

CENTRAL BANK OF MONTENEGRO

PAYMENT SYSTEM OVERSIGHT POLICY FRAMEWORK

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1. Introduction

Payment systems are of extreme importance for the stability and efficiency of Montenegro's financial sector and economy as a whole. To wit, payment systems, as the systems for transfer of money using formal and standardised procedures and common rules, provide “channels” for the transfer of funds between credit and other institutions aimed at executing payment obligations occurring in financial markets and the economy in general. They enable settlement of obligations between the debtors and creditors, i.e. between initiators and funds beneficiaries, and this function makes them critical for the effective functioning of the financial system in Montenegro, i.e. global financial systems in general.

Bearing in mind that the main objective of the Central Bank of Montenegro is to foster and maintain the financial system stability, including fostering and maintaining a sound banking system and safe and efficient payment systems, it is clear that promoting the smooth functioning of the payment systems is one of its key tasks.

The Central Bank, in addition of being the owner and operator of the payment system, has the mandate to control the operators and participants in the payment system and oversee payment systems, and act as a catalyst. These functions of the Central Bank, although different, are not mutually exclusive, but complement each other.

Payment System Oversight Policy Framework is a document displaying the role, principles, objectives, standards and oversight activities conducted by the Central Bank in compliance with the principles for successful oversight advocated by the Bank for International Settlements (BIS).

In publishing this document, the Central Bank, respecting the principle of transparency in performing its payment system oversight function, enables payment system operators better understanding of the oversight objectives, as well as better understanding and monitoring of business requirements

and standards that they are expected to comply with. In addition, the Central Bank, using the transparency of this approach, shows that it is consistent in conducting payment system oversight activities thus providing the basis for the assessment of its successfulness.

2. Scope and Reasons for Payment System Oversight

The Bank for International Settlements defines payment system oversight as a central bank function whereby the objectives of safety and efficiency are promoted by monitoring existing and planned systems, assessing them against these objectives and, where necessary, inducing changes.¹

Central banks are, by their nature, interested in safe and efficient functioning of payment systems. Firstly, the central banks supply the economy with the money, whereby one of the functions of money is to be a means of exchange, and without safe and efficient payment systems this function of money would be seriously threatened. Regardless central bank's issue function, one of its tasks is to maintain confidence in money, a means of payment, and ultimately, in payment systems. Secondly, most central banks have a mandate to foster and maintain the financial stability and it is in their interest to minimise potential sources of systemic risk that could spill over through payment systems (or emerge in them) to otherwise financially sound payment system participants (usually banks) and/or their clients. Thirdly, for the central banks conducting monetary policy, it is very important that transfers of funds between them and the commercial banks in monetary policy operations are safe and efficient.

Payment system oversight, as a regulatory activity, is introduced due to certain market weaknesses i.e. market failures – situations in which markets left alone do not give efficient outcome i.e. the one that results in optimal allocation of resources with regard to wider, social aspect. The most characteristic feature of market failure refers to negative externalities, a situation in which the operator or some of the participants in making business decisions do not consider negative consequences on other participants in the payment system and/or their clients i.e. entire economy, but they are primarily guided by their own interests. An operator may, for example, be insufficiently motivated to invest in system security, while some participants may, for instance, lack sufficient motivation to execute payments in a timely manner to other participants. Systemic risk is in fact one of the forms of negative externalities.

To wit, payment systems are exposed to a wide range of risks, including legal risks, credit risks, liquidity risks and operational risks. These risks may have implications for the payment system operator, its participants and any other financial infrastructures with linkages to, or dependent on, them. In specific circumstances, these risks may become systemic, and thus pose a serious threat to the proper functioning and stability of the payment system but also to that of the wider financial sector and, subsequently, the economy as a whole.

In addition to negative externalities, other similar market failures may occur in payment systems, such as in cases of network externalities, coordination problems, monopoly structures, and the like.

For example, at deciding whether or not to participate in the payment system, a participant may take into account only its costs and benefits, disregarding the additional benefits that all other existing participants in the payment system and/or their clients would have through its participation.

¹ "Central bank oversight of payment and settlement systems", 2005, Bank for International Settlements (BIS)

In that respect, market coordination is sometimes insufficient for establishing new and better system, since the participants in the payment system and/or their clients, with regard to specific perspective and different reasons may be insufficiently interested in the participation in such a system or they may even initiate/coordinate transfer of others in the system. Or, since the establishment of a payment system requires significant fixed resources, whereas the costs of any additional transaction in the system are marginal, large concentration of payment system operators usually occurs and sometimes monopoly structures without available alternatives. In this case, larger market power of the operator than is socially optimal, may lead to provide lower level of services at higher prices, lower investments in risk management systems, and lower level of innovation, and the like.

It is important that payment systems strike a good balance between the operational costs, safety and reliability. Only safe and reliable payment systems that provide fast and cost-effective performance of payment system operations, as well as the level of services that are economically viable for the system participants and their clients and which correspond to their requirements will be largely used.

3. Central Bank of Montenegro Role in Providing Safe and Efficient Payment System Functioning and Legal Basis for Payment System Oversight

Pursuant to the Central Bank of Montenegro Law (OGM 40/10, 46/10, 6/13), the main objective of the Central Bank is to foster and maintain the financial system stability, including fostering and maintaining a sound banking system and safe and efficient payment. Bearing in mind this main objective, the Central Bank is responsible for payment system oversight, which is one of the Central Bank mandates pursuant to the Law.

Regulatory framework for conducting payment system oversight consists also of the Payment System Law (OGM 62/13 of 31.12.2013 and 6/14 of 04.02.2014) and the Decision on Payment System Oversight (OGM 48/14), which implementation will start on 01.01.2016. The Decision on Payment System Oversight (OGM 24/09) will be applied until then.

Payment system oversight is a function complementary to other functions of the Central Bank for achieving objectives in the payment system area.

Specifically, the Central Bank of Montenegro is the owner and the operator of the payment system (the Central Bank Payment System), which consists of:

- Real Time Gross Settlement (RTGS) system, and
- Deferred Net Settlement (DNS) system.

Furthermore, pursuant to the Central Bank of Montenegro Law, it may be the owner and/or operator of a securities settlement system and another payment system, as well as a participant in another payment system. Additionally, the Central Bank is responsible and authorised for licensing payment systems other than the one it operates, passing regulations governing payment systems, establishing rules for payment systems it operates, and performing other activities in accordance with the law. The Central Bank of Montenegro is also a settlement agent, i.e. an institution which performs payment system settlement which is of key importance for their safety.

Thanks to its roles, the Central Bank gives significant contribution to the payment systems development and acts as a successful catalyst for initiating, promoting and conducting their reforms.

The Central Bank provides, through its role as a catalyst, advisory and professional support for payment systems. Through this role, the Central Bank also strives to support the banking sector and its initiatives for innovations and improvements of the payment system which is of mutual interest.

4. Central Bank of Montenegro Objectives and Standards in Payment System Oversight

The main objective of the payment system oversight performed by the Central Bank of Montenegro is to provide and promote safe and efficient payment system functioning in order to maintain financial system stability, although the primary responsibility for the safe and efficient payment system functioning remains on its operator.

Safety refers to limiting risks that may appear and threaten or adversely influence adequate and undisturbed functioning of the payment system and financial stability of the country.

Efficiency implies fast and cost-effective performance of payment system operations, as well as the level of services that are economically viable for the system participants and their clients and which correspond to their requirements.

The Central Bank of Montenegro, in close cooperation with banks and other participants in the payment system, has been continuously working on ensuring optimal long-term balance between safety and efficiency, which implies optimal balance between operational costs, safety and reliability of the national payment system.

The Central Bank translated payment system oversight objectives in a set of standards (principles) and requirements to be met by the payment systems. Payment system oversight principles are determined applying relevant international standards and principles developed by the Committee on Payment and Settlement Systems (CPSS) of the Bank for International Settlements – Core Principles for Systemically Important Payment Systems².

In 2012, Bank for International Settlements and International Organization of Securities Commission published Principles for Financial Market Infrastructures³ that contain new, more demanding international standards – principles for the functioning of systemically important financial market infrastructures, including also payment systems. The principles are developed with the aim to increase their safety and stability, and the central banks are expected to adopt and apply consistently new principles, monitor their fulfilments through oversight function, and cooperate in promoting objectives of safety and efficiency of the infrastructures.

The Central Bank of Montenegro adopted these principles and they will be used in the assessment of safety and efficiency of Montenegro payment systems starting from 1 January 2016.

The principles for payment system oversight are specified in more detail in the decision governing the manner of payment system oversight⁴.

In implementing relevant international standards, the Central Bank ensures equal treatment at international level and harmonisation of regulatory framework for the realisation of its activities

² Core principles for systemically important payment systems (CPSS, 2001).

³ Principles for financial market infrastructures (PFMIs) (CPSS-IOSCO, 2012).

⁴ Decision on Payment System Oversight (OGM 24/09 of 01.04.2009 and Decision on Payment System Oversight (OGM 48/14), which shall apply from 01.01.2016.

directed to overseeing payment systems with internationally accepted best practice. On the other hand, the Central Bank ensures that, by modifying and specifying international standards and recommendation for Montenegro, specificities of Montenegro's economy should be taken into consideration in setting up the requirements to be met by the payment systems in Montenegro. Payment system operator is primarily responsible for the compliance with the set up policies and standards.

5. Scope of Oversight

The scope of payment system oversight performed by the Central Bank arises from its main objective set forth in the Central Bank of Montenegro Law, which refers to fostering and maintaining safe and efficient payment system.

In that respect, the Central Bank oversees payment systems in the country and systemically important payment systems, important payment systems and other payment systems.

Important payment systems are those that are determined based on criteria prescribed by the Central Bank.

An important payment system whose disruption in operations may cause systemic risk shall be systemically important payment system.

RTGS system of the Central Bank Payment System, which processes large-value payments, is a backbone of the financial infrastructure in Montenegro. This payment system, whose owner, operator, participant and settlement agent is the Central Bank, is systemically important payment system.

The Central Bank Payment System is currently the only payment system in the country.

Pursuant to the prevailing regulation, systemically important payment systems should be harmonised with all principles for the payment system functioning. Non-systemically important payment systems should be complied with a part of principles in the manner set forth in the decision governing the manner of payment system oversight.

6. Payment System Oversight Activities

The Central Bank of Montenegro oversees the payment systems through the compliance assessment of the payment system operations with the principles for payment system functioning.

The compliance assessment of the payment system operations with the principles for the payment system functioning is performed:

- *On-site* – direct insight in the payment system operations, and/or
- *Off-site* – monitoring and analysing information, statistical data, reports and other documents relevant for the payment system functioning.

Main sources of information consist of regular and ad hoc reports on payment system activities submitted by the payment system operator at the Central Bank's request, documentation on the

payment system, internal audit reports, board of directors' reports, and direct review of the payment system operations, bilateral contacts with the payment system operators and payment system participants, and the like.

The Central Bank of Montenegro, pursuant to the prevailing regulation, has powers to obtain from the payment system operators and participants all information and documents relevant for the payment system operations for the purpose of payment system oversight.

The compliance assessment of the payment system operations with the standards and principles for the payment system functioning is realised with the aim to review compliance of the payment systems with the determined requirements and standards and it is not directed to individual participants in the system, but to the payment system as a whole.

When planning oversight activities, the Central Bank adopted approach of determining priorities in accordance with the assessment and sources of risks identified in the payment system.

Depending on the assessment of the level of the compliance of the payment system, the Central Bank may recommend changes in the payment systems and undertake other adequate activities for the purpose of reaching compliance with the principles for the payment system functioning.

With a view to providing transparency, the Central Bank presents the realisation of oversight activities within the Central Bank of Montenegro Annual Report and within other reports it publishes on its website.

The Central Bank ensures consistent implementation of the oversight standards and it applies the same standards and requirements against all payment systems in Montenegro, including that which it operates and owns. To that end, the payment system oversight function within the Central Bank is separated from the operational payment system oversight function, and the direct line of management is also separated. Thus, the conflict of interest is minimised in the process of the compliance assessment of the payment system whose operator and owner is the Central Bank.

In conducting oversight function, the Central Bank ensures confidentiality of specific statistical data, information and other documents pertaining to the payment system functioning and it uses them only for the purpose of performing activities covered by the system oversight.

For the purpose of successful oversight and fulfilment of the objectives set, the Central Bank cooperates actively with other relevant institutions at national and international level.

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