The CPSS-IOSCO Principles for Financial Market Infrastructures

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The Principles: what is new?

Objectives of CPSS-IOSCO work

- **Harmonize** existing standards for different types of FMIs
- **Strengthen** existing standards, based on
  - Lessons from the crisis
  - Experience/gaps in applying standards
- Ensure **consistent application** (through Responsibilities, Disclosure Framework and Assessment methodology)
  - CPSS-IOSCO members commit to apply "to the fullest extent possible"
  - Support consistent disclosures by FMIs
  - Support consistent assessments of FMIs by national authorities
  - Support consistent external assessments of FMIs and authorities (eg, FSAPs)

Overview of the principles

General organization	Credit and liquidity risk management	Settlement
1. Legal basis 2. Governance 3. Framework for the comprehensive management of risks	4. Credit risk 5. Collateral 6. Margin 7. Liquidity risk	8. Settlement finality 9. Money settlements 10. Physical deliveries
CSDs and exchange-of-value settlement systems	**Default management**	**General business and operational risk management**
11. CSDs 12. Exchange-of-value settlement systems	13. Participant-default rules and procedures 14. Segregation and portability	15. General business risk 16. Custody and investment risks 17. Operational risk
Access	**Efficiency**	**Transparency**
18. Access and participation requirements 19. Tiered participation 20. FMI links	21. Efficiency and effectiveness 22. Communication procedures and standards	23. Disclosure of rules, key procedures, and market data 24. Disclosure of market data by TRs

Credit risk: previous requirements

- **All FMIs: current exposure (CE)**
  - Cover largest CE to a single participant

- **CCPs: potential future exposure (PFE)**
  - Cover largest PFE to a single participant
    - With 99% confidence, via margin
    - In extreme but plausible conditions, via default fund

Credit risk: what is new? All FMIs

- Requirements based on *"participant family,"* (*i.e* consolidated exposure to a participant *and its affiliates*)

- Cover CE to *every* participant, not just *single largest*
  - DNS PS or SSS without settlement guarantee: "Cover 2"

- Rigorous collateral requirements for "coverage"

- Rules/procedures to address/allocate uncovered credit losses (including to repay liquidity providers) and to replenish used resources (to function even in extreme but plausible conditions)

Credit risk: what is new? CCPs only

- PFE coverage
  - Cover every participant family with 99% confidence
  - Minimum additional resources in extreme but plausible conditions:
    - "Cover 2" participant family, if CCP: (i) has a more complex risk profile or is systemically important in multiple jurisdictions
    - "Cover 1" participant family for all other CCPs

- Rigorous stress testing of financial resources
  - Daily stress testing of total available resources
  - "Feed-back" mechanism to increase resources
  - Monthly analysis of scenarios, models, parameters and assumptions and Annual full model validation
  - Strong governance over entire process

Liquidity risk

Previous requirements

No explicit liquidity resource standard (implied: largest pay-in of a single participant).

What is new? (all FMIs) new, explicit liquidity risk principle:

- Maintain sufficient liquid resources in all relevant currencies. Minimum requirement: cover the default of the participant family that would generate the largest liquidity obligation for the FMI in extreme but plausible market conditions.
- to settle same-day/intraday/multiday payment obligations…
- with a high degree of confidence under a wide range of stress scenarios

A CCP should "consider covering 2" participant families, if it has a more-complex risk profile or is systemically important in multiple jurisdictions.

Liquidity risk: what is new? ALL FMIs

- **Rigorous requirements for stress testing liquidity risks**
- **Rigorous requirements for qualifying liquidity resources**
  – Cash and committed lines of credit, swaps, and repos
  – Highly marketable collateral, but only if:
    - Convertible into cash…
    - with prearranged funding arrangements that are…
    - highly reliable even in extreme but plausible market conditions
- **Required due diligence on liquidity providers**
  – Confirm each LP's capacity to perform as required
  – Confirm each LP has information to manage its risks
- **Rules/procedures to address/allocate uncovered liquidity shortfalls** (to avoid unwinding, revoking, or delaying same-day settlement) **and to replenish used resources** (to function even in extreme but plausible market conditions)

Revisions to reflect greater internationalisation: access, interdependencies and links

Principle	Purpose	Rationale
Principle 3: Comprehensive risk management	FMIs should address risks to and from other FMIs	FMIs should address risks to and from other FMIs
Principle 18: Access and participation requirements	Facilitate expanded direct access without compromising the safety of the FMI (CGFS report)	G-20 agenda calls for compulsory direct and indirect clearing of OTC (and exchanges) derivatives
Principle 20: FMI links	More specific and demanding requirements on different types of links	CCPs for OTC derivatives have been established.
Responsibility E: Cooperation between authorities	Strengthening the need for cross-border cooperation between authorities	Global FMIs require strengthening more cross-border cooperation between authorities

Other issues addressed in the new principles

Principle	Purpose	Problem during Lehman crisis
Principle 14: Segregation and portability	Protect indirect participants; Increased importance following mandatory clearing	Financial losses due to lack of appropriate segregation or inability to properly move positions
Several principles	New requirements for trade repositories and new transparency requirements (including disclosure framework)	Lack of transparency on (Lehman) trades
Principle 19: Tiered participation	Identify and address any risks that that the FMI may face from indirect participants	Lehmann was indirect participant in many FMIs
Principle 15: Business risk	Recognise the fact that FMIs may fail and create systemic disruptions not only as a result of member default, but also as a result of non-default related risks	Lack of clear resolution regime for FMIs and increasing concerns that FMI may fail or need central bank assistance

Revisions to prevent or facilitate recovery and resolution

Principle	Amendments
P1 (legal risk) P 8 (finality)	• Enforceability of rules to facilitate wind-down or recovery • Finality protected also in case of recovery or resolution
P2 (governance)	• Appropriate rules for decision making in recovery or resolution • Incentives to support financial stability in such circumstances
P3 (comprehensive risk framework)	• Identify scenarios that could lead to it becoming unviable • Need for effective crisis management arrangements
P4 (credit risk) and P7 (liquidity risk) P21 (Risks in links)	• FMI to have rules on replenishing resources and allocating uncovered losses (or address unforeseen liquidity shortfalls) • FMI to identify any risks from default of a linked FMI
P13 (default procedures)	• Plan to replenish resources to ensure continuity of operations after default
P15 (business risk)	• Sufficient equity capital to ensure continuity of operations as going concern

Specific issues for CSDs/SSSs

Definition of CSD

A CSD

- holds securities accounts;
- in many countries operates an SSS (see definition below)
- Provides central safekeeping and assets services (including co-productions and redemptions)
- Help ensuring the integrity of the issue (for assets held at the CSD)

An SSS enables securities to be transferred and settled by book entry according to a set of predefined multilateral rules.

Financial risks

Current exposure	100 % collateralisation of <u>all</u> current exposures (all FMIs) for FMI that guarantee settlement. For FMIs that do not guarantee settlement (e.g CSD/SSSs with model 2 or 3 DVP), in case of residual credit or liquidity risk: need for cover 2 or more depending on the results of the stress testing
Additional tools	Clear rules that indicate how any remaining uncovered losses would be allocated to non-defaulting participants (e.g. a survivor-pay arrangement)

Custody risk, segregation and portability

Custody risk	Key Consideration 4 in the Principle 11 requires protection against custody risk
Segregation and portability	Key Consideration 5 in the Principle 11 Requires a robust system that ensures segregation between the CSD's own assets and the securities of its participants and segregation among the securities of the participants. CSDs should also support operationally segregation „, and facilitate the transfer of the customer holding.

8. Settlement finality	Explicit requirement to consider adopting multiple batches for intra-day or intra-night finality; Define point in time before settlement when unilateral revocation can't occur.
9. Money settlement	Strict monitor of liquidity providers, limited purpose bank status.
18. Access and participation requirements	Clear reference to indirect participants; new notion of on-going review of compliance with access rules.
19. Risks in tiering	Understand risks in tiering; access to relevant information.
20. CSD links	Indirect links, relayed links and links with TRs

The Assessment methodology

Objectives

- Is a tool to promote the implementation and on-going observance of the principles and responsibilities and to help ensure objectivity and comparability across all relevant jurisdictions;
- Draws from the methodologies that were developed for the CPSIPS, the RSSS and the RCCP, taking into account the lessons learned from the use of the existing approaches
- Support different objectives of national and regional authorities and IFIs

Structure

The *five steps* involved in an assessment against the PFMI are:

1. determining the appropriate scope of an assessment;
2. gathering facts useful to evaluate the key considerations;
3. developing key conclusions by key considerations;
4. assigning a rating category to each principle or responsibility; and
5. indicating an appropriate time-frame for addressing each identified issue of concern, including a discussion on priorities

Use of rating framework

- Different types of assessors may communicate the outcome of their assessments of FMIs differently, depending on their specific objectives
- The rating is built on the key conclusions and reflects the assessors' judgment regarding the type or impact of the risks, concerns, or other issues associated with each identified gap or shortcoming
- **National authorities** may choose to use the AM rating scheme or may choose to use another EQUALLY EFFECTIVE rating scheme.
- The AM rating scheme is expected to be used in the context of cross-border cooperative oversight arrangements
- **IFIs** use the rating scheme presented in the AM in the context of the FSAP. Technical assistance (TA) assessors are not necessarily expected to use a rating scheme

Observed	The FMI observes the Principle. Any identified gaps and short-comings are **not issues of concern** and are minor, manageable, and of a nature that the FMI could consider taking up in the normal course of its business.
Broadly observed	The FMI broadly observes the Principle. One or more **issues of concern** have been identified that the FMI is encouraged to address and follow up to better manage risks or improve operations. The FMI should pursue such improvements in a **defined timeline**.
Partly observed	The FMI partly observes the Principle. The assessment has identified one or more **issues of concern** that could become serious if not addressed in **a timely manner**. The FMI should accord a **high priority** to address these issues.
Not observed	The FMI does not observe the Principle. The assessment has identified one or more serious **issues of concern** that warrant **immediate action**. Therefore, the FMI must accord the highest priority to timely address these issues.
Not applicable	The Principle does not pertain to the type of FMI being assessed because of the particular legal, institutional, structural or other characteristics of the FMI.

The Disclosure framework

Objectives

- Improve the overall transparency of the FMI governance, operations and risk management

- To this end, need standardised disclosure practices to allow for a more robust comparison across FMIs by participants, authorities and the broader public.

⇒ The Disclosure Framework prescribes the form and content of public disclosures expected from FMIs under Principle 23

⇒ In addition, development of a separate set of quantitative information disclosure to be updated more frequently

Structure

- Executive summary of the key points from the disclosure
- Summary of major changes since the last update of the disclosure
- Description of the FMI's functions and the markets it serves, basic data and performance statistics on its services and operations; description of the FMI general organisation, legal and regulatory framework and system design and operations
- Comprehensive narrative disclosure for each applicable principle
- List of publicly available resources referenced in the disclosure framework and any other relevant public resource that may help the reader understand the FMI and its approach to observing the principles

Oversight, recovery and resolution

FMIs are different from banks

- Different functions and need for continuity of critical services
- Different risk profiles
- Different balance sheets
- Different structure (participation, links, etc.)

FMIs are different from each other

a) FMIs that do ***not*** take on credit risk

- Recovery: as losses would typically result from general business risk, focus on capital resources to address business risk
- Resolution: transfer of operations to third parties if available or need to create a bridge institution

b) FMIs that take on credit risk

- Recovery: need for FMI's loss allocation rules and (in case of CCPs) re-establishment of matched book
- Resolution: need for statutory loss allocation rules or alternatively transfer of operations to third parties or bridge institution

Need to ensure continuity of services: observance of PFMIs, recovery, and resolution

Level of activity	Tool	Responsibility	Relevant rules
Observance of PFMI	Risk management	FMI (overseen by authorities) and overseers	All PFMIs
Recovery	Recapitalisation, loss sharing rules	FMI and overseers	Mainly Principles 1, 4, 7, and 15
Resolution	Resolution tools (including loss allocation; transfer of services)	Resolution authorities (in co-operation with overseers)	Key Attributes (Insolvency Legislation)

Recovery/resolution

Specific issues for CSD

1. Bridge entity
   - need to continue to ensure consistency between securities and cash leg
   - continuity of the "notary" function
   - links

2. Links
   - need for clarity on how assets available in another CSD (because of links) will be treated

Cooperation with the resolution authority

- Resolution authority may or may not be the same as FMI's overseer/regulator
- Their powers and responsibilities come from different sources: While the responsibilities of the FMI's overseer/regulator are inidicated by the PFMI, the powers of resolution authorities are specified by the FSB's *Key Attributes of Effective Resolution Regimes for Financial Institutions*
- Both sets of rules define obligations for cooperation: e.g. PFMIs specify a requirement to inform/notify the resolution authority of regulatory actions; the *Key Attributes* require resolution authorities to involve and cooperate with other relevant authorities
- As proposed in the CPSS-IOSCO consultative report on recovery and resolution of FMIs, the basis of cooperation should be Responsibility E

Thanks for your attention!

Shukran!