

Please note that the comments expressed herein are solely my personal views

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08 July 2011

- **Public comment on Consultation Report on
Principles for Financial Market Infrastructures**

Dear Mr. Dudley and Mr. Hoogervorst.

Thank you for giving us the opportunity to comment on your Consultation Report on "Principles for Financial Market Infrastructures". I welcome and support your commentary and main principles. I would like to comment on some general issues concerning financial market infrastructures (FMIs).

Conflicts of interest

A conflict of interest can arise when the FMI's obligation to act in the best interest of its participant / client / customer conflicts with any of:

- the FMI's own interest
- an interest of the regulated market as a whole
- the interests of third parties including other participants / clients / customers and the wider public interest

Effective rules on conflicts of interest are critical, and these must include a general principle that FMIs must ensure that their ability to provide objective service is not, and cannot be perceived to be compromised. It is the FMI's responsibility to ensure that it is aware of any existing or potential conflicts of interest, and that these are disclosed up-front and documented, and that the FMI should disqualify itself from acting, if necessary, in the particular case. Such rules and principle must apply to all FMIs, regardless of scope or size. This means that exemptions from conflicts of interest rules and principles should not be granted based on size, scale, resources or functionality.

Chief compliance officer

I would strongly recommend that each FMI should have a chief compliance officer (CCO). The specific duties of the CCO should include, but not be limited to:

- reviewing and reporting to the board on the FMI's compliance with relevant regulations, rules and principles
- establishing procedures for the remediation of noncompliance issues
- identifying and reporting to the board any conflicts of interest that may arise
- establishing procedures for the resolution of such conflicts of interest

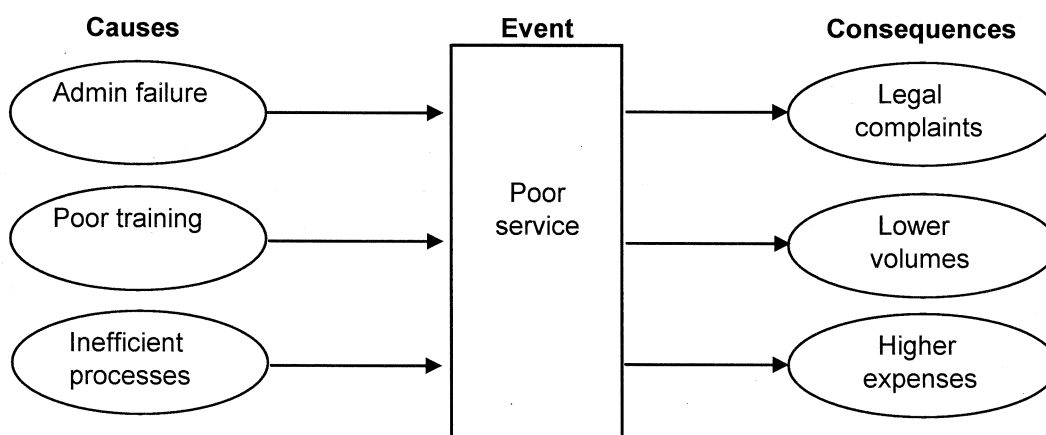
The CCO role is the single most important compliance role in an FMI and it is critical that its job description, the rules and the FMI's structures and procedures, act to secure and maintain the CCO's independence. For example the CCO should have a single compliance role and no other competing role or responsibility that could create conflicts of interest or threaten its independence. Furthermore the remuneration of the CCO must be specifically designed in such a way that avoids potential conflicts of interest with its compliance role.

Given the pressures that bear on the CCO with regard to managing conflicts of interest and maintaining independence, I would strongly recommend that the sole responsibility to appoint or remove the CCO, or to materially change its duties and responsibilities, only vests with the independent board members and not the full board. This would help to ensure the independence of the CCO within the FMI.

Operational Risk

Operational risk¹ is notoriously difficult to identify and quantify, let alone to model, monitor and manage. Furthermore, poor control of operational risk allows other types of risk, such as legal risk, market risk or credit risk to be excessive. It is important that FMIs understand fully the consequences and potential losses arising from operational risk events. From this, the appropriate risk management response should deal effectively with the root causes rather than with the consequences. The following diagram illustrates the distinction between causes, events and consequences:

¹ Operational risk is commonly defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This definition includes legal risk, but excludes strategic and reputational risk.



Consider a poor customer service event, such as a serious processing error. One possible consequence might be an increase in legal complaints, leading to reputational damage, falling volumes and consequently higher expenses and lower efficiency. An investigation into the complaints reveals that the root causes of this error were people-related, for example poor training, and partly system-related. The appropriate risk management response here should deal with these root causes as a priority.

Central counterparties (CCPs)

Financial resources requirements: I support your proposals, which should act to improve the robustness of CCP clearing systems and help to protect the financial system from contagion. However, I do not think that the proposals go far enough. We have to anticipate and work with the “tail-risk” conditions which would be expected to apply in the event of the default of a significant CCP participant. Default of a significant participant would almost certainly occur in conditions of financial uncertainty and stress. Such conditions could be accompanied by reduced liquidity and funding, widening spreads, falling solvency and increasing defaults and other systemic impacts. The CCP would also need resources to continue operating and to satisfy the additional expectations of its participants post-default. For this reason I would recommend that the proposed financial resources requirements for a CCP should be significantly in excess of those required “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”.

I would also recommend that consideration should be given in this context to differentiating risk and therefore resource requirements by broad derivative / product class, or at least by exchange-traded and over the counter (OTC) derivative types. OTC derivatives tend to be more complex, less transparent and less liquid, which presents greater problems to CCPs compared with exchange traded derivatives.

Types of financial resources: The types of financial resources that would be available to a CCP to meet its financial obligations to its participants include: (1) the margin of the defaulting participant; (2) the CCP’s own capital; (3) any guaranty fund deposits of the defaulting participant and non-defaulting participants; (4) default insurance; (5) potential assessments for additional guaranty fund contributions on non-defaulting participants; and (6) any other

financial resource deemed acceptable by the regulator. I would suggest splitting these financial resources into two classes. Class A would consist of (1) to (3) above, and should be required to make up the significant part of the total financial resources, and class B would consist of (4) to (6) above, on which larger prudential haircuts should be applied. Care should be taken with (4), as default insurance may be particularly unreliable in times of financial stress, and we should be more careful not to anticipate (5) excessively, as this may cause pro-cyclical problems and increase systemic risk in times of financial stress.

Trade repositories (TRs)

I agree that well-established TRs will enhance transparency and promote standardisation in financial markets. I am less convinced that TRs themselves will reduce systemic risk, but rather they should provide the meaningful input for reports or other data sets that could be used by regulators in monitoring risk and the build up of systemic risk in financial markets. Such reports and data sets must be standardised and employ a common terminology in order to optimise this role.

I agree that TRs should be able “to provide data to relevant authorities in a timely and appropriate manner”. I would strongly recommend that TRs should be able to provide data in real-time, which would mean as soon as technologically practicable.

Recordkeeping

I would recommend that FMIs should be required to keep records indefinitely. Any original documents should be scanned. There is no technological or practical reason for limiting the record retention period, and it would be useful to keep this information for future analytical and investigative purposes.

Testing and validation

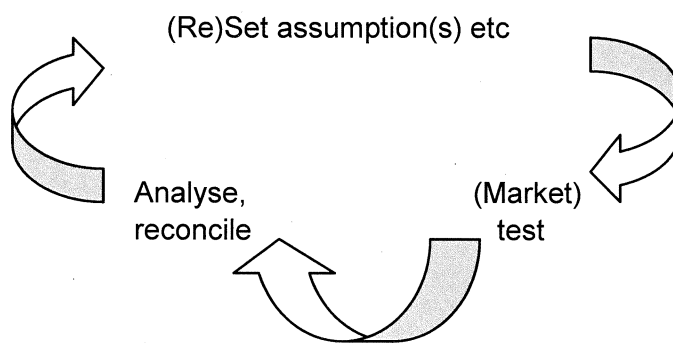
FMIs should maintain appropriate testing regimes and validation procedures, which should be documented and signed off by the chief risk officer (CRO, or equivalent). As a minimum, all new products, models and valuation methodologies, including significant changes thereon should also be signed off by the CRO.

I agree that stress testing, backtesting and reverse stress testing are important tools in order to validate models, processes, procedures, systems, outputs, results and quantities. Testing the sensitivity of outputs and results to key assumptions² can also help to manage expectations concerning the potential outcome-distribution based on uncertain future events. For completeness, I would recommend that you propose or note the following (additional) tests, which would provide more meaningful information to FMIs, their participants and other users:

² Including qualitative methodologies and quantitative inputs.

- 1) the sensitivity of outcomes to changing individual assumptions (sensitivity analysis as proposed in paras 3.4.13 and 3.15.3);
- 2) the sensitivity of outcomes to changing several assumptions at the same time, where the assumptions could reasonably be expected to change together (scenario analysis as proposed in paras 3.6.4, 3.17.12 etc);
- 3) the sensitivity of outcomes to changing the correlations and dependencies assumed between assumptions.

An FMI should also monitor and control the expectations and outcomes of their models etc by using a control cycle technique as follows:



The results of this testing and validation should be disclosed to regulators when required. I do not believe that such additional disclosure would be onerous for FMIs. I would argue that having a good understanding of your business, operational and risk drivers, including their dependencies, is vital to properly manage an FMI.

Systemic risk

The consultative report refers several times to systemic risk,³ particularly in paras 1.15, 1.23, 2.2, 2.3 and 3.20.11. However, the report has not addressed how FMIs and regulators should measure systemic risk. For example, it seems clear with hindsight that we have suffered a systemic crisis. However it is very difficult to say when the crisis became systemic, or at what point regulators and controllers needed to step in during the past years, and deal with the emerging crisis. The Property Casualty Insurers Association of America advocate two key tests for measuring systemic risk: the "too big to fail" and the "too interconnected to fail" tests.⁴ Perhaps we could think about such measures and determine how they could be used in practice to measure systemic risk. I also suggest that the report should distinguish more between endogenous systemic risk (generated by the FMIs and the system itself), that can lead to widespread market failure, such as excessive leverage, from exogenous shocks, since each requires a different set of controls, approach and policy response.

³ For a definition see www.iosco.org/library/pubdocs/pdf/IOSCOPD78.pdf, IOSCO, Risk Management and Control Guidance, page 7.

⁴ See [http://www.pciaa.net/web/sitehome.nsf/lcpublic/392/\\$file/pci_systemic_risk_definition.pdf](http://www.pciaa.net/web/sitehome.nsf/lcpublic/392/$file/pci_systemic_risk_definition.pdf)

Access, costs and fees

Principle 18 requires that an FMI should have objective criteria, which permit fair and open access. Additionally, para 3.23.5 required an FMI to publicly disclose its fees, discounts and services, and requires transparency thereon. I would recommend that you propose a stronger requirement here, in order to promote fair and open access, such that an FMI should be required to charge fees in an equitable and non-discriminatory manner. The only acceptable reason for having different charge / cost / fee structures would relate to the differing costs of providing access or service to particular categories of participant. Anything else would be discrimination⁵ by definition. I would also suggest that preferential pricing such as volume discounts or reductions should not be generally viewed as equitable. Such volume discounts and reductions tend to discriminate in favour of large players, and in some cases a small number of large players dominate the market anyway.⁶

I would additionally recommend that full disclosure should be required here, which should include all explicit and implicit charges, costs (including hidden, or side costs) and fees. This would formalise the market practice and ensure that current and potential participants could make informed decisions.

Yours sincerely

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⁵ E.g. hidden and unfair cross-subsidy or other anticompetitive measure.

⁶ E.g. the swaps and other OTC derivatives market.