DANMARKS
NATIONALBANK

CPSS Secretariat
[cpss@bis.org]

IOSCO Secretariat
[fmi@iosco.org]

Payment Systems
Havnegade 5
1093 København K
Tlf.: 33 63 63 63
Fax: 33 63 71 03
bfk@nationalbanken.dk
www.nationalbanken.dk

12 July 2011

Sagsnr.: 118666
Dokumentnr.: 1116089

Response by Danmarks Nationalbank to the CPSS-IOSCO consultation on the report *Principles for financial market infrastructures*

Danmarks Nationalbank welcomes the opportunity to comment on the consultative CPSS-IOSCO report on *Principles for financial market infrastructures.* Our response reflects our practical experiences with assessing infrastructures against international standards.

1. General observations

The new principles for financial market infrastructures serve two main functions. First, they attempt to integrate existing standards and recommendations into a single set of principles. Second, they seek to incorporate the lessons learned from the financial crisis. In our opinion, they succeed in achieving these aims.

The move to integrate the existing sets of standards into a single set of "principles" is greatly appreciated. It should help ensure a more consistent oversight effort and facilitate improved cooperation between overseers of different types of infrastructures. Moreover, the principles themselves are generally clear and provide improved guidance to overseers as compared to the existing standards.

A number of additional risks, which are only discussed in passing in existing standards, are also addressed in the principles. We find it encouraging that the risks of indirect participation are addressed, and appreciate the extra attention paid to interdependencies and credit, liquidity and general business risks, though we do have some general comments concerning the treatment of these risk categories (see below).

More detailed remarks on certain principles are given in section 2.

Credit risk

In discussing credit risk (principle 4), the cover note to the report raises the question of whether CCPs should have adequate financial resources to cover the default of its one or two largest participants. We would encourage further analysis of this issue, with a view to weighing the benefits of reduced systemic risk against the additional financial costs borne by the participants.

The analysis should consider the risk characteristics of different types of CCPs. Based on the outcome of the analysis, the rule could depend on the characteristics of the CCP as suggested in the cover note (option 3). A "cover one" rule could, for instance, apply in liquid cash markets where the systemic risks are much smaller than in derivatives markets.

Liquidity risk

The cover note also specifically addresses the issue of liquidity risk, which is dealt with in principle 7. However, we find it difficult to give plain answers to the questions raised because the principle itself lacks in clarity. It is often ambiguous whose liquidity risks, the FMI's or the participants', are being discussed.

Principle 7 states that an FMI "should maintain sufficient liquid resources" to effect same-day settlement. Some FMIs such as those granting credit to participants or central counterparties, who need to finance own positions, are directly exposed to liquidity risks and therefore need to maintain liquid resources. Yet, many FMIs do not maintain any liquid resources for settlement purposes and are not themselves exposed to liquidity risks. It is their participants who hold liquidity and will be affected in case of liquidity shocks. It is not sufficiently evident how the principle is to be applied in such cases.

In general, principle 7 should clearly distinguish between the liquidity risks of the FMI itself and those of its participants. Participants are ultimately responsible for their own liquidity management, but FMIs can influence participants' liquidity management through e.g. system design, rules, and incentives. The principle should make clear the extent to which an FMI is responsible for the liquidity management of participants. In particular, it should explain the nature of this responsibility in the context of ensuring a timely completion of settlement. If it is to be understood that the FMI itself is responsible for ensuring a timely settlement, the principle should more clearly spell out the means, e.g. the establishment of a liquidity pool, by which this is to be accomplished.

Related to this are the stress tests envisaged in the principle. Again it is unclear whose risk is being discussed. The stress tests at first appear to be concerned with the FMI's own liquid resources, indicating that the purpose of the stress tests is to protect the FMI's ability to withstand liquidity pressures.

Yet, the scenarios discussed, e.g. concerning defaults that generate large aggregate liquidity needs, suggest that they are also concerned with the participants' liquidity risk. To be sure, stress testing is informative and desirable in either case, but the principle needs to spell out what the purpose(s) of stress testing is (are), and whether they also apply to FMI's that are not themselves exposed to liquidity risk.

General business risk

The introduction of a principle on general business risk (principle 15) is sensible. However, we are not sure that the establishment of a rigid quantitative requirement on liquid net assets funded by equity is the most suitable means of addressing this risk. First, the amount of time required to wind-down an FMI will differ depending on the type and complexity of FMI. Second, other circumstances often suggest that such measures would be superfluous. In many cases the participants in an FMI depend on the continued operations to such an extent that it is unthinkable that it would be allowed to fail. Finally, other schemes such as insurance or guarantees could also be employed instead of liquid assets backed by equity, provided that the financial health of the insurers or guarantors is independent of the FMI's circumstances.

Information storage and availability

Finally, we have a plea for the introduction of a requirement into the principles. A recurring problem for overseers is the lack of available data from financial market infrastructures. Frequently, it is difficult to determine whether an infrastructure complies with a certain standard because they do not gather the data necessary to perform an adequate assessment.

In the same vein as trade repositories are required to collect and store data that permits analysis (principle 24), a similar requirement would be helpful for other types of infrastructures. For payment and securities settlement systems, for instance, it could be required that they record the various events that are part of clearing and settlement chain and make them available to regulators in an understandable format. This would not only help regulators perform their oversight tasks, but could also contribute to the development of safer and more efficient infrastructures. As an example, such data could be used to e.g. simulate and analyse the effects of changes to infrastructure design.

2. Specific comments

Principle 1: Legal basis

In the section on conflict-of-law issues (3.1.10.) we would suggest the introduction of a modifier such that FMIs are only required to obtain legal opinions in cases of *reasonable doubt* about the choice of law. Presumably, this is already implied in the section, but it could be read to mean that FMIs are required to obtain legal opinions in every conceivable conflict-of-law case.

Principle 3: Framework for the comprehensive management of risks
While we agree with the notion that FMIs should take an integrated and comprehensive view of risks, it may be difficult to apply the principle in practice given its high level of generality. The principle also overlaps extensively with other principles, furthering the difficulty of determining what is to be assessed.

We would recommend a redrafting of the principle such that it only focuses on themes that are not already covered elsewhere. One example of such a theme is interdependencies between FMI's (other than those covered by principle 20 on links). Another is incentives to manage risks (section 3.3.5.). It would be useful to have further guidance on how to approach these issues.

Principle 7: Liquidity risk
See section 1 for our general comments.

On the question in the cover note about extending the "cover one" or "cover two" requirements to all FMIs, we should first like to have clarification on whether the liquidity risk requirements apply to the FMI's own liquidity risk or that of its participants. The answer to the question could also depend on market structure. If a market is highly concentrated, and two participants represent, for example, more than 80 per cent of the total volume, it seems excessively demanding to require that settlement can continue uninterrupted if both default at the same time.

We would also suggest modifications to the sections on FMI's that employ DNS designs (sections 3.7.3. and 3.7.6.). As accurately noted, there is a risk of unwinding in such systems, and this risk is particularly acute if the net settlement takes place late in the day. In actual systems, however, net settlement often takes place during the night, and netting has the advantage of reducing participants' liquidity needs and the associated liquidity risk. Moreover, gross settlement systems frequently employ netting features, weakening the distinction between net and gross settlement systems.

Instead of criticising DNS designs per se, therefore, it would be more productive to explicitly focus on whether the particular settlement design protects participants against the risk of unwinding.

As regards the stress tests, the requirement of (at least) a monthly stress test seems excessive in the case of infrastructures which are only exposed to limited liquidity risks.

Principle 13: Participant-default rules and procedures
The introduction of a specific principle on default rule is highly beneficial. We should only like to see one addition to the principle: A section on coordination with other parties, especially other FMIs (e.g. connected payment systems) that are also involved in the management of participant defaults.

Principle 20: FMI links
Formulating a principle on links presents obvious difficulties as there are substantial differences between types of links. For the same reason the recommendations laid out in the first sections of the principle tend to be overly general, making them difficult to apply in practice. Moreover, they overlap with other recommendations related to matters such as legal and operational risk. We would prefer instead if the principle elaborated further on the risks which are specific to the various types of links (sections 3.20.6 and onwards) and lessened the emphasis on general risks.

Yours sincerely,

Kristian Kjeldsen