

GENERAL APPLICATION  
PRINCIPLES OF  
COLLATERAL, GUARANTEE  
AND CREDIT MECHANISM  
FOR PAYMENT AND  
SECURITIES SETTLEMENT  
SYSTEMS

Payment Systems Department

Regulation and Oversight Division

## **GENERAL EXECUTION PRINCIPLES OF COLLATERAL, GUARANTEE AND CREDIT MECHANISM**

Smooth operation of payment and securities settlement systems (systems) are critically important for the stability of financial system, the conduct of central banks' monetary policy, and the development of economics. Spillover probability of any trouble, which can stem from the systems, to the other part of the financial system increases the vital importance of the systems with respect to the financial stability. In this context, it has great importance to manage these risks effectively and efficiently.

Despite to set up collateral, credit and guarantee mechanism is not a legal mandate, these mechanisms stand out as important instruments for the operators of the systems in order to manage their risk exposure properly, especially credit and liquidity risks. In case of using mechanisms mentioned above, principles and procedures that the system operators are required to comply with, are determined in detail in Article 23 of the Regulation on Operations of Payment and Securities Settlement Systems (Regulation on Operations) that entered into force by promulgation in the Official Gazette No. 29044, dated 28/06/2014.

Furthermore, among the main goals and policies of the Central Bank of the Republic of Turkey (CBRT) on Payment and Securities Settlement Systems there is the goal of ensuring that the system operators operate in line with the Principles for Financial Market Infrastructures (PFMIs) which was prepared by the Committee on Payment and Market Infrastructure (CPMI) and International Organization of Securities Commissions (IOSCO). The fifth principle of the PFMIs, entitled "Collateral", defines various execution principles.

In this context, system operators should comply with the principles stated below in case they set up collateral, credit or guarantee mechanism.

### **1. Collateral Mechanism**

Collateral mechanism is defined as a structure consisted of rules and procedures regarding the giving of eligible assets by system participants to the system operator as collateral to be used in the event of a default stemming from system participants; the management, terms of use, rules and procedures regarding collaterals, with the aim of ensuring the smooth functioning of systems.

### **2. Guarantee Mechanism**

Guarantee Mechanism is defined as a structure, built peculiar to system, to be used when operations in systems cannot be completed due to any reasons and incorporates assets suitable to the qualifications specified by system operator.

### **3. Credit Mechanism**

The other method that can be used for managing liquidity risks which may cause no settlement or late settlement of transactions in system, is building a special credit mechanism by the system operator to be used when a system participant has a liquidity shortage.

In the case of building a credit mechanism by the system operators, special attention is paid to collateralisation of credit facilities which are available to participants.

### **4. Objective and General Provisions**

The main objective of the above-mentioned mechanisms is to mitigate the risks that can occur regarding the smooth settlement of transactions in a system.

Within this context, it is expected that the mechanisms mentioned above are built in the normal course of business, the assets are collected when "everything is going well" and that these mechanisms and assets are in charge when a problem arises.

Accordingly, even though it is possible to collect assets in different amounts from participants depending on their financial situations, it is not practicable and consistent with these mechanisms that a system operator excludes a participant from these mechanisms and does not collect any assets from the participant just because it operates smoothly in the current situation.

The assets within the collateral mechanism are generally collected regarding the participant's own transactions in system and they are used in the event of the participant's default regarding this transaction.

However in a guarantee mechanism, a pool, which is composed of the assets collected from all participants in a fix or variable ratio which is determined depending on different conditions, is created and the assets in this pool are used when transactions in the system cannot be completed for any reason.

Within this context, especially in the systems which operate according to netting principle, usage of a guarantee mechanism to manage the risks arising from the participants default is a generally accepted application.

In a credit mechanism, a system operator provides liquidity facility peculiar to the system by using its own assets directly or by the support of a third party. In this mechanism, liquidity facilities are provided to participants in return for collateral and the main objective here is to help participants resolve their temporary liquidity shortage.

System operators may operate in different areas and their systems have different characteristics. Within this context, it is required that system characteristics, participants pattern and size of possible financial liabilities in a system are taken into account when a decision is being taken regarding whether a mechanism like mentioned above is built and for determining its characteristics and design is the

mechanism is built. The provisions of designating principles and procedures of collateral, credit and guarantee mechanisms by system operator in system rules and the Central Bank of the Republic of Turkey (CBRT)'s approval for coming into force are requirements that are set in Article 23 of Regulation on Operations.

#### **4.1. Determining the Amount of the Assets to be Collected**

While determining the level of assets that should be given by the system participants regarding collateral, credit and guarantee mechanisms, the system operator should take into account the sizes and probabilities of potential financial risks (caused by participants or other), participants' financial conditions and their credit scores in the system, operation principles of the system and its settlement cycle etc.

#### **4.2. Types and Valuation of Assets to be Collected**

The assets to be accepted as collateral should have low credit, liquidity, and market risks. Within this context, the assets consisting of Turkish Lira, foreign currency and governments bonds etc with low or zero risks can be accepted.

The types of assets that can be accepted from system participants should be clearly identified in system rules document (related rules and procedures).

The system operator is required to investigate legal, administrative and other risks thoroughly that can limit or hamper the use of assets collected according to the mechanisms mentioned above and not to accept inappropriate collateral assets.

The methods to be used in calculating the values of non-cash assets accepted by system operator according to the mechanisms mentioned above, should be clearly stated in system rules document. Within this concept, in order to determine today's value for assets collected from participants, system operator should establish prudential valuation practices, test them regularly and use haircuts that take in to account stressed market conditions.

In this context, system operator should take into account potential losses in value under abnormally stressed market conditions and developments in related markets when developing haircut ratios for each type of non-cash asset according to prudence principle and in order to reduce the need of procyclical adjustments.

System operator should monitor and assess whether there is a concentration on the basis of asset type.

#### **4.3. Use and Management of Assets**

It is prohibited to use the assets collected from system participants regarding collateral, credit and guarantee mechanisms apart from the main usage objective determined in system rules document.

In this context, the assets collected must be used with the aim of covering a loss when a risk arises while completing a settlement of transactions in a system.

As stated above, the assets regarding collateral mechanism are generally collected related to participant's own transactions in the system and are used in the event of participant default related to these transactions. However, provided that various conditions are met pursuant to the Operation Regulation, the collateral of the system participant may be used to realize the extra liability, by the system participant bearing a certain amount the liability of another participant which is determined by the system operator. The amount of extra liability to be beared in this context is limited to the amount of assets that the participant which undertakes this extra liability, keeps in collateral mechanism according to system rules. In addition, in the case of using an asset of a participant in order to meet an other participant's liability, system operator should take into account participants' financial conditions when determining the amount of extra liability. In the case that system operator accepts different types of assets from participants according to the mechanisms above, when a problem occurs in a system that requires the use of a mechanism, it is required that the assets collected by system operator are used starting from the most liquid one to the least liquid one for the same mechanism. This rule should also be clearly stated in system rules.

If a system contains a collateral, credit and guarantee mechanism at the same time, system operator should clearly define the existing mechanisms are used according to which method and which order.

On the other hand, infrastructure of collateral management is required to be configured to give backup and return opportunities in emergency situations.

#### **4.4.Reuse of assets**

In a case that a system operator uses any liquidity facility from the Central Bank of Turkey (CBRT) or a financial institution because of unmet liabilities in the system and when the operator has to give a collateral in order to use this liquidity facility, the operator can give the assets to CBRT or a financial institution as collateral, which are collected from participants as part of collateral, credit or guarantee mechanisms.

For such an application, system operator must get legal permissions from related parts regarding transfer of the assets to the institution providing liquidity.

#### **4.5. Gaining Benefit from the Assets**

Accumulation of interest (Gainig benefit) is permitted over cash assets that system participants give in scope of collateral, credit or guarantee mechanism.

In this case, the assets mentioned above should be invested in financial instruments with low credit, liquidity, and market risks and high liquidity.

It is required that the financial instruments to be in accumulation of interest are defined clearly in system rules document and are submitted for the approval of the CBRT.

#### **4.6. Segregation of Assets**

System operator should hold the assets, that participants gave in scope of collateral, credit or gurantee mechanism separately from system operator's own assets and from the collaterals of other customers.

In addition, an effective segregation arrangement should be established in order to monitor and manage all cash and non-cash assets.

#### **4.7. Margin call**

In case that assets given by participants are fully or partially used, system operator should establish rules and procedures in oder to regain these diminishing assets.

System operator should take into account market conditions and participants' financial conditions while regainig the diminishing assets.

***In the event that it is intended to establish a collateral, credit or guarantee mechanism within a sytem operator, the CBRT's examinations will be conducted in accordance with the provisions mentioned above and regarding the related legislation, not limited to these provisions.***