Overview: Risks and Oversight of Payment, Clearing and Settlement Systems

Payment System Policy and Oversight Course
May 16, 2016
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Presentation Outline

- What are the key risks?

- Why do central banks care?

- How can central banks be effective overseers?
  - Potential tools of the central bank
  - Role of international principles
  - Role of cooperation among authorities
  - Federal Reserve approach
What are the key risks?
Daily Settlements

Risks
- Liquidity
- Credit
- Operational
- Systemic
Might not be paid on time

Possible consequences:

• Borrow money
• Sell assets
• Borrow securities
• Pay penalties for settlement failures
Credit Risk

- Might not ever be paid

- Possible consequences:
  - Unwanted open position
  - Replacement cost
  - Loss of entire principal
Operational Risk

- Disruption of payment/clearing/settlement functions

- Possible consequences:
  - Unsettled, past-due obligations
  - Extended liquidity risks
  - Extended credit risks
Systemic Risk

- One failure may trigger many others

- Possible consequences:
  - Shortage in market-wide liquidity
  - Major pressure on interest rates/exchange rates
  - Large swings in asset prices

- Impact financial system stability
  - That’s one reason why central banks care!
Why do central banks care?
Why Do Central Banks Care?

- FMI safety and efficiency can affect...
  - Financial system stability
  - Transmission of monetary policy
  - Functioning of banks
  - Functioning of the financial system
  - Functioning of the macroeconomy
Potential roles of the central bank:
- Operator of payment systems
- User/participant
- Liquidity/credit provider: intraday, overnight
- Bank supervisor
- System supervisor
- Catalyst/collaborator: public/private sector
- Overseer of payment, clearing, and settlement systems
What is “Central Bank Oversight of Payment and Settlement Systems”?

Working definition:

“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 change.”

CPSS, May 2005
Part 3

How can central banks be effective overseers?

- Potential tools of the central bank
- Role of international principles
- Role of cooperation among authorities
- Federal Reserve approach
How can central banks be effective overseers?

- **Potential tools of the central bank**
  - Setting policies/objectives/standards
  - Dialogue with private sector
  - Dialogue with other authorities
  - Voluntary agreements/contracts/MOUs
  - Specific laws and regulations
  - Enforcement and sanctions
## Potential Roles and Tools

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<tr>
<th>Potential Roles</th>
<th>Setting policies, objectives, and standards</th>
<th>Dialogue with the private sector</th>
<th>Dialogue with other authorities</th>
<th>Voluntary agreements, contracts, and MOUs</th>
<th>Specific laws and regulations</th>
<th>Enforcement and sanction powers</th>
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# Role of international principles: CPSS-IOSCO Principles for FMIs

## General organization
1. Legal basis
2. Governance
3. Framework for the comprehensive management of risks

## Credit and liquidity risk management
4. Credit risk
5. Collateral
6. Margin
7. Liquidity risk

## Settlement
8. Settlement finality
9. Money settlements
10. Physical deliveries

## CSDs and exchange-of-value settlement systems
11. CSDs
12. Exchange-of-value settlement systems

## Default management
13. Participant-default rules and procedures
14. Segregation and portability

## General business and operational risk management
15. General business risk
16. Custody and investment risks
17. Operational risk

## Access
18. Access and participation requirements
19. Tiered participation
20. FMI links

## Efficiency
21. Efficiency and effectiveness
22. Communication procedures and standards

## Transparency
23. Disclosure of rules, key procedures, and market data
24. Disclosure of market data by TRs
Harmonize existing standards
- Core Principles for systemically important payment systems (2001)
- Recommendations for securities settlement systems (2001)

Strengthen existing standards, based on
- Lessons from the crisis
- Experience/gaps in applying standards

Ensure consistent application
- CPSS-IOSCO members commit to apply “to the fullest extent possible”
- CPSS-IOSCO implementation monitoring

Reinforce with “disclosure framework”, “assessment methodology”, recovery guidance, and quantitative disclosures
- Support consistent disclosures by FMIs
- Support consistent assessments of FMIs by national authorities
- Support consistent external assessments of FMIs and authorities (eg, FSAPs)

Q: Would further guidance or standards be helpful?
How Can Central Bank Overseers Be Effective? CPSS-IOSCO Responsibilities for Authorities

A: Regulation, supervision, and oversight of FMIs
   - FMIs should be subject to appropriate and effective regulation, supervision, and oversight by a central bank, market regulator, or other relevant authority.

B: Regulatory, supervisory, and oversight powers and resources
   - Central banks, market regulators, and other relevant authorities should have the powers and resources to carry out their responsibilities effectively.

C: Disclosure of policies with respect to FMIs
   - All relevant authorities should clearly define and disclose their regulatory, supervisory, and oversight policies with respect to FMIs.

D: Application of the principles for FMIs
   - Central banks, market regulators, and other relevant authorities should adopt the PFMI principles and apply them consistently.

E: Cooperation with other authorities
   - All relevant authorities should cooperate with each other, both domestically and internationally in promoting the safety and efficiency of FMIs.
Role of Cooperation among Authorities: Key elements of cooperation

- Mutual support
  - In normal circumstances, and times of stress
- Notification of cross-border or multi-currency FMIs
  - In light of potential systemic importance to other authorities
- Efficiency and effectiveness
  - Cooperation is not “one size fits all”: must be tailored to circumstances
- Establishment of cooperation
  - Presumption: by authority with primary responsibility for the FMI
- Assess FMI periodically against PFMI
  - Consult authorities with systemic interest in FMI
- Assess payment arrangements and liquidity risk management in each currency
  - Consider views of central bank of issue and authority with direct responsibility for FMI
- Advance notification (where practicable) of pending material regulatory changes
  - If other authorities interests would be affected significantly
- Ensure timely access to data in trade repositories
  - Through coordination among relevant authorities
- Discretion of each authority to discourage use of FMI, or to provide services to FMI
  - If authority judges FMI not prudently designed/managed, or PFMI not adequately observed
- Cooperation does not prejudice or constrain an authority’s powers or discretion
International standards were adopted as Fed policy
- Federal Reserve Policy on Payment System Risk ("PSR Policy")
- Requires "self assessments" against these standards

PSR Policy states that these standards guide the Fed
- As supervisor
- As payment service operator
- As intraday credit provider
- When working with other domestic and foreign financial authorities
  - Including where Fed does not have direct authority over an FMI

Fed encourages relevant authorities to consider these standards
Fed is guided by cooperative oversight principles
Key players: FSOC, Fed, CFTC, SEC

Six key powers

- Designate
  - Systemically important financial market utilities
    - “Designated FMU” (“DFMU”) = “systemically important FMI”
  - Systemically important PCS activities
- Set risk-management standards
  - For DFMUs
  - For financial institutions’ designated PCS activities
- Examine and enforce standards
- Impose reporting requirements
- Review/object to proposed material changes
- Grant DFMU access to FR accounts and services
### Designated Financial Market Utilities

**Primary Supervisory Agencies of eight DFMUs:**

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- **Adopted CPSS-IOSCO PFMI in regulation and policy**
  - Regulation HH
  - PSR Policy

- **Fed uses the PFMI under new powers**
  - For DFMUs, where Fed is the primary supervisory agency
    - CHIPS, CLS
  - When conditioning DFMU access to accounts and services
  - With respect to DFMUs under direct CFTC or SEC jurisdiction
    - When consulting on scope of CFTC/SEC examinations
    - When participating on CFTC/SEC examinations
    - When reviewing proposed material changes to DFMUs
    - When establishing information/reporting requirements of DFMUs
  - When working with other domestic and foreign financial authorities
    - Including where the Fed does not have direct authority over an FMI
Presentation summary

- **What are the key risks?**
  - Liquidity, credit, operational, and systemic

- **Why do central banks care?**
  - Financial system stability
  - Transmission of monetary policy
  - Functioning of banks, financial system, macroeconomy

- **How can central banks be effective overseers?**
  - Potential tools of the central bank
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