Niklaus Blattner: Global trends in financial market infrastructures and their significance for financial stability

Introductory remarks by Mr Niklaus Blattner, Vice-Chairman of the Governing Board of the Swiss National Bank, at the end-of-year media news conference, Zurich, 14 December 2006.

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Developments at banks and financial markets are subject to extensive daily media analysis and commentary. By contrast, financial market infrastructures, i.e. stock exchanges, payment and securities settlement systems, only rarely make the headlines. I have decided to shift the focus today and concentrate on financial market infrastructures. In particular, I wish to highlight some interesting global trends and assess how these trends impact on the stability of the financial system.

Internationalisation of financial market infrastructures

Traditionally, most financial market infrastructures have a strong national focus. This made sense as long as the financial markets also had a strong domestic focus. However, the deregulation and liberalisation of financial markets and the associated increase in cross-border financial flows resulted in a widening gap between financial markets and financial market infrastructures, with the latter remaining constrained within national bounds. More internationalisation of financial market infrastructures became inevitable in order to avoid a loss of competitiveness due to inefficiencies. This process of opening up market infrastructures still continues today.

We can differentiate between different types of internationalisation. First, direct access to infrastructures that used to be reserved exclusively to domestic participants is now being granted more frequently to foreign participants as well. Swiss Interbank Clearing, for example, has admitted participants from abroad since the late 1990s. Second, the consolidation of infrastructures is in full swing, especially in Europe. In some cases, consolidation takes place through mergers between formerly independent systems. For example, Euroclear group integrated the formerly independent central securities depositories of the Netherlands, Belgium, France and the UK. In other instances, consolidation takes a less direct form. National infrastructures may, for example, set up mutual links to facilitate trade, i.e. the settlement of cross-border transactions. The internationalisation of stock markets has also made it possible to trade an increasing number of stocks on several different trading platforms. And finally, we have also witnessed the emergence of a few completely new infrastructures which have adopted an international – and in some cases even global – focus from the outset. A classic example is the Continuous Linked Settlement (CLS) system, which was designed for the settlement of foreign exchange transactions and started operations just over four years ago. It now settles transactions in as many as 15 currencies.

But how has the opening up of trading centres and settlement channels, which traditionally had a domestic focus, impacted on financial stability? On the one hand, it is obvious that the adjustment of the financial market infrastructures to the special features of global financial markets may contribute to reducing risks related to the settlement of cross-border transactions. For example, the risk associated with traditional foreign exchange transaction settlements (Herstatt risk) can be largely eliminated through CLS. On the other hand, the growing interconnection and internationalisation of infrastructures result in new kinds of transmission channels (often cross-border), through which the credit or liquidity problems of individual market participants can spread to other participants. In the new environment, operational problems experienced within individual financial market infrastructures can also spread much more rapidly to a larger number of players.

A working group is currently dealing with precisely these issues. It was set up by the Committee on Payment and Settlement Systems (CPSS) of the Bank for International Settlements (BIS) and one of the participants is the SNB. What is already clear is that the advantages of internationalisation clearly outweigh the drawbacks so far. Any threats to financial stability would have to be countered by modifications to the systems’ architecture, the applicable rules and oversight.

Tentative adjustment to market developments

While financial market infrastructures were internationalised quite rapidly, they repeatedly lagged behind the deregulation of the financial markets. In today's environment, it is possible for innovative financial products to gain popularity quickly and to achieve enormous trading volumes shortly after their introduction. A recent example is the rapid growth in the market for credit derivatives. While the trading volume of credit derivatives absolutely exploded in the last decade, the efficiency of the transaction confirmation and settlement processes for a long time left much to be desired. As a consequence, the backlog of concluded, yet unconfirmed transactions grew steadily. This development resulted in higher risks, since the failure to confirm a transaction jeopardises its enforceability, i.e. the possibility to net it with other transactions. This, in turn, can lead to financial intermediaries incorrectly measuring and controlling their market and counterparty risks.

In the aforementioned example relating to credit derivatives, the US Federal Reserve and other leading bank supervisors had to intervene just over a year ago to oblige market participants to rapidly reduce the confirmation backlog and to promote the introduction of more efficient cross-sector procedures. Market participants should not focus exclusively on the lucrative trading aspect of future innovations, but they must also speed up the development of convincing solutions for the processing of these new transactions. Otherwise, financial stability will be jeopardised.

Financial market infrastructures and banks increasingly share roles

Differentiating between traditional financial market infrastructures and banks – which was straightforward 20 years ago – is becoming increasingly difficult. On the one hand, the major international banks, in particular, provide services that one would normally allocate to financial market infrastructures. For instance, their customer base is so large that it is possible for them to conclude and settle trade orders outside the stock exchange. The same holds true for the settlement of payment transactions: the larger a bank, the more payments it can settle directly through its own systems. These 'in-house systems' compete with the actual interbank payment system, especially if the banks' customers are banks themselves.

On the other hand, operators of financial market infrastructures are expanding into the core business of banks. For example, a number of central securities depositories and their participants are providing loans and liquidity facilities. Although this is done primarily to facilitate the settlement of securities transactions, the line of demarcation from traditional financial intermediation is becoming increasingly blurred. Also, by granting remote access or by establishing more efficient connections between the individual central securities depositories, they are offering serious competition to the traditional custodians.

Technological progress has been the driving force behind this blurring of roles between financial market infrastructures and banks. Technology has enabled large banks to break into the operational field of infrastructure operators without much additional expenditure. Indeed, they have been virtually obliged to do so, in order to utilise their IT platforms to full capacity and to run them efficiently. On the demand side, the smaller financial institutions also benefit. As they outsource their back office functions to larger banks or specialised institutions, they can better focus on their core business. The infrastructure operators, in turn, are finding themselves in a situation where hardly anyone is willing to pay for traditional transaction services that have taken on a commodity character. Consequently, they are diversifying and providing services that generate a higher added value. Those infrastructure operators that are organised as profit-oriented public companies, in particular, are likely to further intensify competition with the banks in the future.

This development is confronting the regulators with new challenges. Many supervisory and oversight authorities still pursue an institution-based approach. In other words, they apply different criteria to the same functions, depending on whether these functions are exercised by a bank, on the one hand, or by a stock exchange or central securities depository, on the other. Furthermore, banks and financial market infrastructures are mostly supervised or overseen by different authorities. The same applies to Switzerland. This brings with it the risk that regulatory differences are deliberately exploited. The question of whether financial market regulation needs to focus more on the function rather than on the institution so as to limit regulatory arbitrage would have to be examined. Regulation would then not be based on the legal status of an institution but on the functions actually exercised.

Conclusion

The picture I have given you of developments in the field of financial market infrastructures is by no means complete. Other developments that should be mentioned are the tendency nowadays to attach greater significance to measures relating to contingency planning and crisis management, or the growing movement towards organising financial market infrastructures as profit-oriented public companies observed in many countries. In Europe, in particular, there is pressure to consolidate the strongly fragmented infrastructure environment. This dynamic development challenges the operators of financial market infrastructures in particular. The decision-makers at the Swiss financial market infrastructures – SWX Swiss Exchange, SIS group and Telekurs group – also have to decide how they want to position themselves strategically. This is no easy task considering that the stakeholders often pursue differing interests. In addition, there are various potential conflicts, for example between the objective of exploiting economies of scale as much as possible – which might only be possible through cross-border cooperation – and the objective of maintaining independence.