OPINION OF THE EUROPEAN CENTRAL BANK

of 6 January 2023

on payment and settlement systems

(CON/2023/1)

Introduction and legal basis

On 10 October 2022 the European Central Bank (ECB) received a request from the Estonian Ministry of Finance for an opinion on a draft law on payment and settlement systems (hereinafter the 'draft law').

The ECB's competence to deliver an opinion is based on Articles 127(4) and 282(5) of the Treaty on the Functioning of the European Union and the third, fifth and sixth indents of Article 2(1) of Council Decision 98/415/EC[1], as the draft law relates to Eesti Pank, payment and settlement systems, and rules applicable to financial institutions insofar as they materially influence the stability of financial institutions and markets. In accordance with the first sentence of Article 17.5 of the Rules of Procedure of the European Central Bank, the Governing Council has adopted this opinion.

1. Purpose of the draft law

1.1 As noted in the explanatory memorandum accompanying the draft law[2], the main objectives of the draft law are: (1) to regulate settlement finality in payment and securities settlement systems, in line with Directive 98/26/EC of the European Parliament and of the Council[3] (hereinafter the 'SFD'); (2) to provide uniform access criteria for different payment systems so as to avert undue discrimination between different market participants; and (3) to provide clear grounds for the recognition and oversight of payment and settlement systems by Eesti Pank.

1.2 As clarified in the explanatory memorandum[4], the national provisions transposing the SFD have thus far been contained in various national legal acts, primarily the Law on credit institutions[5] and, in relation to securities settlement systems, the Law on securities markets[6]. Certain requirements have also been established by decrees of Eesti Pank. This has caused some legal uncertainty in terms of the scope of regulation and the content of the rules. By consolidating the regulatory provisions into one legal act, the draft law aims to increase legal certainty. The draft law also formalises the oversight by Eesti Pank of payment and settlement systems. To that effect, the draft

1 Council Decision 98/415/EC of 29 June 1998 on the consultation of the European Central Bank by national authorities regarding draft legislative provisions (OJ L 189, 3.7.1998, p. 42).

2 See p. 2 of the explanatory memorandum accompanying the draft law.

3 Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems (OJ L 166, 11.6.1998, p. 45).

4 See pp. 2 and 4 to 15 of the explanatory memorandum accompanying the draft law.

5 Krediidiasutuste seadus, RT I 1999, 23, 349.

6 Väärtpaberituru seadus, RT I 2001, 89, 532.

law consolidates the law into one text with harmonised terminology, establishes the conditions for recognising a payment system as a settlement system, restating the principles of settlement finality also in insolvency proceedings, as well as restates and elaborates on the principles of netting (relevant both for settlement regulation and derivative transactions) and regulating the role of Eesti Pank in the exercise of its oversight authority.

1.3 The term 'payment system' in the draft law means payment systems as defined in Directive (EU) 2015/2366 of the European Parliament and of the Council[7]. Settlement systems that are covered by the draft law are securities settlement systems and payment systems that meet the conditions specified in the draft law, including the that they are recognised as settlement systems by Eesti Pank and of which the European Securities and Markets Authority has been notified.

2. General observations

2.1 The ECB welcomes the objectives of the draft law to implement the requirements of the SFD more clearly into Estonian law by adopting a single legal act governing settlement finality in payment and settlement systems, establishing the criteria for the recognition of payment systems as settlement systems, and setting out the principles applicable to the oversight of payment and settlement systems by Eesti Pank.

2.2 The ECB also welcomes the aim of the draft law to increase legal certainty by reducing the likelihood of misinterpretation and clarifying the scope of application of settlement finality principles.

3. Specific observations on the draft law's definitions of relevant terms

The draft law's definition of system operator

3.1 The draft law[8] defines a system operator as a person who, in accordance with the relevant system's settlement rules and contracts entered into with other participants in that system, is responsible for ensuring the continuous operation of the system and organising the execution of transfer orders and netting of claims between the participants in the system. The explanatory memorandum[9] specifies that each settlement system may only have one system operator, as this will avert potential disputes over the rights and obligations of multiple operators.

3.2 The definition of system operator provided in the draft law does not specify whether a settlement system may have more than one system operator. Article 2, point (p), of the SFD states that a system operator is 'an entity or entities'. This means that a system may have multiple operators. It cannot be excluded that certain systems may have or need multiple operators (e.g. specifically in relation to possible future settlement systems that operate based on new technologies such as distributed ledger technology). Hence, the draft law could leave open the option of having different

7 The term 'payment system' is defined as having the same meaning as under paragraph 3(4) of the law on payment institutions and e-money institutions which adopts the definition of payment systems provided in Article, 4 point (7), of Directive (EU) 2015/2366 of the European Parliament and of the Council of 25 November 2015 on payment services in the internal market, amending Directives 2002/65/EC, 2009/110/EC and 2013/36/EU and Regulation (EU) No 1093/2010, and repealing Directive 2007/64/EC (OJ L 337, 23.12.2015, p. 35).

8 See paragraph 4(1) of the draft law.

9 See p. 24 of the explanatory memorandum accompanying the draft law.

system operators for a single system while ensuring that their roles are well defined through contractual agreements or system rules. The ECB understands that even though the explanatory memorandum seems to limit the number of operators that one system may have, the draft law's wording does not, and in case of discrepancies between the wording of the draft law and its explanatory memorandum, the wording of the draft law will prevail.

The draft law's definition of insolvency proceedings

3.3 Under the draft law[10], insolvency proceedings include bankruptcy, reorganisation, and crisis resolution proceedings as well as moratoria and proceedings opened on the basis of foreign law in order to reorganise or wind up the activities of a system participant or a person who has provided collateral security to a settlement system or to a system participant, or implementation of any measures involving the suspension of, or imposition of limitations on, the discharge of transfer obligations.

3.4 The draft law's definition of insolvency proceedings includes crisis resolution proceedings[11]. Crisis resolution proceedings conducted in line with the Law on financial crisis prevention and resolution[12] are aimed at ensuring the continuing operability and functioning of an entity in circumstances where that entity's liquidation or bankruptcy could threaten financial stability and/or the wider financial system and the real economy[13]. The Law on financial crisis prevention and resolution implements into Estonian law Directive 2014/59/EU of the European Parliament and of the Council[14] (hereinafter the 'BRRD'). Given the nature and purpose of such crisis resolution proceedings, in particular their aim of maintaining the continuity of the relevant entity from the operational and functional perspectives, the Estonian legislator may wish to reconsider the inclusion of crisis resolution proceedings in the draft law's definition of insolvency proceedings and to ensure that sufficient regulation is in place to ensure that once crisis resolution proceedings have been initiated, the affected entity's substantive obligations under the relevant settlement contracts will continue to be performed. Should the entity in relation to which crisis resolution proceedings have been initiated become unable to submit executable transfer orders, as foreseen under the draft law[15], this could have a serious negative effect on the continued operation of the entity and, as a result, generally undermine the achievement of the aims of crisis resolution proceedings. This is highlighted in the recitals of the BRRD, which clarify that the possibility of suspending certain contractual obligations in order to give time to the resolution authority to use resolution tools, should not, however, apply to obligations in relation to systems set out in the SFD. A crisis prevention measure or a crisis management measure should not, as such, be deemed to be insolvency proceedings within the meaning of the SFD if the substantive obligations set out in the contract continue to be performed[16].

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10 See paragraph 7 (1) of the draft law.

11 See paragraph 7 (1) 3) of the draft law.

12 Finantskriisi ennetamise ja lahendamise seadus, RT I, 19.03.2015, 3.

13 See paragraph 1 of the Law on financial crisis prevention and resolution.

14 Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council (OJ L 173, 12.6.2014, p. 190).

15 See paragraph 19 (1) of the draft law.

16 See recital 93 of the BRRD.

Furthermore, by including crisis resolution proceedings in the definition of insolvency proceedings, the draft law arguably goes beyond the definition provided in the SFD[17], according to which 'insolvency proceeding' means any collective measure provided for in the law of a Member State, or a third country, either to wind up the participant or to reorganise it, where such measure involves the suspension of, or imposition of limitations on, transfers or payments. During crisis resolution proceedings, transfers and payments might not be suspended or limited.

4. Specific observations on the draft law's provisions regarding settlement finality and insolvency proceedings

The draft law's provisions regarding the finality of the execution of settlement upon insolvency

4.1 The draft law provides that transfer orders shall be executed and netting shall be performed, and such execution of transfer orders and netting shall also be legally binding on third parties, even if insolvency proceedings have been opened against a system participant, provided that the transfer orders have been received before the opening of the insolvency proceedings, as required by the settlement system rules. This also applies, upon the opening of insolvency proceedings, to a participant in a linked system and to a linked system operator who is not a participant in a system[18].

4.2 According to the SFD[19] transfer orders and netting are legally enforceable and binding on third parties even in the event of insolvency proceedings against a participant, provided that transfer orders were entered into the system before the moment of opening of such insolvency proceedings. The draft law seems to go further than the SFD, which only provides for the finality of transfer orders and netting, meaning that a transfer order as such is to be deemed legally binding and executable according to system rules. The SFD does not require that transfer orders *shall be executed* and that settlement in fact occurs. Under the SFD, the execution of transfer orders and settlement, also where insolvency proceedings have been initiated, depend on the system operator and system rules. However, the draft law provides that transfer orders shall be executed, which suggests that, in addition to transfer order finality, the draft law also foresees the finality of settlement and execution of transfer orders. The ECB understands that the purpose of the draft law is to establish more far-reaching protection of settlement than the SFD.

The draft law's provisions regarding the moment in time when transfer orders become irrevocable

4.3 The draft law provides that transfer orders shall be executed, provided that they have been 'accepted by the system according to the rules'[20] or 'issued to it'[21].

4.4 The phrase 'entered into the system' is used in the SFD[22]. Given that different points in time, each of which bear a different legal meaning, can be discerned between the submission of a transfer

17 See Article 2, point (j), of the SFD.
18 See paragraph 19 (2) of the draft law.
19 See Article 3(1) of the SFD.
20 See paragraph 19 (2) of the draft law.
21 See paragraph 20 (2) of the draft law.
22 See Article 3(1) of the SFD.

order and its execution, it is important to ensure the clarity and coherence of the terminology used[23]. The processing of a transfer order essentially consists in at least six different points in time, which correspond to different operational and legal moments. From an operational perspective, one must distinguish between: (1) the moment when the transfer order is technically submitted to the system; (2) the moment when the transfer order is validated by the system as corresponding to the requirements of the system rules and as being suitable for fulfilment; and (3) the moment when the execution of the transfer order is initiated. From a legal perspective, one must distinguish between: (1) the moment when the transfer order is entered into the system[24]; (2) the moment at which a transfer order may not be revoked by a participant in a system or third party; and (3) the moment when the transfer order is executed, and the settlement is finalised. Under the SFD, it is this first legal moment, which is the moment of the entry into the system that bears the consequences of transfer order finality. If insolvency occurs after this second legal moment, the transfer order is deemed legally enforceable and binding on third parties.

4.5 Under the draft law, the moment when the transfer order has been accepted by the system would seem to correspond to either the second operational moment or the second legal moment, while the moment when the order has been issued to the system would seem to correspond to either the first operational moment or the first legal moment, i.e. the technical submission or 'entry of a transfer order into the system' under the SFD. For reasons of legal certainty, the ECB invites the Estonian legislator to review the terminology used in the draft law and align this terminology with that used in the SFD by using the phrase 'entered into the system' instead of 'accepted by the system' or 'issued to it'.

Differences in the treatment of insolvency of system participants and system operators

4.6 The draft law[25] regulates system participant and system operator insolvencies differently. In the case of a system participant, the draft law refers to insolvency proceedings as defined in the draft law. However, in relation to system operators, reference is only made to bankruptcy proceedings. In order to ensure compliance with the SDF, the ECB invites the Estonian legislator to consider which proceedings should be included.

5. Specific observations on the draft law's provisions regarding Eesti Pank's oversight of payment and settlement systems

5.1 The draft law formalises the role of Eesti Pank in overseeing payment and settlement systems. Eesti Pank must collect information on payment service providers' participation in payment and settlement systems, analyse the structure, functioning and risks of such systems. Eesti Pank may provide guidance and recommendations for improving the structure and functioning of the systems, and provide assessments on system rules and principles[26]. Eesti Pank also cooperates with the Estonian Financial Supervisory Authority (FSA) and may pass on to the EFSA documents and data

23 The ECB has previously stressed the importance of terminological clarity in this context. See paragraph 3.2.1 of Opinion CON/2008/78. All ECB opinions are published on EUR-Lex.

24 Within the meaning of Article 3(1) of the SFD.

25 See paragraphs 19-20 of the draft law.

26 See paragraph 23 of the draft law.

collected by it. Eesti Pank and the FSA may also conclude a cooperation agreement to better fulfil the oversight obligation. Eesti Pank may, under certain circumstances, also make a proposal to the FSA to mitigate the risks related to participation in systems[27]. Under the draft law, Eesti Pank may request information from system operators, system participants, government authorities, supervisory authorities and national and municipal databases for the purposes of fulfilling its obligations under the draft law, as well as to provide data to competent authorities of other Member States of the European Economic Area (EEA) and other persons, if required by law.[28]

5.2 The ECB welcomes the formalisation, clarification and consolidation of Eesti Pank's role, duties and obligations as the body that conducts this oversight since it increases legal certainty by clarifying the legal basis on the basis of which Eesti Pank fulfils its oversight role. This should also help Eesti Pank in the performance of the basic task of the European System of Central Banks of promoting the smooth operation of payment systems[29].

5.3 The ECB understands that Eesti Pank's right under the draft law to transmit information, documents and other data collected to discharge an obligation or other duty of Eesti Pank under the draft law, other legislation or legislation issued on the basis thereof to a competent authority of another EEA Member State, as well as to another person or institution if this arises from legislation,[30] provides a legal basis for Eesti Pank to transmit information gathered in the performance of its duties under any legal act to all central banks in the European System of Central Banks acting as oversight authorities with respect to payment and settlement systems, including the ECB.

6. Specific observations on the draft law's provisions regarding close-out netting

6.1 The draft law would introduce a new type of set-off, which would allow parties to conclude netting arrangements in certain circumstances, in Estonian law. Netting arrangements would be regulated on a general level in the Law on obligations[31]. A netting arrangement would be defined as a bilateral or multilateral agreement for netting claims that have arisen in the case provided for separately in legislation, from a standard contract entered into in the course of a continuing business relationship or from another similar contract. Pursuant to such arrangement the mutual claims of the parties terminate to the extent that they overlap at the time prescribed in the arrangement or on the occurrence of an enforcement event and they are substituted by the net claim or net obligation resulting from netting. A netting arrangement may prescribe a close-out netting arrangement under which, on the occurrence of an enforcement event defined in legislation or in the arrangement, the obligations of the parties are accelerated so as to become immediately due or are terminated by netting in the manner mentioned in the previous sentence[32].

6.2 The ECB understands that this general regulation that is to be added to the Law of Obligations foresees that netting arrangements may only be concluded if so provided in the law, meaning that

27 See paragraph 24 of the draft law.
28 See paragraph 25 of the draft law.
29 See Article 127(2), fourth indent, of the Treaty.
30 See paragraph 25 (1) of the draft law.
31 Võlaõigusseadus, RT I 2001, 81, 487.
32 See paragraph 33 1) of the draft law adding paragraph 205^1 to the Law on obligations.

other legal acts would have to make reference to a netting arrangement and further clarify the circumstances in which parties are allowed to conclude a netting arrangement. The ECB understands the draft law[33] satisfies this requirement. The Estonian legislator might, however, wish to consider including a more specific reference to the provision of the Law on obligations[34] that regulates netting arrangements.

6.3 In relation to derivatives and financial collateral transactions, the ECB understands that netting in case of bankruptcy is currently authorised under specific provisions of the Estonian Law on bankruptcy[35], which make reference to derivative and financial collateral transactions, and that these provisions would not be amended by the draft law and would remain in force after its adoption[36]. As such, even though the explanatory memorandum to the draft law highlights the importance of netting arrangements in relation to master agreements, such as that sponsored by the International Swaps and Derivatives Association (ISDA)[37], the new netting arrangement solution would technically not apply to derivative transactions, and the enforceability of close-out netting for derivative transactions would continue to function under the existing system.

6.4 Legal certainty regarding close-out netting is important for ensuring settlement and netting finality under the SFD, but also for reducing counterparty credit risk and to ensure the efficient use of collateral exchanged on over-the-counter (OTC) derivative markets. As such, the enforceability of netting agreements and close-out netting plays a vital role for the organisation of settlement systems and OTC derivatives markets.[38] However, the wording of the draft law's provisions relating to netting arrangements may lead to some legal uncertainty.

For example, the wording extends to netting arrangements concluded only in a continuing business relationship as part of a standard or similar contract. However, in the derivatives markets, netting and close-out netting arrangements could also be relevant in occasional or ad hoc business relationships, or in one-off or ad hoc transactions that are not subject to a standard contract.

Regarding netting in the context of credit institution crisis resolution proceedings under the Law on financial crisis resolution and prevention, the existing provisions of the Law on crisis resolution and prevention contain a definition of netting arrangement[39]. While the draft law[40] amends these provisions, the new wording does not refer to the Law on obligations. Instead, it refers to the draft law, which does not regulate netting arrangements. This may increase legal uncertainty regarding netting arrangements in the context of credit institution crisis resolution proceedings. The relevant provisions could be amended to clarify that, under the Law on financial crisis prevention and

33 See paragraph 8 1) of the draft law.
34 paragraph 205[1] of the Law on obligations.
35 Pankrotiseadus, RT I 2003, 17, 95.
36 See paragraphs 48 and 99 (5) of the Law on bankruptcy.
37 See p. 57 of the explanatory memorandum accompanying the draft law.
38 See paragraph 2.1 of Opinion CON/2021/1 and paragraph 4.1 of Opinion CON/2011/14.
39 See paragraph 17 (10) of the Law on financial crisis resolution and prevention.
40 See paragraph 28 1) of the draft law.

resolution, 'netting arrangements' means netting arrangements as defined in the relevant provisions of the Law on obligations[41].

The draft law provides that in a settlement system, bilateral or multilateral netting of claims may be used in accordance with the system rules and in the cases determined by the system rules in order to satisfy financial claims between the system participants[42]. The reference to bilateral and multilateral netting of claims could, however, in Estonian also be understood to be a reference to set-off of claims under the Law on obligations[43] and not to a provision enabling the conclusion of netting arrangements under the Law on obligations.[44] If the aim of the draft law is to allow netting arrangements to be concluded under settlement system rules, then, for the sake of legal certainty, the Estonian legislator may wish to consider further amendments to the draft law to achieve this result.

To sum up, the draft law could benefit from increased clarity in relation to the provisions relating to netting arrangements.

This opinion will be published on EUR-Lex.

Done at Frankfurt am Main, 6 January 2023.

The President of the ECB

Christine LAGARDE

41 In particular see paragraph 205[1] of the Law on obligations.

42 Paragraph 8 (1) of the draft law.

43 In particular see paragraph 197 of the Law on obligations.

44 In particular see paragraph 205[1] of the Law on obligations.