BANK OF ENGLAND

News release

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Global pipes – challenges for systemic financial infrastructure

In a speech at the Official Monetary and Financial Institutions Forum on Wednesday, Sir Jon Cunliffe examines three challenges facing international financial market infrastructure: operational risk, in particular cyber risk; prudential risk, and the regulation and supervision of cross-border infrastructure.

On this last point, Jon cautions against the view that financial stability can only be managed if all transactions and trades directed through central counterparties (CCPs) in a jurisdiction's currency are kept within the borders of that currency.

"There may of course be trade or industrial policy reason to such an approach. And there can also be broader political considerations. We cannot ignore the fact that such incentives may be at play – now or in the future. But a policy of "currency nationalism" is not a necessary condition for either financial or indeed monetary stability – as is demonstrated by international experience in relation to financial market infrastructure over recent decades. Such a policy, if applied by all jurisdictions, is in the end likely to be a road to the splintering of this global infrastructure – and to further fragmentation of the global capital market – rather than the route to the sound and efficient management of risk."

Jon observes that many financial products are multi-currency by their nature. For example, LCH Ltd. provides central clearing within a single pool for interest rate contracts in multiple currencies for financial market participants worldwide. The single pool allows opposing interest rate exposures in different currencies to be partially offset against each other. This reduces the cost of central clearing – which is ultimately borne by the real economy - as well as allowing a more efficient and effective management of the risks that brings significant global financial stability benefits.

"Requiring each of these instruments to be cleared in the jurisdiction of the currency in which they are denominated would render multi-currency central-clearing impossible," Jon notes.
"In central clearing, in settlement, in payments if we wish to maintain the infrastructure to sustain an open and integrated global capital market, we will need to build upon the arrangements we have developed for supervisory cooperation and co-ordination."

“And because they are in essence global, we will have to find co-operative ways to manage the changing risks they present in order to maintain the benefits that they provide.”

“These are not insignificant challenges. But the history of the development of this infrastructure is one of both private and public sector co-operation to provide international plumbing that is both efficient and safe.”

Turning to operational risk, Jon notes that this is the “number one” risk for most FMIs. A serious operational incident affecting one firm is likely to have an impact on the system as a whole in several jurisdictions, rather than just upon the firm itself. Moreover, as the infrastructure that supports the financial system grows in scale, complexity and inter-connectedness, the potential risks and costs of systemic operational risks increase as well.

“To successfully mitigate this requires a focus on both operational risk and operational resilience; the ability to respond and recover, as well as prevent and protect. This is well highlighted by the risk presented by cyber-attack.”

The Bank of Bangladesh incident last year in which $81 million of fraudulent payments were effected through the SWIFT network, brought to the forefront the need to manage cyber risk not only in the infrastructure firm itself, but also in its surrounding ecosystem of users and intermediaries, Jon says.

The attack risked undermining the credibility of a key piece of global financial infrastructure, and it highlighted the growing risk from cyber attacks generally. It also showed why, given the critical nature of the services provided by SWFT, effective international coordination in its oversight is essential.

The general need for regulators and other financial stability authorities to give a high priority to operational risk and within that cyber risks has been well recognised. In the UK, the Financial Policy Committee formally recognised this risk to financial stability in June 2013, and improving resilience to cyber risk is one part of the Bank’s wider work on broader operational resilience.

“Operational resilience is not a technical issue, especially for the infrastructure firms that need to act as ‘systemic risk managers’. It must begin in the board-room. The Bank has worked with supervised firms to improve governance, so that standards can be maintained or strengthened, and threats responded to, without regulatory or supervisory pressure,” Jon says.

The second risk, prudential risk, arises mainly from central counterparties in the form of counterparty credit risk and liquidity risk. CCPs are, by their very objective, heavily exposed to the counterparty credit risk of their members, and the biggest risk they face is that the failure of their largest members would leave the CCP unable to meet its obligations to its other members. In order to ensure that CCPs do not transmit shocks under stress, CCPs hold collateral from their members in addition to default funds large enough to cover the default of their two largest members. And they are able to call for further resources from their members under their recovery plans if these funds are exhausted.

But Jon highlights three further prudential risk challenges for CCPs.

The first is to ensure that CCPs are prudent and require enough collateral or margin from their counterparties in good times so that they are protected in times of stress against movement in financial assets prices and in counterparty creditworthiness.

“CCPs need strong internal systems and controls to ensure that over time, commercial pressures and competition from other CCPs do not lead to inadequate margining. It is crucial to ensure that the models that drive CCPs margin requirements are robust, conservative and do not act pro-cyclically. This is an area that, as a supervisor, we look at closely.”

The second is to develop further the arrangements for the recovery and resolution of CCPs. This month the FSB published draft guidance on CCP resolution and resolution planning. This guidance will be finalised by the G20 meeting in July, with further investigation into the potential requirements for additional resources in resolution, which has been scheduled for 2018.

The third challenge is for CCPs to develop a culture of the “systemic risk manager” - responsible not just for managing the risks to the firm but also managing the risks to the system more broadly.

“CCP management, with encouragement from supervisors and regulators, have made significant progress in strengthening their governance and risk culture. But as the reforms are implemented, as greater use is made of CCPs and as they become more important as a systemic shock absorber, CCP’s management and boards will need to continue to up their game. And we will continue to hold them to account in doing so.”

Meanwhile, the increasing dependence on cross-border financial market infrastructure means that regulators and supervisors also need to continually up their game, according to Jon.

In regulation, CPMI-IOSCO is consulting on granular standards for CCP resilience covering governance, stress testing, coverage and margin as well as CCP recovery actions, with the aim of ensuring both higher standards and greater consistency between jurisdictions.

Jon also highlights the importance of authorities with responsibility for the supervision of FMIs being subject to independent evaluation and challenge.

Last year the IMF and CPMI-IOSCO published independent reviews of the Bank’s approach to supervision and how far it meets common minimum international standards, and today the Bank’s Independent Evaluation Office is publishing its review of the Bank’s supervision of financial market infrastructure firms.

The IEO evaluation concluded: *"Investments made by the Bank in recent years have had the desired effect. Our view is that the Bank is delivering effective, risk-based and forward-looking supervision in respect of FMIs."*

As globally systemic infrastructure evolves, the nature and strength of co-operative arrangements between supervisors will need to evolve to reflect the changing nature and scale of cross-border risks.

"The evidence so far, is that this can be achieved through shared incentives, dynamic common standards like the PFMI, the assurance provided by peer review and by the IMF - and through a degree of collective oversight and effective cooperation between supervisors and central banks," Jon concludes.

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