

# Oversight of financial market infrastructure faces new challenges

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The financial markets are currently being reshaped by a number of factors as Europe's financial markets seek solutions for the future and competitive advantages in the global environment. In the face of these challenges, oversight of financial market infrastructure will also have to change. To guide this process, the Board of the Bank of Finland approved in spring 2006 a revised framework for oversight.

A basic component in any exchange of goods and services is payment. Whether this takes place over the counter, through online banking or on the money and securities markets, it requires a properly functioning infrastructure. Reliable and efficient payment and settlement systems are a fundamental requirement of all economic activity. It is thus in the interest of society as a whole to ensure their proper functioning. The job of oversight is normally assigned to the central banks. The oversight tools available to central banks include the monitoring of system performance, research and analysis, assessment of systems against established core principles, assessment of trends and developments, and the defining of policy objectives. The purpose of the present article is to provide an account of the policies and principles applied by the Bank of Finland in carrying out its

oversight responsibilities, and in this way to increase the transparency of oversight.

The 'hard core' of oversight is the assessment of systemically important systems against jointly agreed core principles that define system structures, governance, the rights and responsibilities of parties, management of risks, and operational reliability and efficiency. The objective is to ensure the stable and reliable functioning of payment and settlement systems vital to the smooth operation of the financial markets, and that any problems experienced by parties to the system do not spread to others. Oversight is used to ensure the efficiency of monetary policy transmission channels and support the effectiveness of risk management by the central banks. Thus, oversight is directed towards crisis prevention, while at the same time being prepared for the management of any crises that may nevertheless arise. The core principles also require payment systems to be efficient from the perspective of society. The importance of this aspect of oversight is underlined by the fact that the legislation or central bank strategies of many countries specifically include the task of assessing and promoting efficiency. Both the Act on the Bank of Finland and the Bank of Finland's own strategy highlight promoting efficiency as an important function of oversight.

Oversight's impact on the financial markets is indirect: by raising the general level of risk-



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Box.

### What is meant by oversight of financial market infrastructure?

The concept 'financial market infrastructure' refers to systems, processes and rules by means of which the clearing and settlement of payments and securities transactions are conducted. These are collectively referred to as 'payment and settlement systems', and their function is to ensure that the rights and obligations of parties to payment or securities transactions are fulfilled, and that payment is both legal and final.

Oversight of payment and settlement systems is a central bank responsibility, the aim of which is to ensure the efficiency and reliability of both existing and future systems. Oversight is conducted by monitoring and assessing systems' operation and risks, and where necessary requiring that changes be made. Oversight is part of the broader central bank responsibility of ensuring financial market stability and crisis management.

In Finland, as in all Eurosystem countries, oversight is a statutory function of the central bank. It is also provided in the Statute of the European System of Central Banks and of the European Central Bank and in the Treaty establishing the Euro-

pean Community. The Act on the Bank of Finland provides that the Bank of Finland shall 'participate in maintaining the reliability and efficiency of the payment system and overall financial system and participate in their development'.

Oversight is a relatively new function. The first clear definition of central bank oversight was provided in the Lamfalussy report<sup>1</sup> in 1990. At that time interest focused above all on limiting systemic risk<sup>2</sup> in netting systems. Oversight has been developed essentially within the G10 countries, with other countries' central banks adopting, either directly or in adapted form, the principles agreed by the G10. These include the document 'Core Principles for Systemically Important

Payment Systems', based on which the Eurosystem has drawn up guidelines for application to both large-value and retail payment systems. The ESCB and European securities regulators have also cooperated in drawing up general operating principles for securities clearing and settlement systems, with application guidelines currently under preparation. Work is also under way on the extension of the scope of oversight to cover payment methods of particular importance to the general public, such as payment cards. As part of the Eurosystem, the Bank of Finland applies in its own oversight the policies and requirements agreed within the Eurosystem.

<sup>1</sup> *Report of the Committee on Interbank Netting Schemes of the central banks of the Group of Ten Countries (BIS 1990).*

<sup>2</sup> *A risk is systemic if there is a 'risk that the failure of one participant in a transfer system, or in financial markets generally, to meet its required obligations will cause other participants or financial institutions to be unable to meet their obligations (including settlement obligations in a transfer system) when due. Such a failure may cause significant liquidity or credit problems and, as a result, might threaten the stability of financial markets.'* ECB Glossary (<http://www.ecb.int/home/glossary/html/gloss.en.html>).

awareness and publishing assessments of system reliability, risks, efficiency and structural changes, central banks help both market participants and other authorities to improve their own operations and regulations (if any), and manage their risks. Risk-management processes are conducted regularly, and their assessment is based on comprehensive and generally approved criteria.

### **The relationship between oversight and supervision**

The aims of central bank oversight and banking and securities market supervision are largely congruent. Both foster the stability and reliability of the financial markets, if in different ways and from different perspectives. While supervision focuses on supervising the systems of individual market participants on the basis of statutory requirements, oversight focuses on systems as a whole based on more generally construed objectives of reliability and efficiency. Oversight thus provides an important complement to the supervision of individual institutions. Oversight also embraces the perspective of system development, which communicates to the markets the key aims of central bank operations: stability in the financial system as a whole, promotion of the single market and integration, and the fostering of efficiency. The coordinating role of the European Central Bank (ECB) also provides oversight with a solid

foundation in respect of cross-border systems. The fact that the ECB is empowered to issue regulations and also enjoys the right of comment on proposed financial markets legislation at national level increases the effective weight of oversight.

### **The pattern of change in the financial sector**

The financial sector is currently undergoing a period of major structural change. Technology is facilitating new forms of activity and new channels of service. Cross-border activities are becoming increasingly common, and financial diversification and conglomeration are bringing new companies into the sector. Efficiency is demanded of all parts of the system – including infrastructure – and the pressures to increase efficiency are enormous. Integration of financial markets within the EU is in the interests of both the private sector and public authorities. The trend is leading inevitably to the development of large, multinational organisations and new ways of working. New operating methods and market structures are, in turn, changing the nature of risks. In oversight, as in crisis management, international cooperation and coordination are becoming increasingly important.

Structural changes and internationalisation have made it necessary to harmonise the legislation and codes of practice regulating the financial markets. Several extensive regulatory

*It is part of the role of oversight to contribute to infrastructure development.*

*It is vital to secure the stability and reliability of national infrastructure.*

and development projects for the financial sector have just been completed, or are nearing completion, with important implications for the sector. These include the creation of the Single Euro Payments Area (SEPA)<sup>1</sup>, a proposed Directive on payment services in the internal market, a new Directive on markets in financial instruments to update the regulation of securities trading, possible new regulation of securities clearing and settlement, and issues raised by EU competition authorities. The above initiatives will change the operating environment for companies in the sector, and national oversight will have to be developed to keep pace.

### **The new framework for oversight**

The changes in the operating environment have also made it necessary for the Bank of Finland to update its oversight practices. In carrying this out, it was encouraging to note that the oversight policy approved in 1999 has proved functional and cooperation between authorities has worked well.<sup>2</sup> The aim of the new framework is twofold: to integrate into oversight the new requirements posed by the changes described above, and to update oversight to bring it into line with issues emphasised in the Bank of Finland's new strategy.

<sup>1</sup> See Marianne Palva's article 'Towards the Single Euro Payments Area', p. 34–39 below.

<sup>2</sup> An article setting out the previous oversight policy was published in the Bank of Finland Bulletin 3/1999.

Deepening integration and the growing importance of international cooperation are increasing the ECB's role in oversight. The scope and depth of oversight is the focus of lively debate within the Eurosystem. ECB oversight covers international payment systems. Other systems, such as national payment systems, payment methods and securities clearing and settlement systems, are the responsibility of the national central banks, with the ECB's role being to ensure that assessments are commensurate. Deepening integration raises the question of when the ECB should assume responsibility for oversight of a system, and this is something that will need to be decided on a case-by-case basis. The challenge for national central banks is how to retain influence both over the conduct of oversight and in defining the content of oversight and the standards applied. Through its oversight activities, the Bank of Finland seeks to foster European integration and at the same time be an active member of the Eurosystem in such a way as to secure the operating requirements of a market area like Finland as financial systems are progressively centralised. As internationalisation advances, it is vital to ensure that national authorities remain able to secure the stability and reliability of the country's infrastructure and the capability for crisis management. The Bank of Finland also considers it necessary to broaden

the scope of oversight over the most important payment instruments.

The Bank of Finland's recently updated strategy emphasises the importance of exploiting new technology, introducing digital solutions and fostering efficiency in the financial sector. Oversight, for its part, seeks to promote the adoption of modern practices and procedures across Europe as a whole and to foster the use of information technology to enhance the efficiency of the financial system. The Bank seeks to spread awareness of the benefits and features of Finland's highly efficient systems in a variety of international forums.

The development of crisis management capabilities is one of the priorities in both the Bank of Finland's strategy and the Eurosystem. In practical terms, this means a strong focus on analysis of developments in financial and payment systems. In line with the Bank's strategy, oversight processes are also subject to review and improvement, and this requires continuous assessment of performance. In order to maintain efficiency and keep processes up to date, it is essential to further develop cooperation with the Financial Supervision Authority, the Ministry of Finance and other European authorities.

The simulator developed at the Bank of Finland for analysing payment and settlement systems is a

highly effective tool for assessing both the efficiency of systems and the risks threatening them. It is already in use in over 30 countries. Both the simulator itself and its various operational applications are still being actively developed. This development work contributes to the stability of financial markets and the further development of their infrastructure worldwide.

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