FEDERAL RESERVE BANK *of* NEW YORK

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

Payment System Policy and Oversight Course

May 16, 2016

Important note

The views expressed in this presentation do not necessarily reflect the views of the Federal Reserve Bank of New York or any other component of the Federal Reserve System.

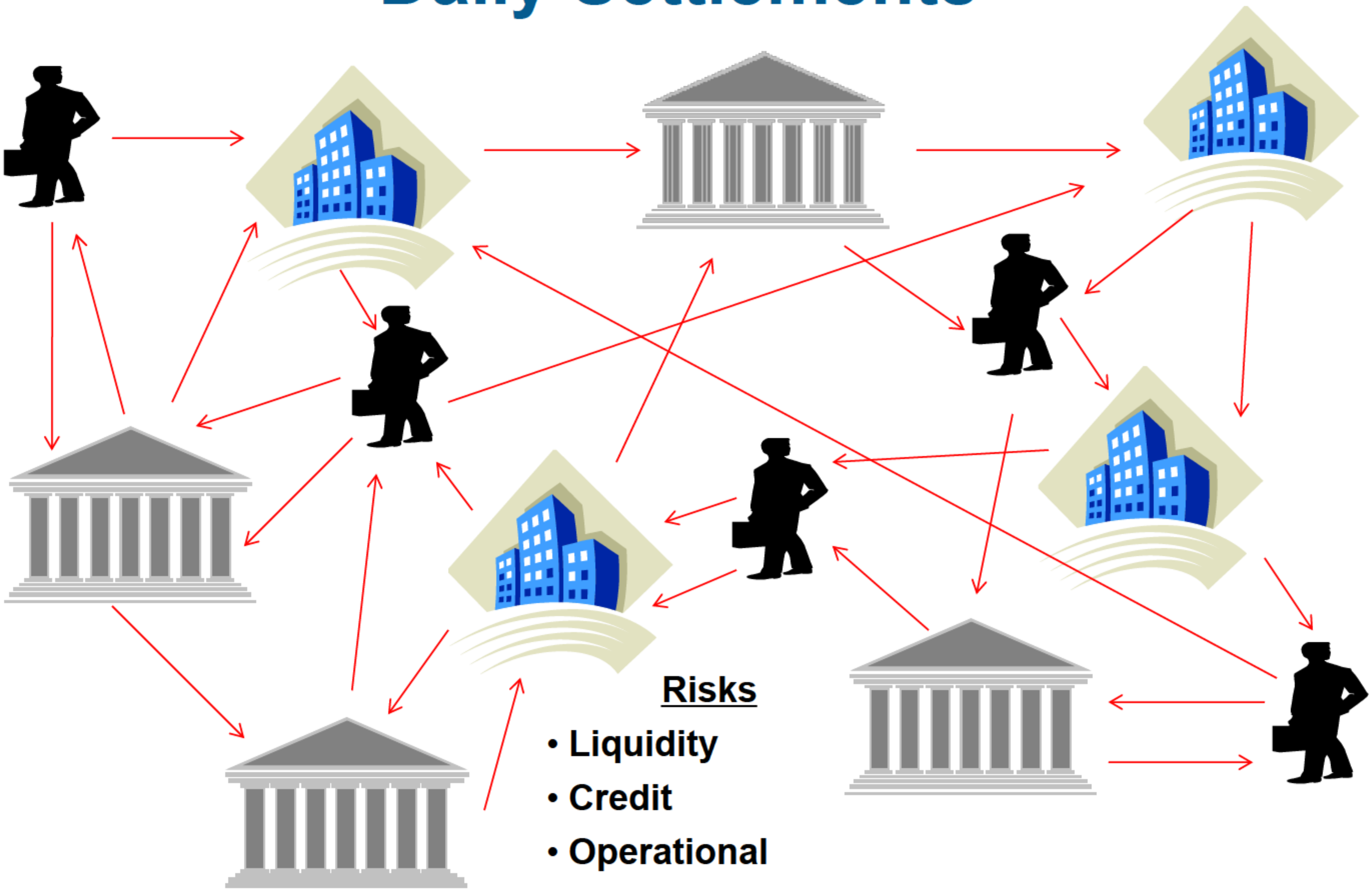
Presentation Outline

- **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

Part 1

What are the key risks?

Daily Settlements



Risks

- Liquidity
- Credit
- Operational
- Systemic

Liquidity Risk

- **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!

Part 2

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

Why Do Central Banks Care? *(continued)*

- **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

Potential Tools / Potential Roles	Setting polices, objectives, and standards	Dialogue with the private sector	Dialogue with other authorities	Voluntary agreements, contracts, and MOUs	Specific laws and regulations	Enforcement and sanction powers
Operator						
User/participant						
Liquidity/Credit provider						
Bank supervisor						
System supervisor						
Catalyst/ collaborator						
System overseer						

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

CPSS-IOSCO Principles for FMIs: Finalized and Issued in 2012

- **Harmonize existing standards**
  - Core Principles for systemically important payment systems (2001)
  - Recommendations for securities settlement systems (2001)
  - Recommendations for central counterparties (2004)
- **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 PFMIs 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 PFMIs**
  - 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 PFMIs not adequately observed
- ***Cooperation does not prejudice or constrain an authority's powers or discretion***

Federal Reserve Approach: Pre “Dodd-Frank” Act (2010)

- **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**

“Dodd-Frank” Act, Title VIII: Payment, Clearing, and Settlement Supervision

- **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:

	Federal Reserve	CFTC	SEC
CHIPS	X		
CLS	X		
CME		X	
DTC			X
FICC			X
ICE Clear Credit		X	
NSCC			X
OCC			X

Federal Reserve Approach: Post "Dodd-Frank" Act (2010)

- **Adopted CPSS-IOSCO PFMIs in regulation and policy**
  - Regulation HH
  - PSR Policy
- **Fed uses the PFMIs 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
  - Role of international principles
  - Role of cooperation among authorities
  - Federal Reserve approach