

## Chapter 2

# The role of Financial Market Infrastructures in Financial Stability: An Overview

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### ABSTRACT

*Financial Market Infrastructures (FMIs) are essential for the well-functioning of the financial system, as they play a central role in facilitating clearance and settlement of financial transactions such as payments, securities, and derivatives contracts. Nowadays, it is widely acknowledged that the proper functioning of systemically important FMIs is also vital to maintain financial stability; their failure for solvency reasons or operational disruptions could almost certainly lead to systemic instability. As a consequence, the adequate supervision of FMIs is inherent to the function of preserving financial stability. The aim of this chapter is to provide a general overview of the different FMIs; discuss their role in financial stability and to give an overview of the efforts made by some financial authorities towards the supervision, risk assessment and reinforcement of FMIs.*

### INTRODUCTION

Financial market infrastructures (FMIs) are essential in modern economies as they represent the platforms and interfaces through which financial operations are performed. In order to avoid threats to the stability of the system as a whole, their adequate supervision is of the utmost importance. The aim of this chapter is to provide a general overview of the different FMIs; discuss their role in financial stability

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by presenting specific cases, and to describe efforts made by some jurisdictions in the supervision, risk assessment and reinforcement of FMIs under the framework provided by the Principles for Financial Market Infrastructures (PFMIs).

It is important to state that although in this chapter we review the relationship between FMIs and financial stability and we focus more specifically on the risks that FMIs may pose to financial stability, FMIs were designed in the first place to provide and improve upon the stability of the financial system. In the absence of such key infrastructures, financial stability would be much more difficult.<sup>1</sup>

The reader will find many definitions of Financial Market Infrastructures (FMIs) in the current growing literature. Nevertheless, for the purpose of this chapter, it is enough to say that FMIs are composed of the organisations and entities in charge of the registration, clearing and settlement of financial transactions. Among them can be found: payment systems (PSs), central securities depositories (CSDs), securities settlement systems (SSSs), central counterparties (CCPs), and trade repositories (TRs).

This chapter turns on two important axes: the first is the rationale for the strong relationship between financial stability and the proper functioning of FMIs, including significant cases on the role played by FMIs in financial stability; the second axis provides the reader with a general view of the Principles for Financial Market Infrastructures (PFMIs), jointly issued by the Committee on Payment and Settlement Systems (CPSS) and the International Organisation of Securities Commissions (IOSCO).

### **Financial Stability, Systemic Risk and FMIs: Important Definitions**

In order to provide an ordered discussion on the role FMIs play in financial stability, we use this section to make some important definitions. For further details on some of the concepts introduced in this chapter, we refer the reader to the references mentioned throughout this section. The following are simple definitions for some FMIs as stated in CPSS-IOSCO (2013a):

- **Payment System.** Set of instruments, infrastructures, procedures, and rules for the transfer of funds between or among participants; the system includes the participants and the entity operating the arrangement.
- **Central Securities Depository.** Provides securities accounts, central safekeeping services, and asset services, which may include the administration of corporate actions and redemptions. This FMI plays an important role in helping to ensure the integrity of securities issues (that is, it ensures that securities are not accidentally or fraudulently created, destroyed, or have their features changed). A CSD can hold securities either in physical form (but immobilised) or in dematerialised form (that is, they exist only as electronic records).
- **Securities Settlement System.** Enables securities to be transferred and settled by book entry according to a set of predetermined multilateral rules. Such systems allow transfers of securities either free of payment or against payment.
- **Central Counterparties.** Interposes itself between counterparties to contracts traded in one or more financial markets, becoming the buyer to every seller and the seller to every buyer; therefore ensuring the performance of open contracts.
- **Trade Repository.** A trade repository is an entity that maintains a centralised electronic record (database) of transactional data.

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