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CPSS Secretariat
IOSCO Secretariat
Bank for International Settlements
Basel, Switzerland

28 July 2011
Re: Principles for Financial Market Infrastructures – Consultative Report

Dear CPSS and IOSCO Secretariats,

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The Canadian Payments Association (CPA) welcomes the opportunity to comment on the CPSS-IOSCO consultative report on *Principles for Financial Market Infrastructures* (March, 2011).

The CPA plays a key role in the Canadian economy as the owner and operator of Canada's Large Value Transfer System (LVTS) which is the Canadian equivalent of a real-time gross settlement (RTGS) system and is designated as systemically important by the Bank of Canada. Canada is unique compared to other countries since the large value payment system is operated by a non-central bank entity and the roles and responsibilities to ensure the safety and soundness of LVTS are shared between the CPA and the Bank of Canada. The CPA manages the system on a day-to-day basis and provides maintenance and support while the Bank of Canada provides the necessary liquidity for the system through the valuation of collateral pledged to settle payment obligations. The Bank of Canada also provides settlement accounts for each of the direct participating financial institutions.

The CPA currently conducts an annual self assessment against the Core Principles for Systemically Important Payment Systems (CPSIPS) for LVTS and is pleased to state that we meet or exceed all of the principles. Moving forward with the adoption of the new FMI principles, we believe that some accommodation needs to be made for future assessments to reflect the unique nature of the relationship between the CPA and Bank of Canada.

The CPA found the 'mappings' between the new FMI principles for systemically important payment systems (SIPS) and the CPSIPS in Table 1, and Annexes A, B and D to be extremely useful in guiding us through the new FMI standards. Annex D is particularly helpful in explaining the compliance requirements for these new principles for SIPS as well as clarifying better, in some cases, the compliance requirements for some of the pre-existing principles in the CPSIPS. Even so, there still remain some points that could be better clarified and explained. Our comments attached focus on these points. In order to provide some context for our comments we have also provided a brief overview of the structure of the large-value payment system in Canada.

Please do not hesitate to contact me or Ms. Penny-Lynn McPherson (Vice President, General Counsel and Corporate Secretary) should you have any questions on our submission.

Regards,

Guy Legault
President and CEO

General Overview of the CPA and LVTS

The CPA is a not-for-profit organization, created by an Act of Parliament in 1980.

The Association's mandate, as amended through the *Canadian Payments Act* in 2001, is:

(i) to establish and operate national systems for the clearing and settlement of payments and other arrangements for the making or exchange of payments,
(ii) to facilitate the interaction of the CPA's systems with others involved in the exchange, clearing and settlement of payments, and
(iii) to facilitate the development of new payment methods and technologies.

In support of its mandate the Association also has public policy objectives to promote the efficiency, safety and soundness of its clearing and settlement systems and take into account the interests of users.

The large-value payment system in Canada involves the joint efforts of the CPA, which operates the Large Value Transfer System (LVTS), and the Bank of Canada, which operates the settlement account management and settlement credit facilities using its High Availability Banking System (HABS), for Canadian dollar payments between CPA members. In this regard Canada is unique compared to other countries since the large value payment system is operated by a non-central bank entity. There are 119 CPA members, mainly bank and non-bank deposit-taking institutions, of which 16 (including the Bank of Canada) are direct participants in the LVTS. Each of these direct participants has an LVTS settlement account at the Bank of Canada as well as various credit and collateral accounts that are used for both intra-day and overnight loans from the Bank of Canada, to facilitate settlement of LVTS payments throughout the daily cycle. The LVTS and its direct participants also rely on SWIFT as the primary provider of messaging and communications services for the system. Each of these organizations provides and operates a market infrastructure for information exchange, clearing and settlement of large-value payments in Canada that are integrated with each other (technically and through contractual agreements) to formulate Canada's large-value payment system.

The CPA's LVTS is a continuous netting system providing real-time settlement of individual payments. Real-time settlement is based on the automatic provision and repayment of collateralized intra-day (implicit) credit from the Bank of Canada to LVTS direct participants that will incur a net debit position with other participants in the system due to the completion of the payment settlements to them. Subsequent in-payments from other participants reduce or eliminate a real-time net debit position and, thus, automatically reduce or extinguish the direct participant's intra-day credit liability to the Bank of Canada. Direct participants that are in a net credit position at some point during the day have accumulated more in-payment value than the value of their out-payments in the system. The payment of net value of the Bank of Canada funds owed to the direct participant in a net credit position is covered by the net value of the Bank of Canada funds owed by the direct participants in a net debit position, which is, in turn, covered by the collateral pledged by the participants in the system to the Bank of Canada at the start of each day. Accordingly, the Bank of Canada is able to guarantee payment of all the net credit positions of LVTS direct participants that occur throughout the day. The guarantee is covered by the funds owed to it by the participants in a net debit position under the normal circumstances and by the collateral pledged to it by participants in the unusual event of a direct participant's default on its net debit position, under a specified loss allocation agreement. In the unlikely event that the liquidity requirement is exceeded, the Bank of Canada has provided an express guarantee that LVTS will settle and any shortfall in liquidity will be provided by the Bank.

Each payment that arrives during the day from one direct participant to another, and is accepted for immediate settlement in Bank of Canada funds, alters the net debit and/or credit positions of the two counterparties involved in the bilateral payment by the same value in real time.[1] Similarly, it alters their intra-day loan and/or guaranteed positions with or from the Bank of Canada. At the end of the daily cycle, those direct participants in LVTS that were unable to 'flatten out' their end-of-day net debit position in the private inter-bank market for overnight loans from other direct participants in a net credit position, borrow overnight from the Bank of Canada using collateral pledged at the start of the day and additional collateral if necessary. These Bank of Canada funds are then used to cover the payment of their net debit position in the system and to fund the payments to the other participants in a net credit position at the end of the cycle.

The CPA's LVTS offers two payment streams for its direct participants for clearing and settling large-value payments through the day, known as Tranche 1 (T1) and Tranche 2 (T2). The 'T1' stream requires that each direct participant have sufficient funds in its T1 net credit position or sufficient collateral pledged to the Bank of Canada and allocated to the T1 stream to cover the full value of each T1 payment it sends. In effect, the sum of its T1 net credit position and available T1 collateral indicates its real-time net debit cap for T1 payments. The T1 stream functions very much like a standard RTGS system. The 'T2' stream involves a collateral pooling mechanism in which each participant assigns a bilateral credit limit (BCL) to each other and contributes a specified fraction of its maximum BCL to a collateral pool. Each direct participant's net debit cap (NDC) is the same specified fraction of the sum of its aggregate BCLs. By design, each direct participant's NDC can never exceed the total value of the collateral pool and in practice the NDC of the largest participant is substantially lower than the total value of the collateral pool even at its normal daily peak level. The NDC's ensure that no single participant can acquire all of the collateralized value of Bank of Canada intra-day credit and the BCLs ensure that no direct participant can acquire all the in-payments from other direct participants without sending some payments to other participants.

The T1 payment stream is used principally for settlement of monetary policy transactions and for cash settlement of other systemically important FMIs, notably the Canadian Depository for Securities (CDSX) and the Continuous Linked Settlement (CLS) System, through accounts held at the Bank of Canada. The T2 payment stream processes the highest value and volume of large-value payments between CPA members for customers or on their own account. At the end of the daily cycle the net positions in the T1 and the T2 streams are summed for each direct participant to obtain their single end-of-day net debit or credit position. At the end of the day, the direct participants are provided with a short window in which they can flatten their positions before turning to Bank of Canada overnight credit to close-out their net debit positions for that day.

[1] An individual direct participant in the LVTS may alternate between a net debit and net credit position throughout the day.

Finally, each direct participant can monitor its net debit or credit position and its available collateral position in T1 and T2, as well as its queued payment position, in real-time throughout the day. The CPA and the Bank of Canada can monitor all these positions for all participants throughout the day.

It is important to note some key points with respect to the CPA and the operation of LVTS:

- Access to the LVTS is not based on a formal tiered system.
- Funding of LVTS operations is based entirely on dues paid by LVTS participants. The CPA does not publically disclose the fees paid by its members but the formula used to calculate members' annual dues is publically available under CPA By-law No. 2 - Finance.
- As a not-for-profit organization, the CPA operates on a cost recovery basis with minimal reserves.

Response to Principles for Financial Market Infrastructures Consultative Report

The CPA has reviewed the Principles for Financial Market Infrastructures and the comments provided focus on the details of a SIPS – specifically the large-value payment system in Canada - rather than to other types of FMIs. In this regard our comments focus on the nineteen principles which would directly or indirectly apply to the CPA as the payment system operator of LVTS (based on Annex D in the Consultative Report).

General Comments/Observations

Definition of an FMI

Paragraphs 1.8, 1.9 and 1.10 provide definitions of an FMI and of a payment system. These definitions and most of the FMI principles are expressed in a fashion that implies that the market infrastructure of a payment system and the critical information exchange, clearing and settlement services in the payment system's infrastructure are provided by a single entity. As indicated in the general overview of the large-value payment infrastructure in Canada, this is not the case, for example, obligations outlined in Principles 4, 5, 7 and 16 are addressed by the central bank in Canada as opposed to the CPA. Moreover, it may not be the case in other systems such as Euro1 and CHIPS where some settlement services are also provided by their respective central banks.

We would propose some wording changes, at least in these definitional paragraphs, to clarify that the critical comprehensive infrastructure for large-value payment systems can involve more than one infrastructure organization, each providing a particular type of critical service for clearing and settling large-value payments.

We would suggest slight wording changes such as the following to provide greater clarity:

Paragraph 1.8: **"... financial transactions among themselves or between them and a central party. Indeed there may be more than one market infrastructure organization that initiates, processes and settles a particular type of financial transaction, each providing a specific type of needed service. The specialization and centralization of these FMI organizations can allow for greater efficiency, reduced costs and some risks. ..."**

Paragraph 1.9: **"... For the purposes of this report, an FMI is defined collectively as one or more market infrastructure organizations providing critical services to five general types of financial infrastructures: payment systems, CSDs, ..."**

Paragraph 1.10: **"... the system includes the participants and the entities operating the arrangements. Payment systems are typically based on agreements between or among participants and the operators of the infrastructure arrangements. ... Many LVPSs are operated entirely by central banks, ..."**

Principle Specific Comments/Questions

> Principle 1, key consideration 5: An FMI conducting business in multiple jurisdictions should identify and mitigate the risks arising from any potential conflicts of laws across jurisdictions.

It is not entirely clear if this principle applies to the location of an FMI's offices or operations, or if it applies to any jurisdiction where payment or other information related to the operation of the system may originate with, or be processed by, remote participants in an FMI. Further refinement on the meaning of "conducting business" to provide guidance would be beneficial.

> Principle 2, key consideration 2: An FMI should have objectives that place a high priority on the safety and efficiency of the FMI and explicitly support financial stability and other relevant public interests.

With regard to key consideration 2, the CPA explicitly subscribes to efficiency, safety and soundness as principle high-level objectives for its operation of the LVTS. Although the *Canadian Payments Act* does not set out objectives that explicitly support financial stability, we see that there is a two-way causal association between a safe, sound and efficient large-value payment system and overall financial stability.

The CPA and its members have an obvious interest in a safe and efficient LVTS and in stability in the general financial system, which coincides with public policy interests. It may also have other interests as an FMI, such as good governance and fair and open access to its payment systems, which also coincide with other public interests. Many 'relevant public interests' in payment systems should remain in the realm of public policy. Even so, the CPA does have clear direct interest in cooperating with its regulatory authorities with respect to their formulation and implementation of public policies that would have an impact on the CPA and the LVTS.

Consequently, the key consideration 2.2 (and similar statements in paragraph 3.2.2) might be clearer and more specific with slight wording changes such as the following:

"... **and explicitly assert its intent to cooperate with regulatory authorities in formulating and implementing the best possible procedures for achieving financial stability and other relevant public interest objectives**."

Principle 3, key consideration 2: An FMI should provide the incentives and, where relevant, the capacity to participants and their customers to manage and contain their risks.

Some clarification or guidance would be beneficial on the expectations for how an FMI should provide incentives for participants and, especially, their customers to manage and contain their risks. For example, there are a number of provisions in the CPA LVTS By-law and Rules relating to the collateralization and loss allocation among participants and that require a direct participant to take certain action and the incentive to abide by the By-law and Rules would be to avoid any sanctions that may be ordered, in accordance with the CPA's Compliance By-law, following the determination that a contravention occurred. Additional guidance on this principle would be constructive to future assessments.

Principle 4, key consideration 3: A payment system, CSD, or SSS should cover its current and, where they exist, potential future exposures to each participant fully with a high degree of confidence using collateral and other equivalent financial resources (see principle 5 on collateral).

As explained in the overview section, the LVTS is not an RTGS system but provides finality of payment and certainty of settlement equivalent to an RTGS. There is always sufficient collateral available to complete settlement in the event of the default of the participant with the largest net debit position. In the unlikely event that there are multiple defaults in the same day, under the *Payments Clearing and Settlement Act* the Bank of Canada has provided an express guarantee that LVTS will settle and any shortfall in liquidity will be provided by the Bank. The wording of key consideration allows for "other equivalent financial resources" to be relied upon to meet the requirement and while principle 5 does provide some guidance; there is no reference to an explicit guarantee provided by the central bank.

To provide greater clarity we would suggest slight wording changes to key consideration 4.3 (or elsewhere in principle 5):

"…potential future exposures to each participant fully with a high degree of confidence using collateral and other equivalent financial resources **that could include an explicit guarantee provided by the central bank** (see principle 5 on collateral)".

Principle 12, key consideration 1: An FMI that is an exchange-of-value settlement system should eliminate principal risk by linking the final settlement of one obligation to the final settlement of the other.

Table 1 and Annex D indicate that Principle 12 should apply to payment systems even though paragraph 3.12.1 suggests that this principle applies only to FMIs where the settlement of one side of a transaction that is linked directly to the settlement of a second corresponding side or leg of the transaction, such as a securities transaction, a spot foreign exchange transaction and some derivatives transactions. A payment system FMI involves a single-sided cash settlement transaction. Based on these definitions and the key considerations for compliance with Principle 12, the CPA does not consider that this principle is applicable to the LVTS. But even more generally, it does not appear to apply to any payment system FMI as defined in paragraph 1.10 of the consultative report.

Although it may be that some securities, foreign exchange and derivatives FMIs are directly linked to a LVPS for settlement of the cash leg of a two-sided transaction, it is still the FMIs for securities, foreign exchange or derivatives settlement system that require two-legged settlement – securities, foreign currency or a derivatives contract delivered against a cash payment for the completion of settlement – not the payment system. Rather than provide its own pre-funded or collateralized cash settlement accounts, a securities settlement system or foreign exchange settlement system may link settlement of the domestic currency cash leg of a two-sided transaction to the settlement accounts of its settlement members (e.g., Target 2 Securities) or its central counterparty (e.g., CLS) in an LVPS. However, any requirements to link the cash settlement to the settlement of the second leg of the transaction are typically specified in the non-payment-system FMI; the payment system FMI simply provides it with cash clearing and settlement services. Consequently, as it relates to payment systems, this arrangement would seem to be more appropriately covered under Principle 20 on FMI links than by this principle on exchange-of-value systems.

If there is some other sense in which a payment system FMI can be defined as an exchange-of-value system[2], it should be explained more fully in the explanatory section of Principle 12; otherwise, a payment system should not be assessed against this particular principle.

Principle 15, key consideration 2: An FMI should hold sufficient equity or equity capital, in the form of shareholders' funds (such as common stock, disclosed reserves, or retained earnings), to cover potential general business losses, so that it can continue providing services as a going concern. Resources held to cover potential general business losses should be in addition to resources held to cover participant defaults or other risks covered under financial resource principles.

Principle 15, key consideration 3: At a minimum, an FMI should hold equity capital at normal times equal to [six, nine, or twelve] months of expenses. An FMI may also need to hold additional equity capital, taking into account its general business risk profile. Capital held under international risk-based capital standards should be included where relevant and appropriate to avoid double regulation.

The requirements contained in these key considerations should be amended to account for an entity such as the CPA (not-for profit organization, created by an Act of Parliament) that may not hold

[2] Bilateral (OTC) interbank loans or deposits other financial transactions that exchange cash against an secured deposit liability is an inside-outside asset transfer involving a payment system FMI for the cash exchange in central bank funds and a decentralized bilateral IOU exchange that involves neither the payment system FMI nor any other FMI as defined in this report. Also, a securities settlement FMI that provides cash accounts as well as securities accounts for its participants for intra-day settlement has been traditionally described by the CPSS as a securities settlement FMI not as a payment system FMI. See, for example, the CPSS-IOSCO (2001) *Recommendations on Securities Settlement Systems*.

considerable amounts of equity capital. Introducing a requirement to maintain large amounts of equity capital may not be appropriate for all FMIs, particularly those like the CPA that operate on the basis of an annual budget and member dues, and have the ability to initiate special assessments against the membership, to which they agree, should additional funding be required.

We would suggest slight wording changes such as the following to reflect the organizational governance and financing structure under which the CPA operates:

"An FMI should hold sufficient equity or equity capital, in the form of shareholders' funds (such as common stock, disclosed reserves, or retained earnings) **or have the ability to acquire equity through an assessment of its participants**, to cover potential general business losses, so that it can continue providing services as a going concern."

> Principle 15, key consideration 5: An FMI should maintain a viable plan for (a) raising additional capital should its equity capital approach or fall below the minimum; and (b) if the FMI is unable to raise new capital, achieving an orderly wind down or reorganisation of its operations and services. This plan should be approved by the board of directors (or an appropriate board committee), updated regularly, and reviewed by the FMI's regulator, supervisor, or overseer.

The CPA was created by an Act of Parliament and the Act states that the affairs of the Association may only be wound up by Parliament.

Given the range of legal organizational arrangements for FMIs, it is suggested that this consideration be amended to account for some form of legislative provision that supports the reorganization or orderly wind down of the FMI's operations and services. It may be re-worded, for example, to state: "… This plan should be approved…. appropriate board committee) in compliance with any relevant statutory or regulatory requirements, updated regularly …"

> Principle 17, key consideration.3: An FMI should have clearly defined operational reliability objectives and should have policies in place that are commensurate with those objectives. An FMI should have adequate capacity and scalability, as well as the tools and procedures to monitor the performance of the FMI.

Clarification would be beneficial to confirm whether monitoring the performance of the FMI applies only to the system or to the performance of the system operator as well. If the latter, as suggested by Principle 15 on business risk and by the definition of an FMI in paragraph 1.8, it would be clearer to re-phrase the final sentence in consideration 3 as follows: "… operational capacity and scalability …. and its operator should have the tools and procedures to monitor and manage its operational performance."

> Principle 17, key consideration 6: An FMI should identify, monitor, and manage the risks that key participants, other FMIs, and service and utility providers might pose to its operations. In addition, an FMI should identify, monitor, and manage the risks its operations might pose to other FMIs.

The consideration makes reference to identifying, monitoring and managing risks that other FMIs might pose but does not speak to what criteria would define the material nature of critical direct or indirect connections between FMIs so that such connections may be more clearly identified and assessed. For example, the Canadian dollar leg of CLS settlement is designated as systemically important by the Bank of Canada and is settled using LVTS with the Bank of Canada as its settlement agent. It is unclear whether this type of link between the LVTS and CLS – through the Bank of Canada as settlement agent for CLS - would be considered material under the principle.

> Principle 19: An FMI should, to the extent practicable, identify, understand, and manage its potential risks arising from such tiered participation arrangements. The risks identified and the proposed mitigating actions should be reported to the FMI's board of directors.

The introduction of the new principle on tiered participation arrangements may create some challenges, particularly for those systems that do not have formal tiered participation in place, such as the CPA.

(i) Definition of a tiered payment system

The descriptions of tiered participation in paragraphs 1.24 and 1.26 and in the explanatory sections of Principle 19 are not very clear as to what specifically defines a tiered payment system for the application of this principle. Should this principle be applied to a large-value payment system in which the arrangements between the direct participants in the LVPS and indirect participants are bilaterally contracted and outside the formal rules and procedures of the LVPS or only to one in which indirect participation is formally defined within its rules and procedures? In other words while indirect participation may not be formally recognized as a specific class of participation in the system, it can still exist functionally among active eligible members in the FMI that operates the system.

For example, CPA members can choose to participate directly in the LVTS and thus acquire LVTS settlement accounts and credit facilities with the Bank of Canada (subject to the Bank's requirements) or choose to contract to clear and settle its large-value payments indirectly in the LVTS through a direct participant in the system. Such contracting between the direct and the indirect participating CPA members are bilaterally negotiated without any contractual conditions imposed by the CPA for the LVTS. For the purposes of the LVTS, and for other large-value payment systems in the same situation, would this arrangement constitute a tiered arrangement, and thus be subject to an assessment of compliance with Principle 19, since it involves eligible CPA members or would it be considered a non-tiered arrangement since the clearing and settlement contracts are bilaterally negotiated with no LVTS or CPA rules and requirements relating or referring to the contractual arrangement? We also question whether this is a responsibility of an FMI or the supervisor of financial institutions since these are private contractual relationships between regulated financial institutions.

Further clarification on the definition of a tiered arrangement along these lines for the purpose of application of Principle 19 to a payment system would be very useful.

(ii) Protection of the indirect participant

The discussion of a tiered payment system is largely from the perspective of protecting a direct participant from a systemically important indirect participant in the FMI. There is one important exception to this observation in paragraph 1.24 where a direct participant is expected: (i) to protect the assets of an indirect participant provided in support of the FMIs risk management requirements; and, (ii) to allocate a fair share of the costs of the FMIs risk-management requirements to the indirect participant (based presumably on its share of the overall risk to the system from the group of direct and indirect participants). However, these expectations are not included among the key compliance considerations for Principle 19.

Also, there is no consideration of how an FMI might arrange the clearing and settlement of payments of an indirect participant in an LVPS, particularly for a systemically important payment system, in the event of an operational problem or failure event of its direct participant. A mechanism to readily switch the clearing and settlement of the large-value payments of an indirect participant to another mechanism – be it another direct participant or direct submission of batched payments at multiple points during the day supported by emergency funding, for example – would seem to be beneficial to the overall safety and financial efficiency of the payment system.

The text on Principle 19 and its key considerations might be more balanced and effective if it included some references to the protection of indirect participants in a tiered payment system along the lines suggested above.

> Principle 20: Before entering into a link arrangement and on an ongoing basis once the link is established, an FMI should identify and assess all potential sources of risk arising from the link arrangement. Link arrangements should be designed such that each FMI is able to observe the other principles in this report.

Table 1 of the report indicates that the principle on FMI links applies to payment systems while Annex D of the report indicates that it does not. This anomaly needs to be addressed in the final report.

The CPA would tend to agree that the first two considerations of this principle should apply to an LVPS. The CPA recognizes that the interdependencies between the LVTS, CDSX, CLS and even the (Automated Clearing Settlement System (ACSS) in the Canadian financial system can, under some abnormal circumstances, channel systemic risks among these FMIs.[3] For the most part, these FMIs are linked through common participants that act as settlement members in all of them.

> Principle 21, key consideration 3: An FMI should have established mechanisms for the regular review of its efficiency and effectiveness.

The ability of an FMI to assess and measure its efficiency and effectiveness may introduce some challenges. It is understood that each FMI will determine the metrics for how to measure whether it is efficient but some additional guidance would be beneficial in order to create a baseline for all FMIs.

> Principle 22: An FMI should use, or at a minimum accommodate the use of, internationally accepted communication procedures that can support interoperability between the FMI, its participants, their customers, and other users (such as third-party service providers and other FMIs).

The addition of this new communication principle raises some questions with respect to the relevancy of managing risk within an FMI. The expectation is that an FMI will engage its participants in a discussion regarding the use of specific communication channels and standards and any decision will be based on solid business rationale. Recommending the use of internationally accepted standards through the FMI principles may not be appropriate.

As a final comment, while the consultative report on Principles for Financial Market Infrastructures does not include an explicit self-assessment methodology, the CPA would suggest that such a methodology be developed for publication at the same time or soon after publication of the final principles report. Moreover, the CPA would propose that the self-assessment methodology be designed in a fashion similar to that of the CPSS-IOSCO (2004) Recommendations for Central Counterparties in which the compliance rating for each principle was directly related to the extent of the principle's key considerations.

[3] See, for example, CPSS (2008), *The interdependencies of payment and settlement systems*; and Embree, L. And K. Millar (2008), *The Effects of a Disruption in CDSX Settlement on Activity in the LVTS: A simulation Study*, Discussion paper No. 2008-7, Bank of Canada.

Response to Cover Note Questions

The responses provided below specifically address the questions raised in the cover note that was circulated along with the consultative report.

Principle 4

The questions related to Principle 4 apply specifically to a Central Counterparty (CCP). As the CPA is not a CCP, it does not have any feedback to provide on the pros and cons for the minimum requirements.

Principle 7

What are the pros and cons of establishing for liquidity risk (1) a "cover one" minimum requirement for all FMIs; (2) a "cover two" minimum requirement for all FMIs; and (3) either a "cover one" or a "cover two" minimum requirement for a particular FMI, depending on the risk and other characteristics of the particular payment obligations it settles, the products it clears, the markets it serves and the number and type of participants it has? What potential risk, competitiveness or other concerns might arise if certain FMIs that settle certain payment obligations or that clear certain products would be subject to a "cover one" minimum requirement, while certain other FMIs that settle certain other payment obligations or that clear certain other products would be subject to a "cover two" minimum requirement? How and to what extent could these concerns be addressed?

Which risk and other characteristics of the payment obligations settled by a payment system, CSD or SSS are relevant in weighing the pros and cons of a "cover one" versus a "cover two" minimum liquidity requirement for such an FMI? Which risk and other characteristics of the products cleared by a CCP are relevant in weighing the pros and cons of a "cover one" versus a "cover two" minimum liquidity requirement for a CCP? In particular, to what extent are any or all of the following risk and other characteristics of the payment obligations settled or the products cleared by an FMI relevant: OTC versus exchange-traded; mandatory versus voluntary clearing; "cash" versus "derivative"; the duration, volatility and degree of leverage; the number and type of CCP participants; the degree of market concentration; and the availability and reliability of prices from continuous, transparent and liquid markets?

The requirement for minimal liquidity requirements should be based on objective criteria such as the value of transactions cleared and settled through the system and the level of concentration held within direct participants (i.e. those acting on behalf of other financial institutions). Also, for FMIs that operate the same type of system they should be held to the same minimum liquidity requirements as it relates to "cover one" or "cover two". To treat FMIs differently would introduce competitive advantages for one FMI over another. The CPA feels it is well positioned in this regard as LVTS was designed to support the "cover two" minimum liquidity requirement and, in the unlikely event that the liquidity requirement is exceeded, the Bank of Canada has provided an express guarantee that LVTS will settle and any shortfall in liquidity will be provided by the Bank.

Principle 14

The questions related to Principle 14 apply specifically to a Central Counterparty (CCP). As the CPA is not a CCP, it does not have any feedback to provide on the pros and cons for the minimum requirements.

Principle 15

What are the pros and cons of establishing a quantitative and/or a qualitative requirement for the amount of liquid net assets funded by equity that an FMI should hold to cover general business risk?

If a quantitative requirement is established, what are the pros and cons of setting this amount equal to six, nine or twelve months of operating expenses?

Establishing a requirement for a certain amount of liquid net assets for an FMI will ensure that the FMI will have the ability to absorb certain cash-flow shocks that may materialize from time to time and still continue to meet its short-term financial obligations. Liquid asset holdings are a standard requirement for financial management of any business, including an FMI, and one which the CPA observes rigorously. However, establishing an arbitrary quantitative requirement that does not align the on-going financial management needs with the organizational, operational and financial structure of the specific FMI may introduce new and possibly unnecessary challenges for at least some of those organizations.