July 27th 2011

Ref: BNP Paribas Response to the "*CPSS-IOSCO Principles for Financial Market Infrastructures*" Consultative Report

General Comments:

1 – Market Infrastructures are Central to the Market

We welcome the conceptual clarity in which the Financial Market Infrastructures (FMI) are framed throughout the Consultative Report. The Report, despite its aim to encompass all systems worldwide, appears successful in being able to present a consistent and clear vision of what Market Infrastructure are and what they should be. *Inter allia*, the Consultative Report recognises in several occasions the following facts:

- Market Infrastructures are central to the market; hence:
- Their rules and procedures are common to all participants and they are public ; therefore these rules exclude bilateral relationships between financial institutions and their customers (p. 7)
- Without appropriate regulation, Market Infrastructures have the power to leverage their central position against their participants
- The immediate commercial interest of Market Infrastructures can lower their standards of risk management and thus potentially impact the whole market.

This clear conceptual framework translates into two important clarifications, which strengthen significantly the efficiency of the Principles as a regulation tool:

- The Operators of Market Infrastructures are included into the perimeter of the regulation covered by the Principles; thus the approach of the Principles is an efficient mix of functional approach (based on general definitions) but directly applying to corporate entities.
- The commercial banks, which do not operate any central system or function and have only bilateral and private relationships with their clients, are totally excluded from the scope of the principles[1].

[1] Following is an example of this clearer conceptual approach of the current Principles, compared to one of their predecessors, the "Recommendations on Securities Settlement Systems (RSSS)" (p. 8) : "*The definition of an SSS in this report is more narrow than the one used in the RSSS, which defined an SSS broadly to include the full set of institutional arrangements for confirmation, clearance, and settlement of securities trades, and safekeeping of securities across a securities market. For example, the RSSS definition for SSSs included CSDs and CCPs, as well as commercial bank functions involving securities transfers. In this report, CSDs and CCPs are treated as separate types of FMIs. As noted above, in many countries, CSDs also operate an SSS.*"

2 – Any rule on commercial banks should be clearly separated from the Principles

The Consultative Report states that, despite not having been reviewed nor included in the Principles for FMIs, the "Marketwide Recommendations" of the former sets of standard "remain in effect" (p. 6, par. 1.7). Indeed, the marketwide recommendations are not included in the Principles on Market Infrastructures; they are now listed in a separate annex.

It seems to us that this statement is counterproductive, since these "Marketwide Recommendations" ("*trade confirmation", "settlement cycle", "securities lending", "protection of customers securities*" *etc*) were partly responsible of the uncertainty regarding the scope of application which was inappropriately extending beyond the market infrastructures.

We would welcome a separate and comprehensive work of CPSS and IOSCO regarding regulation of participants to market infrastructures, but we want a clear delimitation between what belongs to infrastructure regulation and what belongs to market participants activity.

Suggested modification (p. 6):

1.7. A full reconsideration of the marketwide recommendations from the RSSS was not undertaken as part of this review. ~~Those recommendations remain in effect.~~ Specifically, RSSS recommendation 2 on trade confirmation, RSSS recommendation 3 on settlement cycles, RSSS recommendation 4 on central counterparties, RSSS recommendation 5 on securities lending, RSSS recommendation 6 on central securities depositories, and RSSS recommendation 12 on protection of customers' securities ~~remain in effect~~ do not apply specifically to FMIs and therefore should be part of a different set of standards. These recommendations are provided in annex C for reference. In addition to keeping RSSS recommendations 6 and 12, this report contains focused principles on the risk management of CSDs (see principle 11) and on the segregation and portability of assets and positions held by a CCP (see principle 14). The CPSS and Technical Committee of IOSCO may conduct a full review of the marketwide standards in the future.

3 – FMIs have to be stringently regulated and supervised; they should not be transformed into regulators themselves

A positive evolution integrated in the Consultative Report is that regulation on FMIs is necessary: it is clearly stated that market forces, alone, cannot do the job[2]. One of the main reasons is the conflict of interests that we had already listed, i.e.:

1/ the natural ability of Market Infrastructure, if not regulated, to leverage their central position against their participants if they want to expand into the non-infrastructures/commercial activities and

[2] "*Market forces alone will not necessarily achieve fully the public policy objectives of safety and efficiency*" (p. 11)

2/ the risk that the FMIs' goal to develop commercial activities can generate for the infrastructure and hence for the whole market place[3]

Considering these conflicts, we strongly oppose conferring regulatory and enlarged supervisory functions to FMIs which would go beyond their direct participants. This trend appears clearly especially in the Principle 19 ("Tiered participation arrangements"), and as well in the Principle 1 ("Legal basis"). The Principle 19 confers upon the FMI regulatory powers on the whole market participants, while Principle 1 create a new "rule book" for the whole market, in which the contracts and rules of the FMIs are put as the same level and bundled together with laws and regulations promulgated by the regulators. But the negative externalities, in term both of systemic risk and fair competition, of giving regulatory powers to the FMIs on the whole market, by far exceed the potential advantages.

Suggested modification (pp. 84 to 86): the entire principle should be taken out.

> ~~**Principle 19: Tiered participation arrangements**~~
> ~~**An FMI should, to the extent practicable, identify, understand, and manage the risks to it arising from tiered participation arrangements**~~
> ~~(...)~~
> ~~... participation requirements.~~

4 – <u>Contractual agreements cannot be part of FMIs' Legal basis</u>

FMIs can legitimately rule their relationship with their direct participants, provided that these rules would be <u>uniform</u> (common to the participants or to a class of participants), <u>publicly accessible</u> and <u>approved by the regulator</u>/supervisor. Contractual arrangements, which by principle are known only by the two parties of the contract and which differ from one contract to another, cannot be part of the Legal basis of a market infrastructure.

Suggested modifications (p. 19-20):

> Legal basis
> 3.1.2. The legal basis should provide a high degree of certainty for each aspect of an FMI's activities in all relevant jurisdictions. The legal basis consists of the legal framework and the FMI's rules~~,~~ and procedures~~, and contracts~~. The legal framework includes general laws and regulations that govern, among other things, property, contract, insolvency, corporations, banking, secured interests, and liability. In some cases, competition, consumer, and investor protection laws and regulations may also be relevant. (...)

[3] "*FMIs also concentrate risk. If not properly managed, FMIs can be also sources of financial shocks*" (p. 5)

5 - Principles are "minimum standards" to be propagated worldwide, however their goal is not to undermine efficient regulation on FMIs where it already exists

The Principles cannot justify to export/import less stringent rules and practices in countries which already benefits from higher risk management standards. In particular, for instance, while the Principles recommend to reduce to the maximum extent the credit risk taken by CSDs, especially by adopting DVP ("exchange of value settlement") and by realising the money settlement in central bank money, the fact that the Principles provide remedies to the situations where commercial bank money is used does not imply that future regulations based on the Principles should feel deemed to propagate this lesser desirable arrangement when the better one is already in practice.

Thus we hope that the application of the Principles will drive towards an upgrading of the global and individual safety of Market Infrastructures, and will not translate into a race to the bottom taking into account that some recommendations will appear less stringent in some markets than the existing organisation in place. This issue is of particular relevance in the context of the Markets infrastructures' interoperability: it remains indeed unclear if the compliance of linked infrastructures with the relevant dispositions disseminated throughout the Principles can be considered as sufficient to force national authorities to authorise such links.

6 – Towards a new global coordination

In this regard, we welcome very much the axis developed for the international cooperation between market authorities. In particular, the necessity, for market authorities, to justify to their peers their oversight and regulatory choices while applying the Principles is a positive evolution.

In particular, we feel confident that, soon to be established as global regulatory standards by the Financial Stability Board (FSB), the CPSS-IOSCO Principles will play an important role in strengthening and contributing to the development of market infrastructures in emerging financial markets. This consistent and complete set of Principles should indeed efficiently contribute to the propagation of good practices in emerging economies and foster global harmonisation.

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<u>Specific comments on the text and content of the Principles</u>:

<u>General organisation</u>

Principle 1: Legal basis

An FMI should have a well-founded, clear, transparent, and enforceable legal basis for each aspect of its activities in all relevant jurisdictions.

We have major concerns with the way the Principle 1 is considered in the report. For instance as it appears in the following excerpts:

"*The legal basis defines, or provides the foundation for relevant parties to define, <u>the rights and obligations of</u> the FMI, its participants, and, where relevant, <u>participants' customers</u>."*
(p.19, par 3.1.1)

"The legal basis consists of the legal framework and the <u>FMI's</u> rules, procedures, and <u>contracts</u>"
(p.19, par 3.1.2).

"One recommended approach to articulating the legal basis for each aspect of an FMI's activities is to obtain well-reasoned and <u>independent legal opinions</u> or analyses. A <u>legal opinion</u> or analysis, among other things, <u>should</u> identify and, where necessary, <u>interpret the laws and regulations</u> applicable to an FMI's operations and services."
(p. 20, par. 3.1.4)

A/ Our first main concern, (echoed by the Principle 19 on tiered participation), is the trend to establish FMIs (which are commercial entities) as regulators, not only of their direct participants but of the whole market. FMIs would therefore become even more than Self-Regulatory Organisation, by being able to regulate not only their direct participants but the customers of these ones and so on. The quote *supra* is one among many expressing this ability to push self-elaborated rules beyond their direct participants. The "legal basis", putting at the same level contracts of the FMI and the applicable laws and regulations (which themselves can be "interpreted" by the counsels of the FMI) give the possibility to FMIs to edict a "rule book" which applies beyond direct participants and it appears to give a too large interpretative margin to the FMIs.

Considering both the systemic importance of FMIs and their commercial interest to leverage their central position in the market in order to unfairly compete with their participants, we consider that FMIs should be submitted to stringent enforcement of specific regulation and that it should be avoided that FMI could exercise discretionary regulatory powers.

B/ The second concern comes with the introduction of contracts, and hence of contractual choice of law, in the "legal basis" of the FMIs, at the same level and bundled with the regulatory framework.

For systemic risk reasons, it should be stated clearly that the contractual choice of law cannot be an option for the determination of the law applicable to the system and for the proprietary aspects of securities held on a participant's account in the system.

The same law should be applicable to the FMIs and their participants. This would avoid introducing uncertainty (for the FMIs themselves, for their participants, and for the customers of their participants) by allowing different applicable laws to be chosen in the context of each different contractual relation the FMI could enter into. In case of financial stress, the need for the FMI and its participants to sort out the diverging applicable laws which would have been introduced by the contractual choice of law would certainly deepen the crisis and put the survival of the FMI itself at risk.

Additionally, the rules of the FMIs must be uniform (common to the participants or to a class of participants), publicly accessible and approved by the regulator/supervisor. Contractual arrangements, which by principle are known only by the two parts of the contract and which should differ for each counterpart, cannot be part of the Legal basis of a market infrastructure.

Suggested modifications (p. 19-20): contracts cannot part of the rule book of the FMI and cannot allow interpretations or introduce choice of the applicable legal framework.

Legal basis
3.1.2. The legal basis should provide a high degree of certainty for each aspect of an FMI's activities in all relevant jurisdictions. The legal basis consists of the legal framework and the FMI's rules~~,~~ and procedures~~, and contracts~~. The legal framework includes general laws and regulations that govern, among other things, property, contract, insolvency, corporations, banking, secured interests, and liability. In some cases, competition, consumer, and investor protection laws and regulations may also be relevant. (...) An FMI should establish rules~~,~~ and procedures~~, and contracts~~ that are consistent with the legal framework and provide a high degree of legal certainty.(...)

3.1.4. An FMI should be able to articulate its legal basis to relevant authorities, participants, and, where relevant, participants' customers, in a clear and understandable way. ~~One recommended approach to articulating the legal basis for each aspect of an FMI's activities is to obtain well-reasoned and independent legal opinions or analyses. A legal opinion or analysis, among other things, should identify and, where necessary, interpret the laws and regulations applicable to an FMI's operations and services. In addition, a~~An FMI should seek to ensure that its activities are consistent with the legal basis in all relevant jurisdictions. These jurisdictions could include (a) those where an FMI is conducting business (including through linked FMIs); (b) those where its participants are incorporated, located, or otherwise conducting business for the purposes of participation; (c) those where collateral is located or held~~; and (d) those indicated by any choice-of-law provisions in relevant contracts~~.

Principle 2: Governance

An FMI should have governance arrangements that are clear and transparent, promote the safety and efficiency of the FMI, and support the stability of the broader financial system, other relevant public interest considerations, and the objectives of relevant stakeholders.

We welcome especially the following paragraph (we underline):
"3.2.5. (...) <u>An FMI that is part of a larger organisation</u>, for example, should place particular emphasis on the clarity (including in relation to any conflicts of interest and outsourcing issues that may arise because of the parent or other affiliated organisation's structure) and adequacy of its own governance arrangements to ensure that decisions of affiliated organisations are not detrimental to the FMI. If an FMI is wholly owned or controlled by another entity, authorities should also review the governance arrangements of that entity to see that they do not have adverse effects on the FMI's observance of this principle. <u>In some cases where an FMI provides services that present a distinct risk profile from its primary function, the FMI may need to separate legally the additional services that it provides</u>. Similarly, a for-profit entity may need to place particular emphasis on the independence of its risk-management arrangements to manage any conflicts between income generation and resilience."

We indeed consider that segregation between the FMIs "infrastructure (core) services" and the commercial banking (ancillary) activities should be imposed, along the lines applied in other network industries.
In particular:
- Legal and functional unbundling between infrastructures services and commercial services: independence of legal form, organisation (operation and IT), decision making (management and board).
- Accounting separation based on costs and revenues.

For infrastructure services the following principles need to be enforced:
- Equal access to infrastructure services, equal treatment of users accessing these services (digressive fares may apply but no bilateral negotiations should take place, no "special deal").
- Transparency and clarity of governance rules, of pricing and of the conditions of service; all Infrastructure rules should be public and non-discriminatory.
- User oriented governance with fair representation of all types of users.

Suggested modification (p. 24):

3.2.5. (...) In some cases where an FMI provides services that present a distinct risk profile from its primary function, the FMI ~~may~~ need to separate legally the additional services that it provides. Similarly, a for-profit entity ~~may~~ need to place particular emphasis on the independence of its risk-management arrangements to manage any conflicts between income generation and resilience.

Principle 3: Framework for the comprehensive management of risks

An FMI should have a sound risk-management framework for comprehensively managing legal, credit, liquidity, operational, and other risks.

We are concerned by one perspective adopted in the report, as it can be seen in particular within the following excerpts, pp. 28-29 (we underline):

"*Key considerations*
(…) 2. An FMI should provide the incentives and, where relevant, the capacity to participants and their customers to manage and contain their risks.
3. An FMI should regularly review the material risks it bears from and poses to other entities (such as linked FMIs, settlement banks, liquidity providers, or service providers) as a result of interdependencies and develop appropriate risk-management tools to address these risks.
(…)
3.3.1. An FMI should take an integrated and comprehensive view of its risks, including the risks it bears from and poses to its participants and their customers, as well as the risks it bears from and poses to other entities, such as linked FMIs, settlement banks, liquidity providers, and service providers. (…)
3.3.5. In establishing risk-management policies, procedures, and systems, an FMI should provide the incentives for its participants and other interdependent entities to identify, measure, and manage their own risks."

However, the creation of "incentives" for market participants should be done by the regulatory authorities, not by FMIs. FMIs should indeed have a risk management system in place that allows them to efficiently fulfill their role in stabilising the market and mitigating systemic risk. However we are concerned by this regulatory function given to FMIs which goes beyond their direct participants. Once these "incentives" are adopted by the FMI and integrated to the "legal basis", their stringency will be *de facto* as solid as the one of the applicable regulatory framework itself.

Another concern relies with the lack of stringency of the report related with the risks imported in a FMI by interoperability arrangements. Interoperability arrangements need careful consideration on a case-by-case basis and should be strictly controlled, given the additional risks that they bring to the financial system.

Suggested modification (pp. 28-29):

Key considerations
(…) ~~2. An FMI should provide the incentives and, where relevant, the capacity to participants and their customers to manage and contain their risks.~~ (…)
Explanatory Note
3.3.1. An FMI should take an integrated and comprehensive view of its risks, including the risks it bears from and poses to its participants ~~and their customers~~, as well as the risks it bears from and poses to other entities, such as linked FMIs, settlement banks, liquidity providers, and service providers.
(…)
~~3.3.5. In establishing risk-management policies, procedures, and systems, an FMI should provide the incentives for its participants and other interdependent entities to identify, measure, and manage their own risks.~~

Credit and liquidity risk management

Principle 4 and 7: Credit and liquidity risks

Principle 4: Credit risk

An FMI should effectively measure, monitor, and manage its credit risk from participants and from its payment, clearing, and settlement processes. An FMI should maintain sufficient financial resources to cover its credit exposure to each participant fully with a high degree of confidence. A CCP should also maintain additional financial resources to cover a wide range of potential stress scenarios that should include, but not be limited to, the default of the [one/ two] participant[s] and [its/their] affiliates that would potentially cause the largest aggregate credit exposure[s] in extreme but plausible market conditions.

Principle 7: Liquidity risk

An FMI should effectively measure, monitor, and manage its liquidity risk. An FMI should maintain sufficient liquid resources to effect same-day and, where appropriate, intraday settlement of payment obligations with a high degree of confidence under a wide range of potential stress scenarios that should include, but not be limited to, the default of [one/two] participant[s] and [its/their] affiliates that would generate the largest aggregate liquidity need in extreme but plausible market conditions.

We strongly support CPSS-IOSCO's goal to ensure that FMIs effectively manage their credit risk. We have the following comments:

A/ First, Market Infrastructure should not assume more financial and credit risks than is necessary in their function as central providers.

For this concern, the recourse to Central Bank Money is the best available tool and should be generalised. Therefore we strongly support the recommendation to conduct money settlement in central bank money. If we can understand in theory the caveat of central bank money being "available" or not (especially if the central bank is not willing to provide such mean to a specific FMI); however we consider that the word "practical" could be misleading in giving the erroneous feeling that recurring to central bank money would depend on a convenience (commercial or organisational) of the FMI. The wording should either (preferably) disappear, either be reinforced by "practical" being replaced by "feasible in practice"

The main CCP function being counterparty risk management, strong credit risk management have indeed to be imposed. In particular, a CCP must have intraday access to Central Bank liquidity for its principal currency. The manners a CCP absorbs principal risk should be approved both by its users and the supervisors. The Principles therefore constitute a starting point, notwithstanding they are not stringent enough.

A CSD, in its infrastructure function, should not take any other risk than operational risk. The infrastructure function of CSDs is to centrally immobilise securities (there should therefore always be

only one CSD for each issuance of securities), to guarantee their existence and to centrally settle transactions by exchanging securities against cash. Operational risk is the only risk inherent to this infrastructure function. Credit and liquidity risks are not essential to the provision of the infrastructure function, and settlement in Central Bank Money is the best protection against risk concentration. Therefore risk generating services should be strictly ring-fenced (unbundling principles) to prevent any spill over risk to the CSD. In particular, a CSD should settle on DVP basis in Central Bank Money, and a CSD should not grant credit to its participants.

Suggested modification (p. 30 & 46):

Principle 4: Credit risk
An FMI should effectively measure, monitor, and manage its credit risk from participants and from its payment, clearing, and settlement processes. The recourse to Central Bank Money is the best available tool and should be generalised. CSDs should be ring-fenced from taking any credit risk. A~~n FMI~~ CCP should maintain sufficient financial resources to cover its credit exposure to each participant fully with a high degree of confidence. A CCP should also maintain additional financial resources to cover a wide range of potential stress scenarios that should include, but not be limited to, the default of the [one/ two] participant[s] and [its/their] affiliates that would potentially cause the largest aggregate credit exposure[s] in extreme but plausible market conditions.
(...)
Principle 7: Liquidity risk
An FMI should effectively measure, monitor, and manage its liquidity risk. . The recourse to Central Bank Money is the best available tool and should be generalised. CSDs should be ring-fenced from taking any liquidity risk. A~~n FMI~~ CCP should maintain sufficient liquid resources to effect same-day and, where ~~appropriate~~ possible, intraday settlement of payment obligations with a high degree of confidence under a wide range of potential stress scenarios that should include, but not be limited to, the default of [one/two] participant[s] and [its/their] affiliates that would generate the largest aggregate liquidity need in extreme but plausible market conditions.

B/ Second, while we support the introduction of specific minimum requirements (cover 1 or 2), it is important that such minimum requirements avoid the suggestion that a simple quantitative standard is a substitute for prudent risk management. Specifying compliance in such a way could also result in FMIs simply adopting the baseline without its own risk management committee and local regulator performing the requisite risk management and supervisory work respectively to determine the appropriate amount of coverage for its market.

We consider that it is far more important that a FMI's credit requirement is based on an assessment of the relevant risk factors such as the quality of the counterparties to a given FMI and the products serviced by the FMI. The relative importance of each criterion would vary depending upon the FMI. Such a risk sensitive assessment could show that even a cover two standard was inadequate for a particular FMI's credit risk. CCPs must engage their clearing members and their

respective regulators in seeking the appropriate coverage level, taking into consideration a variety of risk factors, including the price volatility of products cleared; their liquidation period and price transparency; the correlation of default probability amongst clearing members; the correlation of products cleared and collateral held; the concentration of positions at aggregate CCP level.

Additionally, given the Basel Committee proposal that "qualifying CCP" status depends on compliance with these CPSS-IOSCO principles, there is the risk that breach of a known number standard (either "cover one" or "cover two") could result in a sudden change in capital requirements. Such a sudden change gives rise to serious concerns about the settings among market participants and CCPs, and the potential disruption caused by the determination itself that the CCP is in breach.

C/ Thirdly, and importantly, we want to strongly underline that for a CCP, the quality of its membership criteria, and hence the financial strength of its clearing members is certainly its best protection, both as criteria for joining a CCP and as an ongoing process of monitoring of the members.

These financially sound clearing members then manage their own credit risk with their clients of lesser creditworthiness, which would be ring-fenced from the CCP by remaining indirect participants. While mandatory clearing is progressively enforced globally and will give raise to a progressive extension of the material scope covered, it is of the utmost importance that the quality of membership in CCPs is preserved, despite the commercial interest of the CCPs themselves.

Principle 5: Collateral

An FMI that requires collateral to manage its or its participants' credit risk should accept collateral with low credit, liquidity, and market risk. An FMI should also set and enforce appropriately conservative haircuts and concentration limits.

We support the key principles regarding collateral management, and in particular the necessity for a CCP to collect sufficient collateral to covers fully its participants open positions ; and, for this collateral to be, as far as possible, easily valuable in the event of liquidation and sufficiently acceptable to avoid credit, liquidity and market risks.

The ability for a CCP to be able to assess and value efficiently collateral is indeed crucial. Requiring too much or not enough collateral have distorting effects, either on the cost of using financial products or as a liquidity drain. This is all the more important in the context of the G20 action to send more flows towards CCPs.

There are for CCPs two obvious ways to compete: lowering initial margin, and accepting a wider range of collateral with lower haircuts. Both of these actions are undesirable. The CCP can easily become under-margined due to changes in the value of the collateral. The set of "eligible collateral" should be limited to containing assets with the following features: high credit quality; high liquidity; low volatility; and have low correlation with the exposure. Collateral with these features, along with minimum cash thresholds and concentration limits by instrument, would help ensure both adequate liquidity and loss coverage at the CCP in the event of a clearing member default.

Rehypothecation of non-cash collateral provided to an FMI should be prohibited as it would create additional types of risks, thus limiting the purpose of collateral as a means to reduce counterparty and market risks.

Securities collateral should be segregated and cash collateral should be held with the relevant central bank.

Principle 6: Margin

A CCP should cover its credit exposures to its participants for all products through an effective margin system that is risk-based and regularly reviewed.

We broadly support this Principle. Margin, especially initial margin, plays a crucial role in absorbing the losses a CCP might incur in liquidating the portfolio of a defaulting clearing member. Indeed, in a default context, the largest proportion of the financial resources available to the CCP will be initial margin and default funding. If initial margin is not sufficient to cover the losses from disposing of a clearing member's position, the CCP will turn first to the defaulting member's default fund and then to a combination of the CCP's own capital and the default funding provided by the other clearing members.

It is vital that CCPs be required to design default fund calculation processes in a manner that is both transparent and replicable by clearing members, so that the requirements resulting from client clearing activity are ascertainable in advance by market participants. In particular, it will be difficult for clearing members to provide scalable OTC clearing services if they are unable to ascertain funding costs and mutualised risk potential due to opaque default fund structures.

There must be regular CCP back-testing of its initial margin calculation; and periodic disclosure by the CCP to its clearing members and regulators of its back-testing methodology, its stress tests and results. The relevant local CCP supervisors as having responsibility for periodically reviewing the stress test methodology and, if appropriate, require changes. Self-certification of compliance with margin calculations is not adequate.

<u>**Settlement**</u>

Principle 8: Settlement finality

An FMI should provide clear and certain final settlement, at a minimum, by the end of the value date. Where necessary or preferable, an FMI should provide final settlement intraday or in real time.

Settlement Finality is a major component of systemic stability. Indeed, providing robust settlement finality is the keystone of the entire settlement process. The settlement process could be described as the following package of integrated steps: matching; settlement; finality (exchange cash vs securities, preferably DVP and with central bank money). Providing settlement finality ensures the certainty of the ability to dispose, for any possible purpose, of the cash and securities liberated by the finalisation

of the settlement of the trade. Imposing uncertainty on the finality of the settlement put the entire settlement at risk.

Regarding the issue of the links between CSDs, there should be only one system providing settlement finality for any transaction and it seems that this issue is not addressed in the Report.

The circulation of conditional finality throughout linked systems is the most dramatic way to propagate systemic risk, by submitting all participants of several domestic markets to unexpected unwinding of settlement with systemic domino effects.

Suggested modification (p. 54): (added "Key consideration" 6)

> Key considerations (...)
> *6. In case of links between CSDs, there should be only one SSS providing settlement finality for any transaction.*

Principle 9: Money settlements

> An FMI should conduct its money settlements in central bank money where practical and available. If central bank money is not used, an FMI should minimise and strictly control the credit and liquidity risk arising from the use of commercial bank money.

We strongly support the recommendation to conduct money settlement in central bank money.

We can understand the caveat of central bank money being "available" or not (especially if the central bank is not willing to provide such mean to a specific FMI); however we consider that the word "practical" could be misleading in giving the erroneous feeling that recurring to central bank money would depend on a convenience (commercial or organisational) of the FMI. The wording should either (preferrably) disappear, either be reinforced by "practical" being replaced by "feasible in practice"

"Settlement on the books of a FMI" (p 56 par 3.9.6): considering the systemic risks that such an organisational scheme brings to the market place, we definitely consider that the wording of this paragraph totally lacks of stringency. The suggested remedies does not seem to bring much safety either.

Suggested modification (p. 54):

> **Principle 9: Money settlements**
> **An FMI should systematically conduct its money settlements in central bank money where ~~practical and~~ available and feasible in practice. If central bank money ~~is~~ cannot be used, an FMI ~~should~~ must minimise and strictly control the credit and liquidity risk arising from the use of commercial bank money.**

Key considerations

1. An FMI should conduct its money settlements in central bank money, where ~~practical and~~ available and feasible in practice, to avoid credit and liquidity risks.
2. If central bank money ~~is~~ cannot be used, an FMI should conduct its money settlements using a settlement asset with little or no credit or liquidity risk.

(...)

5. FMIs should not conduct money settlement on its own books. If an FMI conducts money settlements on its own books, it should minimise and strictly control its credit and liquidity risks.

<u>Central securities depositories and exchange-of-value settlement systems</u>

Principle 11: Central securities depositories

A CSD should have appropriate rules and procedures to help ensure the integrity of securities issues and minimise and manage the risks associated with the safekeeping and transfer of securities. A CSD should maintain securities in an immobilised or dematerialised form for their transfer by book entry.

A/ The definition of CSDs(p. 8 par 1.11) is still disappointing. The primary role of CSDs, "central banks for securities" is indeed not to "hold" (or to maintain) securities accounts (as would do a banking intermediary) but to be the main entity in charge of ensuring the integrity of an issue by ensuring the reconciliation between on one side the issued securities deposited in the issuer account (either at registrars or at the CSD level) and on the other side the securities in circulation. The CSD is indeed the keystone of the integrity of the issuance of securities (even when this function is exercised taking into account the existence of registrars).

Suggested modification (p. 8):

Central securities depositories

1.11. A central securities depository ~~holds maintains securities accounts~~ is the main entity in charge of maintaining the integrity of an issue by ensuring the reconciliation between on one side the issued securities deposited in the issuer account (either at registrars or at the CSD level) and on the other side the securities in circulation ~~and, i~~In many countries, a CSD operates as well a securities settlement system (as defined in paragraph 1.12). ~~A CSD also provides central safekeeping and asset services, which may include the administration of corporate actions and redemptions, and plays an important role in helping to ensure the integrity of securities issues (that is, securities are not accidentally or fraudulently created or destroyed or their details changed). A CSD can hold maintain securities either in physical form (but immobilised) or in dematerialised form (that is, they exist only as electronic records). The precise activities of a CSD vary based on jurisdiction and market practices. For example, the activities of a CSD may vary depending on whether it operates in a jurisdiction with a direct or indirect holding arrangement or a combination of both.A CSD may maintain the definitive record of legal ownership for a security; in some cases, however, a separate securities registrar will serve this notary function.~~

B/ Would a CSD decide to perform other services that could bear credit or liquidity risk, the provision of these services should be clearly disconnected and segregated from the provision of core services and be subject to a separate (usually banking) license and to the related (usually prudential) rules, in particular for the authorisation and supervision.

We therefore share the view of CPSS-IOSCO that a CSD need to separate legally the other high-risk activities its operator may perform alongside the CSD core functions. we believe that, between the market infrastructure's role and the higher-risk other services (quite often banking-type services) it may perform as a distinct commercial entity (often in competition with the participants of the CSD), a clear ring fencing is essential in order to prevent that the credit or liquidity risks associated to these separate commercial activities spills over into the core functions of a CSD, bringing systemic risk to the market.

C/ While the Principles recommend to reduce to the maximum extent the credit risk taken by CSDs, **especially by realising the money settlement in central bank money** and by adopting DVP ("exchange of value settlement"), the fact that the Principles provide remedies to the situations where commercial bank money is used should not however imply that future regulations based on the Principles should feel deemed to propagate this lesser desirable arrangement when the better one is already in practice.

The remedies suggested in the Report in order to alleviate the credit risks in cases of use of commercial bank money are disappointing as well. The central and systemic role of CSDs is reinforced by the fact that, most of the time (as underlined by the report), a CSD operates a central settlement platform (SSS). This makes the exposure of a CSD to credit risk especially undesirable: the systemic risk is maximal in case of settlement in the books of the CSD. Unfortunately, the Report does not address the necessary ring-fencing of the infrastructure from these risks by any specific disposition and it appears definitely lacking stringency in its recommendations.

Default management

Principle 13: Participant-default rules and procedures

> An FMI should have effective and clearly defined rules and procedures to manage a participant default that ensure that the FMI can take timely action to contain losses and liquidity pressures, and continue to meet its obligations.

As a general principle, it is important to note that the imposition of unlimited or unquantifiable liability on the part of clearing members may exacerbate systemic risks significantly and should be prohibited.

CCPs should have detailed default plans and test them regularly in order to demonstrate the time in which the relevant portfolio of assets can be liquidated. Results of these tests should feed into the CCP's initial margin methodology.

Regulators should have view of, and sign off on the default management plan and tests.

An FMI is expected to remain vigilant on the financial condition of its participants and, in that regard, it should promptly inform the competent authority where it considers that a participant may default. Early warning should permit a timelier handling of potential conflicts between the interests of the infrastructure and the interests of the market as a whole.

Principle 14: Segregation and portability

> A CCP should have rules and procedures that enable the segregation and portability of positions and collateral belonging to customers of a participant.

We agree that the segregation of indirect participants' positions and collateral plays an important part in the safe and effective holding and transfer of their assets. Effective segregation arrangements can reduce the impact of a participant's insolvency on its customers. Therefore, we support that CCPs have rules that protect indirect participants' positions and collateral to the largest possible extent.

However, we consider that under the proposed Principle 14 on segregation and portability, segregation should not be a universal requirement, i.e the level of segregation should be chosen by the client (a thus a CCP should be able to offer different options as to the level of segregation a client want). It is important for CCPs and their regulators to consider the different risk profiles and requirements for the clearing of different instruments, and that this concept of considering different instruments should be worked into the principles.

When arranged at the request of the participant, acting on behalf of its customer, segregation should be conditional on a specific instruction of the latter to make use of this facility and the provision of sufficient details in the trade instruction to the CCP to identify the underlying customer.

We believe that it is the general clearing member, not the CCP, that must maintain the customer records. CCPs are not in a position to obtain or maintain this data; the client relationship is between the CCP participant and his client.

General business and operational risk management

Principle 15: General business risk

> An FMI should identify, monitor, and manage its general business risk and hold sufficiently liquid net assets funded by equity to cover potential general business losses so that it can continue providing services as a going concern. This amount should at all times be sufficient to ensure an orderly wind-down or reorganisation of the FMI's critical operations and services over an appropriate time period.

An FMI should hold substantial equity capital sufficient to cover its operating costs and likely exit costs during its own liquidation. In case of CCPs, its capital should be separate from any CCP equity contribution to the required default resources. Thus, if defaults exhaust a CCP's default-related resources and the CCP is unable or unwilling to recapitalize itself on a timely basis, then it must in addition have sufficient resources to permit an orderly wind-down of its business.

Principle 16: Custody and investment risk

An FMI should safeguard its assets and minimise the risk of loss or delay in access to those assets, including assets posted by its participants. An FMI's investments should be in instruments with minimal credit, market, and liquidity risks.

It should be clear that investment of collateral provided to the FMI should be prohibited. Collateral serves the limitation of market risk and counterparty risk. Investment of collateral implies other types of risk, which limit the very purpose of collateral. The Principle should focus on the fact that securities collateral should be held segregated and cash collateral should be held with the relevant Central Bank.

Suggested modification (p. 74):

Principle 16: Custody and investment risk
An FMI should safeguard its assets and minimise the risk of loss or delay in access to those assets, including assets posted by its participants. An FMI's investments should be in instruments with minimal credit, market, and liquidity risks. Investment of collateral provided to the FMI should be prohibited.

Principle 17: Operational risk

An FMI should identify all plausible sources of operational risk, both internal and external, and minimise their impact through the deployment of appropriate systems, controls, and procedures. Systems should ensure a high degree of security and operational reliability, and have adequate, scalable capacity. Business continuity plans should aim for timely recovery of operations and fulfilment of the FMI's obligations, including in the event of a wide-scale disruption.

We support the principle that an FMI should establish a robust operational risk-management framework that should allow complete and rapid identification, monitoring, management and prevention of operational risk. Appropriate systems, policies, procedures and controls to minimise operational risk should also be made available to all FMIs' participants (in their capacity as users of infrastructures) to ensure transparency in risk management.

Principle 18: Access and participation requirements

An FMI should have objective, risk-based, and publicly disclosed criteria for participation, which permit fair and open access.

An FMI should permit participants fair and open access to its services. Access to an FMI cannot, however, be indiscriminate: participants in an FMI should also be subject to certain objective risk-based requirements.

Access requirements need to be objective, non-discriminatory and publicly disclosed to provide open participation to market participants, market infrastructures, trading venues and service providers.

Considering its impact on competitiveness, access to an FMI should be regularly monitored by corresponding competent authorities.

Principle 19: Tiered participation arrangements

An FMI should, to the extent practicable, identify, understand, and manage the risks to it arising from tiered participation arrangements.

We believe that the requirements within this principle are excessive and unnecessary. It is the role of direct participants to manage the risks of their indirect participants. The CPSS-IOSCO proposals involve a FMI in monitoring and assessing "indirect participants", which we assume includes end-users. While this expansion of oversight may provide benefits, many FMIs do not currently have the systems or infrastructure to monitor or assess indirect participant risk. Accordingly, without further requirements from policy-makers at the local level, these proposed standards may not amount to practical risk management improvements.

Client risk is the risk of the clearing member or CSD participant. Participants are responsible for managing this, not the FMI, and we do not believe the FMI can or should be given this responsibility. Furthermore, the FMI is not privy to the necessary degree of detailed information about its general clearing members' clients, and we do not believe it is either feasible or necessary to make them so aware. The negative externalities, in term both of systemic risk and fair competition, of giving powers to the FMIs on the whole market, by far exceed the potential advantages.

Suggested modification (pp. 84 to 86): the entire principle should be taken out.

~~**Principle 19: Tiered participation arrangements**~~
~~**An FMI should, to the extent practicable, identify, understand, and manage the risks to it arising from tiered participation arrangements** (...) ... participation requirements.~~

Principle 20: FMI links

An FMI that establishes a link with one or more FMIs should identify, monitor, and manage link-related risks.

It has primarily to be avoided that links would compromise the initial function of FMIs, including especially risk management, or that it would generate or encourage unfair competition with their participants. In particular, in no case a link should reduce the security of a CCP or provide a special treatment for an infrastructure (CSD or CCP) accessing another one in the capacity of a participant.

Infrastructures (CSDs and CCPs), when being interoperable on the basis of customised access, must provide full transparency on their agreement and the functioning of the link between them. There should be indeed a single public model for interoperability by type of infrastructure, which would be public to all players (infrastructures, regulators, direct participants and indirect participants), instead of private agreements between interoperable infrastructures.

Regarding the links between CSDs, there should be only one system providing settlement finality for any transaction (cf. comment of Principle 8) and it seems that this issue is not addressed in the Report. The circulation of conditional finality throughout linked systems is the most dramatic way to propagate systemic risk, by submitting all participants of several domestic markets to unexpected unwinding of settlement with systemic domino effects.