Gertrude Tumpel-Gugerell: Enhancing infrastructures for the EU financial market

Speech by Ms Gertrude Tumpel-Gugerell, Member of the Executive Board of the European Central Bank, at the 11th Euro Finance Week, European Transaction Banking Conference, Frankfurt am Main, 17 November 2008.

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Ladies and gentlemen,

In 1909, almost one hundred years ago, the Frankfurt Festhalle was opened. The Festhalle is the main historic building of the Messe Frankfurt exhibition grounds and stands next to the modern hall in which this conference takes place today. At the time of its inauguration, the Festhalle was the largest domed building [Kuppelbau] in Europe and a symbol of Frankfurt's pride as an important commercial and financial centre. The construction of the steel dome is intriguing: the weight of the roof is evenly distributed between the various crossbeams, with circular beams providing additional support. Just like in a gothic cathedral, each beam plays a key role in ensuring the safety of the entire building.

For me, the construction of that dome-shaped roof reflects the set-up of financial infrastructures. The network of links and connections in such infrastructures ensures broad coverage and an efficient flow of liquidity. Changes to the infrastructures can only be made in a coordinated fashion, as each individual part plays an important role in the network as a whole.

It is thanks to steel engineering technology and the excellence of the architects and builders at the time that such a roof could be constructed. However, it is evident that, since 1909, the public authorities have also played a significant role in ensuring that the static construction of the building has remained safe and resilient over time. Similarly, regulation and oversight standards play a vital role in ensuring that the market infrastructures provide a robust foundation for our financial system, particularly during these turbulent times.

It is therefore a great pleasure for me to speak today at the opening of this conference on transaction banking and to share with you my views on future priorities for enhancing the market infrastructures of the European Union (EU). In my speech, I would like to focus on the following two main issues:

First, it is clear that EU infrastructures have not yet reached a sufficient level of integration to provide effective support to the single financial market, especially in the fields of securities clearing and settlement, and retail payments. The present degree of fragmentation needs to be reduced significantly if we are to get closer to our objective of achieving a truly integrated and highly competitive single financial market in Europe. Today, I would like to highlight a number of priorities in this regard.

Second, more must be done to ensure the reliable functioning and resilience of market infrastructures. So far market infrastructures have performed well despite the financial market turmoil, but there is no room for complacency. The increasing pace of globalisation, the blurring of the boundaries between financial institutions and market infrastructures, as well as the emergence of new products continue to give rise to new challenges that are a test of the soundness of our market infrastructures.

My remarks will be structured into three main parts. **First**, I will briefly discuss the role of market infrastructures in supporting the financial integration process and systemic stability, highlighting the fact that these two objectives are closely related. **Second**, I would like to draw your attention to two important initiatives which aim to foster a closer integration of the infrastructures for securities and retail payments, namely TARGET2-Securities and the Single Euro Payments Area. **Finally**, I will examine the role of market infrastructures during the market turmoil and assess steps that could be taken to enhance their resilience. Such steps are aimed particularly at making progress towards a more consistent prudential framework for securities clearing and settlement systems, and at enhancing the infrastructure for the over-the-counter derivatives markets.

Financial integration and systemic stability: the role of market infrastructures

Allow me to begin by discussing the crucial role of well-integrated and sound market infrastructures in achieving financial market integration and stability. Market infrastructures form the backbone of the financial system: they provide the networks through which financial institutions and financial markets are connected. Given this network character and the associated economies of scale, and also considering the significant growth in financial activity over the past decades, market infrastructures often handle very large volumes and values.

Against this background, it is obvious that any weaknesses in the functioning of these systems are likely to have a negative impact on financial trading activities.

Let me emphasize that there is wide agreement on the fact that the integration of large value payment systems like TARGET and today TARGET2 have been key to the integration of money and wholesale activities in the euro area. The single pricing structure, the harmonized set of cash settlement services and the single technical communication interface allow to exploit economies of scale and gains in efficiency that will spur even further integration in money and wholesale markets.

Therefore, can we really afford even closer trade relations between the different regions in Europe and globally without organizing financial services in a smooth, safe and efficient way?

European infrastructures for securities clearing and settlement, as well as those for retail payments, remain highly fragmented, which makes cross-border transactions in these areas very costly. This is widely recognised as a major contributor to the fact that the European markets for corporate bonds, equity and retail payments are still not integrated to a satisfactory degree.

It should be emphasised here that when financial markets are not fully integrated, not only does this imply substantial economic cost in terms of a less efficient allocation of financial resources, which consequently limits opportunities for economic growth in Europe, but this can also be associated with financial risk. Fragmentation of the financial markets has negative implications in particular for the financial system’s overall capacity to absorb shocks, since it reduces the opportunities for risk-sharing and diversification among economic agents and limits the depth and liquidity of financial markets. Therefore, from the perspective of both financial efficiency and financial stability, financial integration is a key issue.

European infrastructures should not only be well-integrated; they also need to meet the highest standards in terms of risk management and resilience. Indeed, it is critical that market infrastructures are robust in order to reduce systemic risk in the financial system. After all, the failure of a clearing, payment or settlement system is likely to cause major disruption to the underlying trading processes, thus putting wider financial stability at risk.

Therefore, the reliable functioning of market infrastructures is indispensable for a stable financial system, complementing the soundness of financial institutions and markets. While it is the operators of these infrastructures that are primarily responsible for taking the appropriate measures to ensure this reliable functioning, specific regulatory and oversight requirements are also in place to ensure that the infrastructures are designed to be robust and are operated in an effective manner.

The challenges posed by the current ongoing turbulences in financial markets underscore the importance of not just continuing but of stepping-up financial integration efforts.

Fostering the integration of market infrastructures: TARGET2-Securities and the Single Euro Payments Area

I would now like to take a closer look at work which is under way to foster the integration of European market infrastructures, namely in the fields of securities clearing and settlement, and retail payments. As you are aware, a number of initiatives have recently been adopted or are currently under way with a view to achieving progress in these fields, led by both market participants and public authorities. Today I will focus on two major projects featuring on the EU agenda: TARGET2-Securities (T2S) and the Single Euro Payments Area (SEPA).

The T2S project is a project of the Eurosystem and was developed in close consultation with all relevant stakeholders. It is a good example of the Eurosystem's capacity to advance European financial integration through the provision of central bank services. While SEPA is a market-led initiative to spur financial integration, the Eurosystem has actively supported this project, together with the European Commission and ECOFIN. Why do we as a pan-European public authority engage in these types of projects? The Eurosystem is both a pan-European public authority and, in its capacity as a central bank, an active market participant, and, therefore, generally in a good position to act as a catalyst for private sector activities which encourage European financial integration. Indeed, this is particularly the case in the field of market infrastructures. It is one of the Eurosystem's basic tasks under the Maastricht Treaty to promote the smooth functioning of payment systems, and the Eurosystem acts as both operator and overseer of these systems. Because we offer services to all market participants which use the € as a transaction currency we see the need for integration of systems and harmonisation of rules, regulations and priorities. Why – 10 years after the introduction of the € – we still do not have an adequate infrastructure? Everyday European citizens – corporates and consumers pay much more than citizens in the US for getting cross-border security services. Why do we need there cross-border services? Because financial integration allows better risk sharing and this benefits economic development.

TARGET2-Securities

Let us now examine T2S in more detail. Over two years ago now the Eurosystem embarked on this project in an effort to meet the increasing demand for an integrated and harmonised European settlement infrastructure and to reduce the high settlement costs in the EU, especially for cross-border securities transactions. T2S will be a multi-currency platform used by central securities depositories (CSDs) for the settlement of securities transactions in central bank money. The participating CSDs will maintain legal relations with their customers and continue to perform custody and notary functions.

The T2S project will make cross-border securities settlement transactions in central bank money as secure, efficient and cheap as domestic settlement transactions are today. T2S will build on and benefit from the TARGET2 system thereby combining cash settlements and securities settlements – in real time – within a single European infrastructure. The common settlement platform T2S will increase cost transparency and investors will be able to choose the provider on the basis of costs and services rather on the location of the security. Therefore, T2S will increase trading activity in the market, reduce trading spreads, increase competition and lower service prices, and thus improve welfare in general.

Exactly four months ago, on 17 July 2008, the Governing Council of the European Central Bank (ECB) finalised the decision to build T2S, given the widespread support of European CSDs and the confirmation of their intention to use the system once it is in operation. The development and operation of T2S has been assigned to four central banks in the Eurosystem, namely the Deutsche Bundesbank, the Banco de España, the Banque de

France and the Banca d'Italia, and I am convinced that they will continue the good tradition of the "3CB" (the Deutsche Bundesbank, the Banque de France and the Banca d'Italia), the providers of the TARGET2 payment system.

The Eurosystem is actively supporting non-euro area central banks, as well as local CSDs and market participants, as the banks decide on whether to include their currencies in T2S. Danmarks Nationalbank has already decided to do so and the central banks of Sweden, Switzerland and the United Kingdom were invited to express their opinion on this issue. Their participation would, for me, make T2S even more successful.

I believe that T2S will bring tremendous economic benefits, will foster the necessary competition and will crucially to speed up financial market integration, also in the field of bond and equity markets, to the benefit of financial market participants and the citizens of Europe.

The Single Euro Payments Area

Now I will turn to SEPA, the key project for advancing the integration of European market infrastructures in the field of retail payments. You may ask: why are retail payments important at this time of unprecedented financial turmoil? In response, I would tell you that the retail payments business generates about one-quarter of all banking revenue. Therefore, it needs to be as integrated, efficient and reliable as possible.

SEPA is a private sector initiative, led by the banking industry. It has not been an easy road for the European banks, but it is important not to waver now. The resulting integrated and modern retail payment infrastructure will make a significant contribution to the efficiency of European retail finance, as there will be one single payment system for all retail transactions, but potentially many service providers in competition with each other. Indeed, we will no longer distinguish between "national" and "cross-border" euro payments. Moreover, at a time when banks' other sources of income are more volatile, payment services can provide them with stable and regular revenue. So far it would appear that banks which act as universal banks have proven better able to weather the financial crisis than specialised banks.

Small and medium-sized enterprises (SMEs) rely on retail banks for payment services. As a result, it is the banks that know their customers best that will gain the most from SEPA. However, it is important that they use this knowledge to expand their business by offering innovative value-added services to European enterprises. If SMEs can operate with minimal manual intervention, as well as paper and cash-free, they can focus on their business instead of on their payments.

There are currently a number of initiatives aiming to align national differences and develop frameworks for specific value-added services, such as e-invoicing, online payments and mobile payment initiation. Banks should use these frameworks to offer their clients payment services that facilitate end-to-end straight-through processing of all euro payments within Europe. This will deliver banks a stable source of income and enterprises a more efficient payment process.

Market surveys show that awareness of SEPA is increasing, but that not everyone is ready to use it. Let me be perfectly clear: we should not use the financial market turbulence as an excuse to put SEPA on hold. On the contrary, we should use SEPA as an instrument for rationalisation and putting a new focus on the business of retail banking. SEPA will contribute to the creation of a smooth and safe underlying payment infrastructure in this field. Therefore, commitment to SEPA is now more important than ever – for banks, enterprises and public administrations. Awareness must be transformed into readiness.

Lessons learned from the financial turmoil with regard to market infrastructure resilience

I would now like to move on to the lessons that we have learned from the financial market turmoil with regard to the resilience of our market infrastructures. The role of market infrastructures has not been covered very extensively in the policy debate on the financial turmoil so far. There would seem to be two reasons for this relative lack of attention. First, the financial distress clearly originated from shortcomings related to financial institutions, the overall functioning of the market and especially excessive risk taking; therefore, policy discussion has focused on addressing these issues. Second, throughout the financial turmoil, market infrastructures have proven sufficiently robust to cope with the challenges to clearing and settlement.

The performance of market infrastructures during the financial turmoil

Payment systems, central counterparties (CCPs) and securities settlement systems have dealt with peaks in transaction volumes effectively and without any major operational disruptions. Similarly, when some CCPs were required to make greater and more frequent margin calls owing to the increased volatility of asset prices, those margin calls were executed successfully. Overall, by acting as a buffer against the increased and more volatile trading activity, the smooth functioning of the market infrastructures helped to maintain people's confidence in the markets and played an important role in limiting the financial and economic impact of the financial turbulence.

This is certainly reassuring and serves as evidence of the substantial work done in recent years to strengthen the resilience of market infrastructures. However, again, there is certainly no room for complacency. As financial innovation and globalisation progress, the boundaries between financial institutions and market infrastructures are blurring, the interdependencies between payment and settlement systems are increasing, and new challenges in terms of the safety and resilience of payment and settlement systems are continuing to emerge. Market participants and public authorities need to remain highly vigilant so that they can respond to these issues in a timely and effective manner.

The need for a consistent regulatory framework

In Europe, we have recently taken a significant step forward in this regard, with the finalisation of the draft recommendations of the European System of Central Banks and the Committee of European Securities Regulators (ESCB-CESR recommendations) for EU securities clearing and settlement systems and central counterparties. The recommendations are based on the international recommendations which were issued by the Committee on Payment and Settlement Systems and the Technical Committee of the International Organisation of Securities Commissions (CPSS-IOSCO) in 2001 and 2004 respectively, and are open for public consultation until 23 January 2009.

The release of the draft ESCB-CESR recommendations constitutes a major achievement after several years of hard work. However, it is imperative for us to continue making the same amount of effort in the coming months in order to ensure that these recommendations are finalised without delay and, subsequently, consistently enforced by the competent regulators and overseers.

The need for a more resilient infrastructure for over-the-counter derivatives

Another issue which warrants your attention is the need to improve the infrastructure for over-the-counter (OTC) derivatives. Despite the rapid growth of OTC derivatives in recent years, the infrastructure for clearing and settling OTC trades is still predominantly bilateral and non-standardised, and continues to require a considerable degree of manual intervention. Against this background, it is not surprising that OTC markets have struggled to cope with the increasing volumes and complexity of derivatives trades, particularly during the financial turmoil. Therefore, we fully agree with the Financial Stability Forum and the European Commission that measures must be taken to improve the market infrastructures for OTC derivatives.

A particular priority at the present juncture is to reduce risk in the markets for credit default swaps (CDSs). CDSs, a form of insurance against the risk of default by corporate borrowers, are the derivatives which have shown the greatest exponential growth in the past few years.

As the financial turbulence which started in the summer of 2007 turned from a liquidity crisis into a solvency crisis, CDS markets increasingly raised concerns, for three reasons in particular. First, regulators are broadly in agreement that, owing to their private nature, CDSs have contributed to the reduced transparency of the credit markets, helping to shift credit exposures in a manner that makes it very difficult to assess how different institutions are interlinked and how much credit risk they actually hold. Second, given that the related credit exposures are significant in terms of both the total counterparty risk and the capital cushions of the financial institutions involved, and also considering the highly concentrated nature of CDS markets, purely bilateral risk management has proven insufficient, notably in view of the risk of default by a major counterparty. Third, given the absence of any regulatory oversight, CDSs were also seen to be offering incentives for taking credit risk without applying due diligence regarding the respective credit exposures, thereby threatening the stability of an increasingly important segment of the credit market.

These shortcomings in the functioning of CDS markets have played a significant role in the problems experienced by a number of major financial institutions in recent months, such as Lehman Brothers, the American International Group and the Fannie Mae and Freddie Mac mortgage groups, and the resulting difficulties have clearly exacerbated wider credit market strains.

While it is clear that the fundamental rules and structures governing CDS markets will have to be thoroughly reviewed, a short-term priority in terms of enhancing the resilience of these markets is the establishment of central counterparty facilities. CCPs for CDSs will help, in particular, to diversify and share risk exposures and their strict margining procedures will reduce the incentive to take excessive risks. At the same time, CCPs will help to increase transparency in what remain highly opaque markets.

Against this background, how to move forward with the establishment of CCPs for CDSs has been the subject of discussion in recent months among several institutions and fora, including the European Commission, the Federal Reserve Bank of New York and the Financial Stability Forum, as well as the ECB, which hosted a meeting with European stakeholders on this issue two weeks ago.

In Europe in particular, we are close to reaching consensus on three major issues:

First, there is broad agreement on the need for more than one CCP solution for CDSs, given the importance of competition for the efficient functioning of CDS markets. However, an excessive proliferation of clearing solutions should be avoided, as the resulting segregation of financial resources would limit the ability of the CCP to reduce financial risks through multilateral netting and it would also become more difficult to achieve consistent risk management in the market. Furthermore, from a user perspective, it would be overly costly and complex to connect to multiple CCPs.

Second, there is consensus that at least one CCP for CDSs should be located in Europe, given the significant implications of CCP services in this field for European institutions and financial markets, and the corresponding need for effective regulation and oversight by the competent European authorities. In order to achieve rapid progress in the establishment of one (or more) European CCP(s) for CDSs, the European Commission is currently developing a concrete roadmap to ensure that these services are in place by the end of this year. The

Commission has clarified that any solution would need to be fully in line with EU regulatory, supervisory and monetary policy objectives.

Finally, it is widely agreed that cooperation between the relevant authorities is of the utmost importance to ensure that the different CCPs will be robust and that competition between them will not lead to a “race to the bottom”. In this context, the existing risk management standards for CCPs need to be made more specific to account for the risks particular to the CDS business, risks owing to the comparatively limited market liquidity, for example. Within the EU, the aforementioned ESCB-CESR recommendations for securities settlement systems and central counterparties are expected to form the basis for this work. In parallel, international cooperation, namely between the competent EU, US and other international authorities, will be key to making the necessary amendments to the international risk standards (the CPSS-IOSCO recommendations) in order to maintain a level playing-field worldwide.

Conclusions

In conclusion, ladies and gentlemen, by enhancing the integration of EU infrastructures, Europe will move one step closer to a truly integrated and highly competitive single financial market and thus one step closer to realising the full economic benefit of our Economic and Monetary Union. Some have argued that the turbulence in the financial markets could take the attention and determination away from important integration projects, such as T2S and SEPA, given the necessary shift in focus onto the safety and resilience of the financial sector. But as I have outlined it is precisely because of the financial turmoil that we need to strengthen our efforts towards providing integrated, efficient, safe and reliable market infrastructures as backbones of our financial system.

While market infrastructures have managed to cope with the impact of the market turbulence on clearing and settlement, the current crisis has also underlined how important it is for the financial system to have a robust backbone, particularly during times of stress in the system. Therefore, it is imperative to address inefficiencies, as well as the potential risks that result from having fragmented infrastructures, and we must keep up our efforts. One of the clear benefits of T2S is that it will reduce the need for, but provide greater access to, liquidity and collateral. This is crucial for both infrastructures and market participants, especially in these troubled times.

At the same time, it is important to be aware that the dynamic evolution of the financial market environment continues to create challenges which test the safety and resilience of our market infrastructures. We will only be able to meet these challenges if the hard work done in recent years to strengthen market infrastructures continues at full speed and close cooperation between all competent authorities is maintained. Looking ahead, specific priorities will be to make further progress towards a consistent prudential framework for securities clearing and settlement systems, and to enhance the market infrastructures for OTC derivatives, which includes the establishment of one or more European CCPs for credit default swaps.

Thank you for your attention.