David Schraa
Regulatory Counsel

1333 H Street, NW, Suite 800E
Washington, DC 20005-4770
TELEPHONE 202.857.3600
FAX 202.775.1430
WEB www.iif.com

June 8, 2012

Paul Tucker
Chair
Committee on Payment and Settlement Systems (CPSS)
CPSS Secretariat
Bank for International Settlements
4002 Basel
Switzerland

Bill Dudley
c/o Committee on Payment and Settlement Systems (CPSS)
CPSS Secretariat
Bank for International Settlements
4002 Basel
Switzerland
Sent by e-mail to: cpss@bis.org

Masamichi Kono
c/o International Organization of Securities Commissions (IOSCO)
c/ Oquendo 12
28006 Madrid
Spain
Sent by e-mail to: fmi@iosco.org

Re: IIF Response to CPSS-IOSCO Consultative Reports on Assessment Methodology and Disclosure Framework for the Principles for FMIs and the responsibilities of authorities

Dear Sirs,

On behalf of the Infrastructure Working Group of the Institute of International Finance (IIF), the global association of financial institutions, we welcome the opportunity to comment on the consultative reports, *"Assessment Methodology for the Principles for FMIs and the responsibilities of authorities"* and *"Disclosure Framework for financial market infrastructures"* – henceforth "the draft Assessment Methodology" and "the draft Disclosure Framework" prepared by the Committee on Payment and Settlement Systems (CPSS) and the Technical Committee of the International Organization of Securities Commissions (IOSCO) and issued for comment in April 2012. In our response to your 2011 consultation on the draft financial market infrastructure principles – "FMI Principles" – we called for this and we therefore welcome the open and consultative approach.

Before moving to specific comments on the draft Assessment Methodology and draft Disclosure Framework, we also wish to acknowledge the efforts made by CPSS-IOSCO to respond to the comments made on the draft FMI Principles. We particularly welcome the way in which Responsibility E on cooperation with other authorities has been significantly expanded. However we are concerned that in a number of areas, reasonable comments or drafting suggestions were not acted on. In particular, we continue to believe that the FMI Principles would have been stronger if the guidance had been more detailed and had allowed for nuance in the treatment of different types of FMI. Whilst it is desirable to have consistent principles across the different types of FMI, such principles should take account of the distinct and inherent differences between types of FMIs and should therefore differentiate where necessary between them, especially as regards the details of implementation. We hope that you will review this approach in the coming years.

Therefore, in commenting on the draft Assessment Methodology and draft Disclosure Framework, we have looked at whether these apply fairly and practically the final Principles, key considerations and guidance as adopted, rather than the final Principles that we would liked to have seen adopted. This should not necessarily be taken as signalling our full agreement with those final adopted Principles.

Furthermore, although these are principles and not prescriptive rules, it would be useful to have some more guidance on the frequency of assessments. The framework does not mandate assessments, nor does it state they that should be performed annually. Without a clear and stated frequency, it is unclear how CCPs can be considered "qualifying" under Basel 3 on an ongoing basis.

To ensure compliance, sample testing should be carried out to confirm that what has been stated in the assessment is actually done in practice. There also needs to be follow-up testing to ensure that issues of concern have been adequately addressed. Dates of follow up testing and findings also need to be reported and disclosed.

On the disclosure framework we feel that the comprehensive two-year update requirement is insufficiently frequent, and that disclosure should be updated annually (or where appropriate, quarterly or monthly), with any material changes disclosed as soon as feasible.

Comments on the draft Assessment Methodology and draft Disclosure Framework

On Principle 1 on legal basis, in Q 1.1.1, we suggest that the list of examples of material aspects of an FMI's activities that require legal certainty given should be expanded to include a reference to "default procedures" at minimum, and ideally also some or all of the issues identified in the fifth sentence of Explanatory Note 3.1.2 of the Principles such as collateral arrangements (including margin arrangements), immobilization and dematerialization of securities, arrangements for DvP, PvP or DvD and the resolution of the FMI.

We would recommend that Q.1.1.3 be amended so that they clearly ask whether the FMI has obtained legal opinions covering the material aspects of an FMI's activities that

require legal certainty and which opinions have been obtained. This is implied in the current drafting, but could usefully be brought out.

In all three cases, the disclosure framework could also be amended.

On **Principle 2,** we have concerns with two of the questions posed in the draft Assessment Methodology:

Q.2.1.5: "How are other relevant public interest considerations identified and how are they reflected in the FMI's objectives?"

Q.2.4.2: "What are the incentives that the FMI provides to members of the board, particularly incentives to attract and retain members of the board with appropriate skills?"

On 2.1.5, we find the wording "*other relevant public interest considerations*" extremely vague. In our July 2011 comments on the draft FMI Principles we called for greater clarity on "*other relevant public interests*" so that it did not become a "catch all", and for a definition of the types of public interest considerations that are appropriate for FMIs to consider. This clarity is more necessary than ever. One potential way of dealing with this, would be redraft 2.1.5 to read:

"How are other relevant public interest considerations identified ***by those responsible for FMI oversight or supervision*** *reflected in the FMI's objectives?"*

This would reflect the responsibility of FMI oversight or supervision authorities to identify public interest considerations and to communicate them to the FMI, but for the FMI in turn to incorporate them into their objectives.

On Q.2.4.2, we find the use of the word "*incentives*" confusing and undefined, and would suggest that this either be dropped or defined more clearly both here and in the relevant bullet of the draft Disclosure Framework.

We also wonder whether it is really practical to require the FMI to disclose under key consideration 5: "*skills, experience* ***and integrity*** *of management*". How exactly can one disclose integrity? We therefore suggest that the words "*and integrity*" be dropped here. If there were any material lapses of integrity of a board member or officer of an FMI, such lapses and actions taken with respect thereto would in any case need to be disclosed under most national rules.

Under key consideration 6 of the draft Disclosure Framework, we suggest that the third bullet:

"*Identification of authority, independence, resources and access to the board of the risk-management and internal control functions in governance arrangements*"

Be replaced with the more practical:

"*Explanation of how governance arrangements ensure that the risk-management and internal control functions have sufficient authority, independence, resources and access to the board.*"

Under KC 2.7, we think it would be helpful if Questions Q.2.7.1 and Q.2.7.2 could go further to the issue of participant involvement in the risk management process (e.g., participant representation in risk management committees or default management groups).

In the same vein as in Principle 2, under **Principle 3**, we were confused by Q.3.2.1 of the draft Assessment Methodology:

"What incentives does the FMI provide for participants and their customers to monitor and manage the risks they pose to the FMI?"

We do not believe that it is the proper role of an FMI (other than one that also acts as a legally mandated SRO) to provide incentives for participants and customers to manage their risks properly. Such participants will be subject to their own regulatory, supervisory and governance requirements and any further requirements an FMI might attempt to propose would be superfluous. What is essential is that the FMI provides them insofar as necessary at the FSB with the tools to assess and thus manage risks correctly. We therefore recommend that you replace the word "*incentives*" with the word "*tools*" here in both the draft Assessment Methodology and the draft Disclosure Framework.

On **Principle 4,** we believe that Questions 4.4.4 and 4.4.5 of the draft Assessment Methodology would be practically difficult for a CCP to answer.

Q.4.4.4 "If the CCP is systemically important in multiple jurisdictions or involved in activities with a more-complex risk profile, do the additional financial resources cover, at a minimum, the default of the two participants and their affiliates that would create the largest credit exposure in the CCP in extreme but plausible market conditions?

Q.4.4.5: Has the CCP considered whether it is systemically important in multiple jurisdictions when setting its level of financial resources?

These questions suggest that it would be up to the CCP to make the assessment as to whether it is systemically important, something that it is extremely difficult for the CCP itself to assess. We believe that the responsibility here should be with the supervisor or oversight body to make the judgment and communicate it to the CCP. Further, there is no guidance in the explanatory note as to how "more-complex" or "systemically important" are to be defined or understood. We therefore recommend dropping 4.4.5 and amending 4.4.4 to read:

"If ***the oversight body or supervisor has indicated to*** *the CCP* ***that they regard it as*** *systemically important in multiple jurisdictions or involved in activities with a more-complex risk profile, do the additional financial resources cover, at a minimum, the default of the two participants and their affiliates that would create the largest credit exposure in the CCP in extreme but plausible market conditions?*

In Q 4.5.2 it would be helpful to have a question asking "*Who are the "relevant parties" for the purposes of communicating stress test results?*"

We also recommend inserting guidance as to the definitions of "more-complex" and "systemically important".

On **Principle 5**, there are two questions in the draft Assessment Methodology that strike us as unreasonably difficult to answer:

Q.5.3.1: How does the FMI identify and evaluate the potential procyclicality of its haircut calibrations?

Q.5.3.2: How does the FMI incorporate periods of stressed market conditions during the calibration of haircuts to reduce the need for procyclical adjustments?

Whilst we support the use of stable and conservative haircuts, we do not believe that these questions are the right way of getting at the issue. As we argued in October 2010 in a joint response with ISDA to the paper by the Committee on the Global Financial System "*The role of margin requirements and haircuts in procyclicality* ('CGFS 36')" while margins and collateral have some procyclical characteristics, some element of procyclicality in normal economic circumstances is inevitable in the financial system. We believe that it is unrealistic for an FMI or any other economic actor to identify and evaluate the potential procyclicality of any calibrations or to incorporate macroprudential concerns into its decision process. A more reasonable requirement might be to require the FMI when setting haircuts to assess whether its haircuts are conservative and likely to be stable, including in periods of stressed market conditions. Indeed the draft Disclosure Framework already uses wording to this effect.

In the same vein for **Principle 6**, we have concerns on the practicality of 6.3.7 of the draft Assessment Methodology:

Q.6.3.7: How does the CCP address procyclicality in the margin methodology, in particular, does the CCP adopt forward-looking and relatively stable and conservative margin requirements to limit the need for destabilizing procyclical changes?

This could usefully be amended to read:

Q.6.3.7: How does the CCP ***ensure that it adopts*** *forward-looking and relatively stable and conservative margin requirements?*

We also recommend that the final bullet of Key consideration 3 in the draft Disclosure Framework be dropped for the same reason, or amended to delete the word "Procyclicality":

"*Procyclicality and specific wrong-way risk in the CCP's margin system.*"

In **Principle 7** we have concerns on Question 7.4.5 of the draft Assessment Methodology:

Q.7.4.5: How, and to what extent, is the CCP involved in activities with a more-complex risk profile or systemically important in multiple jurisdictions?

Again, we believe that this should be for the oversight body to assess rather than the CCP. We therefore suggest that it be amended to read:

Q.7.4.5: How, and to what extent, is the CCP involved in activities ***deemed by the oversight body or supervisor to have*** *a more-complex risk profile or* ***to be*** *systemically important in multiple jurisdictions?*

In the same vein, the third key element under Key consideration 4 in the draft Disclosure Framework should be amended to read:

"*Consideration to cover the default of two participants by a CCP involved in activities* ***deemed by the oversight body or supervisor to have*** *a more-complex risk profile or* ***be*** *systemically important in multiple jurisdictions"*

As with Principle 4, both "more-complex" and "systemically important" will need to be clearly defined.

We suggest adding the phrase "*including under stressed circumstances*" at the end of Q 7.7.2. This would make it consistent with the aim.

In **Principle 8**, we believe that it – and Principle 20 on FMI links – are missing a critical point on the connection between settlement finality and FMI links. We would therefore suggest that both contain a question similar to the following;

"*How does the FMI ensure settlement finality in the case of linkages with other FMIs?*"

Under Key consideration 8.1 / KE 1, we suggest adding the following question: *"Which BIS DvP settlement model does the FMI use?"*

In Q.8.2.5, we suggest adding the word "How" at the start or adding a second sentence asking how the FMI informs participants of final account balances.

In Key consideration 8.3 / KE 1, we recommend that questions be added asking (i) what the time lag is between the revocation point and the point of settlement finality and (ii) in the case of links, how and when settlement finality is ensured.

In all these cases, similar changes could be made to the disclosure framework.

While we support **Principle 10** on physical deliveries, we believe that Question 10.1.4 in the draft Assessment Methodology is both onerous and is unnecessary:

Q.10.1.4: Is there evidence that the participants have an understanding of their obligations and the procedures for effecting physical delivery?

If an FMI has defined its obligations and responsibilities, and if it has disclosed these clearly as assessed by Q.10.1.2 and Q.10.1.3, we do not believe that it is reasonable for the FMI to be required to verify the understanding of participants. We suggest that you drop this question.

On **Principle 11** on CSDs, under Key consideration 11.6, we suggest adding a question about how the CSD has legally separated its other activities.

On **Principle 13** on default rules and procedures, whilst the explanatory notes make it more or less clear what kind of disclosure is required to the public, it is not clear about the level of disclosure that should be provided to participants. We recommend that you provide more details here.

KC 13.3 / KE 1 – Disclosure to participants and public: add something about distinguishing between disclosures to participants and disclosures to the public, query whether it would make sense to work in that distinction in the questions related to KE 1.

On **Principle 14** on segregation and portability, we accept that the questions as drafted are fair representations of the final Principle and key considerations as adopted. However, we continue to have reservations about the Principle and key considerations themselves. As we stated in our July 2011 response on the draft FMI Principles

"*We also understand the attraction of segregation and portability as being, all other things equal, the simplest and most direct means of ensuring that a high degree of protection and legal certainty exists. To the extent to which segregation and portability are both feasible in the interests of customers and do not have any potential negative consequences, we indeed support them.*

"However, the draft Principle is neither desirable nor feasible in all circumstances. There will be a large number of cases in which separating out the positions of individual underlying customers and keeping them segregated will be disproportionately difficult or inefficient. Equally, there will be cases in which a blanket application of the Principle would lead to perverse outcomes in which operational risk and settlement uncertainty would increase because liquidity would be "trapped" in individual positions or accounts. This would go against the principles of liquidity risk management and more generally risk management. Similarly, as discussed under Principle 4, the presence or absence of some degree of risk mutualization among indirect participants has a very significant effect on the risk, cost, and efficiency of any FMI, particularly a CCP."

On **Principle 17** on operational risk, we suggest amending Q.17.6.1 to specifically ask which "wide-scale or major disruptions" an FMI's business continuity plan assumes as often 'worst case scenarios' change over time.

In our July 2011 comments on **Principle 19** on tiered participation requirements, we called for the qualifier "*to the extent practicable*" to be explained further. It is disappointing that you have dropped this altogether, and believe that the final guidance would have been stronger with it included with a suitable explanation.

As noted above, we suggest that both the assessment methodologies for Principle 8 and **Principle 20** on FMI links contain a question similar to the following;

"*How does the FMI ensure settlement finality in the case of linkages with other FMIs?*"

While we do not have fundamental objections, we believe that the drafting of the Disclosure Framework for **Principle 21** on efficiency and effectiveness could usefully be reviewed. As it stands, the wording is extremely vague.

On **Principle 23** on the disclosure of risks, key procedures and market data. We have concerns over the practicality of the following questions in the draft Assessment Methodology:

Q.23.1.2: How does the FMI determine that relevant rules and key procedures are clearly articulated?

Q.23.3.2: Is there evidence that the means described above enable and actually result in participants' understanding of the FMI's rules, procedures, and the risks they face from participating in the FMI?

Q.23.3.3: In the event that the FMI identifies a participant who demonstrates a lack of understanding, what remedial actions are taken by the FMI?

We believe that 23.1.2 is unnecessary and places an excessive requirement on FMIs, and so should be dropped. What matters is that the FMI clearly articulates rules and key procedures rather than that it has a process for determining that they are clearly articulated.

In the same vein, and in line with our comments on Principle 10, Q.23.3.2 puts the burden on FMIs to determine whether participants understand the FMI's rules, procedures and risks. Provided that the FMI has provided clear and appropriate documentation on its rules and procedures, the burden should be on the participant to ensure that they understand them or seek clarity from the FMI.

On the **Responsibilities**, the assessment methodology looks to be a reasonable interpretation, in so far as they go. However, we believe that Q.D.3.1 as it stands is too vague and should be defined in more detail:

Q.D.3.1: How do authorities promote the consistent application of the principles within and across jurisdictions?

We would also welcome the addition of two further questions under **Responsibility E**:

Has the authority devoted a sufficient level of staff resources to allow it to cooperate fully with other authorities?

How did it assess its needs in this area?

These would ensure that sufficient staff resources were allocated to cooperation, an essential measure.

In addition, we think it could be helpful to add a question here (probably under Responsibility A) to ask if authorities regularly publish an "oversight report." Some regulators do this, and although not a lot of information is given, it at least gives an overview of the ratings, etc. for the different FMIs. All oversight bodies should usefully do this to improve transparency.

Whilst many of the comments above relate equally to the draft Disclosure Framework as well as to the draft Assessment Methodology, we have a specific set of comments on Annex 2 of the draft Disclosure Framework.

First, some items in Annex 2 seem to relate to topics that would be better covered in a CCP's narrative disclosure based on Annex 1 – e.g., "*whether clients are protected against*

simultaneous default of clearing member and fellow clients" and "*policy on how margin and default fund invested.*"

Second, some items call for data that will be of extremely limited use (or no use at all) if updated only once every 2 years – e.g., "*size of pre-paid DF*" or "*number of non-routine margin calls over last 12 months.*"

We therefore believe that Annex 2 should be divided into at least 2 parts.

The first part should set out supplemental instructions to be followed by a CCP in completing the CCP's general description called for in Part II and the principle-by-principle narrative disclosure called for in Part IV of the template. For example, Annex 2 should require the following:

- When the CCP describes the typical transaction lifecycle (in its Part II general description), it should note the timing of trade acceptance and novation.

- The CCP should prepare its disclosure and reporting per clearing segment (e.g., LCH F&O, LCH Equities Clear, LCH Repo Clear, etc.).

- The CCP should update its disclosure at least annually (except for certain key metrics that must be updated monthly or quarterly, as described below), with any material changes reported as soon as feasible.

The first part of a revised Annex 2 should also set out additional questions that should be specifically answered, and call for additional documents to be provided, by the CCP when completing its Part IV principle-by-principle narrative disclosure, with the goal being to elicit more granular and consistent narrative disclosures by CCPs. For example, the first part of revised Annex 2 should mandate that CCPs describe or provide (as applicable):

- In connection with the Principle 1 narrative disclosure: netting/collateral legal opinions and for CCPs offering interoperability with other CCPs, interoperability collateral opinions;

- In connection with the Principle 5 narrative disclosure, with respect to both house and client collateral, the method of collateral transfer for cash/securities (pledge or title transfer), operational structure of collateral accounts (omnibus/segregated, gross/net), segregation of collateral from (or commingled with) CCP's own assets and confirmation of segregation of collateral from assets of settlement banks/custodians;

- In connection with the Principle 12 narrative disclosure, diagrams and flowcharts illustrating the settlement process; and

- In connection with the Principle 16 narrative disclosure, the CCP's investment policy, including restrictions on re-use of clearing member and client securities collateral.

This first part of revised Annex 2 could also be used to clarify, with respect to CCP disclosure, points in the key elements. For example, "identification" (e.g., Principle 1 Key consideration 1 and Principle 2 Key considerations 1 and 2), and we think "description" would be a preferable term to use. Annex 2 could effectively specify that "identification" of a particular feature or aspect of the CCP's structure or activities means a description of the structure or activities. We have a similar question about the meaning of the "features" of variation margin methodology on page 15. Annex 2 could be a tool for clarifying these types of questions for purposes of CCP disclosure without having to modify the key elements in Annex 1.

The second part of the revised Annex 2 should require disclosure of information that is essential for risk management purposes and that must be updated either on a monthly or quarterly basis. Such information should include, for example, the following:

- the aggregate value of a CCP's open positions (updated daily on a public website), with specific data dependent on product type – for OTC, gross notional value of cleared trades and notional value of net open positions (aggregate of open position (net) for each clearing member), for futures, notional value of net open positions (open interest) and for securities, market value of open trades and daily settlement value; and

- documentation of any independent initial margin model review, including scope, results, recommendations and any changes made as a result of review.

We also have some specific suggested amendments on items listed in draft Annex 2. We have identified suggested changes in *italics*, and comments in ***bold italics***:

<u>*Initial* Margin</u>

- Total cash collateral held *and method of transfer (title-transfer or pledge)*

- Total *non-cash* collateral held *(separated into securities, other – LC, gold, etc.) and method of transfer (title-transfer or pledge)*

- Proportions of non-cash collateral held by collateral type (%). ***[We do not understand this – how is the collateral type defined?]***

- List of eligible collateral accepted (Complete details in Principle 5). ***[Again we do not understand the meaning of "Complete details in Principle 5".]***

- Frequency of routine *initial and variation* margin collection *[including intraday and EoD times]*

- Number of non-routine margin calls over last 12 months. ***[As noted above, this item does not seem consistent with a biennial updating requirement.]***

- Value of routine margin collection vs. non-routine margin calls over last 12 months. ***[As noted above, this item does not seem consistent with a biennial updating requirement]***

- Summary description of margin methodology and representative list of factors that would cause margin requirements to change. Should include summary of netting arrangements across positions / products.

- The initial margin requirement that would result from simple specified example trades / portfolios [so that participants, and regulators and market could compare the output].

Default fund

- Size of pre-paid ***[does this mean funded?]*** aggregate DF, including any segmentation by, e.g., type of product [***if segmentation, explain if funds can be applied equally across all segments, as needed].***

- Discussion of ability to call additional contributions from participants *as well as the amounts that may be called.*

- *Total cash collateral held and method of transfer (title-transfer or pledge)*

- *Total non-cash collateral held (separated into securities, other – LC, gold, etc.) and method of transfer (title-transfer or pledge)*

- *Proportions of non-cash collateral held by collateral type (%)*

- *List of eligible collateral accepted*

- Explanation *and risk factors* driving the specific stress test or series of tests from which the size of the DF was derived. (Implicitly, more severe tests would be result in losses beyond the default capabilities of the CCP). ***[We do not understand the phrase between parentheses.]***

- Results of simple standardized stress tests, e.g., parallel shift in relevant curves. ***[We are not sure what this is related to.]***

- Frequency of stress testing *for financial safeguard adequacy*, back testing *of IM* and *IM and DF* model reviews/validation

Capital

Capital / own funds ***[We are not sure what this means – is "capital" meant to be aggregate financial safeguards?]***

Amount of own funds is committed to waterfall

Uncovered credit losses ***[if safeguards insufficient?]***

How these will be allocated

Investment risk

Policy on how margin and default fund invested *and whether returns on cash posted/provided back to members*

Summary details of investments held at the CCPs own risk. [***We suggest that you propose a standard report to be used for this purpose.***]

Summary measure of interest rate and fx risk in the investment portfolio. [***We suggest that you propose a standard report to be used for this purpose.***]

Liquidity risk

Coverage policy (cover one, cover two, etc.)

Arrangements in order of usage to cover liquidity needs in event of failure to pay

Arrangements to manage uncovered liquidity shortfalls

Conclusion

Once again, we welcome the opportunity to comment on the draft Assessment Methodology and draft Disclosure Framework. Should you have any questions on the issues raised in this letter, please contact Crispin Waymouth (cwaymouth@iif.com; +1 202-682-7447).

Very truly yours,