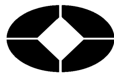
COMMITTEE ON PAYMENT AND SETTLEMENT SYSTEMS



BANK FOR INTERNATIONAL SETTLEMENTS

IOSCO BN01-11 10 March 2011

Cover note to the consultative report

1 Overview of the report

The consultative report on *Principles for Financial Market Infrastructures* (consultative report) was prepared by the Committee on Payment and Settlement Systems (CPSS) and the Technical Committee of the International Organization of Securities Commissions (IOSCO). The CPSS and IOSCO request comments on the proposed principles in the consultative report by 29 July 2011. After the consultation period, the CPSS and IOSCO will review all comments received and publish a final report in early 2012.

When finalised, the principles in the consultative report will replace the existing CPSS and CPSS-IOSCO standards for systemically important payment systems, central securities depositories, securities settlement systems, central counterparties and trade repositories (collectively "FMIs"). Currently, the standards are as follows:

- The *Core principles for systemically important payment systems* (issued in 2001);
- The *Recommendations for securities settlement systems* (also issued in 2001); and
- The *Recommendations for central counterparties* (issued in 2004).

The CPSS and IOSCO believe that a single set of standards will provide greater consistency in the oversight and regulation of FMIs worldwide. Moreover the committees believe that the new principles reflect the lessons learned from the recent financial crisis and the experience of more normal operation and assessments in the years since the current standards were issued.

The consultative report focuses on payment systems, central securities depositories, securities settlement systems, central counterparties and, as a new category of FMI, trade repositories. Compared to the current standards, the report introduces a number of provisions on issues that are not addressed by the existing standards. For example, new principles have been introduced on segregation and portability, tiered participation and general business risk.

2 Market consultation

In light of the scope of this effort, the CPSS and IOSCO propose an approximately four

month comment period for market consultation and request that all comments be submitted no later than 29 July 2011.[1] Following review of the comments, the CPSS and IOSCO propose to publish a final report by early 2012. While the CPSS and IOSCO request comments on all the proposed principles, we particularly request comments with respect to the following points.

Principle 4: credit risk

An FMI or its participants may face credit risk in the FMI's payment, clearing and settlement processes. Credit risk is the risk that a counterparty will be unable to meet fully its financial obligations when due or at any time in the future.

The credit risk principle requires a payment system that is systemically important, a CSD or an SSS to cover its *current credit exposures* and, where they exist, *potential future credit exposures* to *each* participant fully with a high degree of confidence using collateral and other equivalent financial resources. It also requires a CCP to cover its *current credit exposures* and its *potential future credit exposures* to *each* participant fully with a high degree of confidence using margin and other financial resources. A CCP is also required to maintain *additional* financial resources sufficient to cover a wide range of potential stress scenarios identified in regular and rigorous stress testing.

With respect to the particular stress scenarios for which CCPs should hold additional financial resources, the CPSS and IOSCO are considering, and requesting comment on, the establishment of a minimum credit requirement that (1) all CCPs should include the default of the one participant and its affiliates that, in the aggregate, would potentially cause the largest credit exposure in extreme but plausible market conditions (that is, a "cover one" minimum requirement); (2) all CCPs should include in their stress scenarios the default of the two participants and their affiliates that, in the aggregate, would potentially cause the largest credit exposure in extreme but plausible market conditions (that is, a "cover two" minimum requirement); or (3) a CCP should be subject to either the "cover one" or the "cover two" minimum requirement, depending on the particular risk and other characteristics of the products it clears, the markets it serves and the number and type of participants it has. More specifically, the CPSS and IOSCO would welcome comments on the following questions:

- What are the pros and cons of establishing for credit risk (1) a "cover one" minimum requirement for all CCPs; (2) a "cover two" minimum requirement for all CCPs; and (3) either a "cover one" or a "cover two" minimum requirement for a particular CCP, depending upon on the risk and other characteristics of the particular products it clears, the markets it serves and the number and type of participants it has? What potential risk, competitiveness or other concerns might arise if certain CCPs that clear certain products would be subject to a "cover one" minimum requirement, while certain other CCPs that clear certain other products would be subject to a "cover two" minimum requirement? How and to what extent could these concerns be addressed?

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[1] Comments should be submitted by e-mail to both the CPSS secretariat (cpss@bis.org) and the IOSCO secretariat (fmi@iosco.org). The comments will be published on the websites of the Bank for International Settlements and IOSCO unless commentators have requested otherwise.

- Which risk and other characteristics of the products cleared by a CCP are relevant in weighing the pros and cons of a "cover one" versus a "cover two" minimum credit requirement for a CCP? In particular, to what extent are any or all of the following product and market characteristics relevant: OTC versus exchange-traded; mandatory versus voluntary clearing; "cash" versus "derivative"; the duration, volatility and degree of leverage; the number and type of CCP participants; the degree of market concentration; and the availability and reliability of prices from continuous, transparent and liquid markets?

Principle 7: liquidity risk

The liquidity risk principle requires an FMI to 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.

With respect to the particular stress scenarios for which a payment system that is systemically important, a CSD or an SSS should hold sufficient liquid resources, the CPSS and IOSCO are considering and seeking comment on the establishment of a minimum liquidity requirement that (1) all such FMIs should include in their stress scenarios the inability of the one participant and its affiliates with the largest aggregate payment obligation to settle that obligation (that is, a "cover one" minimum requirement); (2) all such FMIs should include in their stress scenarios the inability of the two participants and their affiliates with the largest aggregate payment obligations to settle those obligations (that is, a "cover two" minimum requirement); or (3) such an FMI should be subject to either the "cover one" or the "cover two" minimum requirement, depending on the particular risk and other characteristics of the payment obligations it settles.

With respect to the particular stress scenarios for which a CCP should hold sufficient liquid resources, the CPSS and IOSCO are considering and seeking comment on the establishment of a minimum liquidity requirement that (1) all CCPs should have sufficient liquid resources to meet the required margin payments and to effect the same-day close out or hedging of the one participant and its affiliates with the largest potential open positions in extreme but plausible market conditions (that is, a "cover one" minimum requirement); (2) all CCPs should have sufficient liquid resources to meet the required margin payments and to effect the same-day close out or hedging of the two participants and their affiliates with the largest potential open positions in extreme but plausible market conditions (that is, a "cover two" minimum requirement); or (3) a CCP should be subject to either the "cover one" or the "cover two" minimum requirement, depending on the particular risk and other characteristics of the products that it clears, the markets it serves and the number and type of participants it has.

With respect to the establishment of a minimum liquidity requirement, the CPSS and IOSCO would welcome comments on the following questions:

- What are the pros and cons of establishing for liquidity risk (1) a "cover one" minimum requirement for all FMIs; (2) a "cover two" minimum requirement for all FMIs; and (3) either a "cover one" or a "cover two" minimum requirement for a particular FMI, depending on the risk and other characteristics of the particular payment obligations it settles, the products it clears, the markets it serves and the number and type of participants it has? What potential risk, competitiveness or other concerns might arise if certain FMIs that settle certain payment obligations or that clear certain products would be subject to a "cover one" minimum requirement, while

certain other FMIs that settle certain other payment obligations or that clear certain other products would be subject to a “cover two” minimum requirement? How and to what extent could these concerns be addressed?

- Which risk and other characteristics of the payment obligations settled by a payment system, CSD or SSS are relevant in weighing the pros and cons of a “cover one” versus a “cover two” minimum liquidity requirement for such an FMI? Which risk and other characteristics of the products cleared by a CCP are relevant in weighing the pros and cons of a “cover one” versus a “cover two” minimum liquidity requirement for a CCP? In particular, to what extent are any or all of the following risk and other characteristics of the payment obligations settled or the products cleared by an FMI relevant: OTC versus exchange-traded; mandatory versus voluntary clearing; “cash” versus “derivative”; the duration, volatility and degree of leverage; the number and type of CCP participants; the degree of market concentration; and the availability and reliability of prices from continuous, transparent and liquid markets?

Principle 14: segregation and portability

Principle 14 on segregation and portability is only applicable to CCPs. The substantially new principle recommends that CCPs should have segregation and portability arrangements that protect customer positions and collateral, to the extent practicable and where feasible and supported by the legal framework. This qualifying language recognises that there may be market structure or legal impediments to a CCP facilitating segregation and portability in the cash markets.

The principle is designed to offer CCPs flexibility in achieving segregation of customer collateral and identifies the advantages and disadvantages associated with the use of omnibus and individual accounts. The principle also provides expanded guidance on the way that margin is collected (gross or net basis) by the CCP and explains how different levels of customer protection can be achieved. While the principle presents options, the overall objective is to protect customer positions and collateral, particularly in the case of insolvency of a participant.

The CPSS and IOSCO request comment on challenges associated with establishing segregation and portability regimes for CCPs. In particular, while no specific model of segregation and portability is prescribed in the relevant principle, the CPSS and IOSCO would particularly welcome comments on the following questions:

- 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?

- 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?

- Would it be helpful to distinguish between different types of customers, such as by the degree of tiering or by domestic or cross-border activity? Please explain.

- Would it be helpful to distinguish between different types of products? If so, please explain why and how.

- What are the existing legal constraints that limit segregation and portability?

Principle 15: general business risk

In addition to the credit, liquidity, and other related risks that may result from the default of participants, an FMI also faces general business risk. The inability of an FMI to continue as a going concern could pose systemic risk to its participants and the broader financial market. The new general business risk principle would require an FMI to 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 CPSS and IOSCO are considering, and requesting comment on, the establishment of a specific minimum quantitative requirement for liquid net assets funded by equity. More specifically, the CPSS and IOSCO request comment on the following questions:

- 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?

Principles 18 to 20: access and interoperability

The CPSS and IOSCO consider that mandatory clearing and the integration of international financial markets will increase the importance of ensuring fair and open access to FMIs and, relatedly, of links between FMIs in general and CCPs in particular. The evolution of global clearing structures may affect the degree of tiering, the number of CCPs in operation and interoperability arrangements that may exist or be established between CCPs and other FMIs. The CPSS and IOSCO would welcome comments on the future evolution of global clearing structures and the role that interoperability may have in this regard.

More specifically, Principle 18 emphasises that an FMI should establish fair and open access to its services, for both direct and indirect participants, with any restrictions justifiable only in terms of specific issues impacting the safety and efficiency of the FMI or the markets it serves.

Principle 20 addresses link arrangements between FMIs and establishes new standards for CSD-CSD and CCP-CCP links and special considerations for links established by a trade repository. A link is a contractual and operational arrangement between two or more FMIs that connects the FMIs directly or indirectly. This new principle reflects the growing importance of link arrangements in the financial markets also as a result of mandatory clearing and the importance of establishing strong standards to ensure that FMIs have a well-founded legal basis that supports the design and operation of the link. The principle recognises that the type and degree of risk will vary according to the design and complexity of the linked arrangement and provides guidance as to how each FMI should identify, monitor

and manage all link-related risks. The CPSS and IOSCO acknowledge that links are an important source of additional operational and financial risks, which call for more stringent requirements. Against this background, the CPSS and IOSCO specifically request comment on challenges associated with establishing links between FMIs.

Adoption and implementation of the principles

Relevant authorities will strive to include the principles as appropriate in their legal and regulatory framework by the end of 2012, in accordance with the G20 recommendations. Authorities will be expected to apply the principles as part of their regulatory, supervisory and oversight activities as soon as possible. FMIs will be expected to take appropriate and swift action in order to meet the principles. Against this background, the CPSS and IOSCO request input on how quickly FMIs will be able to implement the changes necessary to increase their resilience consistent with the new principles.

3 Assessment methodology

The consultative report does not contain an assessment methodology. It therefore also does not include any key questions that will be an integral part of the assessment methodology. An assessment methodology, along with the associated requirements with respect to the preparation and public disclosure of FMI self assessments and/or related information and key questions, will accompany the final report, when published.