

Oversight of payment and securities settlement systems by the Swiss National Bank

SCHWEIZERISCHE NATIONALBANK
BANQUE NATIONALE SUISSE
BANCA NAZIONALE SVIZZERA
BANCA NAZIUNALA SVIZRA
SWISS NATIONAL BANK



By Andy Sturm

Over the past few decades, the Swiss National Bank (SNB) has devoted more attention to issues related to the stability of the banking and financial system. This is reflected in the 2004 revision of the National Bank Act (NBA), which explicitly requires the SNB to contribute to the stability of the financial system. The SNB fulfils this requirement in a number of different ways, which include overseeing the payment and securities settlement systems.¹ This article provides a more detailed explanation of the way in which this sovereign instrument of monetary policy works. The first section outlines the SNB's statutory mandate and the objectives it pursues when overseeing payment and securities settlement systems. The two following sections explain the strategy and the main principles by which the SNB is guided when it oversees the systems. The final section provides more details on the way in which these activities are implemented in practice.

1 Mandate and objectives

The SNB is required to contribute to the stability of the financial system (art. 5 para. 2 (e) NBA). A stable financial system is essential for monetary policy to be effective and is of vital importance for economic growth. The task of the financial system is to ensure efficient allocation of financial resources and risks in an environment characterised by uncertainty and asymmetrical information. The financial system may be described as stable when it carries out this task efficiently and when it proves resilient to possible external influences.

In order to assess the stability of the financial system, it is helpful to break it down into its constituent components – financial markets, financial intermediaries and the financial market infrastructure. The primary task of the financial markets is to gather information and process it in the form of prices, which allow financial market participants to allocate resources and risks efficiently. Financial intermediaries are market participants themselves. At the same time, they also play a major role in bringing the other market participants (e.g. individuals and corporations) together – in other words, they match supply and demand in the different market segments (e.g. the money,

capital, foreign exchange and credit markets). In order to fulfil these tasks efficiently, financial markets and intermediaries depend on an adequate financial market infrastructure. Particularly important are stock exchanges and trading platforms, as well as post-trading systems for clearing and settling payments, securities and other financial instruments (payment and securities settlement systems). The task of payment and securities settlement systems is to correctly transfer and record the financial assets (e.g. book money, securities and other financial instruments) between trading partners and to do so at the time agreed.

The oversight of payment and securities settlement systems is one of the instruments at the disposal of the SNB for furthering financial stability. The relevant legal provisions and implementation regulations are contained in the NBA and in the National Bank Ordinance (arts. 19–22 NBA and arts. 19–38 NBO). In particular, the NBA specifies that the oversight function is designed to protect the stability of the financial system (art. 19 NBA). Thus, the sole objective of system oversight by the SNB is to ensure financial stability, which in turn is a precondition for the effectiveness of monetary policy. Individual creditor protection, consumer protection or the protection of payment and securities settlement systems from criminal abuse, however, are not objectives of SNB oversight.

By overseeing the systems operated by the private sector, the SNB promotes their security and efficiency. In so doing, it gives priority to reducing systemic risk. First, it is important to ensure that an operational or technical system failure will not result in major credit or liquidity problems for financial intermediaries. Second, the legal framework, contractual regulations and, in particular, the rules and procedures for the different systems should be formulated such that payment or delivery difficulties of individual system participants do not encroach on other financial intermediaries.

2 Strategy

At strategic level, the focus on financial stability in system oversight is evident in the three-level regulatory approach:

- All system operators are required to provide statistical information.
- Operators of systems that cannot be discounted from the outset as irrelevant for financial stability purposes are subject to a disclosure obligation.

¹ For a review of the SNB's other tasks and activities in the field of financial stability, cf. Swiss National Bank (2007), *The Swiss National Bank 1907–2007*, pp. 381 et seq.

- Operators of systems that pose a risk to the stability of the Swiss financial system are obliged to meet certain minimum requirements.

Duty to provide statistical information: In essence, this is limited to information on the use of various payment systems (e.g. number and value of transactions settled). This information provides the SNB with a general idea of developments in Switzerland's payment environment and allows it to draw monetary policy-relevant conclusions about the demand for money.

Disclosure obligation: This is more far-reaching than the duty to provide statistical information. It applies only to operators of payment systems with a volume above CHF 25 billion per financial year and to operators of securities settlement systems. The disclosure obligation makes it possible to obtain specific additional information from these system operators which is needed to assess whether the system is important for the stability of the Swiss financial system. The most important factors here are the effects which the disruption of operations or payment or delivery difficulties experienced by individual system participants can have on the stability of the Swiss financial system.

Minimum requirements: In principle, operators of systems classified as systemically important are required to fulfil the minimum requirements set out in arts. 22–34 NBA.² The minimum requirements are largely based on international standards, i.e. on the *Core Principles for Systemically Important Payment Systems*, the *Recommendations for Securities Settlement Systems* and the *Recommendations for Central Counterparties*.³ The purpose of the minimum requirements is to influence the behaviour of system operators in such a way that systemic risks are reduced and controlled. They are formulated with regard to the objective, i.e. they define a condition that is to be achieved. It is up to the operators to fulfil this condition in the most efficient manner.

In order to increase the transparency of the regulatory requirements for system operators and facilitate reviewing of compliance, the SNB has also drawn up a set of 'control objectives'. These objectives are more specific and tangible than the minimum requirements. They are also specially formulated for particular systems, so that the risks inherent in that system can be better taken into account. The risk factors of relevance for a central counterparty, for instance, will differ from

those applying to a payment system or a securities settlement system.

To ensure that the SNB is in a position to review compliance with the regulatory requirements, system operators are required to provide it with the necessary information and documentation. In addition, the SNB – or a third party designated by the SNB – may carry out inspections on site (arts. 35–36 NBO). If the SNB concludes that the regulatory requirements have not been fully met, the statutes provide for various administrative sanctions (art. 23 para. 2 NBA and arts. 38–39 NBO). In particular, by issuing a recommendation or an enforceable order, the SNB may oblige a system operator to establish the condition required by law within a given period of time.

3 Principles

The SNB is guided by various principles when formulating and implementing its oversight strategy. Observance of these principles helps to ensure that oversight is effective and efficient.

- Oversight is risk oriented. One consequence of this focus is that only systems which could pose a risk to the stability of the financial system are required to fulfil regulatory requirements. Another is that, when overseeing these systems, the SNB concentrates its activities on the aspects that display the largest inherent risks.
- Oversight is goal oriented. Although the SNB reviews whether system operators comply with the regulatory requirements, it allows system operators to decide how they wish to fulfil these requirements. This avoids unnecessary regulatory intervention and promotes efficient solutions.
- Oversight is transparent. SNB policies should be well justified, comprehensible and predictable. This allows system operators to recognise the purpose of regulatory requirements, to accept them and to take account of them in their decision-making. Moreover, transparent policies promote reliability of planning, which system operators require if they are to make long-term investments.
- Oversight is a cooperative activity. The SNB seeks a close and cooperative collaboration with the system operators. Although it has sovereign instruments which offer the option of imposing modifications when weaknesses are detected, the SNB prefers system operators to carry out measures on a voluntary basis.

² An exceptional provision applies to operators domiciled outside Switzerland. If they are subject to equivalent oversight by a local authority, and if this authority is willing to collaborate with the SNB, the operator in question may be discharged from compliance with the minimum requirements.

³ cf. the following three seminal documents:

- Committee on Payment and Settlement Systems (2001), *Core Principles for Systemically Important Payment Systems*.
- Committee on Payment and Settlement Systems and International Organisation of Securities Commissions (2001), *Recommendations for Securities Settlement Systems*.
- Committee on Payment and Settlement Systems and International Organisation of Securities Commissions (2004), *Recommendations for Central Counterparties*.

4 Implementation in practice

Governance

System oversight is a sovereign instrument of monetary policy. Consequently, decisions of importance for oversight are the responsibility of the SNB Governing Board. This applies in particular to decisions on whether a payment or securities settlement system is of importance for the stability of the financial system, to the issue of recommendations or orders to a system operator, and to amendments made to the implementation regulations on system oversight set out in the NBO. The Governing Board bases its decisions on documentation prepared by the Financial Systems unit, which is responsible for ongoing system oversight.

Systemically important payment and securities settlement systems

The central element in SNB oversight consists of regulatory requirements which the operators of systemically important payment and securities settlement systems are obliged to fulfil. The decision as to whether a system might potentially jeopardise the stability of the Swiss financial system is therefore fundamental.

In practice, the SNB uses six criteria (art. 20 para. 2 NBO) to evaluate the systemic importance of a payment or securities settlement system in the most objective, consistent and comprehensible manner possible. Alongside the number of transactions cleared or settled via a given system, as well as their value, the SNB devotes special attention to whether the system has links to other elements in the financial market infrastructure and whether, if necessary, the transactions can be cleared or settled through an alternative system. The group of participants, the type of transactions and the currencies in which transactions are cleared or settled in the system in question are also taken into account.

The SNB has classified the following five systems as important for the stability of the Swiss financial system:

- Swiss Interbank Clearing (SIC), a large-value payment system operated on behalf of the SNB by SIX Interbank Clearing Ltd, a subsidiary of SIX Group (Swiss Infrastructure and Exchange Group) and PostFinance;
- SECOM, a securities settlement system operated by SIX SIS Ltd, a subsidiary of SIX Group;

- x-clear, a central counterparty operated by SIX x-clear Ltd, a subsidiary of SIX Group;
- London Clearing House (LCH), a central counterparty operated by UK-based LCH Ltd, a subsidiary of LCH Group;
- Continuous Linked Settlement (CLS), a foreign exchange settlement system operated by US-based CLS Bank International.

Ongoing system oversight

The objective of system oversight is to ensure that operators of the systems listed above fulfil the regulatory requirements at all times. In essence, ongoing system oversight consists of three activities: gathering information, analysing this information in order to assess whether the system operators fulfil the requirements and, finally, encouraging and implementing changes in the event that the analysis shows that some of the requirements are not entirely fulfilled.

The SNB depends on detailed and up-to-date information on individual systems and their operators in order to assess whether a particular system operator fulfils the regulatory requirements. Consequently, the system operators are subject to extensive information requirements vis-à-vis the SNB. In addition, regular meetings are held with the system operators to ensure that the SNB is timely informed about current developments and planned changes. A further important source of information are the mandatory inspections conducted by external auditors in particularly critical areas. Finally, system operators are required to carry out annual self-assessments in which they show the extent to which they fulfil the regulatory requirements.

The SNB uses the information that has been gathered to assess whether a particular system operator has complied with the regulatory requirements. The assessments are reviewed at least once a year, and also in the event of material developments or changes.

If the SNB determines that a system operator has not fully complied with one or more of the regulatory requirements, it has a number of options for ensuring that the condition required by law can be established (or restored). In practice, the SNB generally draws up a statement outlining the weaknesses that have been identified and requesting the system operator to take appropriate action to remedy them. In addition, there are two instruments provided for by administrative law and already mentioned above – recommendations and orders. However, the SNB has not needed to use either of these instruments to date.

Cooperation with other authorities

The SNB cooperates closely with other authorities, in particular with the Swiss Financial Market Supervisory Authority (FINMA). Coordination between FINMA and the SNB is especially necessary in the case of the operators of the securities settlement system SECOM and the central counterparty x-clear, both of which have banking licenses and are therefore subject to prudential supervision by FINMA. In the case of x-clear, which qualifies as a recognised overseas clearing house (ROCH) in the UK, the SNB also cooperates with the Financial Services Authority (FSA).

The SNB collaborates with the relevant foreign authorities in connection with the oversight of CLS and LCH, which are both exempt from compliance with the minimum requirements. In the case of CLS, the SNB is part of a cooperative oversight arrangement to which the central banks of all 17 currencies settled via CLS belong and which is headed by the US Federal Reserve System. In the case of LCH, the SNB cooperates with the FSA in the UK.

Reporting

In its *Accountability report for the Federal Assembly*, the SNB regularly informs the general public on its main oversight activities and its most important findings.⁴ This includes a general assessment of system operators' compliance with regulatory requirements. However, the SNB does not publish confidential information obtained in the course of its oversight activities or detailed evaluations of individual payment or securities settlements systems which are based on confidential information. The guarantee that sensitive information will not be revealed is an important factor in ensuring that the dialogue between the SNB and the system operators are candid and can be conducted in a climate of mutual trust.

⁴ cf. Swiss National Bank (2008), 100th Annual Report, pp. 50–53.

Published by

Swiss National Bank
Oversight
CH-3003 Berne
Telephone +41 31 327 02 11

Publication Date

May 2009

Further information

oversight@snb.ch