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COMMENTS OF THE TARGET WORKING GROUP ON THE CPSS/IOSCO PRINCIPLES FOR FINANCIAL MARKET INFRASTRUCTURES CONSULTATIVE REPORT – MARCH 2011

The TARGET Working Group (TWG) would like to thank CPSS and IOSCO for the opportunity to comment on the above report. The TWG represents the European payments industry in discussions with the ECB/Eurosystem on issues relating to the TARGET 2 payment system. Consequently, remarks in this note are restricted to payment systems and no comment is offered in relation to other types of FMIs.

Remarks are divided into three sections:

- general remarks which are not specific to any particular part of the report
- comment on the parts of the cover note which affect payment systems
- detailed comments on the report

GENERAL REMARKS

- 1) Whilst it is recognized that many of the Principles/sub-Principles are common to all FMIs, nevertheless it is believed the report needs to acknowledge more overtly that different types of FMIs have distinctive characteristics. There are various ways of achieving such segmentation but the TWG believes it needs to be done in a structured way rather than suddenly referring to a specific type of FMI in the middle of the text. For example, one option could be to group common features and key considerations under each Principle but then add further short sections covering aspects relating to certain FMIs which have characteristics not applicable to all FMIs. The TWG believes that such an approach would help to make the Principles clearer for all readers.
- 2) Particularly within Europe, many payment systems are split between a scheme (typically responsible for defining the standards to be used and the business and operational rules) and system (typically responsible for providing the underlying technical infrastructure). However, such separation of roles does not apply to all payment systems and the terms 'scheme' and 'system' may have different meanings, particularly outside Europe. Consequently, it is recommended that the Principles acknowledge and define such split of roles.
- 3) It is observed that Note 5 on page 7 states that the report excludes bilateral relationships between financial institutions and their customers such as traditional correspondent banking with which statement we agree. However, it is believed that such arrangements involving transactions handled on an individual basis should be distinguished from any broader based bilateral arrangements which are effectively fulfilling the same function as FMIs. Please note, that the TWG is not expressing any opinion on whether such broader based bilateral arrangements should be categorized as FMIs or addressed separately but regards it important that this issue is addressed by the Principles.

- 4) Public disclosure is referred to in several parts of the Consultative Report with various qualifications but it is considered important that care is taken to ensure that neither safety nor integrity are compromised and commercially sensitive information is safeguarded.

COMMENTS ON THE COVER NOTE

Principle 4: Credit risk

No comment since both specific questions are restricted to CCPs but see comment on Principle 7 below.

Principle 7: Liquidity risk

When addressing Principles 5 and 7, it is suggested that the following two questions require clarification.

- Should these principles also cover system related exposures between participants?
- Where participant exposures are collateralized, should such exposures be treated as credit risk or liquidity risk?

In answering the two questions above, it is assumed that liquidity risk will rest with the participants either directly or through some form of common collateral or liquidity pool with the payment system's responsibility being to implement rules and procedures which ensure that adequate liquidity/collateral is available to enable the system to settle.

In the case of payment systems, the TWG believes that the prime requirement is that the FMI ensures that only high quality and liquid collateral is used, supported by appropriate haircuts. On this basis the TWG members would like to suggest that treating collateralized exposures as liquidity risk is more appropriate

The two questions posed in the cover note to the consultative report are addressed below.

Question 1

It is not disputed that, looked at in isolation, adopting a more stringent approach than 'cover one' has merit. However, taking this argument to its logical conclusion, why stop at 'cover two'. Also, in the event of more than one major participant failing at the same time, it seems likely that this would be accompanied by a major financial crisis with an individual payment system only forming part of a much larger jigsaw being addressed as a whole by the appropriate authorities.

In such circumstances, it is believed that extending the minimum requirement beyond 'cover one' is likely to have a limited impact when considering the wider scenario of the failed participants. In addition, a major practical concern is the likely limit on the availability of suitable collateral which may also be required for a range of other purposes including Basel regulatory requirements, monetary policy operations and other FMIs plus the increasing trend towards collateral being required for commercial inter-bank funding.

The concern of the TWG is that stipulating a minimum ‘cover two’ requirement could result in some institutions relying on other participants’ liquidity by delaying outward payments which would not only reduce operational efficiency but also potentially create additional risk for the other participants who may effectively be acting as unsecured liquidity providers.

On balance, therefore, the TWG favours a ‘cover one’ minimum requirement subject to the following conditions.

- Group situations where participants are financially linked are treated as one participant for this purpose and the phrase “participant and its affiliates” is not considered sufficiently explicit. Instead, it should be replaced with more formal group criteria, possibly based on Basel principles. It follows that several participants (and their affiliates) may be counted as a single entity for “cover one” purposes.
- When applying this requirement, it must be possible for payment systems to measure and control the highest intra-day credit risk, where applicable, and this requirement should be applied to such risk. For DNS systems, the term “intra-day” should be construed as being the highest credit risk arising during the deferred settlement process based on the underlying legal infrastructure. It is acknowledged that some payment systems may require time to accommodate this requirement but it is considered important that the underlying principle should be established.
- Robust default procedures, including where two or more participants fail simultaneously, with mandatory testing at least annually and more frequently if material changes are made, should be put in place so that in a crisis situation they can be implemented without delay.

Question 2

With regard to the risk and other characteristics of the payment obligations settled by a payment system, in the TWG opinion it is important to acknowledge that such payment obligations will normally rest with the participants, not the payment system itself. The risks can therefore be broadly split into two categories:

- The ability of debtor participants to settle their obligations in accordance with the rules of the system
- The FMI’s responsibility to ensure that the legal structure and documentation underpinning the payment system are both robust and kept up to date.

Principle 15: General business risk

In answer to the two questions posed:

- Since financial responsibility for settling payments generally rests with participants rather than the payment system FMI itself, it follows that a payment system's requirement for liquid assets is normally restricted to the funds it needs to undertake its own largely administrative functions. Consequently, a quantitative requirement would seem appropriate. However, the TWG questions the need for it to be mandatory for such requirement to be funded by equity provided other suitable arrangements are put in place which could, for example, include minimum volume throughput requirements and a notice period before a participant can exit.
- In view of the short term nature of payment system settlement, setting the bar at six months would seem sufficient time to make alternative arrangements.

Principle 20: Links

Challenges may include:

- Ensuring a robust and secure technical interface(s) is/are put in place between all inter-dependent FMIs
- As stated in KC2 on page 86 of the report, ensuring that all such links have a well founded legal basis in the relevant jurisdictions that supports their design and provides adequate protection to the FMIs concerned taking into account the exact nature of the link(s);
- Ensuring sufficient liquidity availability;
- Having robust plans in place if settlement fails;
- Co-coordinating and synchronising relevant contingency arrangements including periodic testing;
- Ensuring that such plans also cover potential crisis situations, both specific to the FMIs concerned (including payment systems) and covering systemic/market risk scenarios.

DETAILED COMMENTS

Page 1 Principle 7

Re--wording of the second sentence on the following lines is suggested

"An FMI should ensure that sufficient liquid resources are available to effect settlement when due including where appropriate intra-day settlement of payment obligations..."

The intention is both to broaden the principle to cover situations where the liquidity resources are not under the direct control of the FMI and address deferred net settlement (DNS) systems.

Page 2 Principle 15

It is suggested to define "equity" for this purpose. Also, it is unclear why holdings of liquid net assets need necessarily be funded by equity in the case of payment systems provided that such assets are ring- fenced and specifically dedicated to this purpose.

Page 3 Principle 18

It is suggested to add:

"Where appropriate under local law and /or regulation, these should be subject to competition law approval".

Page 3 Principle 23

It is suggested to add: *"except where such disclosure may risk prejudicing the security and integrity of the system or divulging commercially sensitive information"* to the following sentence:

"All relevant rules and key procedures should be publicly disclosed".

The TWG concern is whether this could be construed as allowing the public to demand sight of such rules and procedures. .

1.8 – While the TWG agrees with Note 5 referring to banker/customer and correspondent banking arrangements, it is not clear why FMIs are restricted to multilateral systems. For example, the definition of system in EU Directive 98/26/EC as amended by EU Directive 2009/44/EC (the SFD) does not include the word 'multilateral' in its definition of system. Also, RTGS systems may well not be multilateral although many of the principles still apply to them. Consequently, it is suggested the third sentence is amended to read:

"FMIs provide participants with some or all of centralised recording, clearing"

See also comment on Note 23 and General Remark 3.

3.1.6 - For clarity, it is suggested that the phrase *"zero-hour rules should be eliminated"* is amended to read *"zero-hour rules should be eliminated by the appropriate authorities"*.

The intention is of course to make it clear that such elimination may well not be within the power of the FMI.

Page 21 Note 23 - This note appears to recognise that not all FMIs are multilateral in nature. (See 1.8 above)

3.2.8 - This section is regarded as being of such importance that it is suggested it should be highlighted in some way.

Page 31 KC 3 – Clarification is requested on when PFE as defined in Note 33 is expected to apply to payment systems. In this connection, it is noted that section 3.4.1 acknowledges that if the FMI does not guarantee settlement (presumably intended to be read as 'without adequate easily realizable security') as is normally the case for payment systems, such exposure may (or will?) be borne individually and directly by its participants. In such cases the TWG would expect the FMI's responsibility to be limited to ensuring that proper procedures and legal documentation are in place to ensure that the maximum potential open position for each participant is adequately collateralized.

Also, please clarify when potential fluctuations in the market value of a participant's open positions will arise in payment systems. It is not clear when such a situation would occur apart perhaps from CLS and a limited number of payment systems operating in a foreign currency such as occurs in Hongkong. Also, where foreign currency collateral is held, the TWG would expect it to be subject to an appropriate hair-cut reviewed at regular intervals.

Page 46- 52 - Much of this section appears to be predicated on an assumption that payment systems themselves are responsible for providing liquidity which as explained in our comments on the cover note re Principle 7 is not normally the case. Appropriate re-drafting is strongly recommended.

Pages 52-54 Principle 8

The TWG would like to suggest that explanation of this principle should be redrafted to distinguish clearly between finality of individual payment transactions and settlement finality at inter-bank level. It is noted in this connection that it is stated in section 3.8.2 that an FMI's rules and legal framework generally determine finality. However, it is not entirely clear which type of finality is being referred to.

3.13.6 – The TWG is concerned with public disclosure of default procedures.

3.13.7 - It is suggested that this section should be strengthened by the addition of a further sentence on the lines "*Where dependencies with other FMIs exist, such testing should be extended to them whenever practical.*"

Page 70 Principle 15

See previous comment on page 2. Notwithstanding the description given here, it is suggested that a formal definition of equity should be provided. In addition, could guarantees from major shareholders be safely substituted for equity in some cases?

3.15.6 and Note 102 - It is assumed that the requirement to maintain sufficient equity capital is based on Basel 3 type reasoning. Conversely, however, there are significant differences between many FMIs and banks in that the former will not normally be making term loans or, in many cases, be counterparties in derivative type transactions. It is suggested that the balance of risk incurred by an FMI, particularly a payment system, may well be likely to be tilted more towards liquidity than capital compared to a bank. It follows that the general business profile of such an FMI will tend to be simpler to assess. Consequently, it is suggested that the circumstances described in Note 102 should not be considered as being exceptional and the viability of equivalent loss absorbing financial resources should be an acceptable alternative..

3.15.8 - Similarly, this section should not be restricted to equity capital but should include equivalent loss absorbing financial resources.

Note 110 - It is not clear exactly what is meant by the reference to "duplication of software". Is it being suggested that completely different software programmes are required which may well not be practical, let alone cost effective? Clarification is suggested.

3.17.15 - Regular testing is of such crucial importance that it is suggested that a maximum period between major tests should be stipulated e.g. the FMI must operate from its back-up site for at least a full business day including any associated night-time processing during a 12 month period based on the assumption that the primary site has been destroyed and no personnel or records at that site have survived including top management.

Page 81 Principle 18 - See previous comment about disclosure to the general public. Furthermore, it is suggested that exit requirements should also be covered since the exit of a major participant could have a material effect.

3.19.1 Whilst not disputing that risk can arise from tiered participation arrangements, the TWG questions whether this should be an FMI responsibility but rather an oversight or regulatory responsibility. Indeed, TWG members can see dangers in attempting to impose a quasi regulatory function on payment system FMIs beyond their responsibility for efficient operation of payment systems for which they are responsible including ensuring participants have the appropriate technical capability. Also, not all such scenarios have the same degree of risk. For example, a participant with a sophisticated real-time system where outgoing payments are not released until the ordering institution's account is debited is arguably only subject to possible legal risk in jurisdictions where intra-day debit is not recognized and/or zero hour type rules still apply and has a different risk profile from a participant which allows its indirect participants to access a payment system directly.

3.19.2 and Note 116 - In some exceptional circumstances, a major corporate or other body not regulated as a bank such as a hedge fund which is not even an indirect participant, may be of such size in relation to the whole as to pose systemic risk in relation to payments. They may also pose other types of risks as well and the TWG finds it difficult to see the argument for addressing payment system risks in isolation. See also comments under 3.19.1 above.

Page 96 Principle 23 - KC1 and 3.23.2 - Restriction of public disclosure to relevant rules and procedures is only supported so long as it is made clear that "relevant" means "relevant to disclosure to the public" as opposed to being relevant to the operation of the system.

3.24.2 - Even if only aggregated breakdowns and anonymised data are being provided, the phrase "*as available and appropriate to the public*" should be stressed.

Page 102 Responsibility B KC2 and 4.2.4 - It is suggested that the term "sufficient resources" should be expanded to read "*sufficient resources and up to date technical expertise*".

Annex F - Again, it is suggested that the term "sufficient resources" should be widened to include the need for appropriate technical expertise.

We hope you will find these comments useful and shall be happy to address any supplementary questions. Please address any queries to Ms Denisa Mularova e-mail d.mularova@ebf-fbe.eu

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