

**INTESA SANPAOLO RESPONSE TO THE CPSS -IOSCO CONSULTATION ON  
PRINCIPLES FOR FINANCIAL MARKET INFRASTRUCTURES**

JULY 2011

The Intesa Sanpaolo Group is one of the largest European banking groups, leader in the Italian market with a strong international presence in different EU and international markets. We are responding to the consultation in our capacity of direct and indirect member of Financial Markets Infrastructures (henceforth FMIs).

We welcome the opportunity to comment on the CPSS IOSCO consultative report on Principles for FMIs and would like to provide the following comments.

**1. GENERAL COMMENTS**

***Policy Objectives***

The Intesa Sanpaolo Group broadly supports the objectives set forth by CPSS-IOSCO which aim at reinforcing the safety of the FMIs and enhancing their efficiency.

Financial markets are global and deeply interconnected with each other and need to be underpinned by a regulatory framework that instills confidence and makes sure that all systems – payments, securities and trade repositories – can withstand the most severe shocks. Against this background, it is crucial to ensure that the Principles are applied and implemented consistently at international level not only for level playing field reasons, but for preserving the soundness and stability of the FMIs at a global level.

Given the systemic nature of FMIs, and the role they play, we believe that the Principles should strike a right balance between preserving financial markets' stability, ensuring a fair competition among them and allowing access to market participants.

***Scope and applicability of the principles***

We disagree with the approach adopted by CPSS IOSCO to provide for a single set of Principles to be applied to all FMIs. The result is that on a one side they do not always acknowledge the difference between the different types of FMI (the risks posed by CCPs are different from those of Trade Repositories or CSDs), on the other, it is difficult to ascertain the scope of applicability, i.e. what Principle applies to which kind of market infrastructure. We would suggest specifying the addressees of each proposed Principle. This would not only provide clarity to FMIs as to their applicability, but also benefit supervisors in their supervisory functions and would ensure a level playing field at a global level.

The definition of uniform criteria for the identification of systemically important FMIs is crucial in order to ensure a level playing field at EU and global level. This is all the more important, if we consider that the EU legislative proposal on clearing houses<sup>1</sup> provides for that CCPs established outside the EU may offer clearing services to entities established in the EU only if they are recognized by the European Securities and Markets Authority (ESMA).

Regarding the scope of the principles, we observe that the principles do not directly address the issue of FMI resolution (§1.2.3) even if the resolution or the insolvency of an FMI is mentioned in some principles (legal basis, credit risk, general business risk, CSDs, segregation and portability). We understand that resolution of FMIs will be part of a separate workstream. We consider crisis management of FMIs as a crucial area as it is for banks.

<sup>1</sup> Proposal for a regulation on OTC derivatives, central counterparties and trade repositories or European Market Infrastructures Regulation- EMIR; COM (2010)484/5.

Resolving FMIs without disrupting the functioning of markets is of paramount importance, in particular for systemic relevant FMIs.

We agree with CPSS IOSCO that the issue of indirect participation deserves to be closely monitored by supervisors, since it can hide the visibility on the risks that indirect participants can add to the FMI and to the financial system. However, we disagree with the proposed approach that entrusts FMIs with the task of gathering basic information about indirect participants and to identify, monitor and manage relevant concentrations of risks and important interdependencies. We do not believe that FMIs have neither the powers to require and gather such information and nor are able to adequately assess the interdependencies that arise from tiered participation arrangements. In our view, it should be up to supervisors to require direct participants to provide information on the identity and risks posed by indirect members and not to FMIs.

Considering the relevance that collateral will play following the implementation of the Principles, we underline the crucial importance of market infrastructures facilitating the easy transfer of collateral at EU and international level.

Finally, we note that CPSS and IOSCO Principles do not cover trading venues. We believe that these infrastructures can also be of systemic relevance, in particular when considering forthcoming consolidation of stock exchanges and when they are the only venue where certain instruments will be traded.

## **2. INTESA SANPAOLO DETAILED ANALYSIS**

### **Legal basis - Principle 1**

Intesa Sanpaolo agrees with the CPSS-IOSCO to guarantee a robust legal basis for FMI activities and to request supervisors and regulators of all jurisdictions a high degree of certainty for each aspect of FMIs' activities. If we agree that the legal framework governing FMIs' activities should cover general laws and regulations that "*govern, among other things, property, contract, insolvency, corporations, banking, secured interests, and liability*", we would like to see prudential requirements (such as the new Basel III requirements) be applied to banking-type ancillary services offered by FMIs (such as the CSDs). In any case, we recommend global regulators to adopt a very cautious regulatory approach regarding the ancillary services that bring additional risks in FMIs.

Making the legal basis for all FMIs clear and broad would allow both more stability and more competition between FMIs, by establishing a level-playing field and reducing possible regulatory arbitrage.

Regarding the settlement finality, we agree with the recommendation to eliminate the "zero-hour rules" as these may give rise to credit and liquidity risks.

### **Governance - Principle 2**

We welcome the principle on governance and its key considerations. We fully support the fact that FMIs should place a high priority on safety, efficiency and should support financial stability and other relevant public interests. Because of the crucial role FMIs play in the functioning of financial markets, the protection of financial stability should prevail over any other profit-making objectives. This is particularly relevant for profit FMIs that could be inclined to maximize their shareholders profits and efficiency rather than pursue financial market stability.

As to their ownership structure, we believe that FMIs should not be controlled only by a certain class of market participants, so as that to avoid that their interests prevail over those of other indirect participants. Moreover, their governance structures should adequately ensure a balanced presence of the buy-side and the sell-side.

Governance arrangements: we welcome the call for “*particular attention on certain aspects on governance arrangements*” depending on “*the ownership structure and organisational form of the FMI*” (par. 3.2.5) but we consider this principle should address more clearly the issue of conflict of interests, particularly in the case where a FMI is a division of an exchange. In this respect, we encourage CCPs to display a clear and legally robust segregation of the financial resources they use for the management of the risks stemming from each of their activities.

Regarding CSDs, the risk management board should be required to make sure that the core settlement functions are not jeopardised by ancillary services. In this respect, we would strongly welcome a provision in the principle allowing for a stronger mandate in the risk-management rules of the FMI, regarding core services of CSDs.

Role and composition of the board of directors: independent members: we support the criteria that are devised by the principles, but we believe that some form of regulators’ intervention should be envisaged to ensure the consistency of the board members profile, including, as a last resort measure, some escalated procedure of regulators’ negative advice against the nomination of board members.

Risk management governance: we agree with the idea that the chair of the risk committee should go to an independent board member and that the committee should be composed of a majority of independent board members..

Furthermore, we fully support the provision that members of the Risk Committee should be independent, have authority, resources and access to the board of directors and be able to provide objective advice on the risks incurred by the FMIs.

Model Validation: we generally agree with the requirements on model validation and would like to insist on the involvement of supervisory authorities in the process of model validation. Supervisors should have the power to assess the adequacy of the models to the general objectives pursued by FMIs (as referred in Principle 1 on legal basis) as it is already the case for credit institutions.

### **Framework for the comprehensive management of risks - Principle 3**

We support the requirement to FMIs to have sound risk-management frameworks which would allow them to manage legal, credit, liquidity, operational and other risks.

Comprehensive risk policies, procedures, and controls: we welcome the requirement to FMIs’ policies, procedures and controls to address legal, credit, liquidity and operational risks and to make the board responsible for risk taking. Furthermore, we would favour a provision clearly prohibiting outsourcing of core risk management functions of FMIs, if such outsourcing can generate systemic risk.

### **Credit and Liquidity Risks - Principles 4 and 7**

Intesa Sanpaolo agrees with the definition of credit risk and liquidity risks provided by the CPSS-IOSCO principles. We underline the importance of the “*high degree of confidence*” between direct participants, indirect participants and FMIs in the risk coverage process. Such high degree of confidence should be translated in transparency requirements for CCPs, where direct participants should be allowed to ask FMIs (and particularly CCPs) full transparency on their stress scenarios, the assumptions on which they are based and methodologies (both backtesting and stress testing). Any refusal to provide participants full transparency should be motivated and communicated to the supervisors.

Regarding the minimum credit requirement to be included in the stress test scenarios for which CCPs should hold additional financial resources, the CPSS-IOSCO principles proposes three options for consultation: (i) the default of the one participant and its affiliates that, in the aggregate, would potentially cause the largest credit exposure (“*cover one*”), (ii) the default of the two participants that, in the aggregate, would potentially cause the largest credit exposure (“*cover two*”) or (iii) either the “*cover one*” or the “*cover two*” minimum requirements,

depending on the particular risk or other characteristics of the products it clears, the markets it serves and the number and type of participants it serves. In our view, while we acknowledge that the EU has already chosen the cover two option in EMIR, thus the strongest one, we believe that the third option (both for the credit and liquidity risks) would allow enough flexibility and adaptation for FMIs and market participants. As a matter of fact, we believe that an efficient regulation of FMIs should take into account the diversity of profiles of credit and liquidity risks among traded products (traditional futures or derivatives), payment services offered (cash clearing) as well as the difference between markets (in terms of concentration).

The third option entails a detailed assessment of the risks and characteristics of each product cleared by a CCP when either a “cover one” or a “cover two” has to be applied. In our view, the following criteria should be used for this assessment: OTC vs exchange traded products, cash vs derivatives, where the risk assessment should be tailored and computed on the basis of the underlying.

In addition, we believe that the risks embedded by the products, the duration, volatility and degree of leverage should be all integrated in a database. This database should enable to calculate not only the leverage but also determine the frequency of stress tests and the appropriate level of the default fund.

#### ***Principle 5 - Collateral***

We mainly support Principle 5 that provides for that collateral can be used by FMIs as a credit risk mitigating tool and that collateral should be of with low credit, liquidity and market risk. We also support the fact that FMIs should set and enforce appropriately conservative haircuts and concentration limits.

Acceptable collateral: we support the principle that participants should not be allowed to post their own debt or equities securities or equities of companies closely linked to them as collateral. We support the fact that covered bonds issued by participants or by closely linked companies can be accepted as collateral provided the underlying is adequately segregated by the issuer from its own assets. We invite the CPSS IOSCO to assess also the possibility to include as acceptable collateral high quality self securitization assets, in line with the European Central Bank rules for collateral eligible for Eurosystem credit operations.

Limiting procyclicality - 3.5.5. we agree with key consideration n°4 and the related Paragraph “Limiting procyclicality” according to which the FMIs should have in place an appropriate collateralization policy that reduces to the maximum extent possible haircuts that can have a procyclical impact on the market.

However, as experience has shown during the sovereign debt crisis, this aim is not always easy to achieve, since especially when the main FMI's policy goal is to preserve the stability of the infrastructure rather than financial market stability. Clearly a trade off between the two goals needs to be found. One way of limiting procyclicality could be – consistently with the risks profile borne by FMIs- by increasing the contribution to the default fund or by requiring a wide composition of collateral to be posted, in order to reduce concentration risks for the FMI.

#### ***Principle 8 – Settlement finality***

We mainly agree with this principle and would suggest that in order to ensure a smooth functioning of FMIs at global level, CPSS IOSCO provides for a definition of final settlement. This would allow avoiding any inconsistency for cross border transactions.

#### ***Principle 9 - Money settlement***

We broadly support Principle 9 and in particular the use of central bank money where practical and available.

Settlement in the books of an FMI: in our view, FMIs established as special purpose institutions that provide banking services, even though strictly related to settlement activities, should be required to have a banking license and be subject to supervision. This is according to the principle *same business same rules*.

### **Central Securities Depositories - Principle 11**

In our view, CSDs should be single purpose utilities, so as to avoid any possible commingling of risks. CSDs providing banking types of services should be required to have a limited purpose banking license and be subject to prudential requirements. In that respect, we would welcome a significant strengthening of the requirements on "other activities" a CSD may provide (3.11.6). In particular, we believe that additional tools **should be mandatory** to address the risks posed by these other services (and not "may be necessary" as proposed in the Principles).

We note that the Principles do not mention ICSDs. We suggest that their existence is acknowledged by the Principles to which they should adhere.

In order to preserve the CDSs stability, they should not be allowed to provide securities lending facilities on a principal basis.

The principles should provide incentives to move towards the dematerialisation of securities.

### **Participant-default rules and procedures - Principle 13**

Intesa Sanpaolo underscores the importance of FMIs rules and procedures in managing members' default. Preserving FMIs and financial markets stability should be the main driver.

**3.13.3 Use and sequencing of financial resources** - As to the waterfall procedure, we suggest FMIs to use also its own funds after depletion of the defaulting member before using the general clearing members' funds. Providing for some "skin in the game" also for FMIs would require them to closely monitor members' exposures and instill discipline in them.

Furthermore, we believe that it is of crucial importance to clearly define the moment when a participants defaults, that triggers the opening of the default procedure.

### **Segregation and portability (Principle 14)**

Intesa Sanpaolo fully supports the principles on segregation and portability proposed in the report, as they aim at protecting indirect clearing members and their customers from the default or insolvency either of the FMIs or of the direct participants. In the report, the CPSS and IOSCO propose two models for segregation of assets and margins held at CCPs:

- i) Individual accounts, where the direct clearing member opens an account for its customers.
- ii) Omnibus accounts, where all collateral belonging to customers of the direct clearing member is commingled and held in a single account.

Among the proposed models, Intesa Sanpaolo considers the individual accounts model as the one that fully protects the positions of indirect clearing members, allows an expedite portability and provides full transparency on the participants exposures. In Italy, where Intesa Sanpaolo operates, Cassa Compensazione e Garanzia – the Italian CCP -is by contract bound to transfer margins and positions of the indirect clearing member held with a defaulting one within 3 hours. This model does not imply excessive costs for customers.

Accordingly, we believe that as a minimum, policy makers should require CCPs to maintain omnibus accounts models and collect margins at a gross level. Omnibus accounts with margins computed at a net level should not be allowed, since the default of one customer could require the posting of additional margins by the non defaulting ones. This could pose an additional liquidity stress on some market participants, thus jeopardizing market stability.

Moreover, we are of the view that CCPs should be required to provide full segregation of margins collected for different products. This would ensure that there is no contagion risk across asset classes.

### **General business risk - Principle 15**

The general business risk envisages that the inability of an FMI to continue as a going concern could pose systemic risks to its participant and to the broader financial stability.

Therefore, adequate cover – different from others such as liquidity risk, custody, operational risk etc) of this risk should be provided for.

While Intesa Sanpaolo sees the policy rationale of covering all kinds of potential risks FMIs could face and understands the proposal that FMIs should hold sufficient equity capital to cover potential general business losses so that they can continue providing services as a going concern or to achieve an orderly liquidation, we observe that the capital requirements associated with the introduction of this new risk will entail higher fees for the use of FMIs, since it is likely that the cost of the additional capital buffer will ultimately be borne by users.

In order to avoid a general increase of fees and costs related to the implementation of these principles, we are of the view that FMIs should be required to have sound and prudent business models, 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.

#### **Principle 16: Custody and investment risk**

We support the provisions on custody of investment risk of FMIs, in particular the requirement for FMIs to safeguard their assets in supervised and regulated entities that have robust accounting practices and safekeeping procedures.

While we agree with the fact that FMIs should have easy and prompt access to their assets and that their investment strategies should be in line with their overall risk-management strategies, we would welcome more clarity on what constitutes the investment strategy of a FMI in terms of criteria and procedure.

Furthermore, financial markets being global and FMIs more and more interoperable, safeguarding FMIs assets and those of their participants is crucial for securing financial stability. Against this background; international regulators should be particularly vigilant in ensuring that assets are protected at all times on a global scale irrespective of the jurisdiction where they are posted.

#### **Operational risk - Principle 17**

We agree with the principle on operational risk and we underline the need for FMIs, which are by definition risk-carrying, to have robust risk-management frameworks that allow full and rapid identification, monitoring, management and prevention of operational risks.

Operational risk management: we would welcome a provision asking FMIs to have a clear and precise classification of operational risks. In order to improve the identification and foster the risk prevention, FMIs could be invited to have 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 that would address minor and more frequent errors (to be solved in a limited period of time) and secondly, the management of bigger and more disruptive problems. Each kind of operational risk should be addressed by specific requirements defined according to the nature and relevance of the risks.

Business Continuity Planning & Interdependencies: we particularly welcome the provision on business continuity planning which we regard as extremely important and necessary so that to make sure that FMIs are able to carry on their functions in all circumstances.

In case of operational problems, participants of the FMIs are the first to be impacted. Therefore, we would welcome a requirement on FMIs to inform their participants of any operational failure which they are experiencing. This would enable participants to adopt internal appropriate measures to cope with the situation. Such an obligation could take the form of time and procedures requirements. For example, an FMI facing an operational problem would have to communicate to its participants the nature of its problems and the solutions envisaged to solve them in less than 2 days. Supervisors should always be informed of any problem incurred by FMIs.

On a general note, we would welcome any provision allowing for a close and stringent supervision by national regulators.

### **Access and interoperability - Principles 18 to 20**

As a participant of FMIs, Intesa Sanpaolo shares the importance of ensuring fair and open access to FMIs. In particular, we agree with the fact that the principles make reference to "reasonable" criteria relating to the ability and readiness to use an FMI's services (see paragraph 3.18.5 on risk based participation requirements).

#### **Principle 18: Access and participation requirements**

We very much welcome this principle. We believe that the issue of access and participation requirements has always been of utmost importance and in particular nowadays, in a context of increasing consolidation of exchanges into vertical silos. Preserving the access of infrastructures to market participants and to other FMIs is crucial in order to ensure fair competition. In this context competition authorities should cooperate closely with supervisors in order to prevent possible uncompetitive behaviors and market distortions.

We fully support the principle that access criteria should be based on objective risk based and publicly disclosed criteria. We believe that the principles should address also the maintenance and exit criteria, the adherence to which should be closely monitored by supervisors. Exit criteria should be clearly spelled out and take into due consideration the impact that the exit of a large market participant can have on the FMI's stability. In these circumstances, rules on asset segregation are instrumental in providing safety to the non defaulting members. Rumors on the possible exit of a participant to a FMI can play a role on its stability; market supervisors should resort to all the regulatory tools they have to preserve the FMIs stability.

As a participant of FMIs, we share the importance of ensuring fair, equal and open access to FMIs for all participants

Furthermore, we believe that ensuring a fair access to FMIs should be an overall objective observed by FMIs when drafting their procedures and criteria for access, maintenance and exit.

#### **Principle 19: Tiered participation arrangements**

We generally agree with the rationale of this Principle, i.e. that risks posed by tiered participants are identified, monitored and managed. However, we believe that Key Consideration 1 could be difficult to implement. In our view, the issue is not granting FMIs with powers that are inherent to supervisors, but rather to require the latter to set objective criteria on tiered participation requirements and a clear allocation of responsibilities between FMIs and supervisors. This would have the benefit of setting a level playing field among FMIs and of providing predictability for direct participants.

Moreover, the principles should define better the meaning of "to the extent practicable".

If we concur with the principle of adopting a cautious and targeted approach to risks and mitigating actions, we underline the technical nature of constraints a FMI may face in identifying and managing the risks that indirect participants present. Moreover, we invite CPSS-IOSCO to involve local regulatory authorities in the supervision process of the criteria and procedures defined by the FMIs to manage risks arising from tiered participants. We believe it is crucial for the FMIs but also for the supervisors to have a clear and broad vision of the risks arising from tiered participants and to be able to identify the source of such risks.

The involvement of regulators is also particularly important in the indirect participant-default procedures (3.19.6), on which we concur with CPSS-IOSCO but which can be a source of confusion. In particular, we note that the phrasing "to the extent practicable" ("To the extent practicable, an FMI should ensure that its default and loss-sharing arrangements can manage the transaction flows that might be generated by such a default") can lead to

misunderstanding or different interpretations. Consequently, we invite CPSS-IOSCO to provide more clarity on the procedures planned and implemented by a FMI to face a default of an indirect participant.

#### **Principle 20: FMI links**

An appropriate supervision of FMI links is a key element of risk management since they may represent a channel of risk propagation among FMIs and across financial markets. In this respect, FMI links may constitute a threat to systemic stability and should therefore be subject to close supervision by regulatory authorities. Accordingly, we welcome this principle, which calls FMIs to be particularly vigilant to their mutual links. On this area, we underline that links between FMIs should be coherent with the FMI's management strategy, be commercially grounded and should not jeopardize the FMIs soundness.

Furthermore, we believe cross-border FMI links should be subject to close supervision. In this respect, any memorandum of understanding establishing cross-border links should obey to a close supervisory action and should be based on equivalence recognition, to the extent possible.

*For any further comments or questions, please contact Intesa Sanpaolo's International Regulatory and Antitrust Affairs Office:*

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