Chapter 4
FMIs – Knights in Shining Armour?

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ABSTRACT

Great hope is being pinned on FMIs. They lie at the heart of the financial system and enable the post-trading business by successfully completing trades and concentrating as well as mitigating risks. This end of the payment and securities settlement business does not usually attract much attention: It is expected to be there and function. In this respect, it is comparable to oxygen in the air – most people do not think about it, however, if something is wrong with it, things can turn bad extremely quickly. Such was the case with the Lehman crisis of 2008, playing a major role in the unfolding of the global crisis of the late 2000s. It became apparent just how vital these FMIs were in enabling the continuation of the globe's securities & derivatives exchanges. In particular, CCPs played a major role in keeping transaction processing ticking over. It became evident which knock on effects the downturn of one institution can have on the global financial landscape. As such, we all depend on those markets and on the performance of what can only be described as 'knights in shining armour'.

Issue & Approach. Since the financial crisis, the role, composition and status quo of our 'knights in shining armour' has been intensively scrutinized from a regulatory and financial intermediary point of view. Despite the fact that FMIs operated well throughout the crisis, the unfolding events emphasized the need for more robust risk management. These needs together with the experience of implementing the existing international standards resulted in the Committee on Payment and Settlement Systems (CPSS) and the International Organization of Securities Commissions (IOSCO) reviewing and updating the standards for FMIs with the aim of strengthening core financial infrastructures and markets. (CPPS,

DOI: 10.4018/978-1-4666-8745-5.ch004

2012) This included technical infrastructure and a specialized risk management framework, appropriate to the risks they incur. These developments will lead to standardization of processes and risk management requirements. While the aforementioned measures are effectively increasing transparency and mitigating counterparty settlement risks, there are also potential adverse impacts stemming from mutualizing these processes – especially in the areas of liquidity and collateral. Risk tends to be like power – it is generally possible to convert it, but it is very hard to effectively eliminate it.

Structure. This chapter consists of four sections. The first section provides a short introduction to the different types of FMIs. The second section provides context and background regarding liquidity and collateral and explores the dynamics and power of FMIs as well as interdependencies among them. The third section outlines potential consequences for market participants with regards to liquidity and collateral as well as potential responses and enhanced product solutions for direct clearing members and third party access that will be essentially required in future. Finally, the fourth section provides a summary and conclusion of sections one to three.

INTRODUCTION TO FINANCIAL MARKET INFRASTRUCTURES

Types of Financial Market Infrastructures

FMIs are essentially the core of the financial payment and settlement ecosystem, either enabling the movement of cash and securities needed to settle transactions and/or intermediating exposures between market participants, thereby ensuring financial obligations are met. The fact that they help reduce and allocate inherent risks arising from transactions between market participants means they are an essential component in the functioning of the financial markets and wider economy (Rehlon, 2013).

In the past, clearing and settlement services were carried out through physical exchanges. Today it is a high-tech IT driven business. FMIs have had to adapt to those developments. To understand their increasing initial function within the financial market landscape globally, we need to have a look at each of them individually. The CPSS and IOSCO differentiate five types of FMIs: Payment Systems (PS), Securities Settlement Systems (SSS), Central Security Depositories (CSD), Central Counterparties (CCP) and Trade Repositories (TR).

Payment Systems

Concept. The PSs are of paramount importance for the smooth functioning of financial markets. A well-developed PS improves the interaction of markets and contributes to eliminating 'frictions in trade' (ECB, 2010). PSs are not accessible to everybody. Membership is governed by access criteria including minimum requirements to secure their robustness. Therefore, two basic access options exist: direct participation referring to full membership, or indirect participation making use of intermediaries (ECB, 2010).

Developments. Since the introduction of the PS there have been a multitude of developments. While in the early years these developments were more in the area of formats accepted and how the PSs could be accessed (including front ends), in recent years most large PSs have developed mechanisms and procedures that allow a more efficient payment processing. Such mechanisms include liquidity saving mechanisms, such as multilateral netting cycles.

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