



EUROPEAN CENTRAL BANK

EUROSYSTEM

Ms. Daniela Russo

Director General

Payments and Market Infrastructure

European Central Bank

The CPSS-IOSCO Principles for Financial Market Infrastructure

CPSS/WB Regional Payments Week

Cartagena, 21 November 2013

1. Motivation

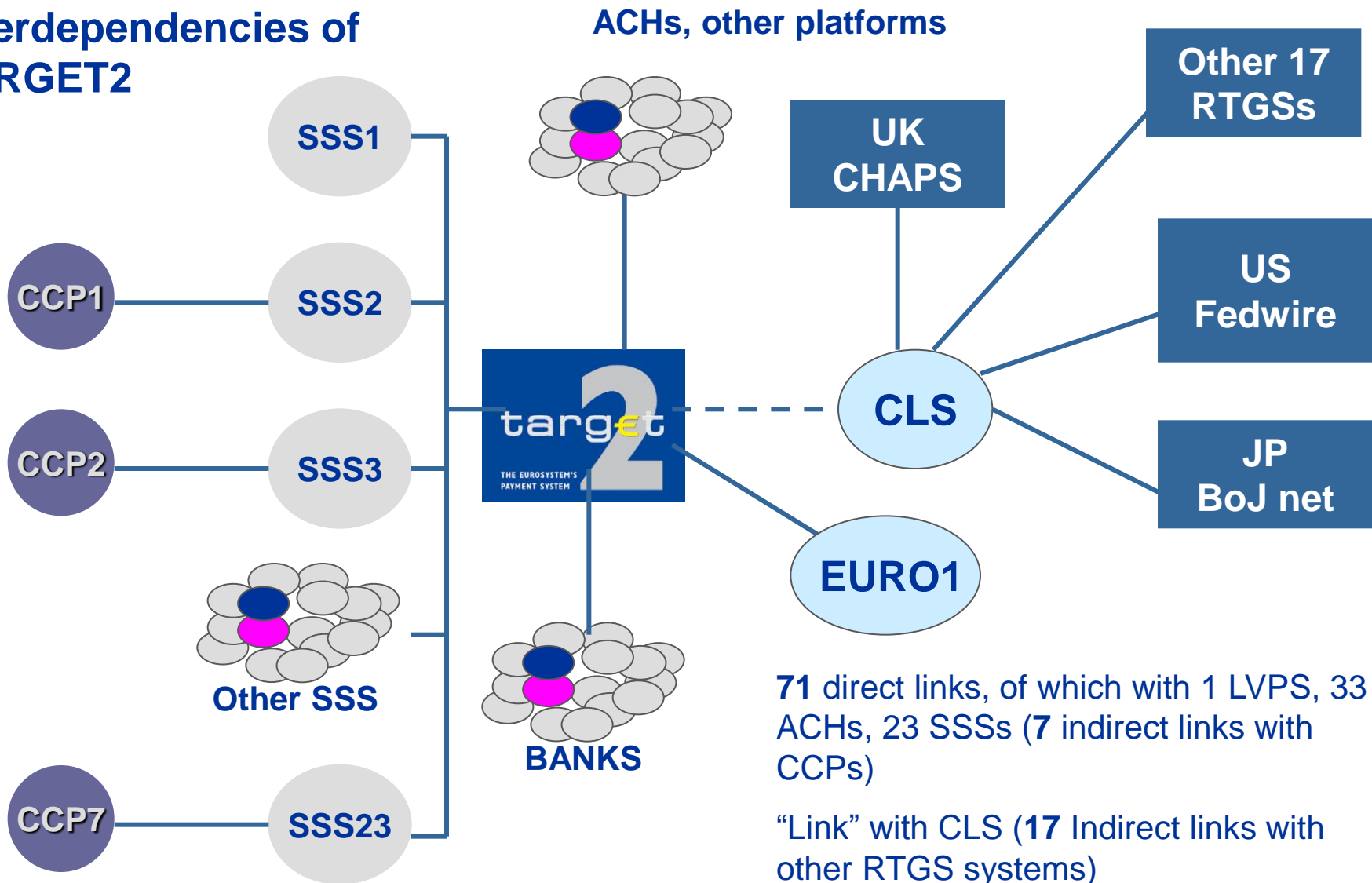
2. Principles

3. Responsibilities

4. Oversight, recovery and resolution

- ✓ **Growing importance of financial market infrastructure**
- ✓ **Important FMI role to preserve financial stability**
- ✓ **Incorporate the lessons of the crisis and implement the G-20 Lisbon Agenda**
- ✓ **Address regulatory gaps and recognising growing globalisation**

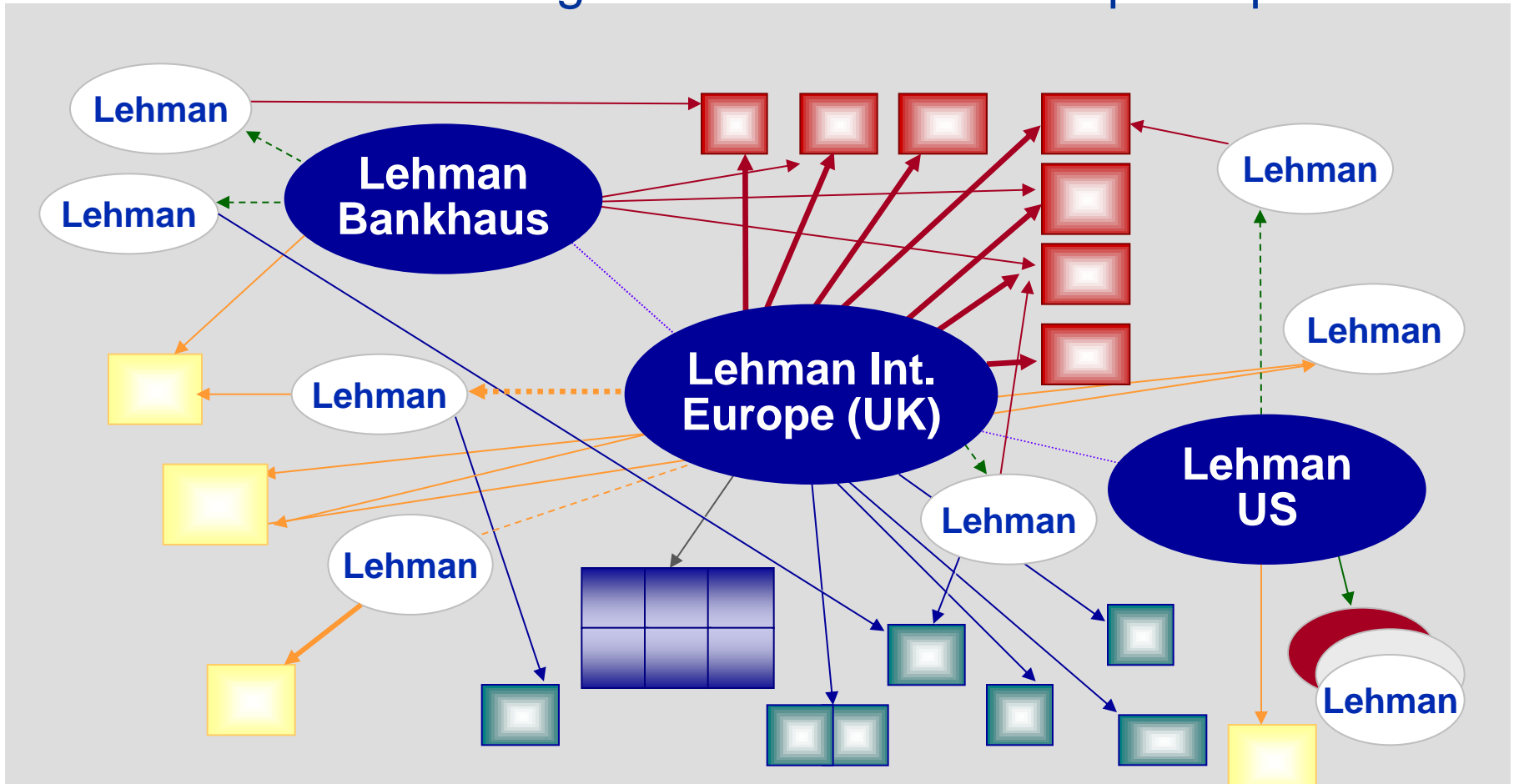
Interdependencies of TARGET2



71 direct links, of which with 1 LVPS, 33 ACHs, 23 SSSs (7 indirect links with CCPs)

“Link” with CLS (17 Indirect links with other RTGS systems)

Too interconnected: e.g. links due to Lehman participation



II. The Principles

2.1. 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)

2.2. Overview of the principles

<p>General organization</p> <ol style="list-style-type: none"> 1. Legal basis 2. Governance 3. Framework for the comprehensive management of risks 	<p>Credit and liquidity risk management</p> <ol style="list-style-type: none"> 4. Credit risk 5. Collateral 6. Margin 7. Liquidity risk 	<p>Settlement</p> <ol style="list-style-type: none"> 8. Settlement finality 9. Money settlements 10. Physical deliveries
<p>CSDs and exchange-of-value settlement systems</p> <ol style="list-style-type: none"> 11. CSDs 12. Exchange-of-value settlement systems 	<p>Default management</p> <ol style="list-style-type: none"> 13. Participant-default rules and procedures 14. Segregation and portability 	<p>General business and operational risk management</p> <ol style="list-style-type: none"> 15. General business risk 16. Custody and investment risks 17. Operational risk
<p>Access</p> <ol style="list-style-type: none"> 18. Access and participation requirements 19. Tiered participation 20. FMI links 	<p>Efficiency</p> <ol style="list-style-type: none"> 21. Efficiency and effectiveness 22. Communication procedures and standards 	<p>Transparency</p> <ol style="list-style-type: none"> 23. Disclosure of rules, key procedures, and market data 24. Disclosure of market data by TRs

2.3. Raising the bar on financial risk management

Issue	Purpose	Problems during Lehman crisis
Credit exposures	Reference to exposure of all affiliated entities of same group Greater emphasis on crisis scenarios: cover 2 for internationally active or high-risk CCPs; otherwise 1+ 100 % collateralisation of all current exposures	Financial losses. Sequential defaults of more than one large participants. Proven ineffectiveness of certain tools (e.g. uncomm. uncoll. credit lines) in certain crisis scenario,
Liquidity exposure	Current exposures also include intraday exposures Reference to different sources of liquidity risk	Ineffectiveness of certain tools special relevant for liquidity. Critical role of settlement/agent liquidity providers. (e.g. CLS)
Collateral	Avoid concentration risk; procyclicality wrong-way risks; higher quality	Quality of collateral affects the size of losses. Procyclicality and wrong-way risks increased the costs for funding.
Additional tools	Clear rules indicating how allocating remaining uncovered losses to non-defaulting participants (e.g. a survivor-pay arrangement)	See above

2.4. 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

2.5. Credit risk: raising the bar

- **All FMIs:** Requirements based on “participant family,” not single legal entity (i.e consolidated exposure to a participant and its affiliates)
- **All FMIs:** cover CE to every participant, not just single largest
 - DNS PS or SSS without settlement guarantee: “Cover 2”
- **CCPs:** PFE coverage
 - Cover every participant family with 99% confidence
 - Minimum additional resources for extreme but plausible conditions
 - “Cover 2” participant families,
 - If CCP has a more-complex risk profile or
 - If CCP is systemically important in multiple jurisdictions
 - “Cover 1” participant family for all other CCPs

2.6. Credit risk: extending the bar

- **All FMIs**
 - Rigorous collateral requirements for “coverage”
 - Rules/procedures to address/allocate uncovered credit losses (including to repay liquidity providers)
 - Rules/procedures to replenish used resources (to function even in extreme but plausible conditions)

- **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
 - Annual full model validation
 - Strong governance over entire process

2.7. Liquidity risk: raising the bar

- **All FMIs: new, explicit liquidity risk principle:**
 - Maintain sufficient liquid resources in all relevant currencies...
 - to settle same-day/intraday/multiday payment obligations...
 - with a high degree of confidence under a wide range of stress scenarios
- **All FMI: Minimum requirements**
 - Cover default of the one participant family...
 - that would generate the largest liquidity obligation for the FMI...
 - in extreme but plausible market conditions
- **A CCP should “consider covering 2” participant families,**
 - If CCP has a more-complex risk profile or
 - If CCP is systemically important in multiple jurisdictions

2.8. Extending the bar: liquidity risk

- **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)**

2.9. Revisions to reflect greater internationalisation: access, interdependencies and links

Principle	Purpose	Rationale
Principle 3: <i>Comprehensive risk management</i>	FMIs should address risks to and from other FMIs	FMIs should address risks to and from other FMIs
Principle 18: <i>Access and participation requirements</i>	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: <i>FMI links</i>	More specific and demanding requirements on different types of links	CCPs for OTC derivatives have been established.
Responsibility E: <i>Cooperation between authorities</i>	Strengthening the need for cross-border cooperation between authorities	Global FMIs require strengthening more cross-border cooperation between authorities

2.10. Revisions to prevent or facilitate recovery and resolution

Principle	Amendments
P1 (legal risk) P 8 (finality)	<ul style="list-style-type: none"> • Enforceability of rules to facilitate wind-down or recovery • Finality protected also in case of recovery or resolution
P2 (governance)	<ul style="list-style-type: none"> • Appropriate rules for decision making in recovery or resolution • Incentives to support financial stability in such circumstances
P3 (comprehensive risk framework)	<ul style="list-style-type: none"> • 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)	<ul style="list-style-type: none"> • 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)	<ul style="list-style-type: none"> • Plan to replenish resources to ensure continuity of operations after default
P15 (business risk)	<ul style="list-style-type: none"> • Sufficient equity capital to ensure continuity of operations as going concern

2.11. Issues addressed in the “new” principles

Principle	Purpose	Problem during Lehman crisis
Principle 14: <i>Segregation and portability</i>	Protect indirect participants; Increased importance following mandatory clearing	Financial losses due to lack of appropriate segregation or inability to properly move positions
<i>Several principles</i>	New requirements for trade repositories and new transparency requirements (including disclosure framework)	Lack of transparency on (Lehman) trades
Principle 19: <i>Tiered participation</i>	Identify and address any risks that the FMI may face from indirect participants	Lehmann was indirect participant in many FMIs
Principle 15: <i>Business risk</i>	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

III. The Responsibilities

3.1. Potential concerns to address (I)

- ✓ **In general, what role does the public sector have for FMIs? More specifically, who should do what and how?**
- ✓ **What is the purpose of the “Responsibilities”? What is their status and relevance for authorities?**
- ✓ **How do the Responsibilities relate to (domestic) statutory and legal obligations that authorities may have? How do they relate to other guiding documents that exist for CPSS and IOSCO?**
- ✓ **How to identify relevant authorities that are responsible for a particular FMI, especially in case of globally acting FMIs (e.g. on the basis of FMI’s location, participants, currency)?**

3.1. Potential concerns to address (II)

- ✓ **How to ensure that infrastructure with the same regular risk profile are subject to consistent requirements and are consequently addressing their risks consistently? And how to ensure that different risk models lead to the same level of resilience? More specifically, who should do what and how?**
- ✓ **How to address issues coming from interdependencies?**
- ✓ **What exactly is the role of each authority? What specifically of central banks?**
- ✓ **What form should cooperation take: information sharing, notification, consultation, discussions, joint assessment etc.?**

3.2. What is new?

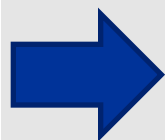
- ✓ For the first time, all aspects relevant for all types of authorities and all types of FMIs are comprehensively covered in a single document
- ✓ Formal commitment by authorities to adopt and apply the PFMI
- ✓ Commitment to consistent application of PFMI (need for implementation monitoring)
- ✓ Commitment towards equal treatment of central-bank FMIs and private-sector FMIs
- ✓ Guidance on choice of framework for regulation, supervision, and oversight (legislation, statutory framework, or versus less formal arrangements)
- ✓ Greater emphasis on the need for public disclosure of policies and the importance of consultations to this end
- ✓ Authorities are explicitly expected to promote both safety and efficiency of FMIs
- ✓ Much greater emphasis and detail on cooperation, while recognising the need for some flexibility
- ✓ Specific reference to the role of the central bank of issue (new for CSD and CCPs)

3.3. Cooperation with other authorities: Responsibility E (I)

- ✓ Need for effective co-operation, under any circumstances: (i) in normal times, (ii) in crisis situation, (iii) for recovery and resolution
- ✓ Obligation to notify other authorities of cross-border or multicurrency FMIs
- ✓ Variety of different forms of co-operation: form, degree, formalisation, and intensity to be tailored to the specific case and circumstances (not easy)
- ✓ Cooperation must not dilute responsibilities: at least one authority should accept ultimate responsibility (typically, but not necessarily, the authority with primary responsibility in the FMI's home jurisdiction)
- ✓ Need for co-operation in assessing FMIs against the Principles by means of information sharing, consultations, and discussions

3.4. Cooperation with other authorities: Responsibility E (II)

- ✓ For assessing payment, settlement, and liquidity arrangements, the authority with primary responsibility needs to consider the views of the central bank of issue (and vice versa)
- ✓ Advance notification to be given to any relevant authorities regarding regulatory changes or adverse events
- ✓ Need for coordination to ensure timely access to data in TRs
- ✓ Ultimately, authorities may decide to discourage the use of an FMI
- ✓ Co-operative arrangements in no way prejudice an authority's legal or statutory powers



Responsibility E offers *general* guidance on how to design frameworks for co-operation; *specific* features of each framework need to be tailored to the individual FMI and specific purpose of co-operation!

IV. Risk management, recovery and resolution (work in progress)

4.1. FMI are different from banks

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

4.2. 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

4.3. Need to ensure continuity of service: observance of PFMI, recovery and resolution

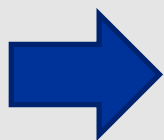
Level of activity	Tool	Responsibility	Relevant rules
Observance of PFMI	Risk management	FMI (overseen by authorities) and overseers	All PFMI
Recovery	Recapitalisation, loss sharing rules	FMI and overseers	Mainly Principles 1, 4, 7, and 15
Resolution	Resolution tools (including loss allocation; transfer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

4.4. Inventory of recovery tools

Objectives	Tools
Allocate uncovered losses from a participant default	<ul style="list-style-type: none">- Cash calls on participants (“assessment power”)- Variation margin haircutting by CCPs- Initial margin haircutting
Address uncovered liquidity shortfalls	<ul style="list-style-type: none">- Obtain liquidity from third-party institutions- Obtain liquidity from non-defaulting participants
Replenish financial resources	<ul style="list-style-type: none">- Cash calls on participants (“assessment power”)
Allocate losses not related to participant default (e.g. Investment risk, operational risk, custody risk)	<ul style="list-style-type: none">- Recapitalisation- Explicit insurance (e.g. from a third party) or indemnity agreements (e.g. from a parent, owners or participants)
(for CCPs) Re-establish a matched book	<ul style="list-style-type: none">- Incentivise acceptance of unmatched contracts- Forced allocation of contracts- Contract termination: tear up- Contractual versus voluntary tools to achieve a matched book

4.5. Implications for cooperation between authorities

- ✓ International nature of many FMIs means that several authorities may have responsibilities for a particular FMI, including for recovery and resolution
- ✓ The FSB's Key Attributes of Effective Resolution Regimes for Financial Institutions specify cooperation and coordination requirements for legal framework conditions (KA 7), Crisis Management Groups (KA 8), and institution-specific cooperation agreements (KA 9)
- ✓ Responsibility E is compatible with all of these requirements: cooperative oversight arrangement under Responsibility E enable effective cooperation in normal times, in times of crisis, and for recovery and resolution.
- ✓ Leveraging the arrangements under Responsibility E will (i) ensure consistency across recovery and resolution plans, (ii) facilitate cross-border communication, (iii) facilitate mutual recognition of resolution actions in different jurisdictions



Responsibility E, as supplemented to meet Key Attributes, helps to avoid any duplicative and inconsistent arrangements, thus lowering regulatory burden and avoiding gaps recovery and resolution plans!

Thanks for
your
attention!