International Banking Federation

Pinners Hall
105-108 Old Broad Street
London EC2N 1EX

tel: + 44 (0)20 7216 8947
fax: + 44 (2)20 7216 8928
web: www.ibfed.org

Mr Greg Tanzer
Secretary General
IOSCO
Calle Oquendo 12
28006 Madrid
Spain
Email: fmi@iosco.org

Mr Daniel Heller
Head of Secretariat
CPSS
Bank for International Settlements
4002 Basel
Switzerland
Email: cpss@bis.org

29 July 2011

Subject: **CPSS-IOSCO consultative report "Principles for financial market infrastructures"**

Dear Mr Tanzer and Mr Heller,

The International Banking Federation ('IBFed') is the representative body for national and international banking federations from leading financial nations around the world. Its membership includes the American Bankers Association, the Australian Bankers' Association, the Canadian Bankers Association, the European Banking Federation, the Japanese Bankers' Association, the China Banking Association, the Indian Banks' Association, the Korean Federation of Banks, the Assocation of Russian Banks and the Banking Association of South Africa. This worldwide reach enables the Federation to function as the key international forum for considering legislative, regulatory and other issues of interest to the banking industry and to our customers.

Against the background of the consultative report prepared by CPSS- IOSCO on "Principles for financial market infrastructures", the IBFed would like to share with you some reflections in the sections below.

As a preliminary remark, however, the IBFed would like to underscore that its comments are written from the perspective of **participants (both direct and indirect) in financial market infrastructures (FMIs).**

General remarks

As financial markets participants in FMIs, members of the **IBFed fully share the IOSCO-CPSS public policy objectives** of (i) enhancing the safety and efficiency of FMIs; (ii) limiting systemic risk; and (iii) fostering transparency and financial stability. Financial markets participants better fulfil their economic and societal role in stable financial markets. Only adequately designed and operated FMIs may prevent financial shocks from being passed from one participant or system to the other.

Given the systemic nature of many FMIs, and the role they play, the Federation believes that the Principles should strike a right balance between preserving financial markets' stability, ensuring a fair competition among FMIs and allowing access to participants and their clients.

The Federation supports that **public policy action is taken to ensure the full achievement of the above-mentioned objectives**. That said, the IBFed would like to remind that the financial services industry has invested significant energy and resources in better organising the FMIs space since the beginning of the crisis. Such efforts have been recognised by the Financial Stability Board (FSB) and other regional public authorities such as the European Commission and the Federal Reserve Bank of New York, particularly in the area of OTC derivatives clearing.

While the Federation has sympathy for the CPSS-IOSCO approach of presenting a set of principles that is broad in its scope and agnostic as to the concrete tools required to satisfy them, the IBFed considers that CPSS-IOSCO's explicit language over the possibility of gold-plating (i.e. "*authorities have the flexibility to consider imposing higher requirements for FMIs"*, page 12) should be removed. The **Federation is of the view that neither global financial stability nor investor confidence will be served by the complexity resulting from the possible co-existence of differing regulatory frameworks** applicable to FMIs.

The IBFed welcomes CPSS-IOSCO's language about general and specific applicability of its principles. Indeed, some CPSS-IOSCO's principles are only relevant to certain FMIs. The Federation would like to note, however, that **it is not necessarily the licensing regime (i.e. the type of FMI) that determines whether a principle should be applicable** but, rather, the functions and responsibilities of any given FMI. For example, principle 24 on disclosure of market data is of application to Trade Repositories only, according to the CPSS-IOSCO document. There are, however, other FMIs (e.g. central counterparties) that could meet - partially or in full - the information needs of participants, authorities and the public.

With regard to the implementation of the principles, the Federation agrees that, **whilst a degree of self-assessment by FMIs is desirable, relevant authorities are expected to regulate and supervise FMIs consistently with the principles**. In this regard, as stated in the paper, international coordination is of the essence, to avoid potential duplications.

Finally, the IBFed would like to underscore the need to embark on as **broad and thorough a reflection as possible to consider the overall impact that the implementation of these proposals may have on the levels of market liquidity**. Whilst tying up liquidity in certain FMIs such as CCP's may be positive for financial stability or prudential supervision approaches, it may have adverse consequences for market making activities and / or efficient collateral management.

Detailed remarks

Principle 2 on governance

An FMI should have governance arrangements that are clear and transparent, promote the safety and efficiency of the FMI, and support the stability of the broader financial system, other relevant public interest considerations, and the objectives of relevant stakeholders.

The IBFed welcomes the explicit recommendation that "*the board should ensure that the FMI's overall strategy, rules, and major decisions reflect appropriately the interests of its participants".* There is uncertainty, however, as to how the above recommendation may be fulfilled if the board includes independent members, as also recommended by the CPSS-IOSCO principles.

Broadly speaking, the **Federation is concerned that the interests of participants in the FMI may be simply addressed along with those of other stakeholders**. The recommendation that "*mechanisms for involving stakeholders in the board's decision-making process* may (our underlining) *include user representation on the board, user committees, and public consultation processes*" seems to be worryingly pointing in that direction.

It should be recalled that, in certain FMIs (e.g. central counterparties), participants ultimately bear the default risk of the infrastructure. Therefore, it is the view of the Federation that there should be a clearer, more direct link between "*financial support*" and "*voice / representation*". In order to manage conflicts of interest and preserve the integrity of the CCP regarding its role as a systemic piece of market infrastructure, the Risk Committee of the CCP should only be composed of participants who are risk mutualisers.

Furthermore, the IBFed would like to underscore its support to CPSS-IOSCO's as they note that **FMI providing services that present a distinct risk profile from its primary function**, should ensure that adequate legal and/or governance arrangement are in place to prevent possible conflict of interests.

Finally, regarding systemically important payment systems (SIPSs), the Federation would suggest **to make a clear distinction between SIPSs and other FMIs in terms of governance.**

Principle 3 on the framework for the comprehensive management of risks

An FMI should have a sound risk-management framework for comprehensively managing legal, credit, liquidity, operational, and other risks.

The Federation agrees that FMIs should take an integrated and comprehensive view of its risks, including the risks it bears from and poses to its participants and their customers. The IBFed backs the recommendation that FMIs should manage risks from a comprehensive perspective and have a sound risk-management framework.

The Federation wonders, however, if, as primarily risk mitigating infrastructures, FMIs should not pay more attention to the risks that they can absorb from the market (and less to the risks that they pose on participants). Whilst it is true that FMIs pose risks to participants and to the wider system as a whole, the **FMI should not be responsible for evaluating the risk it poses to participants and other interdependent entities**.

Principles 4 and 7 on Credit and Liquidity Risks

Principle 4: Credit risk An FMI should effectively measure, monitor, and manage its credit risk from participants and from its payment, clearing, and settlement processes. An FMI should maintain sufficient financial resources to cover its credit exposure to each participant fully with a high degree of confidence. A CCP should also maintain additional

financial resources to cover a wide range of potential stress scenarios that should include, but not be limited to, the default of the [one/ two] participant[s] and [its/their] affiliates that would potentially cause the largest aggregate credit exposure[s] in extreme but plausible market conditions.

Principle 7: Liquidity risk

An FMI should effectively measure, monitor, and manage its liquidity risk. An FMI should maintain sufficient liquid resources to effect same-day and, where appropriate, intraday settlement of payment obligations with a high degree of confidence under a wide range of potential stress scenarios that should include, but not be limited to, the default of [one/two] participant[s] and [its/their] affiliates that would generate the largest aggregate liquidity need in extreme but plausible market conditions.

The Federation is of the view that **FMIs should be required to apply robust risk management policies,** while supervisors should carry out intensive and efficient oversight functions, so as to avoid that FMIs can face the possibility to be liquidated.

The **Federation agrees with the definition of credit risk and liquidity risks** provided by the CPSS-IOSCO principles, and it underlines the importance of the "high degree of confidence" between direct participants, indirect participants and FMIs in the risk coverage process. An FMI's transparency towards its direct participants is of the essence on stress scenarios, assumptions and methodologies.

Furthermore, the Federation considers that, in order to be efficient, **regulation determining FMI's additional financial resources** (i.e. beyond initial capital) **needs to take into account the diversity of profiles of credit risks among traded products (**traditional futures or derivatives), **payment services offered** (cash clearing) **as well as the difference between markets** (in terms of concentration).

Principle 5 on collateral

An FMI that requires collateral to manage its or its participants' credit risk should accept collateral with low credit, liquidity, and market risk. An FMI should also set and enforce appropriately conservative haircuts and concentration limits.

Considering the increasingly scarcity of available collateral, the Federation considers that an **FMI should dynamically adjust its requirements for acceptable collateral,** in accordance with changes in underlying risks.

The Federation notes that, in a situation of market stress, any given FMI's survival reflex may enter intro contradiction with the preservation of wider market stability. For that reason, the Federation strongly supports the recommendation that **FMIs should have in place an appropriate collateralization policy that reduces to the maximum extent possible haircuts** that can have a pro-cyclical impact on the market.

Principle 8 on settlement finality

An FMI should provide clear and certain final settlement, at a minimum, by the end of the value date. Where necessary or preferable, an FMI should provide final settlement intraday or in real time.

The IBFed supports this principle and believes that **settlement finality is a major component of systemic stability and should therefore be guaranteed.**
Regarding the issue of the links between CSDs (see also Principle 20), the Federation stresses that **there should only be one system providing settlement finality for any transaction.**

This seems not to be addressed in the consultative report and the Federation invites CPSS-IOSCO to complement the report in this direction.

Principe 9 on money settlement

An FMI should conduct its money settlements in central bank money where practical and available. If central bank money is not used, an FMI should minimise and strictly control the credit and liquidity risk arising from the use of commercial bank money.

Generally speaking, the IBFed believes that **settlement in central bank money is preferable where available** other options should remain possible. For example, it should remain possible to settle in commercial bank money, or to use a combination of central bank and commercial bank monies, as it emerges from the explanatory note to the Principle.

Principle 11 on central securities depositories

A CSD should have appropriate rules and procedures to help ensure the integrity of securities issues and minimise and manage the risks associated with the safekeeping and transfer of securities. A CSD should maintain securities in an immobilised or dematerialised form for their transfer by book entry.

The IBFed believes that **the role of a CSD is to perform core functions which are essential to the stability and efficiency of capital markets** and ultimately to the safeguard of the interests of the securities' issuers and holders. **These core functions are registration, central safekeeping and central settlement.** If and when a CSD was to conduct other activities, these activities should have a clear connection with the core services (e.g. the administration of corporate actions) and must be **low-risk,** i.e. they should not create additional risk over and above the standard operational risk associated to the core functions above mentioned.

The Federation, therefore, shares the view of CPSS-IOSCO that additional tools may be necessary to address the credit and liquidity risks associated to the provision of services that are not linked to the core functions of a CSD, or that a CSD may need to separate legally the other activities it may perform along its core functions in order to mitigate possible additional risks. The Federation believes that **a clear line of demarcation between the market infrastructure's role and core functions of a CSD and the higher-risk, other services it may perform as a distinct commercial entity is essential** in order to prevent that the credit or liquidity risks associated to these separate commercial activities will spill over into the core functions of a CSD, possibly bringing new systemic risk and instability into the broader financial market.

Principle 13 on participant-default rules and procedures

An FMI should have effective and clearly defined rules and procedures to manage a participant default that ensure that the FMI can take timely action to contain losses and liquidity pressures, and continue to meet its obligations.

The Federation agrees that continued operability of a FMI in distressed situations is of the essence and, therefore, backs that FMIs have access to additional resources (e.g. the default fund). It is, however, important that the **scenarios and conditions for using those resources (e.g. waterfall mechanisms) are clearly defined**.

Principle 14 on segregation and portability

A CCP should have rules and procedures that enable the segregation and portability of positions and collateral belonging to customers of a participant.

The Federation agrees that the segregation of indirect participants' positions and collateral plays an important part in the safe and effective holding and transfer of their assets. Effective segregation arrangements can reduce the impact of a participant's insolvency on its customers.

The Federation reminds that, in its December 2010 consultative document on "Capitalisation of bank exposures to central counterparties", the Basel Committee proposed a favourable treatment for "bankruptcy-remote" collateral for direct participants as well as a favourable qualifying CCP risk weight for non-member banks exposures, provided their assets were segregated and bankruptcy-remote from the direct participants.

The Federation considers that under the proposed principle 14 on segregation and portability, **segregation should not be a universal requirement, and if mandated, should depend upon how bankruptcy-remote the CCP is.**

Finally, the Federation is agnostic as to the presented models for segregation of assets and margins. From a general standpoint, however, the IBFed considers that an ideal model would be one that fully protects the positions of indirect clearing members on their request, allows an expedite portability, and provides full transparency to the participants on their exposures.

Principle 15 on general business risk

An FMI should identify, monitor, and manage its general business risk and hold sufficiently liquid net assets funded by equity to cover potential general business losses so that it can continue providing services as a going concern. This amount should at all times be sufficient to ensure an orderly wind-down or reorganisation of the FMI's critical operations and services over an appropriate time period.

The Federation notes that this Principle requires an FMI to *"hold sufficient liquid net assets funded by equity to cover general business losses so that it can continue providing services as a going concern".* The question is then posed as to what period of operating expenses should be covered. This requirement does not appear to take properly into account different ownership structures and the different levels of risk these bring to the system. In particular this requirement does not seem appropriate in situations where the infrastructure is owned by the users as opposed to third-parties. In view of the short term nature of payment systems' settlement operations, **six months operating expenses are considered acceptable for payment systems** in order to give time for alternative arrangements to be made.

It is also **unclear why holdings of liquid net assets need necessarily be funded by equity in the case of payment systems** provided they are specifically dedicated to this purpose. Also, it is not clear how funding by means of equity would apply where a central bank runs an FMI. A level playing field for competition purposes is considered to be essential.

Finally, it is suggested that **a formal definition of equity should be provided.**

Principle 16 on custody and investment risk

An FMI should safeguard its assets and minimise the risk of loss or delay in access to those assets, including assets posted by its participants. An FMI's investments should be in instruments with minimal credit, market, and liquidity risks.

The IBFed supports the provisions on custody and investment risk, in particular the requirement for an FMI to safeguard its assets in supervised and regulated entities that have robust accounting practices and safekeeping procedures.

While the Federation agrees that an FMI should have an easy and prompt access to its assets and that its investment strategy should be consistent with its overall risk-management strategy, the Federation would welcome **more clarity on what constitutes the investment strategy of a FMI** in terms of criteria and procedure.

Principle 17 on operational risk

An FMI should identify all plausible sources of operational risk, both internal and external, and minimise their impact through the deployment of appropriate systems, controls, and procedures. Systems should ensure a high degree of security and operational reliability, and have adequate, scalable capacity. Business continuity plans should aim for timely recovery of operations and fulfilment of the FMI's obligations, including in the event of a wide-scale disruption.

The IBFed supports the principle that an **FMI should establish a robust operational risk-management framework that should allow complete and rapid identification, monitoring, management and prevention of operational risk**. The Federation reminds, however, that the rulemaking of this principle should be tailored to the specific needs of each type of FMI. Appropriate systems, policies, procedures and controls to minimize operational risk should also be made available to all FMIs' participants (in their capacity as users of infrastructures) to ensure transparency in risk management.

The Federation would, however, suggest requesting an FMI to have a clear and precise classification of the operational risks it may encounter in the conduct of its activities. In order to facilitate the identification of risk and foster the prevention of it, an **FMI could be encouraged to put in place a system of identification of operational risks**. Such a system could be composed of (at least) two levels of risk management: first, the management of minor but more frequent errors; second, the management of more serious and disruptive events. Each kind of operational risk should be addressed by specific requirements that would be defined according to the nature and relevance of the risk concerned.

Furthermore, the IBFed particularly welcomes the provision on business continuity planning that it regards as extremely important and necessary so as to ensure that an FMI is able to carry on its functions in all circumstances. The Federation, however, stresses that in case of operational problems, the participants of an FMI are the first to be impacted. Therefore, the Federation would welcome a **requirement on FMIs to inform their participants of any operational failure which they may experience**. This would enable participants to adopt internal appropriate measures to cope with the situation as soon as possible. Such an obligation could take the form of time and communication requirements.

Principle 18 on access and participation requirements

An FMI should have objective, risk-based, and publicly disclosed criteria for participation, which permit fair and open access.

The Federation agrees with IOSCO-CPSS that **FMIs should permit participants fair and open access to their services**. Access to FMIs cannot, however, be indiscriminate: participants in FMIs should also be subject to certain objective risk-based requirements.

Furthermore, the Federation reminds CPPS-IOSCO of the importance to address exit procedure with clear criteria, the adherence to which should be closely monitored by competent authorities. **Exit criteria should be clearly spelled out** and take into due consideration the impact that the exit of a large market participant could have on an FMI's stability.

Principle 19 on tiered participation arrangements

An FMI should, to the extent practicable, identify, understand, and manage the risks to it arising from tiered participation arrangements.

The IBFed agrees in principle with CPSS-IOSCO that an FMI should try to identify, understand and manage the risks arising from tiered participation arrangements.

Generally speaking, the Federation is **concerned by the extent an FMI can or should try to interfere in a commercial relationship between one of its members and its customers,** relationship of which it may well have no direct visibility.

Principle 23 on disclosure of rules and key procedures

An FMI should have clear and comprehensive rules and procedures and should provide sufficient information to enable participants to have an accurate understanding of the risks they incur by participating in the FMI. All relevant rules and key procedures should be publicly disclosed.

The Federation backs the principle that FMIs should provide sufficient information to its participants and prospective participants to enable them to identify clearly and understand fully the risks and responsibilities of participating in the system. Such principle should, however, be subject to the following **limitations**:

- **Detailed information on a FMI's rules and procedures and / or a description of a system's design** and operations that may compromise the infrastructure's security should not be disclosed to parties with no legitimate interest in it.

- Disclosure of the **information on fees and discounts** should be left to the discretion of each FMI.

Conclusions

The IBFed supports the objectives set forth by CPSS-IOSCO. Robust and sound FMIs are crucial for ensuring a smooth functioning of financial markets in all conditions. Smart regulation of FMIs is, therefore, instrumental in instilling confidence that such all systems – payments, securities and trade repositories – can withstand the most severe shocks.

Given the systemic nature of many FMIs, and the role they play, the Federation believes that the Principles should strike a right balance between preserving financial markets' stability, ensuring a fair competition among them and allowing access to participants and their clients on the basis of adequate risk management.

Consistent implementation of the IOSCO-CPSS principles at the international level is of the essence, not only for level playing field reasons, but for preserving the soundness and stability of the FMIs themselves and capital markets at a global level.