ICMA EUROPEAN REPO COUNCIL

CPSS Secretariat
Bank for International Settlements
CH-4002 Basel,
Switzerland

IOSCO Secretariat
Calle Oquendo 12,
28006 Madrid,
Spain

29 July 2011

Dear Sirs,

Response submission from the ICMA European Repo Council

Re: "Principles for financial market infrastructures"

Introduction:

On behalf of the European Repo Council ("ERC") of the International Capital Market Association ("ICMA"), the purpose of this letter is to provide feedback concerning the 10 March 2011 joint consultative report, of the Committee on Payment and Settlement Systems (CPSS) and the Technical Committee of the International Organization of Securities Commissions (IOSCO) – "Principles for financial market infrastructures".

The ERC was established by ICMA in December 1999, to represent the repo community in Europe. It is composed of practitioners in the repo field, who meet regularly to discuss market developments in order to ensure that practical day-to-day issues are fully understood and dealt with adequately. Its practical work is coordinated through the efforts of the ERC Committee and the ERC Operations Working Group, the latter of which has contributed significantly to the composition of this response.

The repo market is one of the largest and most active sectors in today's money markets. It provides an efficient source of money market funding for financial intermediaries while providing a secure home for liquid investments. Repo is also used by central banks as their principal tool in open market operations to control short-term interest rates. Repos are attractive as a monetary policy instrument because they carry a low credit risk while serving as a flexible instrument for liquidity management, which benefits the functioning of financial markets. Central banks are also able to act swiftly as lenders of last resort (and have done) during periods of market turbulence by way of the repo market.[1]

[1] In July 2010 the ERC published a White Paper on the operation of the European repo market, the role of short-selling, the problem of settlement failures and the need for reform of the market infrastructure. This paper, which sets out in greater detail what the repo market is and its benefits, is available, together with two subsequent supplementary Annexes, at https://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/Repo-Markets/European-repo-market-white-paper.aspx.

In a repo transaction securities are exchanged for cash with an agreement to repurchase the securities at a future date. The transaction is collateralised, with the cash securing the seller's securities and the securities securing the buyer's cash. Collateral and netting are key to the proper functioning of repo markets. In the event of default, the collateral can be sold and exposure to the defaulting party can be netted off.

In the international market, the ICMA Global Master Repurchase Agreement (GMRA)[2] provides a robust legal framework for documenting repo transactions. Supervisory authorities recognise the effect of the GMRA netting provisions for regulatory capital and large exposure requirements provided, inter alia, that a reasoned legal opinion has been obtained to the effect that, in the event of a legal challenge, the relevant courts and administrative authorities would find that, where a counterparty fails owing to default, bankruptcy, liquidation or any other similar circumstance, the regulated firm's claims and obligations pursuant to the GMRA would be limited to a net sum under the law of the relevant jurisdiction(s), and which meets certain other requirements. Accordingly, ICMA obtains and annually updates legal opinions on the GMRA, currently covering 62 jurisdictions worldwide. These opinions cover both the enforceability of the netting provisions of the GMRA as well as the validity of the GMRA as a whole.

The ERC notes that on 10 March a consultative report on Principles for financial market infrastructures (FMIs) was announced jointly by the CPSS and IOSCO, which the ERC has carefully considered from the particular standpoint of repo market participants. The consultative report sets out a single, comprehensive set of 24 principles designed to apply to all systemically important payment systems, central securities depositories, securities settlement systems, central counterparties and trade repositories (collectively FMIs). The ERC has given consideration to each of these 24 Principles for FMIs and comments on them sequentially in the annex to this letter – though in some cases we have not found anything to add to the well developed base reflected in this consultation paper.

Before coming to those more detailed review points the ERC considers that it is helpful to emphasise some more general considerations, mostly being points on which it has previously commented. These form an important part of the backdrop which should be taken into account in formulating the final standards for adoption by FMIs across international markets.

1. *Counterparty Credit Risk*

As a general remark, the goal to improve the recognition and management of counterparty credit risk can only be encouraged. Nevertheless, the current regulatory review of the financial system should avoid inadvertently endangering what has been achieved so far. When the Basel Committee decided to upgrade the Basel 1 framework into Basel 2, adequate provisions were embedded to support migration from unsecured to secured lending practices. This regime was implemented in Europe and was in place as of the beginning of 2007. Its beneficial effects have been somewhat hidden because of other events; notably the use of a wide range of collateral without adequate daily pricing. The financial markets have lived through a period of excesses that need to be corrected, however, it would be unfortunate if these events brought into question market participants' ability to organise an adequate framework for well functioning repo markets. Best practice in this market has already been put in place to a large extent, with haircuts being used in various forms and eligibility sheets for collateral, as well as credit lines for counterparties which have to be validated by each bank's risk committees.

---

[2] On 16 May the ICMA announced the publication of the 2011 version of the GMRA, as further elaborated in the ICMA press release at https://www.icmagroup.org/ICMAGroup/files/31/31fb6108-4cfc-4573-9505-39f1fb4510ef.pdf

Banks are risk takers and the intense competition between banks provides a solid base for ñcheapò credit to the real economy. Providing a regulatory framework with fixed haircuts (even by each underlying collateral type) may prove to be counterproductive to competition and have unintended consequences for the flows of liquidity between wholesale market participants.

On the contrary it is quite right that haircuts should be responsive to risk and that the differential experience of securitisation exposures as against corporate debt should be reflected (the ERC notes however that even pre-crisis there was a rather limited market for repo of asset backed securities; and for the time being there is essentially no liquidity in that particular market segment). The ERC is however concerned that the recommendations of the Committee on the Global Financial System (CGFS), published in its March 2010 report entitled ñThe role of margin requirements and haircuts in procyclicality[3]ò, contradict this principle of risk responsiveness and would be detrimental to the well being of the market.

2. *CCP usage*

In 2009 the G20, supported by EU Member States, advocated maximum use of CCPs. However, the repo market had established the use of CCP clearing in Europe as early as 1999 ï when LCH Ltd, supported by market practitioners in the repo market, created Repoclear. This was followed by Clearnet (later merged into LCH.Clearnet group), Eurex Clearing and CC&G. The ERC firmly supports the use of CCP clearing in repo markets and continues to take steps to promote its development.

CCPs are broadly accepted as a key tool in mitigation of counterparty credit risk in the OTC markets. Quite understandably the authorities are therefore pushing to make the fullest use of CCPs, whilst quite correctly appreciating that CCPs must themselves be subjected to very high risk management standards. If this latter aim is not adequately achieved the CCPs will themselves become a major source of risk.

Given this public policy direction, it is an important component of the incentive structure that market participants should be able to rely upon CCPs and hence not have to treat their concentrated exposures to them in a way that would constrain their use ï neither for capital adequacy nor for large exposure limit purposes. Any failure to adopt such an approach to the treatment of exposures to CCPs would undermine the incentive effect that is otherwise being pursued.

The ERC consider that non-discriminatory access to CCPs is an important element in an efficient and effective post-trade infrastructure. There needs to be fair and open competition between trading venues and/or bilateral voice or interdealer brokered voice trades and this can only be achieved in an environment where such access rights are guaranteed.

One other aspect to which the ERC has devoted significant time is interoperability, particularly in the context of the CCPs for European triparty repo transactions. A specific concern that has been highlighted by these efforts is that in pursuing interoperability other operational inefficiencies may be created. In particular, whilst reviewing proposals to create access to Eurex Clearing for both ICSDs the ERC has noticed that FOP transfers of collateral would be re-introduced into settlement of a market that was hitherto DVP.

---

[3] http://www.bis.org/press/p100322.htm

3. *Cash Settlement*

The ERC notes that principle 9 expresses a preference for ñmoney settlements in central bank moneyò, versus settlement in commercial bank money. Particularly for the repo business which involves a lot of cross-currency transactions, and (in a European context) in light of the acceptance from the Eurosystem in CCBM2 to allow triparty repo to provide collateral for monetary operations, it is crucial that both forms of settlement money continue to be broadly accepted under reasonable and appropriate risk management terms.

Particularly when talking of repos settled in delivery versus payment (DVP), with effective irrevocability (e.g. under the EU settlement finality directive), any CSD should be able to offer settlement in commercial bank money of settlement instructions for any systemically important service provider regardless of its location. Purely focussing on settlements in central bank money will have the negative effect of destabilising external flows in the applicable central bank currency, with negative effects on the real economy ï through dampening of economic activity ï and hence the well being of European citizens dependant on the currency in question.

In this regard, the ERC recalls the August 2003 CPSS report ñThe role of central bank money in payment systemsò[4]. This specifically considers the coexistence of central and commercial bank monies ï see the executive summary at page 1 and section 1 of the report at page 7 ï clearly stating that both should be able to work hand in hand, as both have a social function. Indeed the report notes that systems based on just one or the other form of money have proved to be insufficiently ñstable or efficient to surviveò. The report also explores a range of ways in which developments are affecting the structure and use of payment systems, and the use of central and commercial bank money within them. The report shows that there is much common ground among CPSS central banks in their objectives as well as in the main tenets of their policy concerning the role of central bank money in payment systems. These collective views and practices are presented in the concluding remarks section (at page 42) in the form of 10 propositions, including the statement that ñcontemporary monetary systems are based on the mutually reinforcing role of central and commercial bank money.ò

Albeit that there are differences, the ERC concludes that the significance of settlement in central bank money ï which can in any case only be practically operative for a limited range of currencies and participants ï should not be preferred in a way which would contradict the necessary coexistence of sound practices for settlement in commercial bank money. For example this would include the scenario of CSDs participating into an interoperable arrangement or a multilateral common settlement platform, where the establishment of applicable common rules should not preclude the freedom to settle in either form of money. Commercial bank money is needed and remains highly important for the global economy.

The focus of the G20 Heads of State on CCP clearing where appropriate is fully justified, but prior to this statement various initiatives for CCP clearing have already been adopted. In the particular case of the repo markets, the successful use of CCP clearing solutions has helped the development of the market with different providers throughout the European Union. This has helped mitigate counterparty risk and contributed to a substantial reduction of systemic risk. Reversing existing solutions, by mandating settlement only in central bank money, would be disruptive to a majority of repo settlements in Europe. Hence practical solutions need to be found to allow both settlement practises to continue in the most appropriate way. In this respect the outcome of this consultation is an important guide for future robust developments of a crucial part of the financial markets.

---

4 http://www.bis.org/publ/cpss55.htm

Over the course of the last couple of years the efforts of the ERC to improve the European repo market have included an important project to establish settlement interoperability between triparty collateral providers, in particular between the ICSDs. The importance of this effort lies in achieving the aggregation of the liquidity pool associated with European triparty general collateral products. This will significantly enhance the efficiency of collateral utilisation, with consequent benefits for market safety and stability. Whilst good progress towards a satisfactory conclusion to this project is now being made, this would be undermined in case of any determination that a settlement regime should be established in Europe which mandates the use of central bank money only ï further underscoring the importance of the ERC views expressed in the preceding paragraphs of this response.

The ERC has commissioned a study of the current use of central bank and commercial bank money in the settlement of repo transactions within the centralised clearing environment. The study will be available mid-September and will be made available to your good selves.

4. *Adequacy of collateral*

The significant extensions of collateral requirements for OTC derivative exposures, both where these are moved to CCPs and for ongoing bi-lateral contracts, count amongst several contemplated measures that increase the demand for high quality collateral securities. Each such proposal needs to be developed on its merits, taking due account of the applicable risks. Nevertheless, the aggregate impact of proposals also calls for consideration. In case this aggregate impact becomes too great the outcome will be a market where the requisite collateral is inadequately liquid, leading to price distortions and the introduction of new risks ï all of which may serve to undermine the very benefits which were sought.

Recognised throughout the crisis is the need for enhanced collateral management. As already mentioned above there is a direct link between the need for collateral management and liquidity. The Basle III regime includes liquidity buffers that should be composed of the highest quality collateral. Although the goal is clear to all, the achievement of this may depend upon major market restructuring. We are currently still facing enormous problems with various types of collateral and the ERC feels the global regulatory reform may be impacted by the quality of future bond issues, not only from sovereign states but also from the corporate sector.

As a consequence the impact on the availability of adequate, quality collateral for the purposes of margin calls and default funds to CCPs for all products (fixed income, OTC derivatives, equities, futuresé) may be less clear. It is conceivable that CCPs should also accept non government bonds in the future. The volume of calls for additional collateral due to adverse movements in the positions of OTC derivative markets, with current notional outstanding of US$ 601 trillion (see latest BIS Quarterly Review at http://www.bis.org/publ/qtrpdf/r_qt1106.pdf), may prove to be insurmountable.

The current regulatory reforms calls for increased use of central clearing facilities for eligible contracts from all regulated firms, expanding from the banking sector to the insurance and pension fund sector amongst others. Whereas some of this client base may have been willing to exchange non-government bonds for private issues of AAA rating this may no longer apply in the future. Hence the impact of the recommendations for variation margins, default funds and additional haircuts where applicable may not be as straight forward in the future, particularly taking into account the amount of cross-currency transactions that exist in both centrally cleared and bilaterally cleared transactions.

5. ***Definition of FMIs / Custodian Banks and General Clearing Members***

The ERC observes that for the purposes of this consultative report, an FMI is defined as ña multilateral system among participating financial institutions, including the operator of the system, used for the purposes of recording, clearing, or settling payments, securities, derivatives, or other financial transactionsò and that it excludes bilateral relationships between financial institutions and their customers, such as traditional correspondent banking. The report goes on to state that the functional definition of an FMI includes five key types of FMIs: payment systems, CSDs, SSSs, CCPs, and TRs. This therefore sets out quite a broad scope for the definition of FMIs, but the ERC is concerned that more work is likely to be necessary to ensure that the definition of FMIs is clear. Given the range of different entities engaged in the provision of infrastructure services for the financial markets and the rapid development of new services that technological developments enable, there are likely to be instances where it is unclear to what extent an entity is an FMI, or not.

The ERC also notes that the role of custodian banks and general clearing members (GCMs) is not examined in the context of this consultation paper. Ultimately for reasons of efficiency a lot of market users prefer to use the intermediation services of a domestic custodian (for equities and for government bonds) or a GCM (for access to CCP services). It may be considered that in many respects the service provided to the market end user by such intermediaries is analogous to that directly provided by FMIs to these intermediaries. As such it may be that there are circumstances where the principles for FMIs ought equally to apply to such intermediary service providers. The ERC understand that regulatory initiatives to clarify these issues are being considered and would invite both the CPSS and IOSCO to engage closely with the financial industry in this regard. The way in which intermediary functions, particular including those of GCMs, are conducted in future may bear significantly upon the effectiveness of current regulatory reforms.

Consider a particular practical example. To achieve equivalent outcomes in the case of CSD access intermediated in such a way, the time between the possible deadline for trading and submission by the custodian to the domestic CSD should be narrowed to a maximum of 15 minutes. The ERC is aware of a specific example where the CSD is willing to bring forward reporting for the benefit of overnight processing cycles, but working practices of the custodians make this impossible ï hence embedding inefficiency and higher levels of technical fails.

Closing Comments:

The ERC believes that the interests of all parties are best served if provisions applicable to repos are as efficient and effective as possible. The repo product has been developed subject to carefully designed legal provisions. These are substantively standardised through the GMRA, which provides a leading example of market standard documentation. Nothing should be done that could lead to an undermining of confidence in the current legally robust framework for repos, since that could actually precipitate a worse crisis in the daily management of liquidity.

Moreover, the financial crisis highlighted the global scale of markets and their interconnectivity. The collateral analysis provided in the latest ICMA European repo market survey (conducted in December 2010[5]) shows that collateral is not limited to European countries. Comfortably over 25% of collateral is from outside the European Union, evidencing that ERC members trade with counterparties on a global scale. Therefore any steps to be taken need to be considered and

[5] http://www.icmagroup.org/ICMAGroup/files/6c/6cbe8096-9dd8-4e47-a006-801c0ca97bc2.pdf

consistent at an international level ï in which regard the ERC is keen to see the work of the CPSS / IOSCO providing the applicable international standard to which regions and nations conform.

In this context, the ERC is fully supportive of the important role played by the CPSS and IOSCO in the establishment of internationally agreed standards of the sort articulated in this consultation. It is important that agreements on such standards are supported by their effective implementation. The ERC considers that in this respect the CPSS and IOSCO have an equally important responsibility to discharge, namely the surveillance and peer review of the applicable standards enacted across their member authorities.

The ERC appreciates the valuable contribution made by the CPSS and IOSCO through their examination of the issues articulated in this consultative report and would like to thank the CPSS and IOSCO for their careful consideration of the points made in this response. The ERC remains at your disposal to discuss any points.

Yours faithfully,

Godfried De Vidts
Chairman
ICMA European Repo Council

cc : *ICMA European Repo Council Committee*
ICMA European Repo Council Operations Working Group

Annex: Sequential commentary on the proposed CPSS/IOSCO Principles for FMIs

General organisation

Principle 1: Legal basis

An FMI should have a well-founded, clear, transparent, and enforceable legal basis for each aspect of its activities in all relevant jurisdictions.

The proposals described in respect of this principle all look reasonable. We have no specific comments or observations on this section, but do reiterate the ERCôs strong support for robust legal frameworks ï as evidenced through the extensive effort put into the GMRA and its supporting legal opinions.

Principle 2: Governance

An FMI should have governance arrangements that are clear and transparent, promote the safety and efficiency of the FMI, and support the stability of the broader financial system, other relevant public interest considerations, and the objectives of relevant stakeholders.

Paragraph 1.26 in the introductory section of the consultative report alludes to the governance section covering the need for FMI's to set direction in the interests of the market as a whole, with specific reference to interoperability. Upon review of the governance section we do not feel that this market interest responsibility really comes clearly to the fore. We feel that it is right that it should be stated as a principle of the governance structures and therefore consider that some adjustment to the text may be required. We have no other specific comments on governance.

Principle 3: Framework for the comprehensive management of risks

An FMI should have a sound risk-management framework for comprehensively managing legal, credit, liquidity, operational, and other risks.

In the main the proposals described in respect of this principle seem okay to us. However, we do wish to comment specifically on paragraph 3.3.5 ñIncentives to manage risksò. As the overall document is designed to communicate the core operating principles we are not sure it is appropriate to use examples that could be construed as part of the principle. For example, as mentioned in paragraph, 3.3.5, the introduction of penalties for settlement fails (which, by the way, should apply in a way designed to promote the rectification of the underlying causes of failure, rather than as an automatic penalty applicable to the failing party). The document should either state fail penalties as a principle or, more preferably, leave the FMI to determine the correct incentives. Specifically considering the fail penalties example, this ties in with the above point on governance, in that each FMI should in principle design risk avoidance incentives such that they do not create an unlevel playing field. If one FMI has penalties and another does not, or if penalty levels differ materially, then they create barriers to liquidity and interoperability. This illustrates our reasoning as to why referring to fail penalties as an example in the context of this document may not be helpful.

Credit and liquidity risk management

Principle 4: Credit risk

An FMI should effectively measure, monitor, and manage its credit risk from participants and from its payment, clearing, and settlement processes. An FMI should maintain sufficient financial resources to cover its credit exposure to each participant fully with a high degree of confidence. A CCP should also maintain additional financial resources to cover a wide range of potential stress scenarios that should include, but not be limited to, the default of the [one/ two] participant[s] and [its/their] affiliates that would potentially cause the largest aggregate credit exposure[s] in extreme but plausible market conditions.

This section of the consultative report mainly talks to clearing and all the existing references to credit risk principles of a CCP seem reasonable to us. The ERC note that one point to keep in mind is that CCPs cannot deliver in DVP whilst also offering netting, the result of which being that only the net balances are paid or received (as applicable). Where, for whatever reason, intraday unsecured credit is extended by a settlement system this credit should be limited, committed and fully documented. This is necessary to ensure that its extension is not at the option of the FMI. We consider that this should be stated clearly in this section of the document.

Principle 5: Collateral

An FMI that requires collateral to manage its or its participants' credit risk should accept collateral with low credit, liquidity, and market risk. An FMI should also set and enforce appropriately conservative haircuts and concentration limits.

A daily mark-to-market (MTM) is recommended and market participants may agree to intra-day pricing given the extended trading window in Europe and occasional volatility in pricing. In this context we believe that improvements in real time and batch processing are an important enabler ï also see reference below regarding intraday triparty. An intra-day MTM may reduce sensitivities that local & cross regional flows in euro-bonds have today to end of day MTM valuations which may move considerably before there next remarking.

We wonder if there is expected to be a clear articulation of the source and mechanics of collateral valuation against agreed market depositories and pricing mechanisms. Specifically the ICMA margin and collateral best practice statements[6] could be referenced for initial discussions and/or to make weight for review. We suggest that a useful comparison can be made with collateral statements consistent with the US Regulation W/23A, concerning affiliate concentrations and the non-utilisation of paper/debt issued by group members as collateral.

In terms of collateral acceptability, further to paragraph 3.5.2, we feel that there is perhaps a case for modification, in line with recent commentary which has suggested that this should be significantly expanded to include government bonds and covered bonds in most European jurisdictions.

Separately, it may be that there is a useful opportunity here to express best practice parameters regarding harmonisation of available settlement windows for collateral positioning; particularly where cross regional funding may be required for global institutions ï encompassing parent and subsidiary requirements.

We believe that reference to triparty and other FMI interoperability for collateral pools would reinforce existing messages coming from market participants supporting this activity. Collateral baskets are an important feature of triparty repos, providing markets with an important collateral management tool. It is important that any regulations governing the acceptability of collateral are internationally consistent. Failing to ensure this will lead to the development of fragmented collateral pools, with significant adverse implications for the efficient utilisation of the scarce resource that collateral represents. The ERC also recommend harmonisation of collateral cycles with other FMIs.

In our view, paragraph 3.5.3 might usefully promote valuing collateral intraday instead of taking closes from the previous day, which we think would encourage cross regional liquidity into the FMI.

Overall, we are of the opinion that collateral principles should apply to all and are independent of the underlying products.

Principle 6: Margin

A CCP should cover its credit exposures to its participants for all products through an effective margin system that is risk-based and regularly reviewed.

[6] Available at https://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/Repo-Markets/repo0.aspx

Again, as above, clarification on data source and pricing aggregation / distribution methodology would provide members transparency. We would also draw your attention to the work of the ERC to prepare margin best practice statements. These make a number of operational efficiency statements for market consistency and best practice. Specifically, the timing of margin positioning should be early in the day. Further it should be clear that the margin calculation should as a principle include all live and committed transactions and that the margin calculation should be based on actual rather than assumed settlement. It should also be a principle that all margin calls should be settled in full and not offset against subsequent or previous calls. The ability for participants to be able to trade out of a margin call should be outlawed. The ERC is currently working to upgrade its existing recommendations in this area and anticipates publishing this work within the next two months.

Principle 7: Liquidity risk

An FMI should effectively measure, monitor, and manage its liquidity risk. An FMI should 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 that should include, but not be limited to, the default of [one/two] participant[s] and [its/their] affiliates that would generate the largest aggregate liquidity need in extreme but plausible market conditions.

We wonder if there is potential for demands to be made for additional pools of collateral from larger members; and, if so, then how will this be engaged i.e. in equal pools / funding rates. Any such mechanism needs to be described. We note that one method described recently recommended larger institutions agreeing to additional liquidity pools to support an FMI who may be encountering difficulties.

From the ERC's experience in considering interoperability, OTC bilateral/etrade and triparty collateral pools could be more explicit to enable improved liquidity. Where funding is required to support cross border and/or (ICSD) bridge settlement activity, to facilitate intra-day collateral and funding, processes need to be put in place to support extended trade processing windows and netting cycles.

Particularly in light of certain recent market experience relating to Italy, the ERC see that it is fundamental to stability that active stress testing (in context of market participation) should include market wide contingency testing annually; with representation from all member tiers – which should be adjusted as memberships and markets evolve. Results could be published to encourage confidence and utilisation of the FMIs concerned. Change management and system production changes should only be undertaken with appropriate levels of market participation to ensure systemic impacts are nullified. In the recent Italian case advance notifications and pilot testing would have been beneficial, with clear procedures on what should happen in case of market closing scenarios – i.e. compensation for participants; communication protocols for settlement and priority clearing; and provision of funding to participants

Coming specifically to the question of the cover one or cover two support scenarios. Recent challenges have been in the agreement of collateral allocations and priority of allocations into clearing. How will cover one or cover two obligations be qualified – at start of day or as part of intra-day commitments. How would the FMI decide which defaults to support? What collateral would be reviewed and in what order to enable this decision to be made where there were multiple institutions in trouble i.e. where there are material FMI failure risks.

Settlement

Principle 8: Settlement finality

An FMI should provide clear and certain final settlement, at a minimum, by the end of the value date. Where necessary or preferable, an FMI should provide final settlement intraday or in real time.

The principle should be clear on who is the arbiter of settlement finality. Intra-day finality has been proven a powerful liquidity enabler, now with intra-day settlement cycles and batch processing. As a precursor to settlement finality, risk mitigation through the utilisation of auto securities borrowing and lending should be encouraged by FMIs (where the opportunity exists to recycle client inventory). Additionally in this context, having integrated processing in post execution and pre-settlement events could be further encouraged to enable timely settlement.

Efforts should be made to ensure that overnight batch processes provide for early settlement processing of all items for value on the coming day, even where this means the items are in fact processed at a time before the settlement date itself actually commences (i.e. at midnight). The benefits of such processes are one of the matters highlighted in the ERC's European repo market white paper on short-selling and settlement failures[7]. A principle of FMI's should also be that transaction match status should remain intact regardless of the availability of securities to deliver.

Principle 9: Money settlements

An FMI should conduct its money settlements in central bank money where practical and available. If central bank money is not used, an FMI should minimise and strictly control the credit and liquidity risk arising from the use of commercial bank money.

a. We support the overall direction of the principle, that settlement in Central Bank Money (CeBM) is preferable where available to settlement in Commercial Bank Money (CoBM), but it should not be mandated as outlined in the principles. For transactions where CeBM could be used (eg in the domestic CSD, when the participant has access to CeBM) there should not be incentives which would contradict using it. It is, however, vital to keep in mind that participants may not have access to CeBM and will work via an intermediary which does. In this context it is important to ensure choice for participants. There are also important liquidity considerations from purely mandating CeBM settlement, especially as the higher the proportion of external settlements the higher the overall liquidity requirements will be. We note that these tend to fall at concentrated points in time during the day.

b. 3.9.3, Commercial bank money

FMIs should be reminded to monitor the ratio of internal versus external settlement requirements. This is relevant to liquidity requirements; with a higher external settlement rate liquidity requirements will increase.

c. 3.9.6. Settlement on the books of an FMI

With reference to the notion of "supervised special purpose institution" and footnote 71, we recommend that if an FMI is conducting activities reserved for authorised banks it should be subject to all relevant existing banking requirements (e.g. Basel III). We do not however believe that the activities of all FMIs are such as to require that they require a banking license. Where no banking licence is applicable, the principle should be that FMI's are authorised in accordance with applicable requirements, such as the European Union's proposed regime for CCPs. In either case it should be a requirement of authorisation that the FMI adheres to all applicable CPSS/IOSCO principles.

Principle 10: Physical deliveries

An FMI should clearly state its obligations with respect to the delivery of physical instruments or commodities and should identify, monitor, and manage the risks associated with such physical deliveries.

We note that this section is mostly focused on commodities, which is not our area of specialisation. However, on the general principle, we would suggest adding wording in two areas:

[7] http://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/Repo-Markets/European-repo-market-white-paper.aspx

- Add a requirement for an FMI to have within its rules a standard of care and liability to its participants; and
- Add a requirement for an FMI to state clearly which asset classes are accepted within their service, and to demonstrate formal processes and risk assessment criteria specific to each one.

In addition to these points we note:

a. *3.10.4, Risk of storage and delivery*

A minimum standard for processes, procedures and controls should be set. We suggest referring to the FINRA document on this topic. Outsourcing requirements should also be considered.

b. *P58 - Central securities depositories and exchange-of-value settlement systems*

We endorse this principle, but acknowledge the necessary exception for securities.

Central securities depositories and exchange-of-value settlement systems

Principle 11: Central securities depositories

A CSD should have appropriate rules and procedures to help ensure the integrity of securities issues and minimise and manage the risks associated with the safekeeping and transfer of securities. A CSD should maintain securities in an immobilised or dematerialised form for their transfer by book entry.

a. *The Principle*

We believe that this principle should also apply to ICSDs, and that they should either be explicitly alluded to here, or included within the CSD definition in the glossary to the document on p137.

We propose that the word ñhelpò in the first sentence should be deleted; and also the similar wording in the glossary on p137. This is a core function of a CSD, and CSDs must therefore be required to ensure the integrity of securities issues and minimise and manage the listed risks; and the regulator should be monitoring that they do so.

b. *Key considerations*

#1. We suggest changing the word ñ*appropriate”*ô in the first sentence to ñ*adequate*ò.

#4. We suggest inserting the phrase ñwhere legally possibleò at the end of the first sentence.

#5. We believe that CSDsô ancillary functions should be separated from their core functions; and would therefore suggest amending the wording to allow for this ï we suggest inserting ñ*and alternative structure”*ô after the phrase ñ*additional tools”*.

c. *3.11.4, Immobilisation and dematerialisation*

We suggest inserting the phrase ñ*backed up by law”* at the end of the sentence which follows the reference for footnote 78. We also suggest inserting ñ*or a change in law”* at the end of the final sentence.

d. *3.11.5, Segregation of assets*

We fully support the segregation proposals. However, use of the segregation facilities should not be mandatory but subject to user choice, in consultation with the usersô underlying clients.

We believe that the word ñtransferò would be clearer than the word ñportabilityò in the sentence that refers to movement of client assets in a default.

In the final sentence, we think that a CSD should be required to have insurance, rather than merely ñconsiderò it. We also think that there should be defined standards of liability, and that this phrase should be added to the end of the final sentence.

e. *3.11.6, Other activities*

We believe that there should be legal separation of the ancillary activities of a CSD. We therefore suggest replacing the word “*or”* in the penultimate line on page 60 with the word “*and”*.

On page 61, we strongly disagree with the material on a CSD acting as principal. It is our firm belief that any such activity should be separate from the core functions of a CSD; and that a CSD should not, for example, take principal risk on a securities lending transaction. Risk taking activities need to be ring fenced.

f. *3.11.7*

We agree in general with this paragraph. However, the final sentence is a bad example with which to illustrate the point and we therefore suggest deleting this material – CSDs do not assist CCPs with their liquidity (though the reverse may be true).

Principle 12: Exchange-of-value settlement systems

If an FMI settles transactions that involve the settlement of two linked obligations (for example, securities or foreign exchange transactions), it should eliminate principal risk by conditioning the final settlement of one obligation upon the final settlement of the other.

We agree with this principle but would suggest pushing the aspiration higher. We therefore propose inserting a requirement that markets should strive for consistency and the simultaneous fulfilment of their obligations – i.e. true DVP.

a. *3.12.3, Gross or net settlement obligations*

We suggest tightening up the process described. Having settlement cycles several times during the day is less risky than deferring everything to the end of the day. Our view is that end of day settlement is higher risk and inefficient; and we therefore think that the phrase “on a net basis at the end of the day” should be deleted from this paragraph. A tighter process will also help to minimise any delay between the settlement of cash and securities.

b. *3.12.4, Timing of settlement*

We disagree with the second sentence. Our view is that true DVP is simultaneous; and that this should be the aspiration of these principles that all markets should be striving towards. We agree that blocking is a reasonable remedy, but note that it is not perfect.

Default management

Principle 13: Participant-default rules and procedures

An FMI should have effective and clearly defined rules and procedures to manage a participant default that ensure that the FMI can take timely action to contain losses and liquidity pressures, and continue to meet its obligations.

In our view the proposals described in respect of this principle seem logical and clear.

Principle 14: Segregation and portability

A CCP should have rules and procedures that enable the segregation and portability of positions and collateral belonging to customers of a participant.

This principle talks of FMIs having a choice for customers regarding a participant’s segregation of assets, which can be omnibus or individual. Where omnibus it suggests that the CCP should maintain records that flag which customer of the participant each piece of collateral is owned by (3.14.7). We think if they have to do both this and margin on a gross basis the outcome is tantamount to simply saying that there is a principle to have individual accounts (i.e. omnibus will not prove to be a viable alternative). If the CCP has to margin gross, whether in an individual account or omnibus, then the principle revolves around this gross margin as opposed to the account type.

General business and operational risk management

Principle 15: General business risk

An FMI should 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.

We consider that the statements made for this principle appear sensible and consistent with a full consideration of business risk sensitivities. There is key acknowledgement of working capital, reserves and forecasting of market / business sensitivities that may affect equity / cash flow and operating expenses.

In relation to key consideration #4 and paragraph 3.15.7, the definition of liquid securities is important (i.e. specific definitional language is required e.g. ñin AAA debtò rather than (say) ñin European Government bondsò).

In relation to key consideration #5 we perceive some risk of ambiguity if the local regulators rules applied to this are different to the central regulator recommendations, on capital and business controls ï e.g. EU level ESMA rules over UK FSA rules. In the EU context perhaps it should be that CCP governance is something that is managed under a central European rule book, given the pivotal role played. Additionally if operators are running from non European parents then a component of extra-territoriality may apply here too i.e. US vs. EU prudence, modelling and assessment criteria.

Whilst reflecting on certain European specificities to illustrate potential concerns, the ERC supports the aim of creating a framework of principles which underpin the achievement of the highest possible degree of global consistency.

We consider that the sensitivity and risk assessments are consistent with how CCPs today conduct themselves, with well supported stress tests. We note that there is acknowledgement of the importance of wholesale membership participation and publication of results to ensure market confidence in the business and processing.

Considering specific sensitivities for repo flow, then in terms of orderly wind down of activities there would need to be consideration of return of membership collateral to participants; the redirection of term events posted in systems; and regulators would need to ensure there are appropriate alternatives to the CCP available at market level. We perceive that choices in this regard are to further support the CCP until alternatives become available or ensure that alternatives are sufficiently robust and resilient to support the necessary new direction of repo flow.

Principle 16: Custody and investment risk

An FMI should safeguard its assets and minimise the risk of loss or delay in access to those assets, including assets posted by its participants. An FMI's investments should be in instruments with minimal credit, market, and liquidity risks.

In summary we believe that this principle is acceptable as written. On a point of detail, we note that there does not appear to be a sentence to ensure FMIs obtain independent pricing of assets / investments, in order to ensure adverse price volatility is managed by the FMI / custodian. We consider that something to this effect would be a sensible addition.

Principle 17: Operational risk

An FMI should identify all plausible sources of operational risk, both internal and external, and minimise their impact through the deployment of appropriate systems, controls, and procedures. Systems should ensure a high degree of security and operational reliability, and have adequate, scalable capacity. Business continuity plans should aim for timely recovery of operations and fulfilment of the FMI's obligations, including in the event of a wide-scale disruption.

We agree with this principle as it is described.

Access

Principle 18: Access and participation requirements

An FMI should have objective, risk-based, and publicly disclosed criteria for participation, which permit fair and open access.

We agree with this principle as it is described. We note that ñfair and open accessò becomes particularly significant to achieve in an environment where there is mandated use of certain FMIs e.g. as is becoming the case responsive to the G20 requirement to use CCPs for certain OTC contracts.

Principle 19: Tiered participation arrangements

An FMI should, to the extent practicable, identify, understand, and manage the risks to it arising from tiered participation arrangements.

It seems likely to us that many FMIs will not be in a position to monitor or assess indirect participant risk; the performance of which must fall to be a responsibility of the direct participants. We wonder if it may be the case that this principle applies effectively in the context of CCPs, but may not necessarily apply in the case of other FMIs.

Principle 20: FMI links

An FMI that establishes a link with one or more FMIs should identify, monitor, and manage link-related risks.

We would be keen to understand a little more the general point of this principle regarding links to other FMIs. Under the governance principle we have commented that a principle of FMI governance should be to look for and support interoperability across FMIs. It seems on the face of it that principle 20 ought to be talking to this point. Our point is that it should be a principle to link up with other FMIs as much as possible ï this will both improve the possibility to achieve transfers amongst FMIs and boost competition. We would like to see principle 20 clearly making this point; whilst it seems that as drafted it may simply be saying that where links do exist they need to be properly managed and documented etc. We would also like to see the principle state that, whilst respecting principle 9, differentiation between CeBM and CoBM settlements should not be used as a barrier to FMI interoperability.

Efficiency

Principle 21: Efficiency and effectiveness

An FMI should be efficient and effective in meeting the requirements of its participants and the markets it serves.

We have no additional comments or remarks with respect to the proposals described in respect of this principle.

Principle 22: Communication procedures and standards

An FMI should use or accommodate the relevant internationally accepted communication procedures and standards in order to facilitate efficient recording, payment, clearing, and settlement across systems.

We have no additional comments or remarks with respect to the proposals described in respect of this principle.

Transparency

Principle 23: Disclosure of rules and procedures

An FMI should have clear and comprehensive rules and procedures and should provide sufficient information to enable participants to have an accurate understanding of the risks they incur by participating in the FMI. All relevant rules and key procedures should be publicly disclosed.

We have no additional comments or remarks with respect to the proposals described in respect of this principle.

Principle 24: Disclosure of market data

A TR should provide timely and accurate data to relevant authorities and the public in line with their respective needs.

We have no additional comments or remarks with respect to the proposals described in respect of this principle.