



# Systemic Risk and Investor Rights – a Global Regulatory Perspective \*

## **The Ability of Regulation to Facilitate the Enforcement of Investor Rights**

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\* Views expressed are those of the author and not necessarily those of the BIS or CPSS

# Outline

- The BIS and the Committee on Payment and Settlement Systems
- The Role of International Standards
- Systemic risk
- Regulation, supervision and oversight
- Requirements for Central Securities Depositories and Securities Settlement Systems
- Market-wide recommendations and Requirements for intermediaries
- Conclusions



## The Bank for International Settlements (BIS)

*"The mission of the BIS is to serve central banks in their pursuit of monetary and financial stability, to foster international cooperation in those areas and to act as a bank for central banks"*

- ⇒ The world's oldest international financial institution, established under the Hague Convention of 1930
- ⇒ The BIS pursues its mission by:
  - promoting *discussion* and facilitating *collaboration among central banks and with other authorities* responsible for promoting financial stability
  - *conducting research* on policy issues confronting central banks and financial supervisory authorities and providing statistics
  - hosting ***committees and secretariats of regulatory bodies***
  - acting as *"bank for central banks"*



# The Committee on Payment and Settlement Systems

- ⇒ The CPSS is a global **standard setting body** in the field of payments, clearing and settlement systems and related activities (also including the formulation of common policies and recommendations):
  - e.g. *Central bank oversight of payment and settlement systems* (2005)
  - Principles for financial market infrastructures* (2012)
- ⇒ It also serves as a forum for central banks to **monitor and analyse developments** in large value and retail payment, clearing, settlement and related arrangements, schemes and instruments, both within and across jurisdictions (also including cooperation and sharing information, increasing common understanding, etc.):
  - e.g. *Role of central bank money in payment systems* (2003)
  - The interdependencies of payment and settlement systems* (2008)
  - Innovations in retail payments* (2012)
- Establishment in 1990 (preceded by the 1980 *Group of Experts on Payment*), reporting to the Governors of the Global Economy Meeting
- Today 25 member central banks, chaired by Benoît Coeuré (ECB)



# Lessons from the financial crisis

- Evidence of problems and shortcomings, e.g.:
  - *Inability* of investors *to retrieve securities* held with an insolvent entity
  - Issues with *segregation* (e.g. re-use, confusion between legal entities)
  - Inadequate underlying *legal documentation*
  - *Lack of awareness* of investors about details of nature of their holdings (including liens or consented re-use)
  - A *fragmented regulatory system* (weak information flows, lack of coordination)
  - Lack of workable *resolution mechanisms* and *safeguards for client assets*



## Washington G20 summit, November 2008

- **Strengthening Transparency and Accountability** (enhancing required disclosure on complex financial products and by firms)
- **Enhancing Sound Regulation:** “We pledge to strengthen our regulatory regimes, prudential oversight, and risk management, and ensure that all financial markets, products and participants are regulated or subject to oversight, as appropriate to their circumstances... We commit to transparent assessments of our national regulatory systems”
- **Promoting Integrity in Financial Markets** (bolstering *investor and consumer protection*, preventing illegal market manipulation, ...)
- **Reinforcing International Cooperation** (national and regional regulators to enhance coordination and cooperation on crisis prevention, management, and resolution across all segments of financial markets, including cross-border)

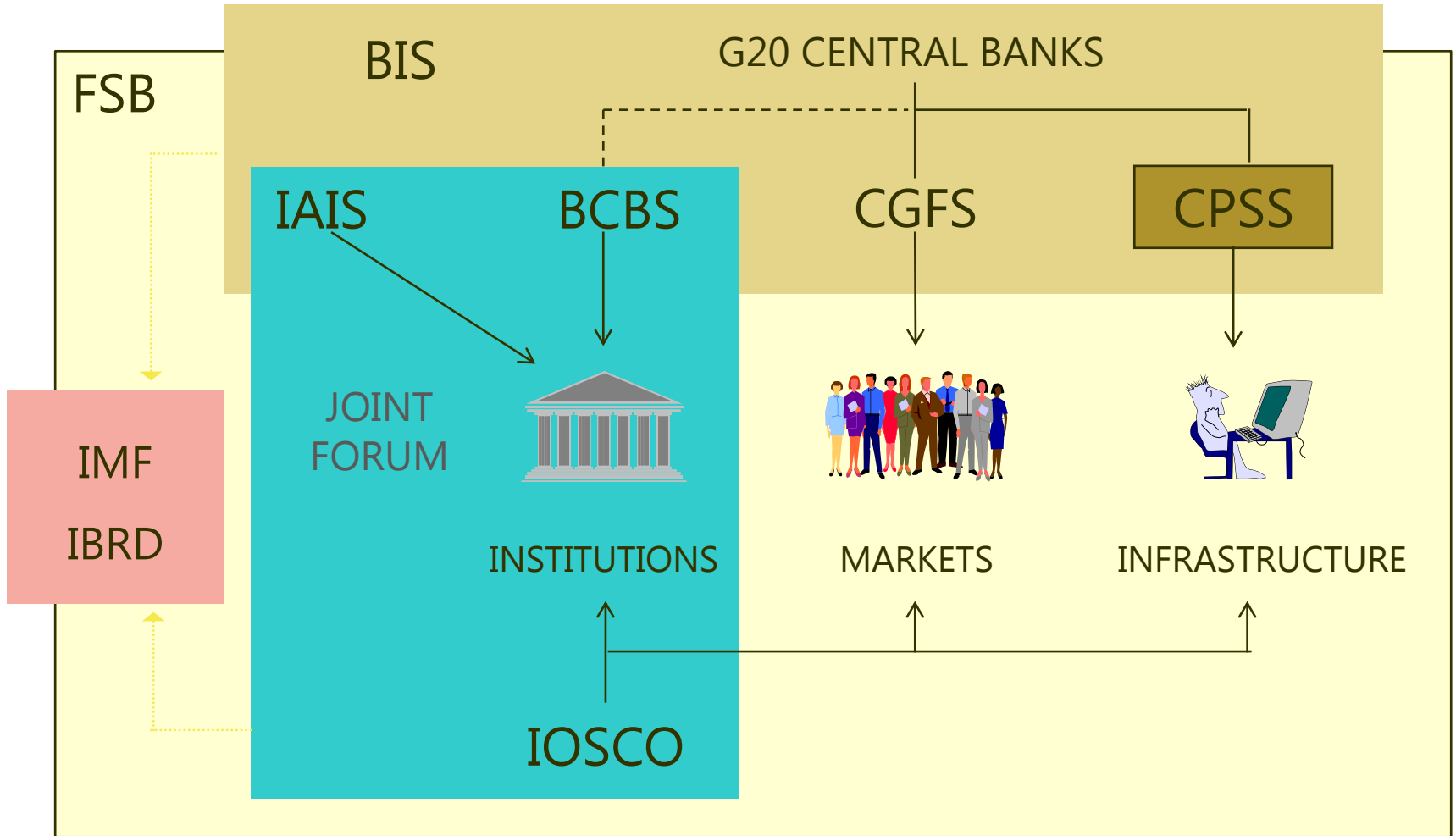


# Benefits of regulatory convergence

- Improved *compatibility* across jurisdictions
- Increased *certainty and transparency*
- Enhanced market and financial *integration*
- Reduction of risks and enhanced financial and systemic *stability*
- Reduction of costs and increase of market *efficiency*
- Cross-border *protection of investors*
- Level playing field and equal *access*



# The "Basel process" (simplified)





# Status of international regulatory standards

- *Not legally binding* as such but national regulation increasingly based on them (sometimes by way of incorporation) because of:
  - Power of the arguments they contain ("*soft law*")
  - *Commitment of members* of the relevant standard setting bodies to adopt the respective standards and put them into effect as soon as possible
- Compliance with standards may be a condition to benefit from lower capital requirements
- Subject to *implementation monitoring* by SSBs and FSB peer reviews
- Basis of assessments by IMF and World Bank as part of the financial sector assessment programmes (*FSAPs*)



## What is Systemic risk?

- Still a comparably recent (and evolving) concept
- ***"You know it when you see it"*** Paul Volcker
- Only ***few and limited past examples*** (e.g. Asian or Russian crises in the 1990s)
  - An extreme result might be an agrarian subsistence economy
- **Current (FSB) definition of 'Systemic risk'**  
*"the **risk of disruption** in the financial system with the potential to have serious negative consequences for the **financial system** and the **real economy**. All types of financial intermediaries, markets and infrastructure may be potentially systemically important"*  
⇒ Can certain products/techniques be "systemic"?



# Types of systemic risk

- The emergence of a sudden focused shock causing **contagion** (e.g. «interdependencies») => *Ring-fencing*
  - The build-up of **imbalances** that suddenly unravel (e.g. «bubbles») => *Countercyclical measures*
  - An **aggregate shock** causing simultaneous problems across the financial system (e.g. «sudden repricing of risks») => *Increasing the resilience*
- ⇒ **micro-prudential supervision and oversight:** looks at the soundness of individual institutions, but: the soundness of an individual institution cannot be equated to the soundness of the whole financial system
- ⇒ **macro-prudential oversight:** aims to prevent the emergence of systemic risk and to mitigate its effects by taking a system-wide perspective



# Potential systemic implications

- Aggregate volume and values of stock and flow
- Interconnectedness of intermediaries and market participants
- Complexity (business, structural or operational)
- Global (cross-jurisdictional) activities of market participants

Lehman case:

- Sudden fragmentation across jurisdictional lines of a previously tightly integrated enterprise
- Risk positions were disaggregated
- Counterparty terminations were effected at once in huge numbers and could not be monitored or managed effectively real-time
- Lack of documentation maintenance and planning for default by counterparties led to wrong or too late exercise of close-out



# Potential for systemic risk

- Weaknesses in the securities infrastructure can be a source of systemic disturbance to (securities) markets
  - market liquidity depends critically on *confidence* in the safety and reliability of the settlement arrangements; traders will be reluctant to trade if they have significant doubts as to whether the trade will settle, potentially leading to asset contractions and extended periods of weak economic activity
  - a financial or operational problem at an institution that performs *critical functions* in the settlement process or at a major user of a settlement infrastructure could result in significant liquidity pressures or credit losses for other market participants (contagion)
  - a disruption of a securities settlement system or major custodian has the potential for a spill over to other parts of the financial market infrastructure due to *interdependencies* (payment systems that settle the corresponding cash leg of transactions or any parts of the infrastructure (such as CCPs) that use the settlement infrastructure to transfer collateral)



# Regulation, Supervision, and Oversight

Key Regulatory Policy Objectives:

- *Investor protection*
- *Safety and efficiency* of holding and settlement arrangements
- *Financial stability*

Scope:

- Central Securities Depositories (CSDs) / Securities Settlement Systems (SSSs)
- Intermediaries / Custodians
- Registrars (?)
- Critical service providers (?)



# Regulation, Supervision, and Oversight

- efficient intermediation can foster an effective and productive optimum allocation of assets
  - however, intermediation necessarily poses risks
- ⇒ the process, to be effective, depends on trust based on **confidence in the safety, efficiency and integrity of institutions and the continuity of markets**
- ⇒ **regulatory policies and standards and effective supervision and oversight** can foster this by providing a framework for governance, risk management, capital, and liquidity, not just for banks, but also for other financial institutions and market infrastructures



# Requirements for Central Securities Depositories and Securities Settlement Systems

- **2012 CPSS-IOSCO Principles for Financial Markets Infrastructures** (PFMIs - *global regulatory standards* containing 24 principles to be applied by FMIs on an ongoing basis in the operation of their business and 5 responsibilities for authorities)
  - Scope: **CSDs and SSSs** (*public, private, bank, non-bank*)

## Content:

- **Governance** (clear and transparent, documented conduct rules)
- **Access and participation** (fair and open access, publicly disclosed, transparent, objective, and non-discriminatory, exit rules)





# Requirements for Central Securities Depositories and Securities Settlement Systems

- Risk management
  - *Legal risk* (clear articulation of rights of participants and clients, legally enforceable, emphasis on cross-border, collateral, finality, netting)
  - *Custody risk* (safeguard rights of issuers and holders (e.g. against risk of loss due to the CSD's negligence, misuse of assets, fraud, poor administration, inadequate recordkeeping, third party claims or insolvency), prevent the unauthorized creation or deletion of securities, periodic (at least daily) reconciliation), prohibit overdrafts and debit balances in securities accounts, immobilization or dematerialization, increased automation *and segregation* (individual participants' accounts and where supported by the legal framework, of securities belonging to a participant's customers; facilitation of transferability of customer holdings to another participant)



# Requirements for Central Securities Depositories and Securities Settlement Systems

- Risk management
  - *Credit risk* (exposures coverage – also intra-day)
  - *Liquidity risk* (sufficient liquid resources/funding arrangements to effect same-day settlement)
  - *Collateral* (high quality, valuation and concentration rules, stress tests) and *money settlement* (in CeBM where practical and available, otherwise monitoring)
  - *General business* and *operational risk* (holistic, IT, processes, persons, testing)
  - *Tiered participation* and *interdependencies*
- **Disclosure framework** (regular public qualitative and quantitative disclosures)
- **Recovery and resolution regime** (preservation of critical functions – forthcoming CPSS-IOSCO guidance for recovery and FMI annex to the FSB key attributes)



# Market-wide recommendations and Requirements for intermediaries

- **Geneva Securities Convention** (*quasi-regulatory requirements, cf. Art. 10 – General duties of the intermediary*)
- **Client Asset Protection**
  - **IOSCO principles and recommendations** (1996, 2010) - High level principles (e.g. for techniques to protect clients assets in insolvency, appropriate customer information, reconciliation, internal controls, and supervision of intermediaries)
  - **2013 IOSCO recommendations regarding the protection of client assets** – e.g. recommendations on appropriate customer records and information, reconciliation, understanding and mitigating of risks for client assets, internal controls), for *opt-out or waiver* of the client asset protection regime and regarding *cross-border risks*



# Market-wide recommendations and Requirements for intermediaries

- 2013 FSB guidance on client asset protection in resolution - expectations on clients' prompt access to their assets, rapid return or transfer to a performing third party or bridge institution; arrangements for the identification and safeguarding of client assets (segregation mechanisms, information systems, and controls to identify quickly client assets, the nature of claims and entitlements including in a holding chain)
- 2001 CPSS-IOSCO Market-wide recommendations for securities settlement
  - Trade confirmations and settlement cycles
  - Book-entry securities and protection of customers' securities (as IOSCO)
  - Further recommendations (e.g. promotion of repurchase and securities lending arrangements as a method for expediting the settlement of securities transactions )



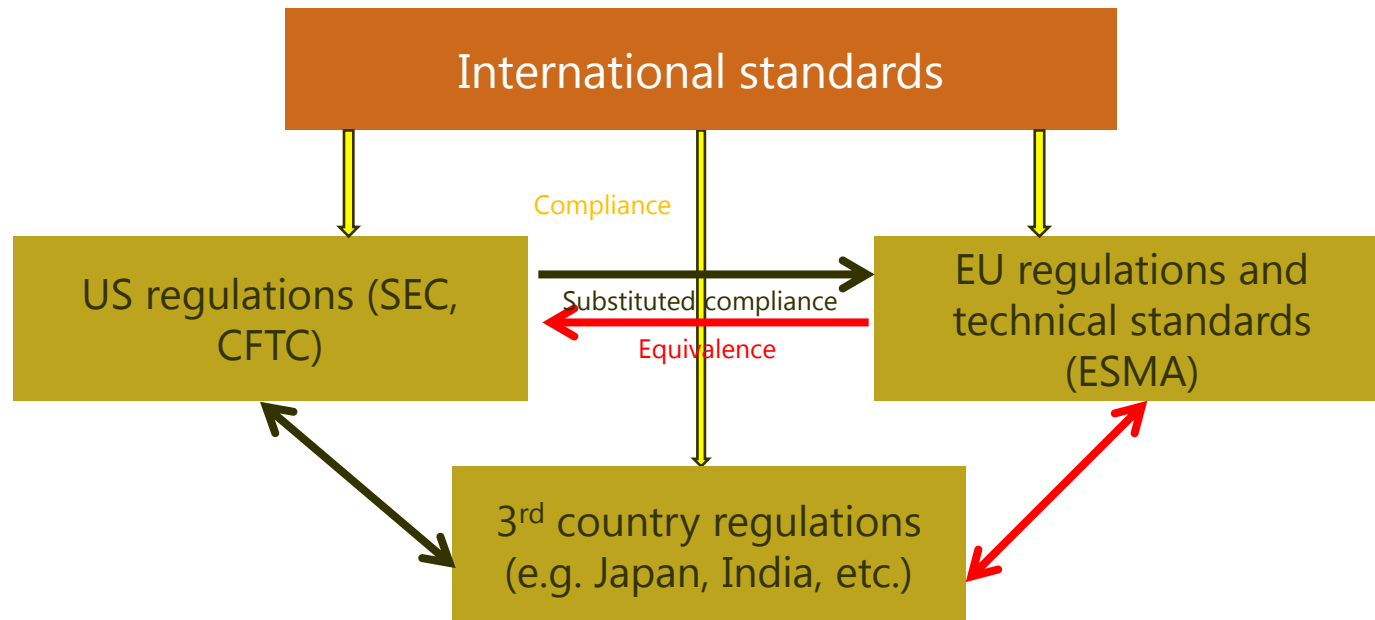
# Market-wide recommendations and Requirements for intermediaries

- 2013 FSB policy framework for shadow banking risks in securities lending and repos
  - 11 recommendations (i.a. improvements in *transparency*, *regulation* of non-bank actors (liquidity risk, maturity transformation, concentration, and credit risks), *safeguard requirements for re-hypothecation* (disclosure to clients so that clients can understand their risks; no re-hypothecation for the purpose of financing the intermediary's own-account activities; only regulated entities to be permitted to engage in re-hypothecation)
  - FSB is still considering whether a further *harmonization of client asset rules* with respect to re-hypothecation is warranted
  - No push for wider introduction of CCPs or changes to the *insolvency treatment of repos and securities lending*



# Need for Global Consistency

- Who is subject to domestic rules (foreign branch or subsidiary of domestic institution, foreign agent)?
- Which transactions conducted abroad have a domestic relevance (because of clients, assets, currencies, etc.)?



- ⇒ *Global consistency* of rules would minimise impact
- ⇒ Consistency (i) of *outcomes* (ii) with *global standards* (iii) *across jurisdictions*



# Outlook

- Comprehensive **global regulatory standards** can be the basis for adequate national regulation, supervision and oversight
  - Global **regulatory convergence and coordination** is a indispensable pre-condition to achieve consistency of results and to avoid cross-border distortions
  - Enhancing the **cooperation of authorities** and ensuring the **sharing of information** as needed to fulfil authorities' mandates is a pre-condition to foster financial stability
- ⇒ ***Desirability of a continued further review of the global regulatory architecture***

