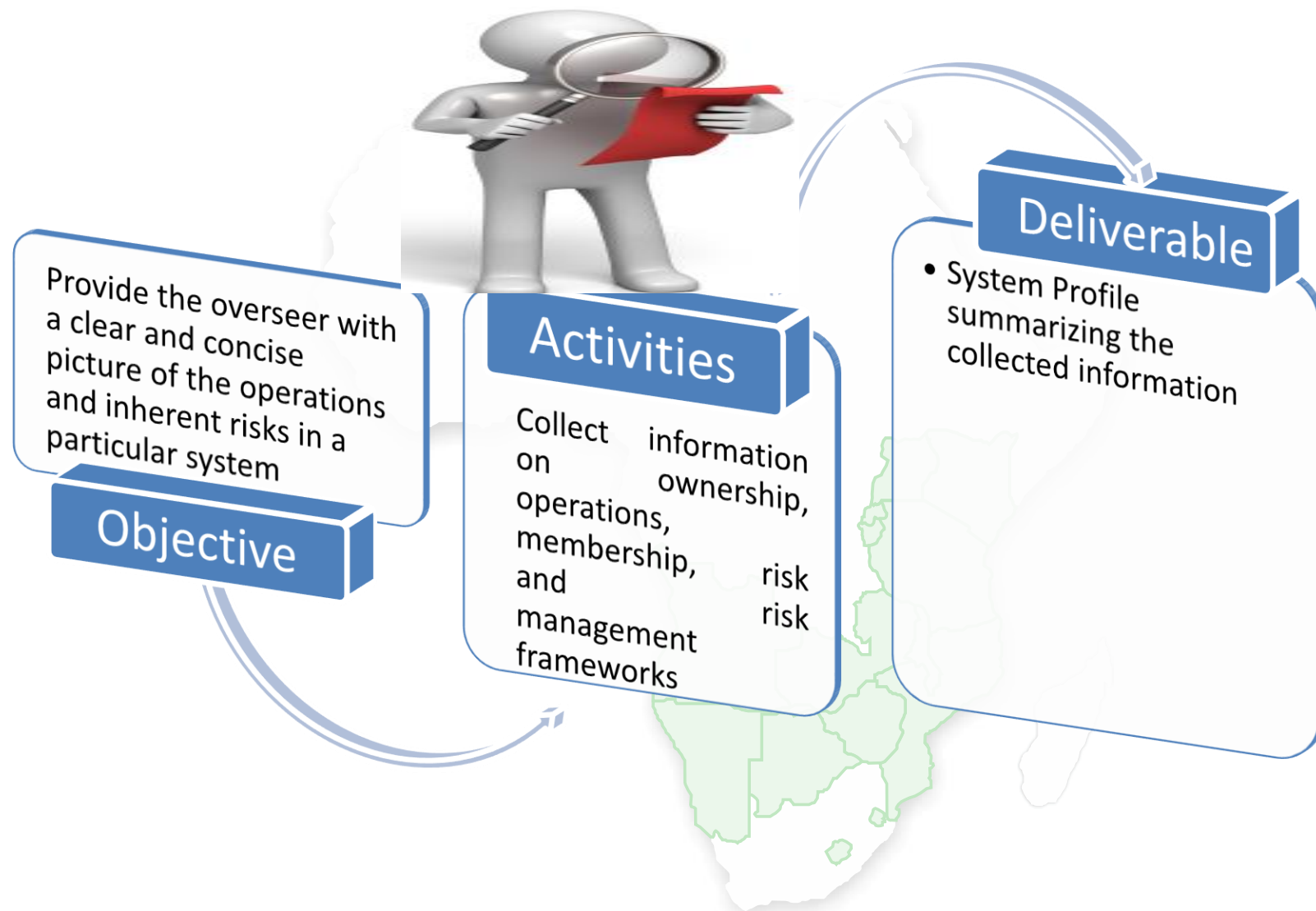




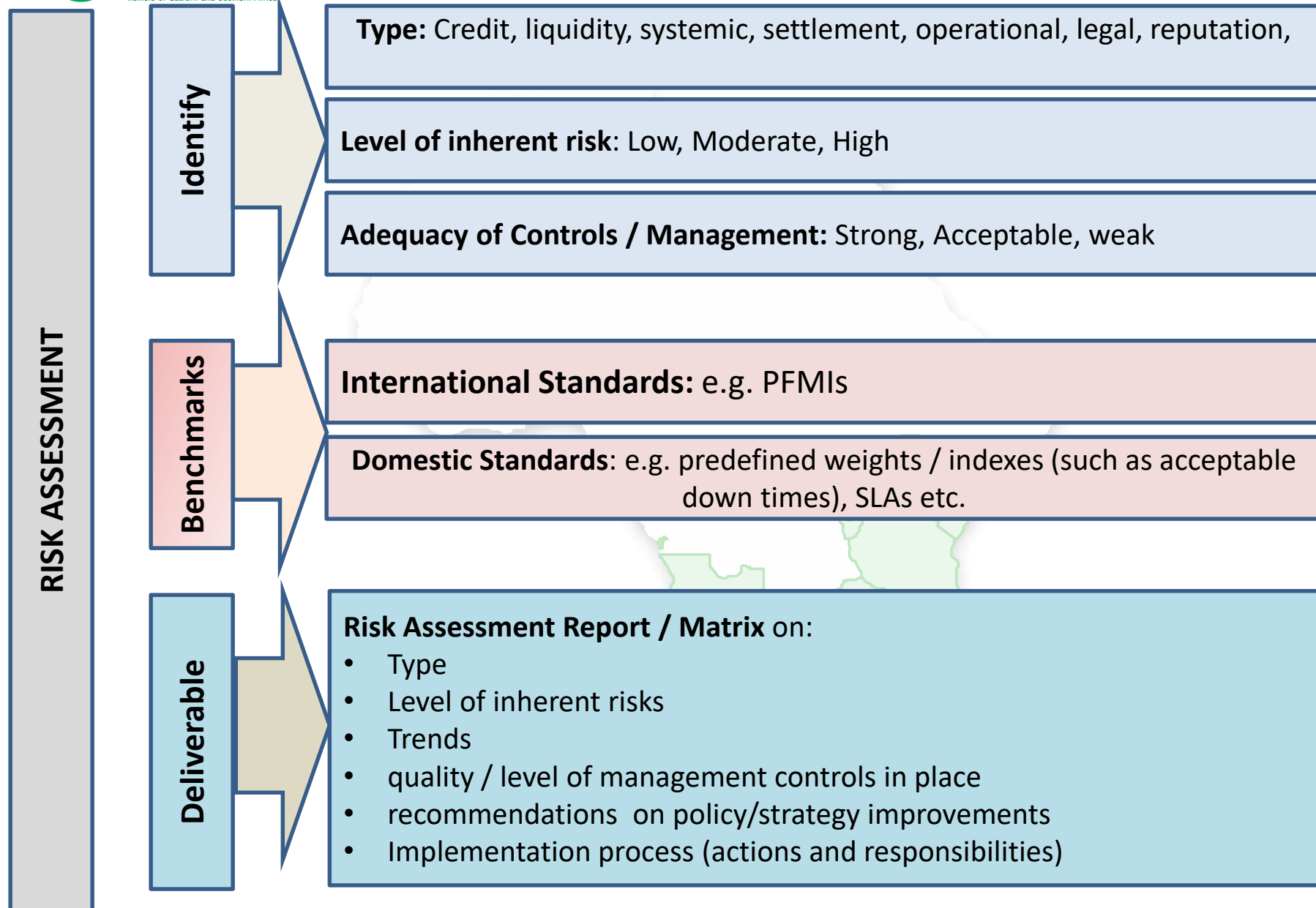
Step 1: Oversight Framework



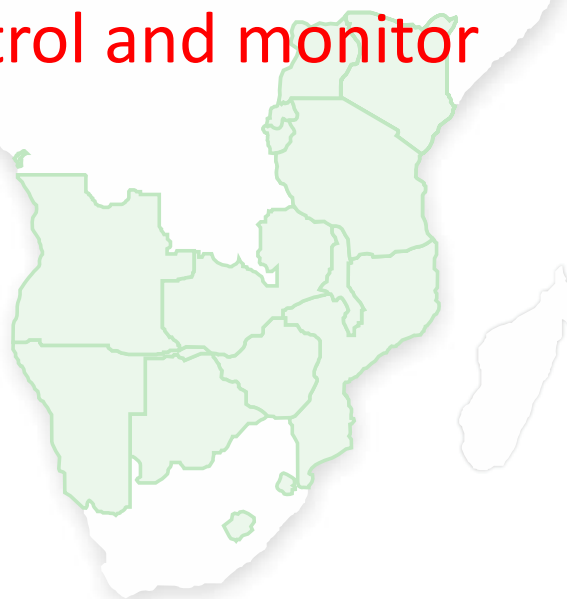
Step 2: Understanding the Systems



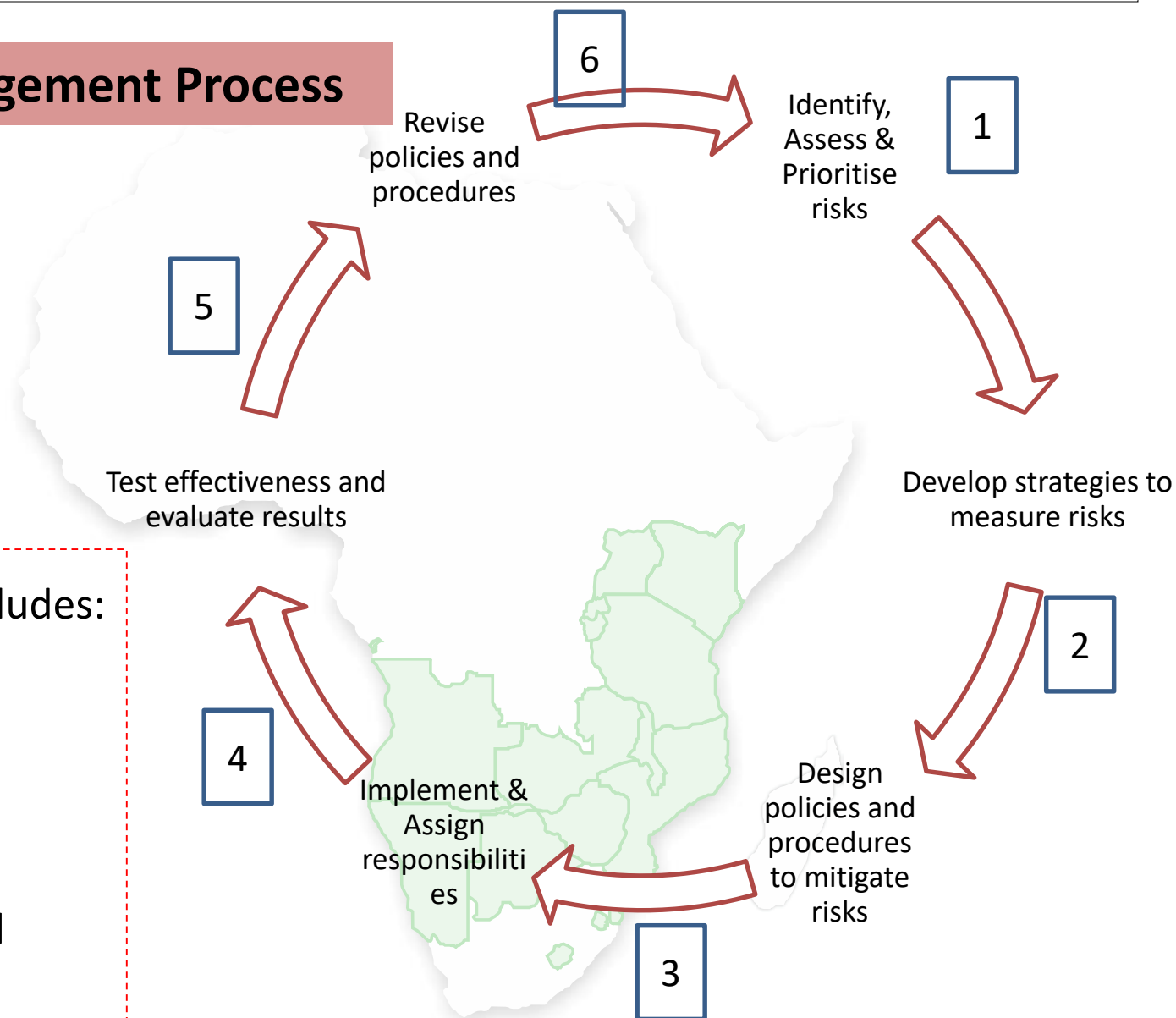
Step 3: Assess the System's Risks



- When you know your risk, you can either:-
 - ✓ avoid it
 - ✓ accept and do nothing
 - ✓ manage it
- If you chose to manage then it means you will **identify, measure, control and monitor**



The Risk Management Process



• A good risk mgt. includes:

- ✓ risk identification;
- ✓ risk measurement;
- ✓ risk control;
- ✓ risk monitoring; and
- ✓ risk evaluation.

A note on evaluation:

- The evaluation of the risk management systems should consider adequacy of:
 - ✓ board and senior management oversight;
 - ✓ policies, procedures and limits for risk identification, measurement, monitoring, and control
 - ✓ internal control systems
 - ✓ management information system
 - ✓ reporting frameworks.

The Risk Matrix

Type of Risk	Level of Inherent Risk	Adequacy of Risk Management Systems	Overall Composite Risk
Credit			
Liquidity			
Operational			
Systemic			
Legal			
Settlement			
Reputation			
Level of Risks		Low/Moderate/High	
Adequacy of Management		Strong/Acceptable/weak	
Overall Composite		Low/Moderate/High	

Levels/Quantity of risks

- **High Risk** - where the operations/activity is significant or positions are large in relation to the system's/operator's resources (e.g. availability of funding options intraday liquidity facilities etc) and could result in failure to settle.
- **Moderate Risk** - where positions are average and the activity could potentially result in a failure to settle but the operator has the ability to remedy the same through available sources of funding/failure to settle mechanism.
- **Low Risk** - where volume, size or nature of activity is such that risk of failure to settle is remote or would have little negative impact if the payment is rejected.

Quality of Risk Management

- **Strong** – The system has effective risk management controls and the system's management has identified such risks and has risk management measures including established policies & procedures and implement them.
- **Acceptable** - risk management measures and systems, although largely effective, may be lacking to some modest degree
- **Weak** - risk management measures and systems are lacking in important ways; deficiencies could have adverse effects on the safety and soundness of the system and could cause systemic risk.

Aggregate/Composite Risk

- **Composite Risk** is determined by balancing the overall level of inherent (quantity) risk of the activity with the overall strength (quality) of the risk management for that activity.
- **High** - where risk management does not significantly mitigate the high inherent risk of the activity
- **Moderate** - where risk management appropriately mitigate the risk even of an inherently high risk activity
- **Low** - where risk management systems are strong and effectively mitigate much of the risk

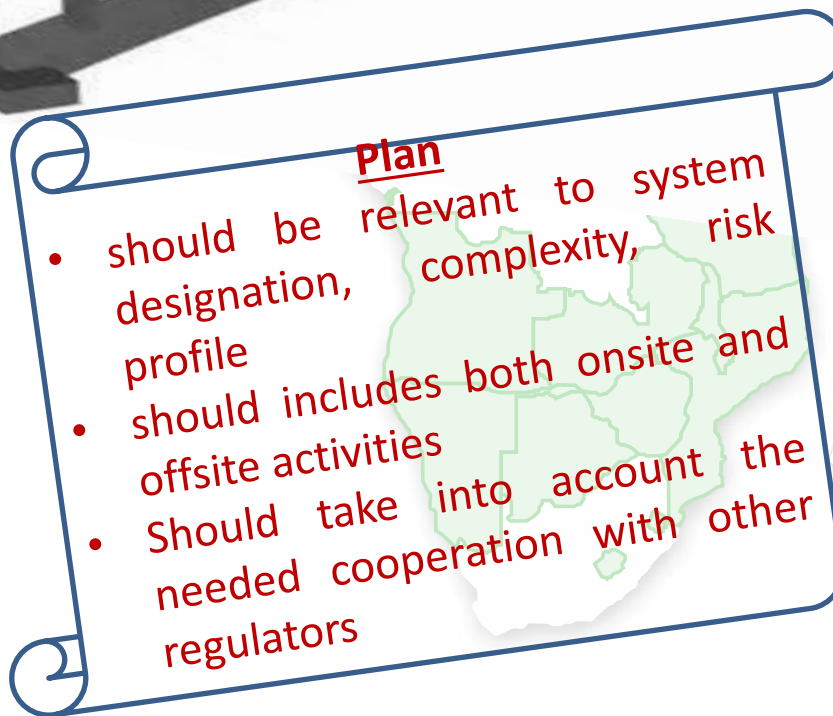
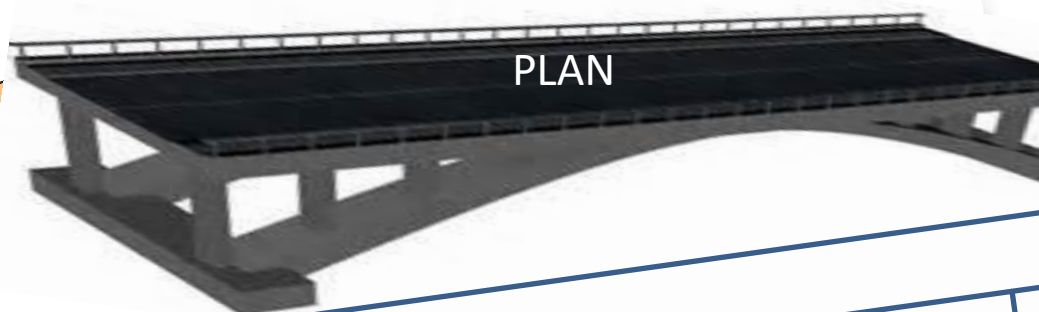
Type of Inherent Risk	Level of Inherent Risk	Adequacy of Risk Management Systems	Overall Composite Risk
Credit	Low	Acceptable	Low
Liquidity	Moderate	Acceptable	Moderate
Operational	High	Weak	High
Systemic	Low	Acceptable	low
Legal	Moderate	Acceptable	Moderate
Settlement	Moderate	Acceptable	Moderate
Reputation	Moderate	Strong	Low

Step 4: Plan & Schedule Oversight Activities

Oversight Concerns



Identified through
risk analysis



Activities to be done



Step 5: Carry Out Onsite Activities

Scope Document

- ✓ Motivation
- ✓ Focus (including excluded areas and reasons thereof)
- ✓ risk profile of the system
- ✓ aspects requiring cooperation with other regulators
- ✓ procedures to be followed
- ✓ required resources (teams, skills, budget, work plan etc).

Summarise findings

Present report to mgt.

Actual analysis

Hold stakeholder meetings

Seek appointments

- SIPS - annual?
- RPS – need basis?
- Assessment templates (based on PFMIs)



Step 6: Carry Out Offsite Activities

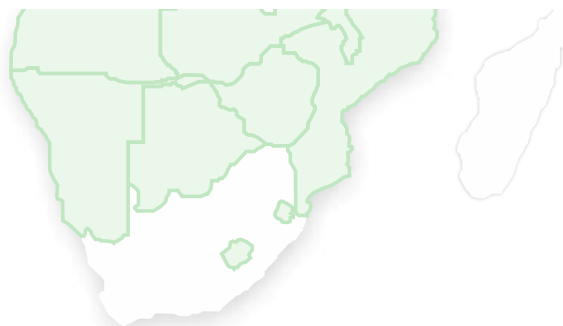


- Develop off-site monitoring tools
- ✓ Systems Monitoring / preemptive intervention
 - early warning signs and system alerts (delayed EOD, SOD)
- ✓ Annual self assessments (based on PFMIIs)
- ✓ Information /data collected from regulated entities
- ✓ System reports from other operators including their risk management measures
- ✓ Establish a prompt corrective action culture
- ✓ Oversight meetings
- ✓ Media reports
- ✓ Participants and customer complaints
- This is not a one-off event



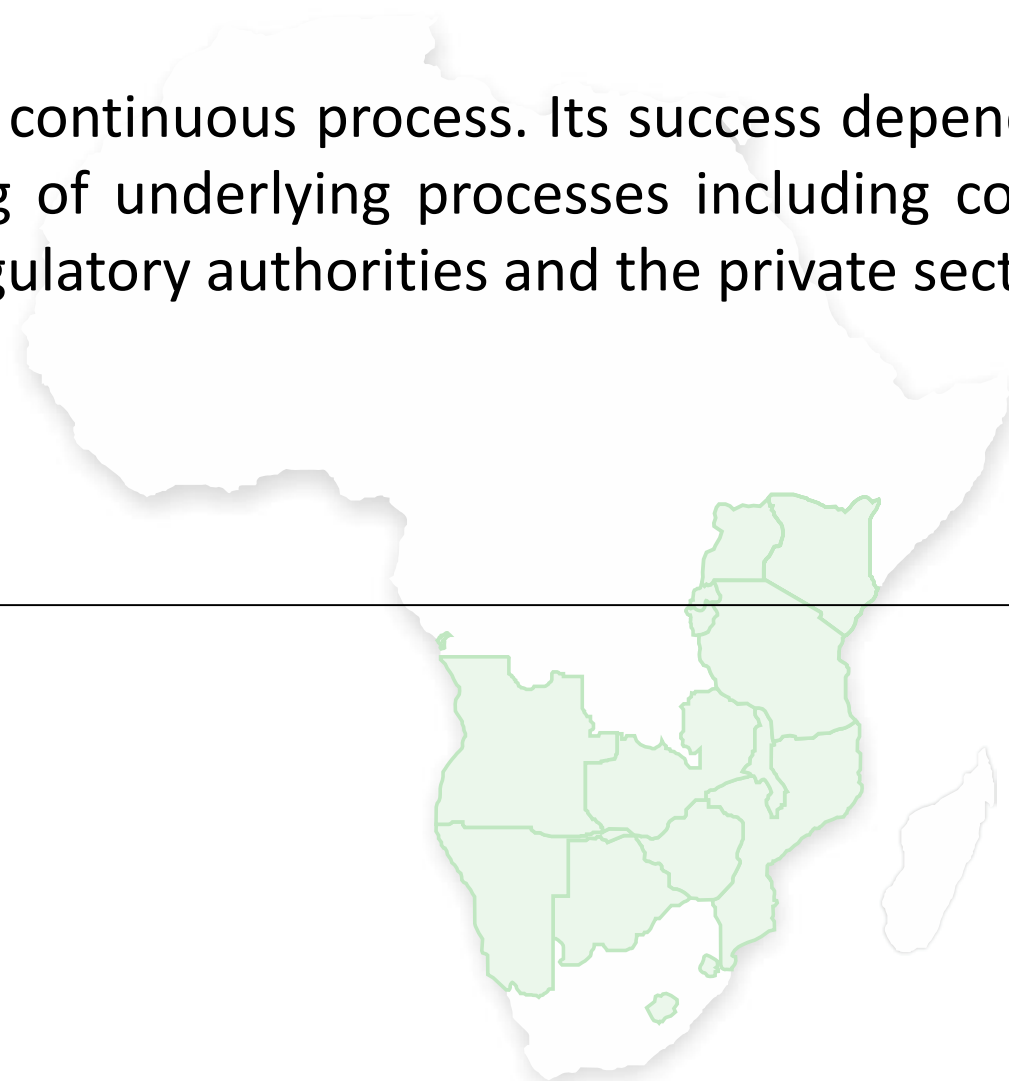
Implementation Challenges

1. Defining the scope of oversight
2. Acquiring formal powers to conduct oversight activities
3. Organization of oversight function within the Central Bank
 - skilled human resources, financial resources
4. Cooperation with other regulators domestically and internationally



Conclusion

Oversight is a continuous process. Its success depend on clear understanding of underlying processes including cooperation with other regulatory authorities and the private sector.

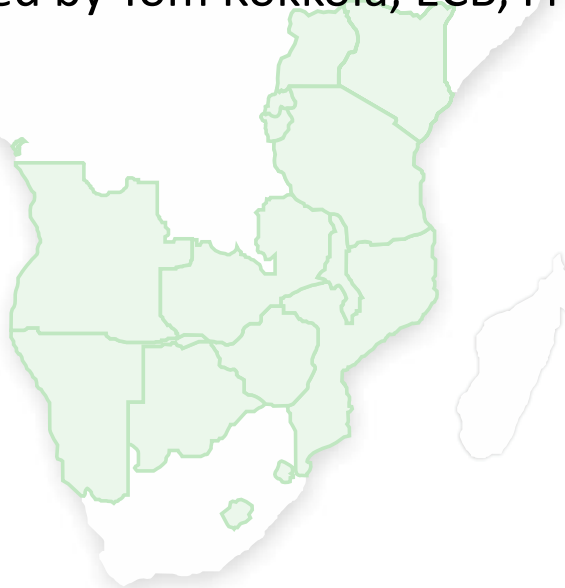


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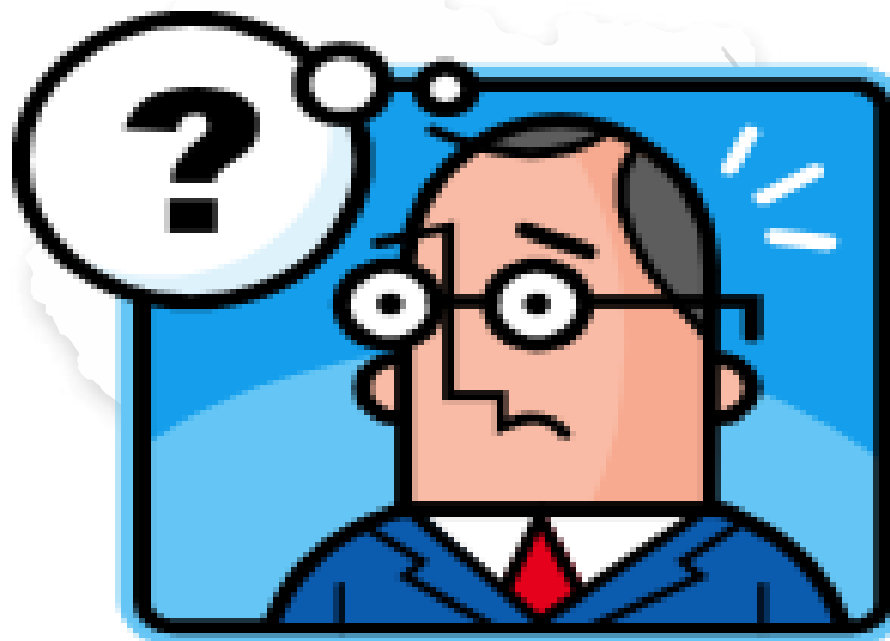
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END OF PRESENTATION



QUESTIONS