

Zurich, 12 December 2003

Comments on the new National Bank Law at News Conference of 12 December 2003

Jean-Pierre Roth, Chairman of the Governing Board of the Swiss National Bank

New National Bank Law in the making

On 3 October, the two Federal Chambers passed the new National Bank Law. We are very happy with the course of the parliamentary debate: only minor amendments were made to the draft of the Federal Council. The deadline for a referendum is 22 January 2004. If no referendum is sought, we assume that the Federal Council will put the new Law into force on 30 April 2004, i.e. the date of our Annual General Meeting.

The new Law will modernise the legal framework of the National Bank. It lays down the mandate of the Swiss National Bank in detail, guarantees the SNB independence in its decision-making, regulates its accountability vis-à-vis the Federal Council and Parliament and strengthens the supervisory powers of the Bank Council. The latter will no longer consist of 40 members as at present; it will comprise only 11 members, six of whom are elected by the Federal Council and five by the SNB's Annual General Meeting. The new Bank Council will be constituted on the day of our Annual General Meeting.

The new Law extends the National Bank's room for manoeuvre on the operational level. Until now, the Law laid down exactly what assets the SNB was permitted to invest in and what securities were eligible as collateral in Lombard business. In future, the National Bank will be responsible for making these decisions itself. At the time when the new Law enters into force, we shall publish two directives. One will spell out the technical preconditions for our monetary operations; the other will set out how we shall use our extended investment policy scope. My colleague, Philipp Hildebrand, in his address will present our first ideas on this subject.

The new Law vests specific responsibilities in the SNB with respect to the oversight of payment and securities settlement systems. Up to now, our oversight of the SIC interbank payment system was based on a contractual relationship. As from next year, our

Zurich, 12 December 2003

2

responsibilities in this domain will be based on the Law and will extend to the oversight of all major payment and settlement systems. My colleague, Niklaus Blattner, will discuss this subject in more detail in his remarks.

The new Law also provides that the SNB shall issue implementing regulations in the area of minimum reserves, statistics and the oversight of payment and settlement systems. The draft of an ordinance has already been submitted to the interested parties for consultation. In the field of minimum reserves and statistics we intend in principle to take up the provisions already existing in the Federal Law on Banks and Savings Banks and the Federal Law on Investment Funds. As regards the oversight of payment and settlement systems, we are advancing into totally new territory, where for the time being only the main principles have been defined. This implies pioneering work in the implementation.

Niklaus Blattner, Vice-Chairman of the Governing Board of the Swiss National Bank

With the revised National Bank Law, the National Bank receives an explicit mandate to contribute to the stability of the financial system. This is, in particular, laid down specifically in the Law in the task of overseeing payment and securities settlement systems.

Why does the National Bank oversee payment and securities settlement systems?

By overseeing payment and securities settlement systems, the National Bank is supporting the security and efficiency of financial market infrastructures in Switzerland. In doing so, it is helping to ensure the stability of the financial system as a whole. This stability is essential to successful monetary policy in particular, and to the economic efficiency of Switzerland in general.

The importance of a market economy's financial system derives from the function that it fulfils. The financial system is responsible for the allocation of financial resources and risks, as well as intermediation between savers and investors. A financial system can be described as stable if it performs these tasks efficiently and its markets and institutions prove themselves to be shock-resistant.

Another part of a stable financial system are secure financial market infrastructures. These include, specifically, payment systems and systems for the clearing and settlement of financial instruments (securities settlement systems).

Deficient payment and securities settlement systems might potentially trigger a crisis in the system. An operational or technical system failure can delay transaction settlement so severely – or even prevent it for such a long period – that widespread credit or liquidity

Zurich, 12 December 2003

3

problems among financial institutions result. In particularly serious cases, the financial institutions concerned, and perhaps even the financial markets, are no longer able to perform their role in the economy or can do so to only a limited extent. Yet on the other hand, payment and securities settlement systems also play a major part in preventing the transfer of payment or delivery problems from one participant to the others. Such difficulties might also trigger a chain reaction which could jeopardise the entire system. This makes the architecture of payment and securities settlement systems all the more important, because it determines their capacity to limit the transfer of weaknesses.

Secure and efficient financial market infrastructures are especially important to the Swiss economy, which has a large financial sector and generates significant payment flows. Their significance is illustrated by the relevant figures: every day, sums amounting to around 180 billion Swiss francs pass between financial institutions via Swiss Interbank Clearing System (SIC), Switzerland's most important payment system. With a system of this scale it is easy to imagine that problems with the clearing or settlement of transactions might jeopardise the stability of the financial system as a whole.

I would like here to outline how the Swiss National Bank can help to ensure more efficient and more reliable financial market infrastructures through its oversight of payment and securities settlement systems. I would, however, like to make one key point right away: state intervention in, or regulation of, financial market infrastructures is justified only if it must be assumed that the private sector will not necessarily perform these functions of its own accord in a manner that is best for the economy.

In reality, when designing a system its operators and participants will probably consider the direct costs that they would bear themselves in the event of a system failure or the withdrawal of a participant. However, the remaining costs that are not borne directly by the parties involved in the event of a system crisis tend to be forgotten in management calculations. It cannot be ruled out, then, that operators and participants take less account of the security of a system than would be necessary from the perspective of the broader economy. It is a classic problem of market failure. The sense and purpose of overseeing payment and securities settlement systems is to give due consideration to the externalities that would be neglected by the private sector and to ensure that financial market infrastructures provide the optimum degree of reliability from the point of view of the national economy.

The oversight of payment and securities settlement systems in practice

In future, the National Bank will be taking a risk-oriented approach, i.e. we will deploy our resources in those specific areas in which the risks are particularly high. The National Bank Law stipulates a three-tier oversight process. The *first tier* is an obligation on the part of operators of payment and securities settlement systems to provide statistical information. The National Bank will use the data it collects to gain an overview of the breadth and importance of the systems and instruments for the clearing and settlement of payments and securities trades that are available in Switzerland. The *second tier* is a more

Zurich, 12 December 2003

4

wide-ranging disclosure obligation that is imposed upon the operators of securities settlement systems and those payment systems which process payments in excess of 25 billion Swiss francs a year. With payment systems of this size and larger, the National Bank will look in greater detail into the extent to which they might jeopardise the stability of the financial system. Finally, the National Bank Law provides for powers on the part of the National Bank to impose minimum requirements on systemically important financial market infrastructures as a *third tier* of oversight.

Detailed implementation provisions for oversight will be laid down in an ordinance to be issued by the National Bank. In early November 2003, the National Bank submitted a consultation draft of this ordinance to interested parties. The draft itself can be found on our website.

I would now like briefly to address three central points connected with oversight: which systems should be overseen by the National Bank? What minimum requirements should the operators of these systems fulfil? And finally: how will collaboration with other regulatory and supervisory authorities – especially the Swiss Federal Banking Commission (FBC) – be structured?

Oversight focuses on systems which might constitute a threat to the stability of the Swiss financial system. The question of the systems to which this applies cannot be answered in precise terms. The ordinance lists a number of criteria that we will consider when assessing the systemic importance of an infrastructure. In addition to the type, number and monetary volume of the transactions that are cleared or settled via a system, the outcome of the assessment will depend, for example, on the other financial market infrastructures with which a system is linked, and whether or not the clearing and settlement of transactions can be diverted temporarily to another system in the event of a failure in the first system. The latter option alleviates the problem somewhat. Given these and other criteria, it can be assumed that the group of systems overseen by the National Bank will be composed first and foremost of those payment and securities settlement systems that are part of what is known as the Swiss value chain. These are the interbank payment system Swiss Interbank Clearing (SIC), the SECOM securities settlement system and x-clear, the central counterparty. In addition, however, the multi-currency payment system Continuous Linked Settlement (CLS), which is used to settle foreign exchange transactions, may also be classified as systemically important. Closer investigation will reveal whether or not this group will be expanded to include yet more systems, such as that operated by Postfinance.

The National Bank's main points of reference in respect of the minimum requirements that the operators of these systems must fulfil are two internationally recognised standards: the "Core Principles for Systemically Important Payment Systems" and the "Recommendations for Securities Settlement Systems".

Like the two standards just mentioned, the National Bank's minimum requirements are target-oriented i.e. the system operator in question is largely free to determine how it will achieve the required state of affairs. The minimum requirements are aimed at two aspects

Zurich, 12 December 2003

5

of the reliability of payment and securities settlement systems in particular. The first of these relates to the technical and operational security of a system. The system itself may not be the cause of a crisis. Specific emphasis is placed on a lasting guarantee of virtually uninterrupted system availability. The regular review and testing of emergency plans and procedures is part of this. However, the minimum standards also call for measures to protect the integrity and confidentiality of data as well as the traceability of transactions.

The second aspect of the minimum requirements concerns risk management and the architecture of payment and securities settlement systems, i.e. the rules and procedures by which transactions are cleared or settled. Structures must be in place to prevent weaknesses in the financial system, such as payment or delivery difficulties on the part of a system participant, spreading in an uncontrolled fashion to other participants. In this context, the focus is, for example, on requirements relating to the payment instruments used, the irrevocability of transactions that have already been settled (finality), and on instruments and procedures to limit credit and liquidity risks.

Collaboration with other authorities

The National Bank is not the only institution which actively endeavours to secure the stability of the financial system. There is also contact with other authorities. One of these points of contact arises from the fact that, for example, the operator of SECOM (SIS Sega Intersettle AG) holds a bank licence and is therefore subject to supervision by the FBC. The FBC will still be the regulatory body responsible for the institution itself, while the National Bank will handle the oversight of the system operated by this institution. A parallel situation exists in the case of x-clear, which is operated by SIS x-clear AG – also regulated, as a bank, by the FBC. The FBC and the National Bank coordinate their activities and avoid overlaps.

A further point of contact with other authorities exists in the case of financial market infrastructures that are of systemic importance to Switzerland but are operated abroad and thus cannot be overseen directly by the National Bank. From the present perspective this applies in particular to the foreign exchange settlement system CLS. Here too, close collaboration between the primary supervisory authority, the Federal Reserve Bank of New York, the National Bank and the other central banks involved is essential.

In addition, the National Bank is considering cooperating with private sector auditors. In the same way as the FBC, which works with private-sector auditors in conducting its supervisory activities, the National Bank intends to use a dual system in which certain examinations may be carried out by private auditing companies. There is a particular need for such an approach in those areas in which very specific specialist knowledge is required, such as in the assessment of information security.

Concluding remarks

Two further points in conclusion: firstly, it must be emphasised that the oversight of payment and securities settlement systems is a new task for the National Bank only where

Zurich, 12 December 2003

6

securities settlement is concerned. As the bank of banks, it already helps to shape financial market infrastructures and limit the systemic risks inherent in them. In both segments, however, the new Law gives the National Bank a more forceful range of instruments that will allow it to act more effectively and more transparently. Secondly, it would be wrong to assume that the explicit mandating of the National Bank to oversee payment and securities settlement systems is in response to any fundamental concerns about the reliability of Switzerland's financial market infrastructures. On the contrary – we believe that the Swiss financial centre has infrastructures that function better than most and come out very well in an international comparison of security and efficiency. By overseeing payment and securities settlement systems, the National Bank is helping to ensure that it will remain so in the future.

Philipp Hildebrand, Member of the Governing Board of the Swiss National Bank

Key features of the SNB's future investment and risk control process

The SNB's investment activity is subordinated to monetary policy and is determined by the criteria of liquidity, risk and returns. The new National Bank Law will extend the SNB's investment opportunities. The current National Bank Law (NBL) limits eligible investments to gold and fixed-interest securities, and eligible borrowers to states, international organisations and banks. Article 9 of the new NBL defines a wider scope of possible transactions. This allows the National Bank to further optimise the structure of its investments with a view to specific central bank needs. As part of this process, we are also evaluating the possibility of enlarging the investment universe. However, such an extension would raise a number of fundamental questions that will first need to be examined. Before the new law enters into force, we will establish and publish investment policy directives setting out how the Governing Board plans to make use of the extended investment policy scope.

While our assets have already been managed largely in conformity with the principles of modern asset management, improvements were nevertheless called for. It was essential to bring our internal investment and risk control processes into line with the new legal framework. The opportunities for diversification brought about by additional investment instruments would, in principle, reduce the market risk of the investments. At the same time, though, the SNB would incur new risks, e.g. additional credit risks. In addition, corporate governance is to be enhanced. The primary goal is to segregate powers as far as possible: firstly between monetary policy and investment policy operations, secondly between investment strategy and its implementation through asset management, and thirdly between risk taking and risk controlling. There are limits to the principle of

Zurich, 12 December 2003

7

segregation of powers insofar as the Governing Board is responsible both for monetary policy and investment policy.

Let me briefly outline our concept regarding the new investment process:

- The Bank Council approves the principles laid down for risk policy and the investment process.
- The Governing Board decides each year on the investment strategy based on the aforementioned criteria of liquidity, risk and returns.
- The organisational unit Asset Management, which is part of Department III, is responsible for the market-oriented implementation of this investment strategy. An investment committee chaired by the head of Asset Management makes the strategic investment decisions and sets the targets for each portfolio manager.
- A well-tested risk control process ensures that risk taking at the different levels is duly supervised.

Responsibilities and competencies are clearly assigned at all levels of the investment process. Performance at the different levels is assessed through the consistent use of benchmarks and the corresponding measurement techniques.

The process described above is applied to the management not only of the international reserves but also of the proceeds from the sale of gold no longer needed for monetary policy purposes. How the gold reserves deemed "free" at the time are finally used will be a political decision. Managing these assets is not part of the SNB's statutory mandate. Thanks to the new NBL and the SNB's internal know-how, however, the Bank is well qualified to perform this task.