CPSS - IOSCO

COMMENTS

Principles for Financial Market Infrastructures
Consultative Report, March 2011

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Dear Committee members,

The Desjardins chair in sustainable management and the Research group in applied finance (Grefa) welcome the opportunity presented by the CPSS and the IOSCO to formulate and submit comments on their consultative report entitled : « Principles for financial market infrastructures».

Our comments are structured into three parts. First, introductory comments are formulated on the form and contents of the CPSS-IOSCO consultative report. Second, specific comments are formulated on a given principle or a given section of the CPSS-IOSCO consultative report. Third, we specifically formulate comments on the important questions asked by the CPSS-IOSCO in its March 10th 2011 Cover note to the consultative report.

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1. Introductory comments

We agree with the CPSS-IOSCO when they express the belief that a single set of standards will provide greater consistency in the oversight and regulation of FMIs worldwide. Moreover, we also agree that the new principles reflect most of the lessons learned from the recent financial crisis and the experience gained in the years since the current standards were issued. Compared to the current standards, the report introduces a number of provisions on issues, new principles and a category of FMIs, trade repositories (TRs), that were not addressed by the existing standards.

Overall, we were most favourably impressed by the breadth, depth and very high quality of the Consultative report. We found the text to be well structured, well documented and also very well written. We believe that Committee and group members are to be congratulated on having written such an interesting and thought provoking consultative report on principles for financial market infrastructures.

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2. Specific comments on a given principle or a given section of the CPSS-IOSCO consultative report

On page 31, Principle 4 Credit risk, it is said that : « An FMI should maintain sufficient financial resources to cover its credit exposure to each participant with a high degree of confidence. As we explain next, this notion of confidence should be more strictly defined much sooner in the text. Further on, on page 31, Key consideration 4., it is said (see principle 6 on margin which specifies 99 percent initial margin coverage and other requirements). Notice that the exact meaning of « 99 percent initial margin coverage» has not yet been defined. Further on, on page 32 in footnote 33 « Potential future exposure is technically defined as the maximum exposure estimated to occur on a future date at a high level of statistical confidence. Finally, on page 34, 3,4.9 managing credit risk it is more clearly written: « Initial margin should meet an established single-tailed confidence level of at least 99 percent for each product that is margined on a product basis….» Again, on page 35, 3.4.11 on backtesting :« A CCP should backtest its initial margin coverage on a daily basis to demonstrate at least 99 percent coverage (See page 6 on margin) ». In comparison, on page 40, Principle 6 : Margin, key consideration 3. Here it is more clearly stated : « Initial margin should meet an established single-tailed confidence level of at least 99% for each product that is margined on a product basis. Further discussions are found on page 42 on initial margin methodology 3.6.6, also on page 44 on portfolio margining 3.6.12, and on page 45 on testing margin coverage3.6.14 .

In section 3 of this text, we formulate comments on Principle 15: General business risk key considerations; as those which pertain to holding sufficient net liquid assets funded by equity.

Principle 21: Efficiency and effectiveness on page 92 states that: «An FMI should be efficient and effective…». On page 93, 3.21.2 it is stated that: «An FMI should be efficient. On page 93, 3.21.3 it is stated that : « Efficiency also involves cost control. In this context, an FMI is efficient when it understands its direct and indirect costs. We suggest that implementing a sound managerial accounting system along with accompanying procedures and tools would also be very productive when accompanied by the more traditional cost accounting framework discussed in the text. For example, an FMI's products and services lend themselves quite well to activity based accounting and activity based costing. In addition, an FMI's products and services, lines of business, client-participant accounts also lend themselves quite well to RAROC (Risk-Adjusted-Return-On-Capital) determination and analysis. In other words, proactive efficiency management generally involves simultaneously optimizing the use of at least three distinct parameters, human capital, physical capital, and financial capital, in order to earn satisfactory long-run risk-adjusted returns on an FMI's value-added products and services to participants, to markets and to society as a whole.

We fully support the formulation and adoption by FMIs of Principle 22 on Communications Procedures and Standards, Principle 23 on Disclosure Rules and key procedures, Principle 24 on Disclosure of Market Data, and Responsibility C (see page 103) of central banks, market regulators and other relevant authorities which should all clearly define and disclose their regulatory, supervisory and oversight policies with respect to FMIs. These very principles foster more extended transparency, more complete financial disclosure by FMIS. As a result, FMIs' operations and financial results are more easily subject to market discipline, and this supervisory and public scrutiny both contribute to improve the level and quality of FMIs' accountability to participants, to markets, and to society as a whole. Moreover, the application of these related principles will positively impact upon the safety, the efficiency and effectiveness of FMIS, participants, and markets.

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3. Important questions formulated by the CPSS-IOSCO in its March 10th Cover note to the Consultative report

On Principle 4 : Credit risk

We support the adoption of the following modified version of alternative (3): « A CCP should be subject to the " cover one" minimum requirement in the short-term, and the "cover two" requirement over the medium-term». We believe that this modulated alternative would help to promote a more level playing field, both domestically and internationally, help reduce the level of systemic risk, and possibly help manage the cyclical impacts of introducing new regulatory requirements for FMIs.

On Principle 7: Liquidity risk

We support the adoption of the following modified version of alternative (3) :« An FMI should be subject to the "cover one" minimum liquidity requirement in the short-term, and the "cover two" requirement over the medium-term». This would contribute to promote a more level playing field both domestically and internationally, reduce the level of systemic risk, and possibly help manage the cyclical impacts of introducing new regulatory requirements for FMIs.

On Principle 14: Segregation and Portability

While no specific model is prescribed in the Consultative report, the choice of the "right" model should be made on the basis of its contribution to efficiency and level of protection. One option or model could be based on minimum requirements which could be based on an in-depth observation and analysis of related practices by a representative sample of existing CCPs. Perhaps, this methodology could provide the needed insights into a preliminary version of "emerging best practices" in the application of the Segregation and Portability Principle.

On Principle 15: General Business Risk

We agree that a FMI should be required to hold sufficiently liquid net assets funded by equity to cover potential general business losses. We also believe that FMIs should establish both a qualitative and quantitative requirement for the amount of liquid net assets funded by equity. This would promote a more level playing field both domestically and internationally; in addition, the level of market safety and efficiency would be improved. In our view the quantitative minimum net liquidity requirement should be initially set at six months of operating expenses in the short-term, to be increased gradually to nine months in the medium-term, and to eventually reach twelve-month coverage over a longer time period. This modulation of the minimum net liquidity requirement helps promote a more level playing field both domestically and internationally. It contributes to market safety, reduces the level of systemic risk, and lends itself to managing the potential cyclical impact of introducing new regulatory requirements.

On Adoption and Implementation of the Principles

We believe that most existing FMIs will be able to implement relatively quickly, over one to two years, the changes necessary to increase their resilience as defined within the new principles. However, some principles like Principle 4 credit risk, Principle 7 liquidity risk, and Principle 15 general business risk which entail meeting minimum net liquidity, equity and operating expense coverage requirements should be more gradually and carefully implemented over a short to medium-time horizon.; that is, over a one to five-year time period.

On Assessment methodology

We appreciate and take notice that an assessment methodology, along with the associated requirements with respect to the preparation and public disclosure of FMIs' self assessments and/or related information and key questions, will accompany the final report when published in early 2012.