POSITION PAPER

Response to CPSS-IOSCO's Consultation on Principles for Financial Market Infrastructures

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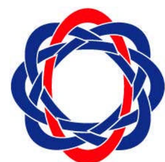

Response to CPSS-IOSCO's Consultation on Principles for Financial Market Infrastructures

The WSBI is grateful to CPSS and IOSCO for the opportunity to comment on the draft Principles dedicated to Financial Market Infrastructures. WSBI (World Savings Banks Institute) is one of the largest international banking associations and the only global representative of savings and retail banking. Founded in 1924, it represents savings and retail banks and associations thereof in 90 countries in Asia-Pacific, the Americas, Africa and Europe, with member bank assets totaling almost € 9,000 billion in 2009.

The WSBI response is structured in two parts: first we make general remarks, then we comment Principle by Principle, where relevant.

General Remarks

1.) The consultative Report is a merger of and further elaboration on three existing sets of Principles. It is the first attempt to provide Principles applicable to all types of FMIs - at the risk sometimes of creating some confusion as to which type of FMI is concerned by which Principle.

2.) Whilst it is well understood that such Principles are broad by nature, at times more granularity could be welcome to avoid conflicting interpretations, which could lead to diverging implementations of a same Principle or set thereof.

3.) The WSBI welcomes the risk-based approach adopted throughout the consultative Report. The Principles related to the risk framework (Principle 3) and the general business risk (Principle 15) represent clear progress. This is well supported by further risk-based approaches such as margin system, collateral management, or the minimum credit and liquidity requirements. Indeed, in a de facto global financial market, continued risk reduction should be the prime objective of such Principles.

4.) Important lessons learned from the 2008 financial crisis have been considered, yet not all. There would be value in providing greater exposure to default management processes, in particular communication procedures in case of insolvency of an institution.

5.) The WSBI suggests that the Principles acknowledge that there are a number of banks (or, as the case may be, institutions performing equivalent functions in either the payments and/or securities and/or foreign exchange markets) that, because of their market positioning, have implications in their relevant markets which can be rather similar to those of FMIs. As a consequence, it is recommended that where relevant Principles for FMIs apply also to such institutions.

6.) The consultative Report stipulates that the relevant authorities should strive to integrate these new Principles into their legal and regulatory framework by the end of 2012. However, for legislative initiatives on the way (such as the European Securities Law

Directive) it is not obvious how new Principles could still be taken on board, whenever a gap exists.

7.) The consultative Report is mostly not specific about OTC markets or products although their shortcomings in terms of e.g. transparency and liquidity were evidenced during the 2008 crisis[1]. The coming Principles should give greater exposure to the calls for greater standardization of OTC products and the promotion of sound infrastructures for OTC derivatives.

Review of the draft Principles

Principle 1
Legal basis

WSBI fully supports that an FMI should have a well-founded, clear, transparent, and enforceable legal basis for each aspect of its activities in all relevant jurisdictions.
WSBI however recommends that the Principle moves one step further and defines that the law applicable to settlement finality and netting be the one of the localization of the account of the participant concerned.
Furthermore, knowing that FMIs provide core services (as defined in Annex H to the Principles) yet may also provide additional, "ancillary" services, the Principle should establish that the latter should at all times be formally segregated from the former, in order to allow participants and other interested parties to properly assess the risks posed by an FMI.

Principle 2
Governance

WSBI certainly supports that 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.
At the level of these Principles it would be useful to acknowledge that FMIs can be either publicly or privately held, or a combination of both. The governance arrangements of publicly-owned FMIs should reflect a strong public good orientation, all the more so whenever a publicly-owned FMI operates as a monopoly or dominant infrastructure. Such FMIs hold a responsibility towards stakeholders on both the demand and the supply side – regardless, as far as the latter is concerned, of the form of participation of individual institutions in a given FMI.

Principle 3
Framework for the comprehensive management of risks

Although the notion of risk management for specific areas can be found in all existing documents, the new Principles go further and recommend FMIs adopt a *"sound risk-management framework for comprehensively managing legal, credit, liquidity, operational, and other risks."*[2] This applies in two ways: the risks borne and the risks posed by FMIs to the institutions and markets they serve including the identification and management of interdependencies. The first step to execute is the concrete and wide identification of all risks, after which policies, procedures and controls that are consistent with the FMIs' risk tolerance and capacity are established. FMIs should create incentives to manage, review and update risks in a timely manner.

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[1] *Report on the lessons learned from the financial crisis with regard to the functioning of European Financial Market Infrastructures,* Frankfurt am Main, European Central Bank, 2010, p.6
[2] *Principles for financial market infrastructures*, Committee on Payment and Settlement Systems, Technical Committee of the International Organization of Securities Commissions, Consultative Report, March 2011, p.1

As an illustration, oversight requirements already imposed on European FMIs to have in place a sound risk management framework before the 2008 financial crisis contributed to the containment of the systemic impact of the default of critical counterparties during this crisis. These frameworks generally limited the risk exposure to the default of one critical counterparty. The ECB therefore recommends enhancing specific aspects of these frameworks such as the direct monitoring of CCPs' creditworthiness or the definition of criteria for, and identification of, FMIs' critical participants. Such enhancements - as lessons-learned from the crisis - could be considered for Principle 3.

One of the lessons-learned from the 2008 financial crisis illustrated in the ECB report[3] demonstrates the need to improve information sharing between authorities and, if possible, FMIs and their participants in case of insolvency of a critical counterparty. The cooperation and communication between market authorities is of particular importance at cross-border level. There is also a real need for a crystal clear identification of legal entities in order to avoid any ambiguity.

The existing European-level information-sharing framework could illustrate this point. It is composed of three main instruments:

- The Memorandum of Understanding between EU authorities on cross-border financial stability introduces common principles, procedures and practical arrangements concerning cooperation among the authorities responsible for preserving financial stability;
- EU Directives related to information-sharing activities (Directives 98/26/EC, 2001/24/EC, 2003/6/EC and 2006/48/EC): introducing respectively a notification regime defining how competent authorities should be notified about the opening of insolvency proceedings, the information and publication requirements to be fulfilled in the event administrative or judicial authorities decide to implement reorganization measures or winding-up procedures, a description of the information requirements applying to issuers of listed financial instruments, and finally the competent authorities shall cooperate closely with each other by providing information which is essential or relevant for the exercise of the other authorities' supervisory tasks;
- Oversight requirements and recommendations for European FMIs: market infrastructures are required to inform their non-defaulting participants about suspended products or participants.

This framework is under review and will be enhanced to better adapt to a cross-border market outside the EU and to include the lessons-learned from the 2008 financial crisis.

As a global harmonized market may not materialize in the medium term, it is important to mitigate discrepancies in international communication as much as possible by for example the use of templates, a checklist and a glossary of common terminology. Central Banks should communicate better and more in order to set the norms to apply in times of a financial crisis. In particular the ECB recommends that all relevant actors in the financial markets better familiarize themselves with default management procedures through the setting-up of strong communication systems.

Above this, shortcomings in the information flow and incentive structure under which government supervisors manage the safety net should also be repaired. For example, the reporting of financial institution managers to regulatory authorities should be reviewed. An important success factor to build a reliable and strong system is that financial institutions and regulatory actors accept responsibility for estimating and controlling in a timely, proactive, and

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[3] *Report on the lessons learned from the financial crisis with regard to the functioning of European Financial Market Infrastructures,* op. cit.

accountable manner the safety-net consequences of transformative financial contracts and institutional structures"[4].

Principle 4
Credit risk

As far as CCPs are concerned, credit risk exposure should also be covered through the imposition of a minimum credit requirement using collateral and other equivalent financial resources.

The consultation document proposes three options. Defining two different covers depending on specific requirements can lead to some misinterpretation or unequal access to the market. However the two-types-of-cover approach could find its justification in the case e.g. of a higher level of interdependencies between markets, which would require a higher level of cover.

Principle 5
Collateral

The consultation report recommends to select collateral with a low credit, liquidity, and market risk and to apply prudent valuation with adapted testing taking into account stressed market conditions.
Unclarity remains as to the types of assets that should be preferably used as collateral. Guidance as to the distribution of classes of collaterals better guarding against asset realization risks under financial stress conditions would improve the selection of adequate collateral. The use of Central Bank (CB) money through an RTGS[5] has proven to be very efficient and safe during market turbulence but could still be strengthened in the area of liquidity management (e.g. via further optimization of settlement algorithms). Settlement in CB money should be considered as the preferred means of settlement.

Currently collateral is still managed at national CB level which may restrict funding capacities. Allowing whenever possible a centralised approach to collateral which could be mobilized across several countries and/or several systems would assist in optimising the use of available assets, and provide for market depth.
Within the euro area, an efficient cross-border approach to collateral management should allow the Eurosystem to enable banks to mobilize collateral quickly to access liquidity.

The collateral valuation process should reflect collateral value in a close to real time fashion, even at times of great stress. In the context of a globalised financial market, processes should be standardized so as to obtain a unique value for the same asset. This should also include accounting principles to enable a correct valuation. Market risk should of course be taken into account for collateral management as there might not be a market available at a point in time, an important problem in itself.

Principle 6
Coverage of credit exposures with risk-based margin system

To cover its credit exposures, a CCP should establish an effective margin system as a key risk management tool to manage the credit exposures posed by its participants' open positions. The margin levels should be commensurate with the risks and unique attributes of each product, portfolio, and market a CCP serves, taking into account potentially longer liquidation times in stressed markets. For example, the margin levels should be more conservative for OTC derivatives due to their complexity and the greater difficulty to obtain price quotes. This margin system has to be reviewed and validated on a regular basis.

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[4] *Report on the lessons learned from the financial crisis with regard to the functioning of European Financial Market Infrastructures,* op. cit., p.22
[5] Real Time Gross Settlement

Principle 7
Liquidity risk

The same logic as for credit risk is applied to liquidity risk, compelling FMIs to maintain sufficient liquid resources to execute same-day and, as often as possible (by running several or even more frequent) settlement cycles, intraday settlement of payment obligations with a high degree of confidence under a wide range of potential stress scenarios. In that sense, all FMIs should include in their stress scenarios the inability of one, two or both (depending on certain characteristics) participant(s) or their affiliates with the largest aggregate payment obligation to settle an obligation.

As a conclusion for Principles 4 and 7, the definition of these minimum credit and liquidity requirements should be at a sufficient level of details to avoid misinterpretation and as a consequence different implementations of the requirement.

Each FMI should accurately define the different forms of liquidity risk to which it is or could be exposed, and lay out its plans for funding each type of liquidity, including in adverse market conditions. FMIs should also lay out in detail how the evolution of each type of liquidity is being monitored on a daily basis, and how they are organized to act on any adverse evolution of the situation.

Principle 8
Settlement finality

Settlement finality is an essential Principle. This Principle should recognize that such finality is not only provided by FMI rules but is also contingent on irrevocable instructions being submitted to an FMI.

Principle 9
Money settlements

WSBI supports this Principle. That settlement in CB money should be the preferred means has already been expressed in relation to Principle 5 above.

Principle 10
Physical deliveries

Physical deliveries are equally an essential cornerstone of settlement finality, and this Principle is fully supported.

Principle 14
Segregation and portability

CCPs should have segregation and portability arrangements that protect customer positions and collateral, to the extent practicable and where relevant supported by a legal framework[6].

As an example, the European Parliament voted the European Market Infrastructure Regulation in first reading this July. The text includes the notion of segregation of accounts for clients for the clearing of OTC derivatives through a CCP. Clients are free to choose their level of segregation. This segregation is applicable for client positions at the CCP but also for their funds or assets deposited with a third party.

The 2008 financial crisis challenged the distinction effectively made between proprietary and client assets. More broadly, the crisis showed that many institutions would benefit from implementing default management processes to limit exposure to a potentially defaulting

[6] There may be market structure or legal impediments to a CCP facilitating segregation and portability on the cash markets.

counterparty. FMIs which were affected by a default activated their default procedures, but as these were tailored to a national legal framework, complexity often resulted for multi-country players and generated inconsistencies between interconnected FMIs. The lack of segregation between a defaulting institution and its customer assets was a direct consequence thereof and complicated the transfer of positions from the defaulting counterparty to other entities. Generally speaking, difficulties in applying default management procedures should be evaluated and remediation actions applied. In this respect it should be acknowledged that supervision alone might be insufficient to overcome constraints set by applicable insolvency legislation.

Principle 15

General business risk

In addition to the risks already mentioned above, Principle 15 stipulates that FMIs have to support general business risk as the inability of an FMI to continue as a going concern could pose a systemic risk to its participants and the broader financial market. WSBI supports that FMIs must identify, monitor, and manage their general business risks but also hold sufficiently liquid net assets funded by equity to cover potential general business losses so that they can continue providing services.

CPSS-IOSCO suggests that FMIs hold at a minimum equity at normal times equal to six, nine or twelve months of expenses. Holding sufficient equity – or very close substitutes - would imply costs for the infrastructure, considering that an efficient buffer, in stressed market conditions, could be 12 months of expenses. Indeed, the TARGET volume traffic evolution from 2008 to 2010 demonstrates that effects of financial instability may persist two years after the start of a financial crisis. Volumes decreased by approximately 14% between April 2008 and 2009, and increased by nearly 3% between April 2009 and April 2010[7]. This example of market volatility justifies the need to have sufficient liquid net assets to cover a potentially long crisis period. This requirement however should always be counterbalanced by a comprehensive cost assessment.

The Principle also covers systemic risk by stressing the need for a viable capital plan to avoid systemic risk disruption. WSBI recommends in addition to acknowledge risks that could be triggered by government policies resulting in gaps and conflicts of objectives, which may be exploited by opportunistic market participants, or result in authorities' proclivity for absorbing losses in crisis situations. To maintain confidence, incentives for government and the financial sectors should be reworked to ensure alignment with those of ordinary taxpayers[8]. Measuring regulatory performance in terms of its potential effect on loss exposures that the safety net would pass through to taxpayers is one of the important steps to reach this goal.

Principle 16

Custody and reinvestment risk

WSBI does support this Principle. The latter would benefit from explicitly stating that FMIs may not re—invest collateral provided by participants.

Principle 17

Operational risk

WSBI does support this Principle. The objectives defined in the latter should be pursued throughout system design, testing, life, maintenance, and change management cycles. Of course adequate contingency and back-up processes and systems must be provided for.

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[7] All statistics on TARGET payments can be found under http://www.ecb.int/stats/payments/payments/html/index.en.html

[8] *Redefining and containing systemic risk*, Edward J. Kane, Boston College, May 2010

Principle 18

Access and participation requirements

WSBI certainly supports that an FMI should have objective, risk-based and publicly disclosed criteria for participation, which permit fair and open access. This Principle would however seem to be insufficient in the face of the fact that on one side – as already highlighted – FMIs can be either publicly or privately owned, or a combination thereof, and hold a certain market position, on that participation (notably indirect) in an FMI may become an obligation for payment service providers as a consequence of a legislative mandate to be reachable for a given payment instrument. Where such mandate exists, the Principle should recognize a duty for legislators and supervisors to enable payment service providers to become – if so they wish - direct participants at no undue expense in any publicly owned or market relevant privately owned FMI.

Principle 19

Tiered participation arrangements

For the first time, indirect participation requirements are included in financial market guidelines. Principle 19 stipulates that an FMI has to be capable, when possible, to identify, understand and manage tiered participation and the risks associated to such participation. Relevant rules and procedures have to be put in place to allow an FMI to retrieve information on indirect participation from their direct participants.
The 2008 financial crisis has shown that tiered access can lead to additional risks in stress conditions when liquidity shocks are transferred from indirect members to the settlement bank or when the settlement bank restricts access to liquidity and credit for indirect members.

WSBI recommends that a distinction should be feasible at any moment between liquidity from own assets and third parties assets. A service provider has to manage segregated accounts in order to provide at all times to third parties and FMIs the positions which are its own and the positions it manages for other parties. If there is management for other parties, thresholds above which a position has to be secured through collateral should be established.

When third parties would consistently generate significant positions, and in particular when such positions would be consistently larger than direct members' own positions, then direct participation of such third parties should be considered.

Principle 20

FMI links

Whether formally or de facto (e.g. as a consequence of participation of more systematically important payment banks) FMI linkage is on the uptake, at times mandated by legislators. FMIs should indeed identify, monitor and manage link-related risks. Whenever interoperability is formalized, how settlement finality is achieved should be made transparent.

Principle 22

Communications procedures and standards

All FMIs should adopt internationally accepted communication standards and procedures especially for those that are operating cross-border, and to facilitate remote access where possible. This should include standardized messaging formats and reference data standards for identifying financial instruments and counterparties.
The Principle could recommend that common, end-to-end business flow representations and data dictionaries be developed whenever possible.

The same Principle was already mentioned in the Recommendations for securities settlement systems but included a few references to ISO standards. The present Principle stops short of making reference to international standardization organizations, their processes and their deliverables. This could become a handicap in a market that turns more and more global.

Principle 24

Disclosure of market data

For the first time, reference is made to trade repositories and the fact that they should provide timely and accurate data to relevant authorities and the public in line with their respective needs. It is specified that the level of detail has to be sufficient to enhance market transparency.

The minimal compulsory data to be reported should have a level of detail that allows to measure financial stability and be aggregated at global level to capture a comprehensive picture. Regulators should also identify and if necessary eliminate the barriers to the collection and dissemination of trade data by repositories.

E.g. the European Parliament emphasized the need for a reinforcement of transparency due to the systemic risk borne by CCPs. It is noted that all relevant market data have to be available to independent bodies and society organizations with a preference for public CCPs rather than private ones.

About WSBI – The Global Voice of Savings and Retail Banking

WSBI (World Savings Banks Institute) is one of the largest international banking associations and the only global representative of savings and retail banking. Founded in 1924, it represents savings and retail banks and associations thereof in 90 countries of the world – via ESBG, the European Savings Banks Group). WSBI works closely with international financial institutions and donor agencies and facilitates the provision of access to financial sectors worldwide – be it in developing or developed regions. At the start of 2009, assets of member banks amounted to almost € 9,000 billion non-bank loans to € 4,300 billion and non-bank deposits to 4,600 billion. Together the member banks conducted operations through 160,000 outlets.

WSBI members are typically savings and *retail* banks or associations thereof. They are often organised in decentralised networks and offer their services throughout their *region*. WSBI member banks have reinvested *responsibly* in their region for many decades and are a distinct benchmark for corporate social responsibility activities throughout the world.

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