CPSS-IOSCO Principles for Financial market Infrastructures: central banks´perspectives on its incidence

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Agenda

1. **Some general comments on the PFMI and the assessment process.**

2. Lessons learned from the recent financial crisis

3. Issues on selected PFMI and related topics

PFMI´s main public policy objectives

- Through the centralization of specific activities, FMIs allow participants to manage their risks more efficiently and effectively, and, in some instances, eliminate certain risks

- However, FMIs also concentrate risk so if not properly managed, they can also be a major channel through which these shocks are transmitted across financial markets, particularly in periods of market stress. The effects of such a disruption could extend well beyond, threatening the stability of the broader economy

- The main public policy objectives of the CPSS and IOSCO in setting forth principles for FMIs are to enhance safety and efficiency in payment, clearing, and settlement arrangements, and more broadly, to limit systemic risk and foster transparency and financial stability.

Some general comments

- The new PFMI harmonize and strengthen the existing international standards for SIPS, CSDs, SSSs, and CCPs. They also incorporate additional guidance for over-the-counter derivatives CCPs and trade repositories (TRs).
- An extended perspective on the whole value chain, starting from trade execution facilities, may be helpful when relevant and applicable.
- The new Principles incorporate a significant number of lessons drawn from the recent global financial crisis and look thus more demanding than the previous set of standards.
- Most Principles are applicable to all types of FMIs. A few ones are only relevant to specific types of FMIs. But in fact certain Principles suggested to apply to all FMIs may apply only in varying degrees to each type of FMI (CCP kind of bias for instance in some of the key considerations for PFMI 4 and 7).

Comments on the assessment process

- Primary responsibility on assessing observance of the PFMIs will rely on relevant national authorities (more likely also supported by FMIs operators´ formal periodic self-assessments of compliance). External assessments by the international financial institutions as part of their Financial Sector Assessment Program (FSAP) are also expected.
- Each FMI should be assessed separately. Key Considerations for each Principle provide the minimum performance baseline that FMIs are expected to meet.
- Access to relevant information is critical to have an understanding on:

  processes and rationale the FMI uses in ensuring the effectiveness of its approach for meeting each Principle; how the FMI measures and monitors its ongoing performance in meeting each Principle; other (independent) evidence available with respect to the FMI's ongoing performance
- The expected outcome of an assessment is to identify gaps, shortcomings or deficiencies with respect to each Key Consideration that may impact financial sector stability and be sources of inefficiency and risks in the FMI.
- The FMI operator should commit therefore in defining an appropriate timeframe for addressing each identified issue

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Lessons learned from the crisis

- Quoting the Principles: "FMIs should first identify and understand the types of risks that arise in or are transmitted by the FMI and then determine the sources of these risks. Once these risks are properly assessed, appropriate and effective mechanisms should be developed to monitor and manage them".

- Some of the many lessons learned from the recent financial crisis:

  - FMIs are complex networks that link financial institutions (FI) in transactions of systemic importance. An individual FI participant in the network may be systemically important not only in function of its size ("too-big-to-fail-TBTF) but also of its connectivity and non-substitutability (too-connected-to-fail-TCTF).

  - If there is not enough clarity on links and risk exposures among participants, in times of turmoil there arrive heard effects, panics and fragility. Trading become more selective and unsafe. Banks more concerned with their liquidity attempt to conserve larger cash holdings; and less willing to lend to others => signs of distress in money markets and funding rates arise.

  - Collateral management becomes even more critical because: 1) non-collateralized interbank lending dries; 2) dependency on "CB intermediation" increases (requiring high quality collateral; 3) and likewise "neutral intermediaries" such as CCPs and CLS (which also have highly demanding haircuts and margin-call policies in volatile environments)

Policy lessons from the crisis

- Public authorities and FMI operators should develop new methodologies to evaluate interdependences among participants and among FMI and to identify too-connected-to-fail (TCTF) financial institutions (FI) based on alternative metrics (connectivity rather than size).
- Back-testing, stress-testing and simulation techniques to estimate the systemic effects of TCTF - FI failures on surviving participants.
- Asses the capacity of survivors to react by: 1) collateralized lending in money markets; 2) accessing CB liquidity facilities (intraday repos and longer term)
- These methodologies provide fresh new policy tools to modulate the intensity of regulation, supervision and oversight of FI according to their systemic importance and prioritize it on those FI whose failure more likely threat the system-wide stability.
- From a purely financial stability perspective, there seems to be a case for CBs to revisit their service policies (access to accounts and liquidity facilities) based on the following considerations:

  - a number of non-bank have become systemically important financial institutions (SI-FI);

  - Deregulacion has brought a shift from a bank-based to a market-based financial sector

  - CB lender-of-last-resort liquidity facilities have been designed to withstand banks funding runs but are not suited to tackle a persistent system-wide liquidity stress that also painfully hit non-bank SI-FI

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Transparency within FMIs

- PFMI 4 support transparency in segregating own account and individual customers positions of direct participants in FMI. Only a few countries in the world, among which Colombia and Brazil, require their CSD and CCP to fully segregate individual customers´ accounts. Handling individual accounts would be worth considered a “best practice” FMI be prepared to manage. However, not all the final clients should be forced to have an individual account.
- In practice, many CSDs currently have no control and no visibility on their clients' clients with the possible exception of a growing number of markets with direct holding or "transparent" systems. But regardless of weather PFMI 19 is imposed all the FMIs directly or not, there is a case for PSs, CSDs, CCPs and others to assess the risks indirect participants potentially present on the system, including through the transactions they conduct with direct participants.
- Interoperability among FMIs is clearly address in the PFMIs even though it is not the focus of any specific Principle. FMIs operators and the authorities themselves might face the need to develop new methodologies to assess how it impact s the FMIs and their participants

Market transparency: a holistic approach*

- Uncertainty over FI risk exposures should be reduced. Transparency could be improved by:

✓ Fostering standarization of documentation and -where possible- products and also trading in multilateral trading platforms

✓ Timely reporting OTC transactions to trade repositories (speeding-up reconciliation and facilitating authorities´ access to comprehensive information)

✓ increasing reliance on CCPs clearing and settlement of OTC derivatives for:

- valuation based on fair prices, market-to-market,

- sounder risk management models and more frequent margin calls

- More stringent risk controls on non-CCP eligible derivatives (ex. increasing capital requirements by adjusting risk weights for exposures *vis-a-vis* a CCP and those *vis-a-vis* other counterparties)

* more details in Heller (JSOC,2010) and Heller-Hollanders (Speed, 2010)

issues on selected principles

- PFMI 1: as of date there are still a number of developing countries coping with reforming their legal frameworks to reach compliance with CPSIPS and RSSS. Issues such as finality, netting agreements, novation, protection of collaterals, segregation and portability of customers´ assets, enforceability of rules and contracts in case of default of a participant and others may conflict with current statutory laws and codes.
- Particularly challenging for some countries has been defining when and where finality takes place, who gives title to the investor and how to protect the settlement cycle when a chain of transfer agents, custodians, registrars and settlement systems are involved in a transaction.
- More generally, regarding adoption and implementation: There are concerns on being able to fully comply with standards that “raise-the-bar” in a short timeframe. Granting an reasonable timeframe for full compliance may alleviate the burden. In the meantime, each FMI should present to its regulator a specific compliance work-plan.

THANKS !