

IX Developments in the financial infrastructure

This section looks at the progress of some key initiatives designed to reduce risks in the international financial system and to improve the arrangements for handling crises if they arise.

International Monetary Fund

Private sector involvement in country crisis resolution

The December *Review* reported that the international official community had endorsed private sector involvement (PSI) as integral to the resolution process for countries in financial crisis. However, only limited progress has been made in turning the concept of PSI into an operational framework. Some argue that the framework should evolve through ‘case-law’ as PSI is applied in specific circumstances. Others would prefer it to be based on clearly articulated principles, so that investors would have a clear idea of what process would be followed when a sovereign was unable to service its debt in full or on time. They argue that this would enable risk to be assessed and priced more accurately. A possible reconciliation of the two views might involve a framework with firm presumptions but sufficient flexibility to deal with individual cases posing major systemic risks.

At its April 2001 meeting, the International Monetary and Financial Committee (IMFC) agreed that, where possible, PSI should rely on voluntary, market-oriented approaches but that there might be cases where concerted action was needed⁵⁶. The IMF was asked to articulate the circumstances in which concerted action would be appropriate. The IMFC also called for progress by the Annual Meetings in September 2001 on practical issues involved in applying the PSI framework, including an improved basis for assessing debt sustainability, prospects for regaining market access, the risk of contagion and comparability of treatment between official and private creditors. Progress on these issues would make a helpful contribution to the overall effectiveness of crisis prevention and management.

Financial Sector Assessment Programme

The IMF Board agreed in December 2000 that the Financial Sector Assessment Programme (FSAP) – a joint initiative with the World Bank, introduced in May 1999 to help countries enhance their resilience to crises and cross-border contagion, and to foster growth by promoting deeper and more robust financial systems – should become a key part of monitoring financial systems in the IMF’s surveillance process. Assessments aim to identify the strengths, risks and vulnerabilities in a financial system, and the links between the financial sector and the macroeconomy; ascertain development needs; and help national authorities to design appropriate policy responses. The Board

⁵⁶: The IMFC’s communiqué can be found at www.imf.org/external/np/cm/2001/010429b.htm.

Table 18: ROSC modules completed and published by 31 May 2001

	Total completed	Total published
Data Dissemination	13	11
Fiscal Transparency	27	26
Monetary and Financial Policy Transparency	24	14
Banking Supervision	24	14
Insurance Regulation	8	5
Securities Market Regulation	8	5
Payments Systems	6	5
Corporate Governance	6	5

Source: IMF, World Bank and Bank estimates.

decided to permit voluntary publication by national authorities of the detailed Reports on the Observance of Standards and Codes (ROSCs) included in FSAP reports and also of the Financial System Stability Assessments derived from the FSAP exercise (which address issues relevant to IMF surveillance, including risks to macroeconomic stability stemming from the financial sector and the capacity of the sector to absorb macroeconomic shocks). The IMF and the World Bank are aiming to complete up to 30 assessments per year. The United Kingdom will itself be the subject of an FSAP in 2002.

In addition to the ROSCs prepared as part of the FSAP process, the IMF and the World Bank are producing ROSCs on other key standards. By end-May 2001, some 116 had been completed and 85 published on the IMF and World Bank websites⁵⁷ (Table 18).

Standards, codes and good practice guidelines

As discussed in the December *Review*⁵⁸, the international community has embarked on a programme of developing standards and codes covering a number of areas of economic and financial policy⁵⁹. Implementing these standards (see above) should help to increase policy transparency and improve institutional and market infrastructure, thereby encouraging less crisis-prone financial systems.

IMF/World Bank public debt guidelines

On 21 March 2001, the IMF and the World Bank published joint Guidelines for Public Debt Management⁶⁰ covering both

⁵⁷: www.imf.org/external/np/rosc/index.htm and www.worldbank.org/ifa/rosc.html.

⁵⁸: Clark, T A and Drage, J (2000) 'International standards and codes', *Bank of England Financial Stability Review*, December.

⁵⁹: A compendium of these standards and codes is available at www.fsforum.org/Standards/Home.html.

⁶⁰: These can be found at www.imf.org/external/np/mae/pdebt/2000/eng/intro.htm.

domestic and external public debt as well as contingent liabilities. Against a background of weak national balance sheet structures contributing to recent country crises, effective implementation of the guidelines could, by improving debt management policies, help to strengthen a country's ability to withstand internal and external shocks.

Good practice guidelines for foreign exchange trading

A new set of good practice guidelines for foreign exchange trading, agreed by 16 major commercial and investment banks, was launched on 22 February, following a recommendation made (in April 2000) by the Financial Stability Forum Working Group on Highly Leveraged Institutions. The trading principles are to be incorporated in the collaborating banks' codes of conduct and have been endorsed by the bodies responsible for foreign exchange market standards in the main financial centres. The principles include: heightened emphasis on market risk and credit management issues during times of volatility; standards for best execution (of orders) for the customer; guidelines for handling suspected false information; and outlawing of manipulative practices and exploitation of electronic dealing systems to generate artificial price behaviour. These principles should help to promote orderly conditions in the foreign exchange market and, in particular, are intended to protect emerging market economy currencies from alleged abusive behaviour.

Standards of risk management controls for central counterparties

In February 2001, the European Association for Central Counterparty Clearing Houses (EACH), an association of some 16 European central counterparties (CCPs) formed in 1991, published standards of risk management controls for CCPs. EACH will not police the standards but supports disclosure of risk controls. The standards cover membership requirements, margining and financial resources. The Bank welcomes this initiative given the importance of CCPs being able to manage the financial, legal and operational risks they incur.

Core principles for systemically important payment systems

The Basel Committee on Payment and Settlement Systems' (CPSS) principles governing the design and operation of systemically important payment systems were approved by the central bank Governors of the Group of Ten (G10) countries in January 2001⁶¹. Central banks world-wide, including the Bank of England, have adopted the Core Principles as a guide for the development and oversight of payment systems. A corresponding initiative in the field of securities settlement is at the consultation stage and will be covered in subsequent *Reviews*.

⁶¹: 'Core Principles for Systemically Important Payment Systems: Report of the Task Force on Payment System Principles and Practices', Bank for International Settlements, January 2001 (www.bis.org). Also see Sawyer, D and Trundle, J (2000) 'Core Principles for Systemically Important Payment Systems', *Bank of England Financial Stability Review*, June.

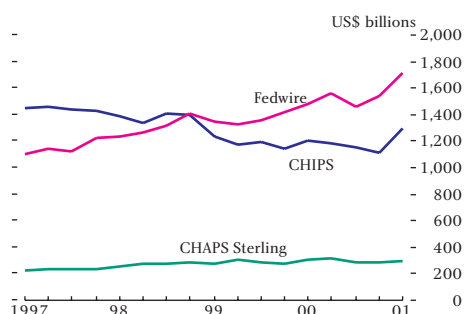
Developments in market infrastructure

As well as the development of ‘principles’ covering various parts of the payments and settlements infrastructure, there have been some important recent developments in systems themselves.

CHIPS finality

On 22 January 2001, the Clearing House Inter-Bank Payments System (CHIPS), the US dollar payment system operated by the New York Clearing House, moved from traditional, net end-of-day settlement to a process involving repeated settlements, throughout the day, of batches of bilaterally and multilaterally offsetting payments. One key objective, potentially significant for financial stability, is to minimise the liquidity impact of a member default by providing intraday finality of CHIPS payments, but without the liquidity ‘cost’ of real-time gross settlement (RTGS). Thus, the economic benefit of netting is preserved, whilst avoiding the uncertainties which end-of-day net settlement may produce.

Chart 169:
CHIPS, Fedwire and CHAPS transactions^(a)



Sources: New York Clearing House, Board of Governors of the Federal Reserve System and APACS.

(a) Quarterly, average daily value.

CHIPS’ previous settlement arrangements, post 1990, were supported by collateral held to assure end-of-day settlement in the event of the largest net debtor (or two largest since 1997) being unable to settle in a timely fashion. In the new system, participants prefund their CHIPS accounts and an algorithm searches for transactions, the net settlement of which can be accommodated using funds on account. To facilitate this, CHIPCo maintains an account on the books of the Federal Reserve Bank of New York. The prefunded amounts average less than US\$2 billion per day, against gross payments averaging US\$1.2 trillion (Chart 169). Amounts still unsettled at the end of the day are settled on a multilateral net basis, provided participants in a debit position send the necessary additional funds to CHIPS.

Spread of use of central counterparties in major markets

The introduction of a CCP to a market enables *multilateral netting of exposures* (which typically reduces the scale of the exposures) and of *settlement obligations*⁶². This may help cushion the impact of a default if the risks initially concentrated on a CCP are mitigated effectively through margin or dispersed through a default fund or insurance arrangements. As CCPs expand their activities, it is vital that they have the means and incentive to manage the risks they incur effectively.

Recently, a consortium of banks (OTCderivNet) reached agreement with the London Clearing House (LCH) to provide strategic direction and funding for the development of LCH’s SwapClear product (central clearing of swaps trades). On 14 March, LCH announced that an initial tranche of

⁶²: Central counterparties are discussed in more detail in Hills, B, Rule, D, Parkinson, S and Young, C (1999), ‘Central counterparty clearing houses and financial stability’, *Bank of England Financial Stability Review*, June.

4,250 existing swaps trades (with a notional principal in excess of US\$250 billion) involving the then eight banks in the consortium had been entered into SwapClear. Four more banks joined on 4 April. SwapClear may come to form a significant part of LCH's clearing activities, with significant implications for the value of transactions it clears and so for the risks it bears and redistributes.

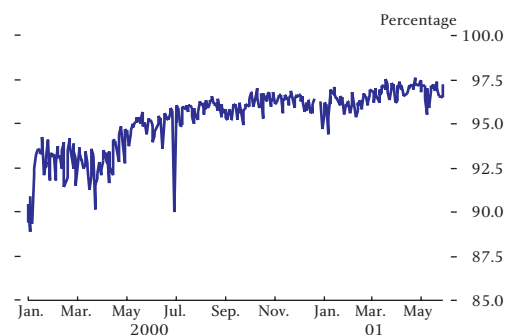
The launch on 26 February of EquityClear, the LCH service for the London Stock Exchange (LSE), is similarly important for UK domestic markets. It covers trades on SETS (the Stock Exchange Electronic Trading Service) and SEAQ (the Stock Exchange Automated Quotation) auctions. Many market participants see its main advantage as the facilitation of settlement netting, which is expected next year.

Reductions in settlement cycles

The gap between trade and settlement is one reason why the failure of a large participant could destabilise securities markets, particularly in volatile conditions. Shortening this gap shortens exposure to counterparty default and reduces the probability of having to replace a trade, potentially at a price disadvantage. Risk is reduced overall, however, only if the incidence of settlement failure does not rise.

The standard settlement period for trades in equities and corporate debt conducted on the LSE, the Irish Stock Exchange and Tradepoint moved from T+5 to T+3 (settlement three business days after trade date) on 5 February 2001. This brings the United Kingdom into line with what is seen increasingly as a minimum standard for developed financial systems (a 1989 report by the Group of Thirty⁶³, a private sector group concerned with the working of the international financial system, recommended T+3 for equity settlement by 1992). Both the LSE and CREST, the settlement system for UK equities, corporate bonds and gilts, reported a smooth transition, with no material rise in settlement fails (Chart 170). The United States still plans to move to T+1, although the Securities and Exchange Commission recently moved the target date from 2002 to 2004 in recognition of the work required.

Chart 170:
CREST deliveries settled on due date



Source: CRESTCo.

Regulatory and legal developments

Authorities and participants are collaborating to improve both the effectiveness of regulation and the certainty and clarity of the legal framework, especially cross-border.

Basel Capital Accord

The Basel Capital Accord proposals⁶⁴ are a prime example. Their main aim is to align regulatory capital more closely with the

⁶³: 'Clearance and Settlement Systems in the World's Securities Markets', Group of Thirty, March 1989.

⁶⁴: 'Consultative package on the Basel Accord', Bank for International Settlements, January 2001. An article summarising the proposals 'Bank capital standards: the new Basel Accord' by Patricia Jackson, appeared in the Spring 2001 *Bank of England Quarterly Bulletin*.

underlying risks than in the 1988 Accord. The Basel Committee on Banking Supervision (BCBS) is expected to release the final version of the new Accord by the end of 2001 for implementation in 2004, so it is too early to analyse any impact on banks' behaviour.

EU Directive on winding-up credit institutions

Effective crisis management requires an effective framework for insolvency proceedings, not least because that affects incentives during any pre-insolvency negotiations. It is therefore welcome that, 16 years after first being proposed, the EU Directive of 4 April 2001 on the reorganisation and compulsory winding-up of credit institutions (banks) has completed its legislative passage. Currently, if a bank with branches across Europe has to be wound up, the authorities in each Member State where the bank is represented can open separate insolvency proceedings. This can lead to conflicts of jurisdiction and unequal treatment of creditors. There can also be divergent approaches if a bank has to be reorganised. Under the Directive, the winding-up process will be subject to a single bankruptcy proceeding initiated in the Member State where the bank has its registered office and governed by that home state's bankruptcy law. This should ensure a clearly established procedure, equally valid for all creditors, for the division of assets. A parallel EU measure for the reorganisation and winding-up of insurance undertakings was finalised in March.

The need for workable insolvency procedures was highlighted by the Asian crises. The World Bank, working with a number of international organisations and insolvency experts, has developed a draft set of Principles and Guidelines for Effective Insolvency and Creditor Rights Systems, on which it is seeking feedback. It has also developed a 'diagnostic template' for conducting insolvency assessments and plans to produce ROSC modules (see above) in respect of the insolvency regimes of six to eight countries during the coming year.

EU requirement for use of International Accounting Standards

Several recent developments aim to promote transparency of risk and risk management which, by aiding pricing, should, in the longer term, help to make markets more resilient to shocks. For example, on 13 February the European Commission proposed a Regulation that would require all EU listed companies on a regulated market to prepare consolidated accounts in accordance with International Accounting Standards (IAS) by 2005. The Regulation is a priority under the Commission's Financial Services Action Plan, which aims to create a fully integrated single market in financial services.

Draft EU Collateral Directive

On 27 March 2001, the European Commission proposed a Directive that would create a uniform EU legal framework for the

provision of securities and cash as collateral. To date, the 1998 Settlement Finality Directive is the only piece of European legislation protecting cross-border provision of collateral in the context of financial transactions⁶⁵. Relevant national rules are often inconsistent, resulting in uncertainty about the enforceability of collateral. The creation of a clear, uniform, pan-EU legal framework should contribute both to the efficiency and stability of the EU financial system. The proposal is another Financial Services Action Plan priority.

US Commodity Futures Modernization Act

Progress was made in a similar area in the United States on 15 December 2000, when Congress passed the Commodity Futures Modernization Act. The main benefit for financial stability will come from provisions, based on recommendations made in a 1999 President's Working Group report, which give legal certainty that swap transactions will continue to be enforceable in accordance with their terms. Given the size of swap markets, this development is very welcome.

Highly leveraged institutions

Following the 1998 turmoil in financial markets, legislation was introduced in the US Congress to require US hedge funds with net assets of more than US\$1 billion, to publish quarterly risk reports. Since the December *Review*, the US Congress has voted down the proposal and has decided not to proceed with the hedge fund disclosure legislation. This probably reduces the chances of similar measures being introduced elsewhere.

Electronic transfer of title in CREST

Currently, there is a short lag between settlement of transactions through CREST and the updating of registers to confer full legal title. This lag introduces a low likelihood, but potentially high impact risk of intervention by a Court between settlement and registration. On 23 February 2001, HM Treasury published a consultation document⁶⁶ including draft new Uncertificated Securities Regulations intended to replace the 1995 Regulations which set up the legal structure for CREST. The planned new Regulations, expected to be passed through Parliament later this year, will implement Electronic Transfer of Title, removing the lag between settlement and registration, so that transfers through CREST immediately convey full legal title to securities.

Abolition of Minimum Funding Requirement for UK pension funds

On 7 March 2001, the Chancellor of the Exchequer announced that the Minimum Funding Requirement (MFR) for pension funds would be abolished. This followed concerns that the MFR

⁶⁵: The June 1999 *Review* described the preparations to implement the EU Settlement Finality Directive.

⁶⁶: 'Modernising Securities Settlement: A proposal for consultation' HM Treasury, February 2001 (www.hm-treasury.gov.uk).

had distorted pension schemes' investment decisions⁶⁷ and adversely affected gilt market liquidity, which is a key medium for the risk management of financial intermediaries. The Government plans to legislate to replace the MFR with, *inter alia*, a 'long-term scheme-specific funding standard'. The Department for Work and Pensions is consulting the pensions industry and other interested parties. Abolition of the MFR is likely to affect investment patterns and liquidity and, hence, risk distribution. It may reduce demand for gilts from pension funds and encourage them to invest in a wider range of assets, including non-government sterling bonds; the full effects will probably not be felt until the MFR is replaced. Of course, the MFR was not the only influence on pension fund investment in the gilt market. The increasing maturity of fund liabilities, relatively price-insensitive demand from insurance companies wishing to hedge guaranteed annuity embedded option liabilities, and declining gilt supply have also been important factors.

Financial Reporting Standard 17

Although abolishing the MFR should extend the scope for portfolio diversification, increases might be limited by Financial Reporting Standard (FRS) 17 on the treatment of pensions and retirement benefits (published by the Accounting Standards Board in November 2000). FRS 17 will not be applied until June 2003 so the full effects might not be felt for some time, but disclosures will be required in the notes to accounts from June 2001. The standard aims to make pension costs in company accounts more transparent and, in so doing, may make reported company net worth more volatile. Deficits and (recoverable) surpluses arising on defined benefit schemes are treated as assets and liabilities for the sponsoring company and reflected on its balance sheet. Substantial surpluses and deficits can arise because the value of scheme assets could fluctuate more than liabilities. Any pension scheme deficits will have to be deducted from 'distributable reserves', lowering dividend cover and possibly forcing a company to pass on, or lower, dividends. Key issues are how investors would react, and what knock-on effects there might be on company behaviour. If investors reacted unfavourably, some companies might aim to reduce variability in pension fund valuations by ensuring pension schemes invest in low-risk bonds. There is potential, therefore, for FRS 17 to affect asset allocation and, conceivably, market dynamics.

⁶⁷: For a description of the effects of the MFR on pension fund behaviour and bond yields, see the November 1999 *Review*, p. 87, and the November 2000 *Bank of England Quarterly Bulletin*, p. 334.

