

The Central Bank of the Republic of Azerbaijan

Oversight Conception on Payment Systems

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Conceptual grounds for the oversight on payment systems

Payment systems have undergone crucial changes from the standpoint of products complexity and a range of payment products offered to customers in recent years. This transformation was primarily due to technological progress and globalization of financial markets.

Recent financial crises urged supervisory bodies and central banks to take robust measures with respect to strengthening of the financial system. The payment systems have been on more focus to that end. Thus, this infrastructure that provides remittances among economic agents is of the key channels the systemic crises passed through.

Internationalization and integration of financial markets triggered close cooperation among countries on management of the payment systems and setting oversight principles.

Oversight on payment systems is of the primal tools that ensures stability of the financial system and efficiency of payment transactions. Oversight on payment systems is one of the fundamental objectives of the Central Bank of Azerbaijan. While “oversight” is comparatively a new concept, the tasks set under this terminology have always been implemented by the Central Bank. The paramount goal of oversight is to ensure reliability and effectiveness of payment systems. This document addresses the reasons that necessitate oversight, goals of oversight and the principles that determine the oversight policy of the Central Bank.

Economic efficiency of oversight on payment systems

Oversight on payment systems is of the key functions of central banks of a number of advanced economies. Reliability and efficiency of wire transfer mechanisms affect effectiveness of the real economy and financial markets, as well as application of the monetary policy.

The Central Bank is an authority that directly governs interbank clearing and settlement systems. Reliable performance of payment systems in the modern economy characterized with the use of “bank money” requires completion of payments through settlement accounts with a central bank.

Transactions among economic agents and interbank payments are specifically made on these accounts through the clearing and settlements system. Due to relation to centralized accounts, operational features of settlements systems and the infrastructure of payment systems impact cash turnover of intermediaries and operational procedures of the monetary policy.

The above display close relation between the oversight on payment systems and management of monetary flows of the central bank and its performance directed at financing illiquid intermediaries.

Indeed, market crises disturb social equality, i.e. the balance that ensures equal benefit for economic agents from services. From this standpoint, the fact that oversight expenses lag behind social expenditures resulting from market crises is of the factors that justify public control over payment systems.

Legal grounds for oversight on payment systems

Under Item 4.2 of Article 4 of the Law of the Republic of Azerbaijan on the Central Bank of the Republic of Azerbaijan, one of the top targets of the Central Bank is to ensure stability and development of payment systems. In parallel, under Item 5.0.8 of Article 5 of the Law, the Central Bank organizes, coordinates, regulates the activity of payment systems, and provides their oversight under the Law.

Under Article 44 of the Law, the Central Bank issues permits for and provides oversight on the national clearing (processing) systems in order to ensure stable operation thereof. The Central Bank shall also set minimum requirements regarding reliability and security of electronic settlements and remittances and clearing systems used by credit institutions as well as ensuring protection of banking information.

Oversight standards and principles for payment systems

The goal of the oversight on payment systems is to monitor compliance of the systems with relevant international standards and principles.

In 2001 the Committee on Payment and Settlements Systems of the International Bank for Settlements (CPSS) established the Core Principles for Systemically Important Payment Systems. These 10 principles cover legal issues (Principle 1), financial risk management (Principles 2-6), security and operational reliability (Principle 7),

effectiveness (Principle 8), participation in payment systems (Principle 9) and management (Principle 10).

The Central Bank is kept responsible for observance of the above principles by payment systems. The Central Bank of Azerbaijan accepts the Core Principles of the CPSS as the minimum requirements for the payment systems of systemic importance operating in the Republic of Azerbaijan with respect to oversight on the payment systems operating in the Republic of Azerbaijan.

The Core Principles of the CPSS shall be partially applied to the payment and settlements systems operating in the Republic of Azerbaijan, however, of no systemic importance.

Core Principles for systemically important payment systems

1. The system should have a well-founded legal basis under all relevant jurisdictions.
2. The system's rules and procedures should enable participants to have a clear understanding of the system's impact on each of the financial risks they incur through participation in it.
3. The system should have clearly defined procedures for the management of credit risks and liquidity risks, which specify the respective responsibilities of the system operator and the participants and which provide appropriate incentives to manage and contain those risks.
4. The system should provide prompt final settlement on the day of value, preferably during the day and at a minimum at the end of the day.
5. A system in which multilateral netting takes place should, at a minimum, be capable of ensuring the timely completion of daily settlements in the event of an inability to settle by the participant with the largest single settlement obligation.
6. Assets used for settlement should preferably be a claim on the central bank; where other assets are used, they should carry little or no credit risk and little or no liquidity risk.
7. The system should ensure a high degree of security and operational reliability and should have contingency arrangements for timely completion of daily processing.

8. The system should provide a means of making payments which is practical for its users and efficient for the economy.
9. The system should have objective and publicly disclosed criteria for participation, which permit fair and open access.
10. The system's governance arrangements should be effective, accountable and transparent.

The Financial Sector Assessment Program (FSAP) evaluated compliance of the payment systems of systemic importance functioning in Azerbaijan with the minimum requirements. The evaluation made by the IMF, the WB and the CPSS built upon jointly developed methodology stated compliance of the systems with the minimum requirements; it was mentioned that no oversight is provided on payment systems as an exception.

How to evaluate systemic importance

A systemically important payment or settlement system is assessed on the basis of the effect of difficulties occurred in the operation or payment of any system participant on the stability of the financial system of the country.

Systemically important payment and settlements systems are determined on the basis of the following criteria:

- *Types of operations*: the systems that provide settlements on financial markets are of particular significance for the financial system of the country. While mainly the problems in the systems that execute settlements on retail payments cause difficulties for users, it does not expose the entire financial system of the country to serious threats.
- *Cohesion with other systems*: If a system is related to other systems, there is a risk of transmission of the problem occurred to other financial infrastructures. However, results may vary depending on the degree of cohesion. For instance, difficulties occurred in operations of a retail payments system that makes settlements on interbank obligations in large payments system do not significantly affect the activity of the latter.
- *Alternative clearing and settlements capacity*: if there is an alternative to replace the system with a new one with no time waste and additional settlements risk, the system has no effect on the financial stability.

- *Volume and number of operations:* Total volume of operations directly relates to potential loss and is a crucial indicator of the systemic importance. The number of clearing and settlement transactions may be considered as well. However, the number of transactions is of less importance than their volume.
- *System participants:* The systems whose direct participants are financial institutions have potential and probability to shake the financial stability.

The Central Bank of Azerbaijan finds the following systemically important payment systems:

- Real Time Gross Settlement System (AZIPS)
- Bulk Clearing Settlement System (BCSS)

These systems are used for clearing and settlements of financial market operations. The system participants are financial intermediaries. Given the volume of operations, the problems to occur in these systems may impact circulation of liquid funds across the overall economy. At the same time, there are no alternative payment systems in place in case of operational problems.

The AZIPS and the BCSS should meet the core principles of the CPSS accepted by the Central Bank as the minimum requirements as mentioned in this document taking their systemic importance into account.

Other systems – Azericard and Millicard processing centers are not found by the Central Bank as systemically important payment systems. While the number of operations processed in these 2 retail payment systems is high, the volume of operations is comparatively low. Also, operational problems that occur in the systems do not have a serious influence on large payment systems. Given the above factors, these systems do not expose the financial sector stability of the country to potential risks.

However, Azericard and Millicard processing centers are sole retail payment systems operating in most regions of the country and play a vital role in access to payment tools in these regions. To that end, the Azericard and Millicard processing centers are considered by the Central Bank as crucial payments and settlements systems.

Given the above, the operators of these systems are not required to meet the minimum requirements of the Central Bank. The Azericard and Millicard processing centers as

well as other processing centers to start functioning in future shall be partially exposed to the core principles of the CPSS and both centers shall be monitored with respect to compliance with Principles 1, 7, 8, 9 and 10.

The Central Bank shall observe performance of and growth in retail payments and periodically review systemic importance of these systems.

Three stage oversight methodology

The goal of the Central Bank in oversight on payment systems is to ensure compliance of payment and settlement systems of systemic importance with the minimum requirements of the Central Bank. To ensure efficient oversight, a three stage oversight methodology shall be applied:

- Monitoring;
- Evaluation;
- Relevant changes.

The above stages are implemented as an ongoing process. While designing the oversight methodology, expertise of the central banks – members of the Committee on Payments and Settlement Systems (CPSS) of the International Bank for Settlements was considered.

Monitoring

To ensure efficient oversight process and evaluate compliance of the system with the minimum requirements, it is crucial to have detailed information on the relevant payment and settlements system, its policy, operations and processes, potential risks and future growth plans. Therefore, the primary goal of the monitoring is to collect necessary data. Monitoring particularly focuses on the directions that expose the financial stability to more threats. These directions mostly include management, IT systems and operations (particularly information security), financial risk management and outsourcing.

Data for monitoring purposes are obtained from the following sources:

- Reports. System operators periodically deliver reports.
- Documents on the system. It includes regulations on operations in the system, operations continuity plan and other documents.

- Self-evaluation. The system operators complete the inquiries submitted to that end. When evaluating, the system operators issue their positions whether they meet the established minimum requirements.
- Audit. Internal or external audit provides audit of the fields that are of vital significance for financial stability. Particularly financial risk management and information security should be audited on a periodic basis.
- Meetings. The changes to the system and the data obtained from other monitoring sources are discussed at the meetings held with the system operators.

How to evaluate compliance with the minimum requirements

The information obtained as a result of monitoring enables to evaluate compliance of the system operator with the minimum requirements. The minimum requirements are based upon the international standards, i.e. the core principles of the CPSS. The Central Bank also evaluates compliance of the system with the standards, particularly standards on IT and information security, established on the banking sector.

To more accurately evaluate compliance with the minimum requirements, concrete oversight goals are to be set. Observance of oversight goals shall be evaluated under the 4-point-scoring-system (compliant, basically compliant, partially compliant and non-compliant). With international standards on payment systems being developed and improved the oversight goals shall be periodically reviewed.

Measures to make relevant changes

In the event the Central Bank discovers incompliance of the payment system with the minimum requirements as a result of evaluation, it issues recommendations for the system operator. The recommendations in details and accurately enumerate which changes are to be made. In the event of non-implementation of the recommendations, the Central Bank may advance a mandatory claim. In the event of non-implementation of the mandatory claims, the Central Bank may pose other sanctions or enforcement measures under the legislation.

General principles of banking supervision

In order to ensure organization and implementation of effective banking supervision, the CPSS established general principles.

The general principles are as follows:

- *Transparency.* A central bank should disclose the banking supervision policy to the public, including requirements against the systems and the criteria for selection of these systems.
- *International standards.* Central banks should apply international standards on payment systems.
- *Authorities and resources.* A central bank should have sufficient authorities and resources to execute a banking supervision function.
- *Continuity.* Supervision standards should be applied to all similar payment systems on an ongoing basis whether the system is managed by the central bank.
- *Cooperation with other authorities.* In order to ensure reliable and effective performance of the payment systems, a central bank should cooperate with other authorities and central banks.

Conclusion

1. The legal basis for oversight on payment systems has been determined through the Law of the Republic of Azerbaijan on the Central Bank of the Republic of Azerbaijan.

2. The Central Bank of Azerbaijan shall oversee systemically important payment and settlement systems. Under the relevant evaluations, the AZIPS and the BCSS payment and clearing systems are of systemic importance. The Azericard and Millicard processing centers are the settlement systems of crucial importance.

3. The Core Principles for Systemically Important Payment Systems approved by the Committee on Payment and Settlement Systems of the International Bank for Settlements are accepted as the minimum requirements against systemically important payment systems. The core principles shall be partially applied to the settlement systems of crucial importance. The Core Principles for Systemically Important Payment Systems shall be published and disclosed to the public.

4. The payment systems shall be overseen on the basis of the three stage oversight methodology (monitoring, evaluation and relevant changes).

5. Oversight processes shall be provided on the basis of the general oversight principles established by the Committee on Payment and Settlement Systems.