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## Consultation on Principles for Financial Market Infrastructures by CPSS – IOSCO

### Information about the ABBL (Luxembourg Bankers' Association):

Identity	Organisation
Capacity	Industry trade body
MS of establishment	Luxembourg
Field of activity/.industry sector	Banking & other financial services
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The ABBL<sup>1</sup>, an association whose members include 2 CSDs and one ICSD, would like to thank CPSS-IOSCO for the opportunity to comment on the proposed Principles for Financial Market Infrastructures. Conceptually, the ABBL supports the principles put forward and appreciates the need to define and adapt high-level global principles for institutions that act as market infrastructures for all financial actors, especially when - as it is the case with these principles - the work done to achieve them was of great quality.

In the ABBL's opinion, the principles defined at such a global level should be of a broad enough nature so as to be accommodated in regulatory texts in the different regions where they would be applicable. Without undermining global convergence and the rise of globally accepted standards, the level of details should be left to these regions, since they are best placed to define functional technicalities that fit their respective markets. Accordingly, the work done by CPSS-IOSCO is already extremely detailed and prescriptive so that little room seems to be left for each region.

<sup>1</sup> The Luxembourg Bankers' Association (ABBL) is the professional organisation representing the majority of banks and other financial intermediaries established in Luxembourg. Its purpose lies in defending and fostering the professional interests of its members. As such, it acts as the voice of the whole sector on various matters in both national and international organisations.

The ABBL counts amongst its members' universal banks, covered bonds issuing banks, public banks, other professionals of the financial sector (PSF), financial service providers and ancillary service providers to the financial industry.

Most of the ABBL's comments are centred on CSDs and CCPs. With regards to payment institutions, the ABBL would refer the Committee to the EBF (European Banking Federation Response) and the EU Target Working Group comments.

## 1 General remarks

One of the ABBL's primary concerns with the principles set forward in this consultation relates to the fact that they would dramatically increase the level of collateral needed to perform financial transactions at all levels.

Collateral will be required at CCP/clearing level as well as CSDs and even for large payments. This at a time when Basel III will put significant additional pressure on financial institutions, especially banks, to raise additional capital. The ABBL foresees at least 2 major risks. The first one is that not enough collateral will be found by all the parties that need it. The second risk relates to the question as to the type of collateral that would be required and as to what would be considered as high quality collateral?

Our first concern, that not enough collateral will be found, bears two further risks: the first one is that only the largest institutions may be able to access enough collateral to join different platforms. And even then, the question may arise regarding the "priority" of collateral to be assigned to preferred market infrastructures. The second risk relates to the blocking of financial resources under the form of these enhanced collateral requirements. Our concern here is that such resources will be blocked to provide FMIs with collateral and hence may not be used for lending and promoting the economy, which if allocated to collateral pools could be detrimental to the development of regions that dearly need all financing means available to sustain their growth. To the ABBL's knowledge, no FMIs have defaulted during the recent financial turmoil. The primary question that the ABBL would thus like to raise regarding these principles concerns their extreme reliance on immobilisation of financial assets as collateral. Would the additional protection be worth the cost? The question of quality of collateral is also central at a time when a default by a Member State may no longer be considered pure fiction.

The ABBL would like to address a further general concern regarding the principles for FMIs, as they were designed for 3 very different types of FMIs: CCPs are different from CSDs, who are themselves different from Payment Infrastructures. Would it thus not be wise to structure the document according to these parts? There may be generally applicable principles, but given the already deep level of details, **the ABBL considers that some discrimination among the principles as to whom they may be applicable should help improve the quality of the paper.** Thus, the ABBL proposes to explicitly segment the paper in 4 parts: the first dealing with general principles (like composition of the board/independent board members, some governance aspects, or

legal basis), then a section on CCPs, followed by a section on CSDs and a fourth section on Payment Infrastructures. Although annex D defines a matrix for which principles are applicable to which FMI, differentiation within the text and formal organisation will considerably help to better understand the document. Furthermore, if some principles are applicable to all FMIs, i.e. risk management, the approach may be different from one body to the next, which is not really explicit in the paper. The same is true for the assessment methodology (not yet available for consultation) where not all institutions could measure under the same rules.

**One of the issues linked to the level of details and numbers of principles is the cascade they imply:** not only will FMIs have to implement the ensuing regional regulatory standards/regulations, but their clients will also have to adapt to more stringent requirements at every level. It may be unwise to consider that only members of these FMIs will have to adapt. Their clients will eventually also have to bear some of the burden, be they other smaller financial institutions or retail, corporate or SME clients. The latter categories of clients run the considerable risk of simply being left out of financial markets altogether because access conditions become prohibitive or financial institutions no longer have any incentive/capital to “sponsor” them.

In the general remarks, the ABBL would raise a final issue on the role envisaged for such institutions by the tiered approach and the segregation of assets. FMIs are not supervisors of financial actors and should probably not be in such a position. Thus, principles on tiering may be a bit too far-reaching compared to the actual benefits. Knowing one’s clients is a good thing, and knowing that among these clients some may be very big could indeed help forging a better view for risk management purposes. Yet the complexity of such a set-up may be prohibitive compared to the expected benefits. Indeed, what will the FMI do with this information? Reject a member because it or some of its clients are too big? Then the question arises where would that risk go?

Concretely, say a member of a CCP is identified as having large clients that may, under extreme stress, present a risk for the CCP. Does that imply this member should forbid its clients to clear transactions? What would these clients then do: stop using a CCP, go to another CCP member...? Doesn’t that create more systemic risks? What principles would this member apply to stop its clients from performing transactions (which one would be eligible?, which party will be subject to additional collateral?...)? Although **on paper this tiering principle may appear to be a good idea, the ABBL is not convinced at all that operationally it is a desirable strategy.** Everyone should know their clients, but not necessarily the entire chain. This being said, it appears that the vast majority of these FMIs are not yet equipped to apply these principles.

## 2 Detailed comments

### General organisation

The ABBL shares the view of CPSS-IOSCO with respect to the necessity to have a sound legal framework that both organises the activities and protects stakeholders to a relevant degree. Thus, **principles 1 and 2 address these issues appropriately**. In the EU, the ABBL is relatively confident that the current and developing framework will duly address these concerns (CCP and CSD regulation as well as current settlement finality and collateral directive). The final milestone, the SLD (Securities Law Directive), may be the most difficult to implement, although defining a EU-based regime for holding securities and ideally ensuring their bankruptcy remoteness is key.

For the ABBL, one uncomfortable consideration is, however, the requirement to have independent board members. The ABBL shares the view that quality, experience and professionalism should prevail at the top of organisations: complete outsiders may in that case not be an appropriate option if they have a disproportionately important weight in the composition of boards. On a tactical front, the issue may be even more complex when the FMI is run by a Central Bank: will it accept outsiders?

Regarding risk management, the ABBL understands the need for active involvement from the top of an organisation, but the board may delegate with appropriate powers the risk management to a committee with ideally active involvement of users.

**Principle 3 raises relevant issues** regarding the framework of risk management, **but** already at this point operational procedures **may differentiate among the types of FMIs**. Some are inherently more risky than others. Emphasis may be put on distinctions between financial risks and operational risks, since providing an infrastructure does not present the same risks as being part of the system (through lending, for example). Furthermore, at a conceptual level, models should be as comprehensive as possible, but they remain what they are: models.

The ABBL is of the opinion that **principle 4 is**, at such a global level, a little bit **too detailed**, especially when considering the fact that it is applicable to 3 very different FMIs. FMIs should indeed have a robust capital and credit risk framework, assess and subject their infrastructures to stress test, but the ABBL is not convinced that principles should be that prescriptive (Key Consideration 4 and 5): these may be perhaps better left to regional regulations. The example of stress testing is first and foremost a good indicative list, but may not be put as it is in KC. What may be missing at this point is the interoperability and systemic risk created by cross-membership among FMIs (although discussed later). An operationally efficient infrastructure will do more to risk

management than all the collateral or margin, since in case of extreme stress, assets have a tendency to converge in the wrong direction.

In **principle 5**, the ABBL strongly wonders **what is quality collateral and how long it will remain so**. In the end, it may be better to accept a wider range of liquid collateral with appropriate hair cuts than limiting it to “soon-to-default” sovereign debt. In that respect, regulated funds may fully or in part be eligible as collateral (consider the case of EU UCITS funds or Money Market UCITS). In addition, with the current definition it may be difficult to avoid concentration on specific collateral instruments for 2 reasons: the extremely good quality collateral is likely to become increasingly scarce, and it is likely that only the largest institutions may become members of FMIs. Thus, if this good quality collateral defaults, it would be among a concentrated pool of institutions that will bear the higher risk of network effect.

Regarding **principle 6**, the ABBL is in line with the proposal and KC presented. The association would like to stress that margins are in its view first and foremost to cover day-to-day business. Assessing margins in case of a stress scenario should only be a tool to help improve the definition and use of margins, but in no way should it be the main basis of definition of margins. The ABBL is surprised by §3.6.10 on limiting procyclicality, as margins are created to protect the CCP and market participants in case of risk (i.e. increased volatility) and thus margin requirements are likely to increase in times of turbulence on markets. It may then be unwise to consider this as procyclical. In the end, margins should be calculated by products according to a transparent procedure, but FMIs (CCPs in this case) should be able to mitigate risks in other ways when they belong to the same legal entity (member) or when markets are disrupted and marking to market is hazardous.

The ABBL **considers principle 7 acceptable, although** participants and affiliate concepts may not be considered sufficiently clear. Does this refer to parent entities, clients of the member? And if the latter is the case, should a client of a member be limited in its recourse to a FMI if its member has restrictions? Regarding liquidity, the principle should differentiate between operational risks linked to a non-efficient infrastructure and FMI financial position or risks in its daily functioning or in case one (or more) of its members defaults. The ABBL does not see access to central bank money as key in the day-to-day life of the FMI, but access in case of crisis may be an opportune option.

## Settlement

In the EU the **principle 8** of settlement finality already exists through the Settlement Finality Directive and broadly speaking **may be considered in force** in that region.

Generally speaking, settlement money could be left to members/clients' choice: this is why the ABBL is **not supportive of principle 9**. Commercial bank money has shown

its merits and the ABBL foresees no reason why it should be ruled out: few if no FMIs failed during the 2007-2009 crisis period. Limiting to Central Bank money may limit markets to their national or regional currency, which may be detrimental to the economy in general (because as such ICSDs may have some difficulty to function and issuers may have difficulty to access remote markets).

The ABBL has **no specific comment on principle 10** beyond the fact that the principle and KC seem acceptable.

The ABBL **would agree with principle 11**, as it considers that CSDs should have by definition a very low to no risk business. This being said, CSDs may also perform tasks that are difficult to extract from their core business/activities and that add value to the entire community. Thus, as long as the business/activity profile of the CSD remains in the remit of services that support its core function as defined in the EU Consultation on CSDs, the ABBL does not see any merit in introducing more complex and burdensome procedures. It is wrong to assume that CSDs offer their services in an unregulated manner, or provide services not linked to their core activities. These services are offered under some form of supervised license, be it as a limited-purpose banking institution, or as a fully-fledged commercial bank acting as settlement agent. In the EU, CSDs have existed for a long time; it may be difficult, counterproductive and perhaps unfair to try to decommission some of their activities if they support their core business (beyond the exception of the Target 2 Securities project of the ECB). The ABBL would invite CPSS-IOSCO to closely examine cases where a Central Bank is operator of an FMI. Specifically for the EU, the case of Target 2 Securities may attract attention according to its specific in-sourcing features from commercial CSDs.

### **Default management**

The ABBL would invite CPSS-IOSCO to **read the EBF analysis on principle 12 & 13, with** which it fully agrees.

The **ABBL supports principle 14** on segregation and portability of accounts at least from a theoretical point of view for CCPs. CCPs should indeed segregate accounts of members and own accounts from members. Below this level of forcing members to segregate their accounts from clients, CCPs may be confronted with the technical difficulties of segregation along the entire chain of stakeholders. How would they be sure that segregation is performed at their clients' clients (across multiple borders, for some)? Furthermore, the concept of segregation and portability cannot be transposed into the CSD sphere as proposed. CSDs provide to their customers the legal arrangements to protect the assets and positions of a participant's customers by other means, such as account segregation, and this should be taken into consideration. The ABBL wonders if it would be technically feasible – and desirable - to force segregation of client accounts not only within one institution but also across various institutions and across borders. Regarding securities, the EU applies for the vast majority of its

Member States the concept of bankruptcy remoteness at the level of the end client (clients' assets are off the balance sheet of the financial institutions and may generally be returned to clients). Finally, on this point most systems across the world rely on the concept of omnibus account, where segregation is made between own account and "collectively managed/pooled" clients' accounts. When these securities are under custody at other institutions, the ABBL does not consider it economically viable to ensure segregation at all levels along the chain up to the final holder. The Basel III accord foresees a preferential treatment for "bankruptcy remote" collateral for clearing. The ABBL is not sure yet if the proposed model by CPSS-IOSCO and actual CCP models are in line with these rules. If this is not the case, this may be a major burden for the financial sector.

### **General business and operational risk management**

The ABBL thinks that **it may be difficult to be against principle 15** on general business risk and not support the idea of an appropriate level of funding for the FMIs. **However**, a difference may be made according to the time horizon of financing and ensuing liquidity of assets as well as regarding the model of ownership of the FMI. It may indeed present a different risk profile if the FMI is market owned, private or owned (totally or partially) by a central bank or a sovereign institution. In addition, although equity is a key element in the capital structure and available means of sustaining financial activity, it should not be the one and only means. The FMI may access other types of liquidity or guarantees of funding that may be cheaper while being as effective as the equity cushion. The ABBL does not consider that setting a time frame for sustaining activity is very relevant, if only based on equity. Indeed, it is more than likely that if the FMI is facing such difficulties that it may not be up and running in 6 months or one year. Members or clients will more likely than not try to disengage before, and in that case the activity of the FMI may rapidly become marginal. Finally, FMIs, although they should be robust, are first and foremost infrastructures that operate systems. They should not engage in other risky activities, like lending or other corporate finance operations. Thus, access to financing means may be more relevant than maintaining Basel III like capital ratio, although a definition of what constitutes appropriate equity capital may be desirable in order to level the playing field.

**Conceptually speaking, principle 16 on custody and investment risk makes sense**, as the FMI should indeed safeguard its assets, protect its investments and invest in quality instruments. The big issue today is what constitutes these "quality, liquid investments" and above all their availability. Indeed, the competition to good collateral may be so huge in the coming years that there may never be enough such collateral for all participants. The ensuing question is should the definition of what is collateral be reviewed and extended (to UCITS or money market funds)?

The **ABBL agrees with principle 17** to develop an operational risk management framework. Emphasis should be put on disaster recovery procedure and alternative

solutions in case of major or temporary unavailability of the service during opening hours (duplication of infrastructure or backup facilities may be the optimal solution). Communication with the FMI's members may be a key parameter to mitigate and prevent/recover from operational risks. Regular tests should be performed, but the scope and depth should be organised appropriately by each FMI in relation with its market. As the FMIs have different profiles, procedures and key operational risks may be different and handled differently.

### **Access**

The ABBL supports the principle of fair, objective and transparent access to FMIs. This is why it **supports principle 18**. Future EU regulations should emphasise this aspect.

The ABBL has **strong reservations on principle 19** on tiered participation arrangements. Although the ABBL does not dispute the fact that FMIs should be in a position to identify their risks, and among them the big users (even if indirect) of their infrastructures. This may in practice be terribly difficult to put in place for most CSDs and probably CCPs. Most CSDs work with their clients (mostly other financial institutions) with omnibus accounts; it is the task of the member to identify risks among its clients and users of CSD/CCP services. The ABBL would strongly prefer a layered approach, where each level addresses its risks and the risks it is in a position to manage or control. Simply knowing who your client's clients are may not be helpful if you cannot impose your views. The resulting situation may be that the FMI would know that a risk might arise but would not be in a position to do anything about it. Regulation may be envisaged to address procedures to increase transparency across the value chain of such risk-related information. FMIs are market infrastructures, but they have no regulatory or supervisory powers and should not have any. Not to mention data protection rules of some countries.

The **ABBL supports sound management of links** (called interoperability in the EU) mentioned in **principle 20**. FMIs may establish different types of links lateral with equivalent FMIs or up or down stream (typically CCP-CSD). In any case, access rules should be transparent, fair and should not discriminate among eligible entities. Ideally, members of FMIs should be warned in advance of the possibility of links when the risk profile of the FMI may be impacted.

### **Efficiency**

The **ABBL has no specific remarks on principle 21** on efficiency and effectiveness, **nor on principle 22** on communications procedures and standards, except that communication should use standardised and customary tools or procedure.

### **Transparency**

Regarding the last principle 23 on disclosure or rules and key procedures, the ABBL agrees to the extent that there is a level-playing field when implementing it on the basis that all relevant communication should be available indiscriminately to market participants.

### **Conclusion**

The ABBL considers that subject to some adaptations the principles proposed in this consultation are heading in a good direction, although their level of details and some confusion among which FMIs they are applicable to may be usefully remedied.