## Reserve Bank of India

### Principles for financial market infrastructures – consultative report – RBI comments

The issues flagged in the cover note and the comments of the Reserve Bank of India on the same are as under:

### 1. Principle 4: credit risk and Principle 7: liquidity risk

### RBI comments

1a. Under the Payment and Settlement Systems Act, 2007, the Reserve Bank of India has oversight powers on Clearing Corporation of India Limited and not on the clearing corporations of the stock exchanges[1]. Thus our comments are limited only with respect to Clearing Corporation of India Limited (CCIL) which acts as a CCP for the USD-INR forex segment, Government securities segment and the Collateralised borrowing and lending obligation (CBLO).

1b. In the Indian context given the crucial and systemic role played by CCIL in various market segments it is appropriate that a 'cover two' requirement is stipulated as a minimum requirement.

1c. In the Indian context CCIL is a CCP for the USD-INR forex segment, Government securities segment and the Collateralised borrowing and lending obligation (CBLO)[2] segment. All these three segments are crucial markets which are systemically significant for the smooth functioning of the Indian financial system. Given this it is appropriate that a CCP like CCIL should have a "cover two" as a minimum requirement.

1d. However, this requirement should be viewed based on the nature, depth, liquidity and the number and type of participants in various market segments where a CCP is in operation. These parameters should be used as an yardstick in determining whether a 'cover one' minimum requirement or a 'cover two' minimum requirement should be prescribed by the regulator to mitigate credit risk, liquidity risk or both.

1e. It is necessary to take into account the development of the financial market and the nature and type of participants when prescribing 'cover two' as a minimum requirement. As stated in the report the use of collateral and margin are two key methods of mitigating and managing credit risk, liquidity risk or both by the CCP. Additional financial resources in the form of prefunded default arrangement should also form part of the risk management framework to take care of participant default. This in the Indian context becomes particularly relevant because the same set of participants are major players in the various segments, they also act as liquidity providers and also provide their services as settlement bank (for entities not eligible to open an account with the central bank).

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[1] In terms of the extant statutory regulations the clearing corporations of the stock exchanges are not under the regulatory purview of the central bank.

[2] CBLO is a money market instrument.

1g. In view of the limited size and the nascent stage of the development of the Indian financial market it is relevant not to impose a high cost of participation (in terms of higher collateral requirements and margin calls, etc.), in these markets on members by prescribing a 'cover two' requirement for both credit and liquidity risk. All three products have a distinct advantage of being mainly exchange traded (with also the facility of reporting OTC trades to the CCP)[3]. The fear that prescribing a 'cover two' requirement would drive up the cost of participation in a CCP arrangement is very valid and would impose additional costs to the participants.

1h. It is therefore appropriate to have 'cover two' requirement as a desirable option with the minimum being prescribed as a 'cover one' requirement. If a 'cover two' requirement is prescribed ab initio, it could lead to participants opting to settle on a bilateral basis rather than through a CCP arrangement. This in turn could lead to a situation wherein a large number of trades are settled outside a CCP arrangement defeating the very purpose of limiting credit, liquidity and systemic risk through the use of a CCP mechanism.

1i. *Given this it would be perhaps be desirable for the principles to be worded in a manner which could prescribe "'cover two' as a desirable option with 'cover one' being specified as the minimum requirement to be followed in various jurisdictions".*

## 2. Principle 14: segregation and portability

- What are the different models and approaches to establishing segregation and portability? What are their pros and cons respectively, for example in terms of efficiency and level of protection that can be achieved?

**RBI comments:**

2a. In the Indian context customer assets are held with the CSD (PDO, RBI) in the form of Constituent Subsidiary General Ledger (CSGL) accounts. Thus segregation of assets is fully ensured.

2b. In the Indian scenario, only government securities are accepted as collaterals in both the G-sec and the CBLO segments by CCIL. Therefore the central bank is able to perform the role of the custodian and also achieve segregation of customer assets through the (CSGL) account structure.

2c. As the central bank itself is acting as a custodian in the Indian context, the issues related to custody and investment risk are totally minimised if not fully eliminated.

2d. *Whether this model of the central bank acting as the custodian could be replicated across various jurisdictions is subject to the relevant central bank legislation. Another important issue is the type of assets for which the central bank could act as a custodian.*

- In view of the different options and models that may exist, is there any one option or model in particular that could usefully serve as a minimum requirement? Would it is be possible to identify a specific approach to segregation and portability that could be defined as best practice?

[3] It is a regulatory mandate for all G-Sec trades and CBLO trades to be cleared through CCIL while in the case of USD-INR segment the same is not mandatory.

**RBI comments:**

2e. The applicability of a particular model would be based on the type of market, the relevant legal jurisdiction and the cost associated thereof. Accordingly it is difficult to suggest any particular model as one which could be recommended as a universal best practice.

2f. *As regards portability it is recognised that it is difficult to achieve a hundred percent portability of client positions. However, it is essential that an alternate arrangement with minimal disruption for smooth porting of client positions / assets is carried out. It should be recognised that such an arrangement would have its own associated costs and that any such portability of positions should be recognised as valid in law.*

**3. Principle 15: general business risk**

- 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?

**RBI comments:**

3a. The advantages of having a quantitative requirement for the amount of liquid net assets is that such a measure could be applied on an uniform basis across various jurisdictions. However, such a measure would perhaps take away the element of discretion that would necessarily be a tool in the hands of the regulators.

3b. *While a quantitative requirement equaling six, nine, or twelve months of operating expenses is always welcome, it would perhaps be appropriate to prescribe a minima with the proviso that the national regulators could take a view on the CCP exceeding the minima. Any qualitative prescription in view of the above would not be required.*

**4. Principles 18 to 20: access and interoperability**

**RBI comments on access and participation:**

4a. Principle 18 on Access and participation requirements has rightly emphasised the need for fair and open access criteria based on risk-related parameters.

4b. It would perhaps be of interest to include information on “off-shore” participants and the impact they would have on a FMI’s access and risk management strategies. The risk management framework for an FMI with an “off-shore” participation vis-à-vis an FMI which has only “on-shore” participants would then perhaps be different. For example in the case of India an FMI like CCIL has only “on-shore” participants. The access and participation requirements of such an FMI would be different from those of an FMI which has both “off-shore” and “on-shore” participants.

4c. *We accordingly suggest that information on “off-shore” participation and the impact that it could have on a FMI’s access and participation requirements be provided.*

**RBI comments on tiering:**

4d. At this point of time it is perhaps difficult to envisage a futuristic scenario that would evolve as regards the global clearing structure and the connected issues. *We therefore have no comments to offer.*

**RBI comments on links:**
4e. *We have no comments to offer on links.*

**5. Other issues**

In page 7 of the consultative report, it has been stated as follows: "*A retail payment system is a funds transfer system that typically handles a large volume of relatively low-value payments in such forms as cheques, credit transfers, direct debits, and* ***debit card*** *transactions*", without any mention of credit cards.

**RBI comments:**
5a. It is suggested that the same could be amended to read as "*A retail payment system is a funds transfer system that typically handles a large volume of relatively low-value payments in such forms as cheques, credit transfers, direct debits, and* ***card payment*** *transactions*" which would then cover both debit and credit cards.