The role of the CPMI as part of the Basel Process

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Today we are celebrating a birthday, a happy event. At a still youthful 25, the CPMI does not yet have to worry about the problems of old age. Congratulations are therefore in order. So let me begin by complimenting the Committee on one fundamental accomplishment that we know but is perhaps not enough publicly recognised.

The crisis that erupted in 2008 revealed the financial sector’s many shortcomings. But the infrastructure that supports payment, clearing and settlement was not among them. On the contrary, the various financial market infrastructures – or FMIs – withstood the battering they received while the markets around them were in turmoil, and continued to function smoothly, with little or no damage.

If in 2008, the market infrastructure had been in the same state as it was back in 1990, then the outcome could have been rather different. It has been said many times before, but it bears repeating: FMIs are fundamental to the ability of markets to work. A weak infrastructure can turn a small crisis into a huge one. The fact that the infrastructure was strong enough in 2008 is in large part thanks to the many efforts of this committee since its inception. The introduction of improvements such as real-time gross settlement (RTGS) for payments, delivery-versus-payment (DVP) for securities, and payment-versus-payment (PVP) for foreign exchange has made a real and substantial difference. So, congratulations!

In the rest of my remarks, I shall first highlight three snapshots from the Committee’s history, corresponding to the three sessions of this conference. Then, I shall talk about how the Committee has been working in the context of what we at the BIS call the Basel Process. Finally, I shall share with you a few thoughts on one of the outcomes of the financial crisis, namely the growing role of centralised counterparties or CCPs.

The history of the CPMI

First, some history and its relation to the three sessions of this conference. To preserve the chronology of the actual events, I will take the sessions in a different order, starting with Session 2.

Session 2 is about the resilience, recovery and resolution of FMIs. As I mentioned earlier, one of the CPMI’s most significant contributions is the promotion of PVP as a safer way to settle foreign exchange. Many of you in this audience would know that the history behind this goes back to 1974 and the so-called Herstatt crisis. The direct consequence of that for us here in Basel was in fact the creation of the Basel Committee on Banking Supervision (BCBS), not the Committee on Payment and Settlement Systems (CPSS). It was only some years later that people recognised the need for a more specialised group to work on settlement issues. Nevertheless, despite its later start, the CPSS embraced FX settlement as one of its initial, defining projects. And with the launch of CLS in 2002, the Committee’s work in FX settlement became one of its major, enduring successes. The CPSS and BCBS worked...
together to produce the BCBS’s 2013 *Supervisory guidance for managing risks associated with the settlement of foreign exchange transactions*. In the coming years, this cooperation will bear fruit as risks are better recognised and addressed.

Session 3 of this conference is about disruptive innovations. Here I’d like to refer to what might be called the prehistory of the Committee. In a way, the Committee can be considered to be not 25 but 35 years old, given that its predecessor, the Group of Experts on Payment Systems, was set up in 1980. What led to the formation of that group was a major innovation that, as it happened, was highly disruptive, namely the conversion of paper-based large-value payment systems to electronic ones. This was a change driven by technology. And it occurred at a time when financial markets were starting to grow rapidly in size. The combination – new technology and bigger markets – led central banks to wonder, quite rightly, what the risk implications might be. And it turned out that what was relatively harmless when payments were slow and small became potentially disastrous when they were fast and large. Back in those days, banks received information about incoming payments in real time during the day and credited their customers’ accounts immediately based on that information. But settlement between banks took place only at the end of the day. The result: large amounts of intraday interbank credit, that was hardly visible, understood or controlled by the banks. This development led to what was, thankfully, only a brief era of electronic large-value deferred settlement arrangements, before real-time settlement came to dominate.

Session 1 is about the evolution of standard setting. For many years, some of the most influential norms in the payment and settlement area came in the report that was, in effect, the father of the CPSS – that is, the Lamfalussy report of 1990, published just as the CPSS was created. This report was a key response both to that disruptive innovation of electronic deferred settlement and to the problem of Herstatt. The first reports issued by the CPSS itself were statistical in nature, very different from standard setting. But soon thereafter, the Committee started producing a wide range of normative statements. The terms used to describe these statements varied, but curiously, the term “standards” was rare. It appeared in the 1990 Lamfalussy report, and then again this year when “disclosure standards” for CCPs were published. But in between, the Committee used a bewildering variety of terms: principles, core principles, general principles, recommended actions, recommendations, responsibilities, propositions, and guidelines. In the last couple years, under the initiative of Paul Tucker and concluded under Benoît Coeuré, the CPSS’s international standard-setting role was explicitly confirmed by its governance bodies: the Economic Consultative Committee (ECC) and the Global Economy Meeting. The CPSS became the CPMI.

The Basel Process

Now let me turn to the second part of my remarks. In this birthday event, a lot is bound to be said about what the Committee has accomplished to date. These accomplishments depend not only on the hard work of successive generations of committee chairmen and members as well as secretariat staff, but also the Committee’s cooperation with others, in particular, in the context of the Basel Process.

We use the term Basel Process to refer to the active cooperation among the committees and organisations hosted by the BIS and their interaction with the BIS to support their work in prudential standard setting or, more generally, in the pursuit of financial stability. Currently, six committees and three associations find their homes at the BIS. The process is based on three key features: synergies, flexibility and openness, and support from the BIS itself. Each of these is relevant in the case of the CPMI.

First, on synergies. The physical proximity of the BIS-based committees and associations facilitates contact and exchange of ideas across groups. In addition, these groups share a common goal of promoting financial stability. It therefore makes sense for them to work together. Good infrastructure
is only valuable if it is used, and used appropriately. It is therefore not surprising that there has been a long history of cooperation between the CPMI and the BCBS, in particular. Of course, the CPMI and IOSCO also have a close relationship – so much so that, over the past five years, roughly half of the CPMI’s publications have been joint publications with IOSCO. Indeed, in an increasingly complex financial system, no committee or group can expect to work by itself in isolation. Cooperation across disciplines and across jurisdictions is essential – as is taking a systemic approach to financial stability. The CPMI should be commended for extending this cooperative spirit and systemic view globally.

Another feature of the Basel Process is flexibility and openness. The BIS-based committees are by design limited in size. This kind of setup makes discussion, coordination and cooperation easier, with corresponding benefits to the quality of the output. At the same time, this output can be much larger than the size of the committees would suggest, as they can leverage the expertise of the international community of central bankers, financial regulators and supervisors, and other public authorities. The committees’ output needs legitimacy if it is to be effective. International standards are not laws. Jurisdictions have to agree to implement them, and that is more likely to happen if the standards are respected not just for the quality of the product but also for the nature of the process by which they are produced. In the latter respect, governance is crucial. An important change in this regard for the CPMI – and some of its sister committees – came in 2009, when the Committee started to report not to the G10 Governors but to the ECC and the Global Economy Meeting, which consists of the Governors of 30 BIS member central banks. Accompanying this change was an expansion of the membership of the Committee itself. Both changes have made the Committee more representative of the world economy and its financial centres. There was indeed some concern at the time that an expanded membership might make the Committee unwieldy and thus less effective. Happily, that proved to be a misplaced concern, and the friendly and cooperative spirit of the committee is undiminished.

Finally, the third key feature of the Basel Process is support from the BIS itself. The work of the Basel-based groups is informed by the BIS’s research and analysis, its work in international financial statistics and the practical experience it gains from its banking activities. Given the very specialised – or some may even say esoteric – nature of the CPMI’s work, most of the interaction has been in the form of BIS statistical support, whether for the Committee’s regular statistics – which are still the most downloaded CPMI publications – or for ad hoc topics. Some of these ad hoc projects, such as the 1998 FX survey, were very large-scale and would have been difficult to carry out if the Committee had not collaborated with BIS colleagues in the statistics area.

Into the limelight?

Let me now proceed to the final part of my remarks and look to the future. I referred a moment ago to the perception that CPMI work was technical or even esoteric. That perception can have certain advantages. By focusing on technical issues, Committee members can have relatively cool-headed discussions of difficult topics without being too much impinged upon by political considerations. The mainly technical and not so political nature of the discussions also means that the CPMI has traditionally been shielded from the limelight – in stark contrast to the BCBS, for example.

But the financial crisis may have changed this to some extent. As I mentioned earlier, by and large, FMIs performed well during the crisis. Nevertheless, there were lessons to be learnt – for both the private and public sectors – and sounder standards were proven necessary. Without the vast public sector support seen during the crisis, for instance, there would surely have been more failures of banks, and thus more stress on infrastructures. FMIs might not have withstood such added stress with so little damage. And as noted earlier, FMIs have to be robust even in the worst crises.
In this respect, let me share a few thoughts on the growing role of CCPs. As you know, one important element of the regulatory agenda to reduce systemic risk is to encourage the use of CCPs, not least by making the clearing of standardised OTC derivatives mandatory.

The benefits of CCPs are qualitatively different from the benefits of the other major infrastructure changes I have mentioned. Mechanisms such as RTGS, DVP and PVP remove what are, in effect, unnecessary frictions in the settlement process. By and large, they remove risks that were due only to poor design or poor processes. And arguably, the safer infrastructure was introduced even before banks themselves fully realised what those risks were.

But this is not the case with clearing, where banks are well aware of counterparty risk. Moreover, such risk is not merely an unnecessary friction of settlement; it is an inevitable feature of trading. CCPs can do a lot both to reduce that risk, for example through multilateral netting, and to ensure that the residual risk is managed effectively by the market as a whole. That is why CCPs are potentially so valuable. However, as CCPs have grown in prominence – and as there is greater awareness of the responsibility put on them to manage risk effectively – there have also been legitimate questions about whether CCPs are safe enough to cope with that responsibility. At the same time, competition between CCPs has brought significant political elements into the picture.

Against this background, the CPMI may be moving into the limelight. Such a move may be uncomfortable at times. But, at least on this occasion, it is helpful. It is helping us to ask the right questions and find the right answers. The substance of this issue will, no doubt, be discussed in the second session, so I will not say much here. But I will note the following: it is certainly important that high standards are set for CCP safety, but it is not enough. CCPs also need to be supervised and overseen with rigour. Supervisors and overseers need to make sure that CCP managers are internalising the economic and social costs that instability in the infrastructure can entail. In other words, competent authorities need to do this work with a systemic view. Again, good infrastructure is only valuable if it is used, and used properly. CCPs cannot magically remove all the risk. Ultimately, banks themselves must be responsible for the risks they take and manage them effectively. CCPs can be an enormous help, but they are by no means a complete solution.

Conclusion

Now let me conclude by simply saying, once again, happy birthday CPMI. And thank you for the great work you have done, and will no doubt continue to do. Thanks also to Benoît, the Secretariat and Klaus Löber, former members and former chairs, Bill and Paul, who are here today.

Enjoy the rest of the conference!