

# The Eurosystem oversight policy framework

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# Rationale and Objectives

“Central banks have always had a close interest in the safety and efficiency of payment and settlement systems. One of the principal functions of central banks is to be the guardian of public confidence in money, and this confidence depends crucially on the ability of economic agents to transmit money and financial instruments smoothly and securely through payment and settlement systems.

*The systems must therefore be strong and reliable, available even when the markets around them are in crisis and never themselves the source of such crisis. “*

(T. Padoa Schioppa, 2005)

# Rationale and Objectives

## **CPSS report on „Central bank oversight“ (2005)**

“Oversight of payment and settlement systems is a central bank function whereby safety and efficiency are promoted by monitoring existing and planned systems, assessing them against these objectives and, where necessary, inducing change”

# Rationale and Objectives

## COMPARISON

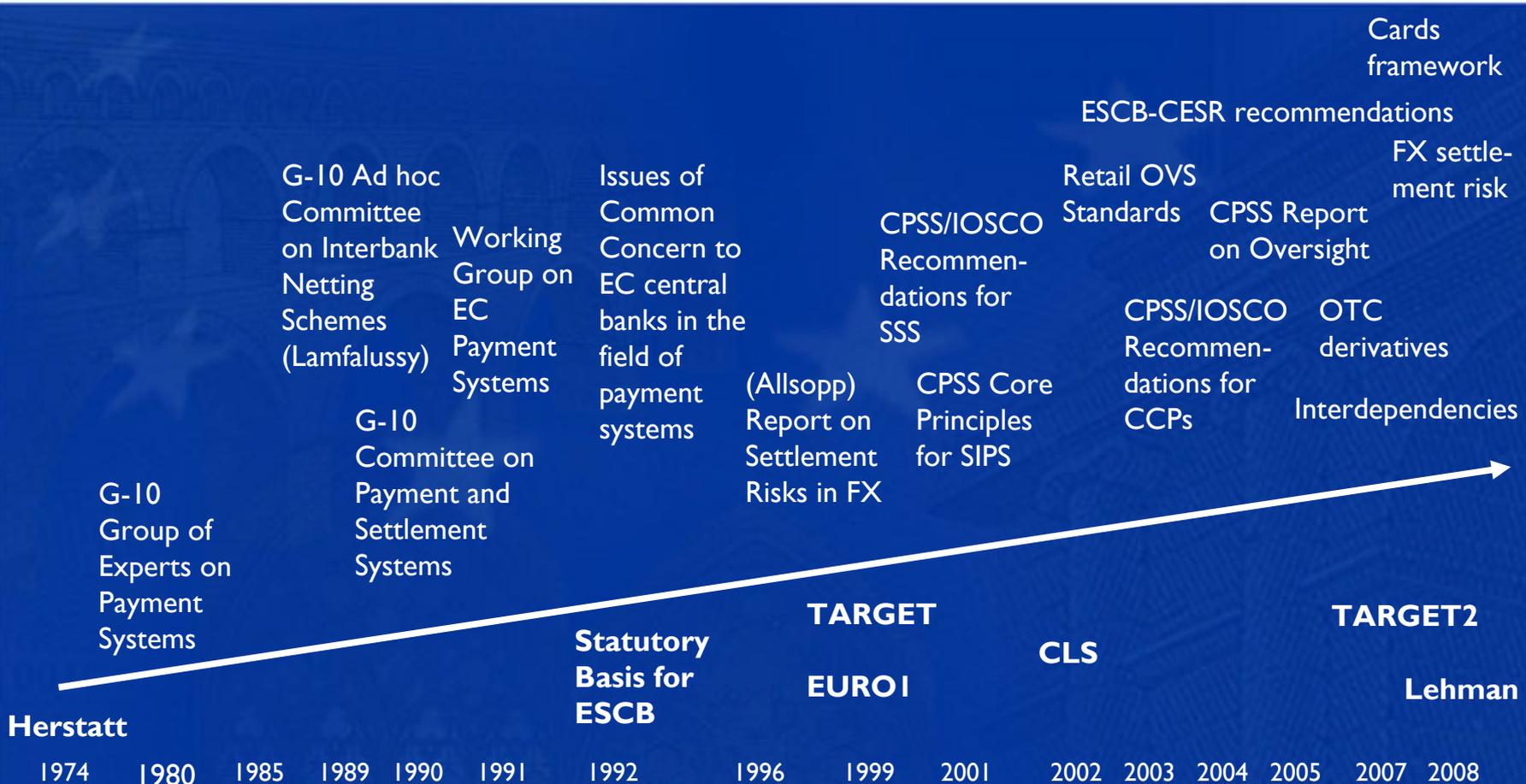
### Prudential supervision

- looks at institutions individually + macro-level
- prudent management / risk control / depositor protection
- extensive regulatory framework
- entails detailed examination of individual institutions
- carried out by central bank or dedicated authority

### Oversight

- looks at arrangements (i.e. infrastructures, systems, schemes, instruments)
- smooth functioning of systems
- mix of moral suasion, standards and recommendations
- entails examination of design of and operation of arrangements
- carried out by central bank

# Development and scope of the oversight role



# Rationale and Objectives

## Legal basis

- Article 105 (2) of Treaty and Article 3 of Statute: *“the basic tasks of the ESCB include the obligation to promote the smooth functioning of payment systems”*
- Article 22 of the Statute: *“The ECB and NCBs may provide facilities, and the ECB may make regulations, to ensure efficient and sound clearing and payment systems within the Community and with other countries”*

## **Eurosystem oversight policy framework** (February 2009)

⇒ main reference point for Eurosystem’s oversight role

# Rationale and Objectives

⇒ Ensure the **safety** and **efficiency** of the systems by preventing / minimising possible market failures:

- Negative externalities
- Moral hazard (“too big to fail” entities)
- Insufficient competition and fragmentation

⇒ Contribute to **financial stability**

⇒ Contribute to the **smooth implementation of the single monetary policy**

⇒ Maintain the **public confidence in the currency**

# Rationale and Objectives

⇒ No active pursuing of other public policy objectives, e.g.:

- anti-money laundering and terrorist financing,
- data protection and
- consumer protection

where other authorities have an explicit mandate

⇒ But:

- Support of private sector initiatives on a case-by-case basis and
- contribution to the work of other public authorities with regard to other policy objectives

# Rationale and Objectives

## Complementary approaches to promoting safety and efficiency

In promoting safety and efficiency, the Eurosystem applies three different approaches:

- it takes an **operational role**,
- **conducts oversight** activities, and
- acts as **catalyst**

These approaches are not mutually exclusive, but complement each other

# Organisation

## Oversight process:

- (I) Formulation of the oversight stance
  - (a) Setting standards
  - (b) Common Eurosystem policy framework
- (II) Collecting and assessing relevant information
- (III) Enforcement of the policy stance
  - (a) Identification of potential weaknesses and trends
  - (b) Inducing changes to remedy weaknesses
  - (c) Co-operation with other authorities

## Transparency of Eurosystem oversight policies

- enables understanding and observation of the applicable policy requirements and standards by the systems concerned
- provides basis for consistency
- permits judging the effectiveness of the Eurosystem's policies

# Organisation

## Allocation of roles within the Eurosystem

- The Treaty assigns oversight responsibilities to the Eurosystem which comprises the ECB and the euro area NCBs
- Sharing of responsibilities to benefit from the Eurosystem decentralised structure
  - arrangements with clear national anchor: domestic NCB
  - arrangements with no domestic anchor: NCB of the country where the arrangement is established, unless the Governing Council assigns the primary oversight responsibilities to the ECB
- Ensuring the coordination of oversight activities and a consistent application of its policy stance throughout the euro area (in particular from a horizontal/interdependence perspective and in crisis situations)

# Scope of Oversight

- ⇒ determined by the relevant provisions of the Treaty
  - ⇒ may evolve over time, as the market infrastructure evolves
  - **Payments systems**
    - **Large-value payment systems**
    - **Retail payment systems**
  - **Securities settlement systems**
  - **Central counterparties**
  - **Payments instruments**
  - **Third-party service providers / critical infrastructures**
- (Currently) not:
- Correspondent and custodian banks

# Large-Value Payment Systems

## Backbone of the euro area market infrastructure

(e.g. TARGET2, EURO1 for euro, multicurrency: CLS)

## Oversight standards applied by the Eurosystem:

- *CPSS Core Principles for Systemically Important Payment Systems (SIPS)*
- Eurosystem refined Core Principle VII by issuing *Business Continuity Oversight Expectations* for systemically important payment systems
- Eurosystem *common methodology* for the assessment of euro systemically and prominently important payment systems against the Core Principles
- *Minimum standards* for the design and operation of cross-border and multi-currency netting schemes (Lamfalussy Standards) and *CPSS report on Central bank oversight of payment and settlement systems*

# Large-Value Payment Systems

## Conduct of oversight of LVPS

**Regular meetings** with overseen entities with focus on:

- Strategy
- New business and IT developments
- Business continuity matters
- Governance issues
- Operations and performance
- Legal issues
- Other issues impacting on compliance with Core Principles

## Ongoing monitoring:

- Scope and frequency decided on a case-by-case basis

## LVPS statistical framework:

Basic information on system features, General indicators for the system, Risk indicators, Concentration indicators ( $\Rightarrow$  systemic risk), Efficiency of the system

# Retail Payment Systems

- used for the bulk of payments to and from individuals, and between individuals and corporates
- currently subject to major changes as a result of the implementation of the Single Euro Payments Area (SEPA)
- major role with respect to both the safety and efficiency of the financial system and public confidence in the euro

⇒ In recognition of their role the Eurosystem introduced “**Oversight standards for euro retail payment systems**”

Aims: Reliability, Level playing field across the euro area, and Public confidence in widely used systems and instruments

⇒ to ensure a consistent application by the NCBs and the ECB, the Eurosystem released a **common methodology** for the assessment of systems against the respective standards

based on: Efficiency, Security and Fraud Prevention

# Retail Payment Systems

## Oversight standards for retail payment schemes

- Classification based on “...the degree of disruption that a malfunctioning of these systems could cause in the financial markets and/or the economy”.
- Focus is on market penetration and size:
  - Systemically Important Retail Payment Systems (SIRPS) posing a potential risk to financial stability → must comply with all ten Core Principles for SIPS (currently six SIRPS)
  - Prominently Important Retail Payment Systems (PIRPS) having a lesser degree of financial risk and market share → must comply with Core Principles I, II and VII – X (currently seven PIRPS)
  - Others → no harmonised oversight standards

# Payment instruments

## Payment Instruments

- Non-cash payment instruments (means to transfer (retail) funds between accounts):
    - payment cards,
    - credit transfers,
    - direct debits,
    - e-money products and
    - cheques
  - Essential part of payment systems
  - Low risks, but important for both maintaining confidence in the currency and promoting an efficient economy
- ⇒ Part of Eurosystem oversight mandate

# Payment instruments

Initially work focused on **individual instruments**

- Aug 1998: Report on electronic money
- May 2003: Electronic money system security objectives according to the common criteria methodology (EMSSO report)
- Jan 2008: Oversight framework for card payment schemes – standards (CPS)
- Aug 2009: Oversight frameworks for direct debits and credit transfer schemes (under public consultation)

**General oversight approach and standards** for payment instruments adopted by the Eurosystem in February 2009

- Feb 2009: Harmonised oversight approach and oversight standards for payment instruments

# Securities Settlement Systems and Central Counterparties

- Key components of the financial market infrastructure
- A potential source of systemic disturbance for the financial system as a whole:
  - Securities transactions usually combine a securities leg and a cash leg, disturbances in the transfer of securities may spill over to disruptions of the payment systems that are used by the **SSSs**
  - **Central bank credit** (including intraday overdrafts in payment systems) requires eligible securities as collateral
  - **CCPs** are, by nature, a focal point for credit risk

# Securities Settlement Systems and Central Counterparties

## Oversight interest and activities

- Central banks do have a strong interest in SSSs and CCPs on account of their responsibilities for financial stability, monetary policy and the smooth operation of payments and clearing systems
- Central banks are involved in
  - Defining the regulatory framework / standards
  - Conducting oversight activities
- Need to cooperate with other competent authorities

# Securities Settlement Systems and Central Counterparties

## Legal basis for oversight

- Legal basis not explicit from the Treaty and Statute (the concept of oversight was still developing), but:
  - Continuous adaptation of oversight focus to market evolution
  - Growth of securities and, more recently, derivatives markets has required increasing attention of overseers to the clearing and settlement infrastructures for these markets
- Many national central banks have a legal basis under national laws (in particular more recent laws) to conduct oversight of clearing and settlement systems, alongside securities regulators

# Securities Settlement Systems and Central Counterparties

## Allocation of responsibilities

- Oversight of SSSs and CCPs at national level (often shared between NCBs and other national authorities)
- Cross-border MoUs among authorities for infrastructures with a cross-border dimension
- Main role of the Eurosystem:
  - ✓ Promotion of euro-area wide consistency of oversight
  - ✓ Cooperation to support horizontal view of interdependencies between systems and sources of systemic risk with euro-area implications

# Securities Settlement Systems and Central Counterparties

Common Standards and Recommendations at global level:

- *CPSS/IOSCO Recommendation for Securities Settlement Systems, January 2001*
- *CPSS/IOSCO Recommendations for Central Counterparties, November 2004*
- *CPSS report on Central bank oversight of payment and settlement systems, May 2005*
- *CPSS report on Cross-border securities settlements, March 1995*

# Securities Settlement Systems and Central Counterparties

Common Standards and Recommendations at EU-level:

- *ESCB/CESR recommendations for securities settlements systems and central counterparties in the EU of May 2009*

Objectives and scope:

- To adapt the global CPSS-IOSCO recommendations for securities settlement systems to the European environment and to reflect recent developments
- Providing a consistent basis for adequate regulation, supervision and oversight, addressed to overseers and regulators
- Scope restricted to CSDs, ICSDs and CCPs, while custodians are excluded to avoid double regulation

# Correspondent and custodian banks

## Third party providers

### Correspondent banks and custodian banks

- key components of an economy's payment and settlement arrangements
- potential for strong concentration, giving rise to possible financial and operational risks
- Eurosystem has an interest in monitoring these risks together with and through bank supervisors

### Third-party service providers

- provide key services to market infrastructures
- critical for the functioning of the infrastructures
- for example, SWIFT is overseen by the G10 central banks with NBB having primary responsibility for oversight

# Co-operative oversight

## Co-operative oversight and the concept of lead-overseer

Basis: “Lamfalussy principles” for co-operative oversight of cross-border and multicurrency netting and settlement systems

- One central bank (the **lead overseer**) assumes primary oversight responsibility
- The lead overseer consults the (most representative) other central banks with a valid interest
- The settlement procedures are overseen jointly by the lead overseer and the **central bank of issue** of the currency
- Central banks involved in co-operative oversight make every effort to reach consensus

# Location policy

- Market infrastructures may affect financial stability not only through their design, but also through their **location**
    - the inappropriate design or malfunctioning of off-shore infrastructures has the potential to affect the smooth functioning of domestic systems
    - off-shore infrastructures may cause serious consequences for financial stability in the euro area
    - potential impact on the Eurosystem's control over the euro
  - Eurosystem ***influence over offshore infrastructures is limited***
    - Cooperative oversight arrangements at the international level can mitigate the loss of direct influence - but not entirely
- ⇒ *infrastructures processing euro-denominated transactions should settle in central bank money and be legally incorporated in the euro area with full operational responsibility for processing euro-denominated transactions*

# Location policy

- Policy statement on euro payment and settlement systems located outside the euro area, November 1998
- The Eurosystem policy principles on the location and operation of infrastructures settling euro-denominated payment transactions, July 2007
- The Eurosystem policy principles on the location and operation of infrastructures settling euro-denominated payment transactions: specification of “legally and operationally located in the euro area”, November 2008
- The Eurosystem’s policy line with regard to consolidation in central counterparty clearing, September 2001
- Eurosystem statement on central counterparties and interoperability, terms of reference, March 2008
- Central counterparty clearing (CCP) for OTC credit derivatives, Decision taken by Governing Council, December 2008, confirmed July 2009

# Co-operation

- ⇒ Co-operation between regulators, central banks, supervisors and other relevant authorities with the aim to:
- align conflicting objectives
  - promote consistency of oversight requirements and approaches and avoid duplication
  - access to comprehensive and timely information on factors that may impact on the safety and resilience of infrastructures
  - clarification of responsibilities and procedures for cooperation among authorities during crisis situations

# Co-operation

Co-operation occurs at several levels:

(i) with ***other central banks*** at international level (e.g. CPSS)

⇒ to define and implement oversight requirements for global infrastructures (e.g. CLS, SWIFT)

(ii) with ***securities regulators*** at European level (CESR) and international level (CPSS-IOSCO)

⇒ to define common standards

(iii) with ***supervisory authorities*** (MoUs)

⇒ to reconcile the “system” and the “bank” perspective

# Upcoming oversight developments

1. CPSS-IOSCO recommendations – Review of the application of the recommendations to clearing arrangements for OTC derivatives
2. Oversight framework for TARGET2-Securities in cooperation with CESR
3. Eurosystem oversight report
4. Completion of the monitoring of the Business Continuity Oversight Expectations implementation by SIPS