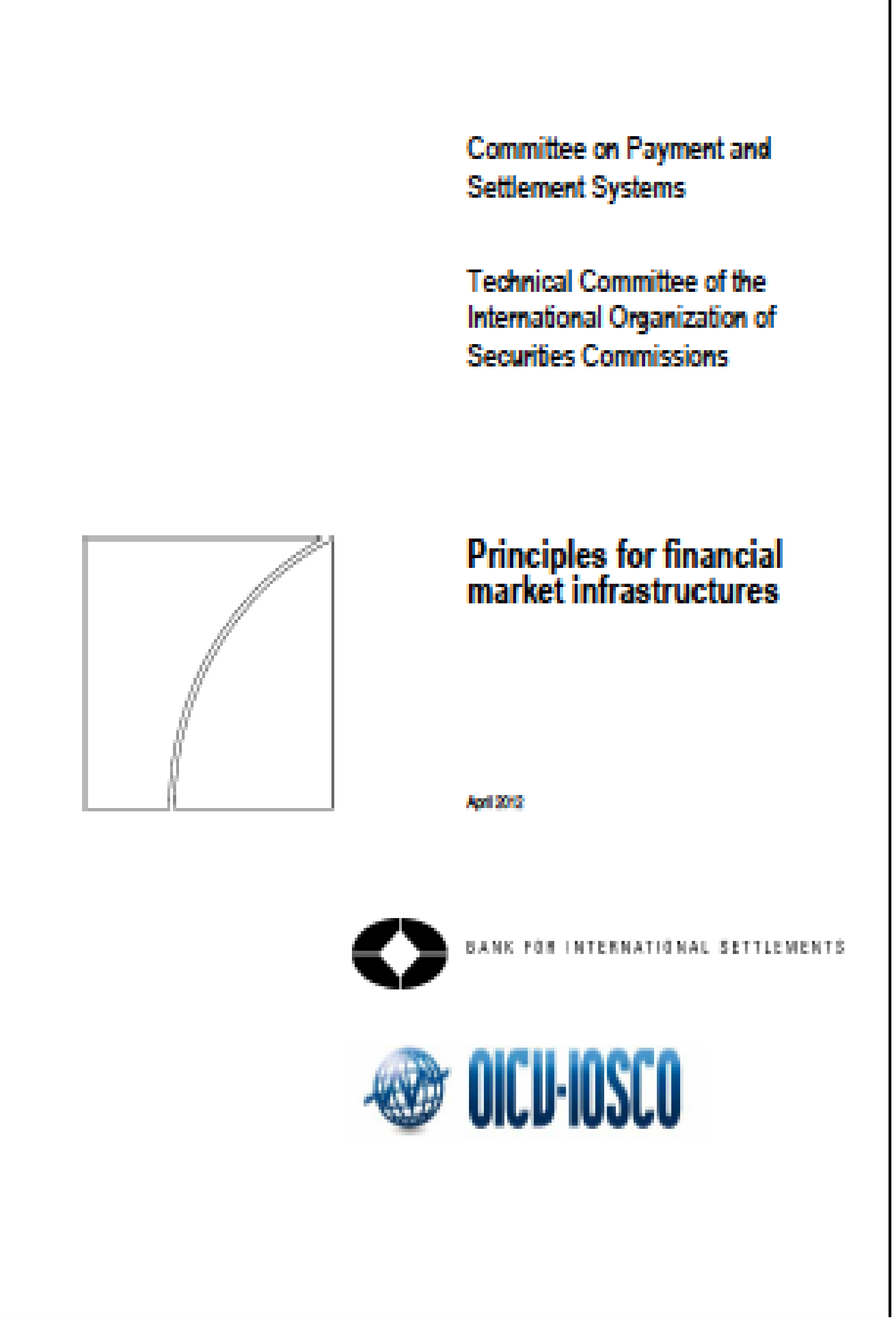

Committee on Payment and Settlement Systems

Technical Committee of the International Organization of Securities Commissions

Principles for financial market infrastructures

April 2012

BANK FOR INTERNATIONAL SETTLEMENTS

OICU-IOSCO

General Organization Principles 1 – 3

Legal Basis | Governance | Framework for Risk Management

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Organization of the principles

- The principles have been categorized into 9 broad categories that encompass the major elements critical to the safe and efficient design and operation of FMIs

General organization

Principle 1: Legal basis
Principle 2: Governance
Principle 3: Framework for the comprehensive management of risks

Credit and liquidity risk management

Principle 4: Credit risk
Principle 5: Collateral
Principle 6: Margin
Principle 7: Liquidity risk

Settlement

Principle 8: Settlement finality
Principle 9: Money settlements
Principle 10: Physical deliveries

CSDs and exchange-of-value settlement systems

Principle 11: CSDs
Principle 12: Exchange-of-value settlement systems

Default management

Principle 13: Participant-default rules and procedures
Principle 14: Segregation and portability

General business and operational risk management

Principle 15: General business risk
Principle 16: Custody and investment risks
Principle 17: Operational risk

Access

Principle 18: Access and participation requirements
Principle 19: Tiered participation
Principle 20: FMI links

Efficiency

Principle 21: Efficiency and effectiveness
Principle 22: Communication procedures and standards

Transparency

Principle 23: Disclosure of rules, key procedures, and market data
Principle 24: Disclosure of market data by TRs

Principle 1: Legal basis

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

✓PS	✓CSD	✓SSS	✓CCP	✓TR

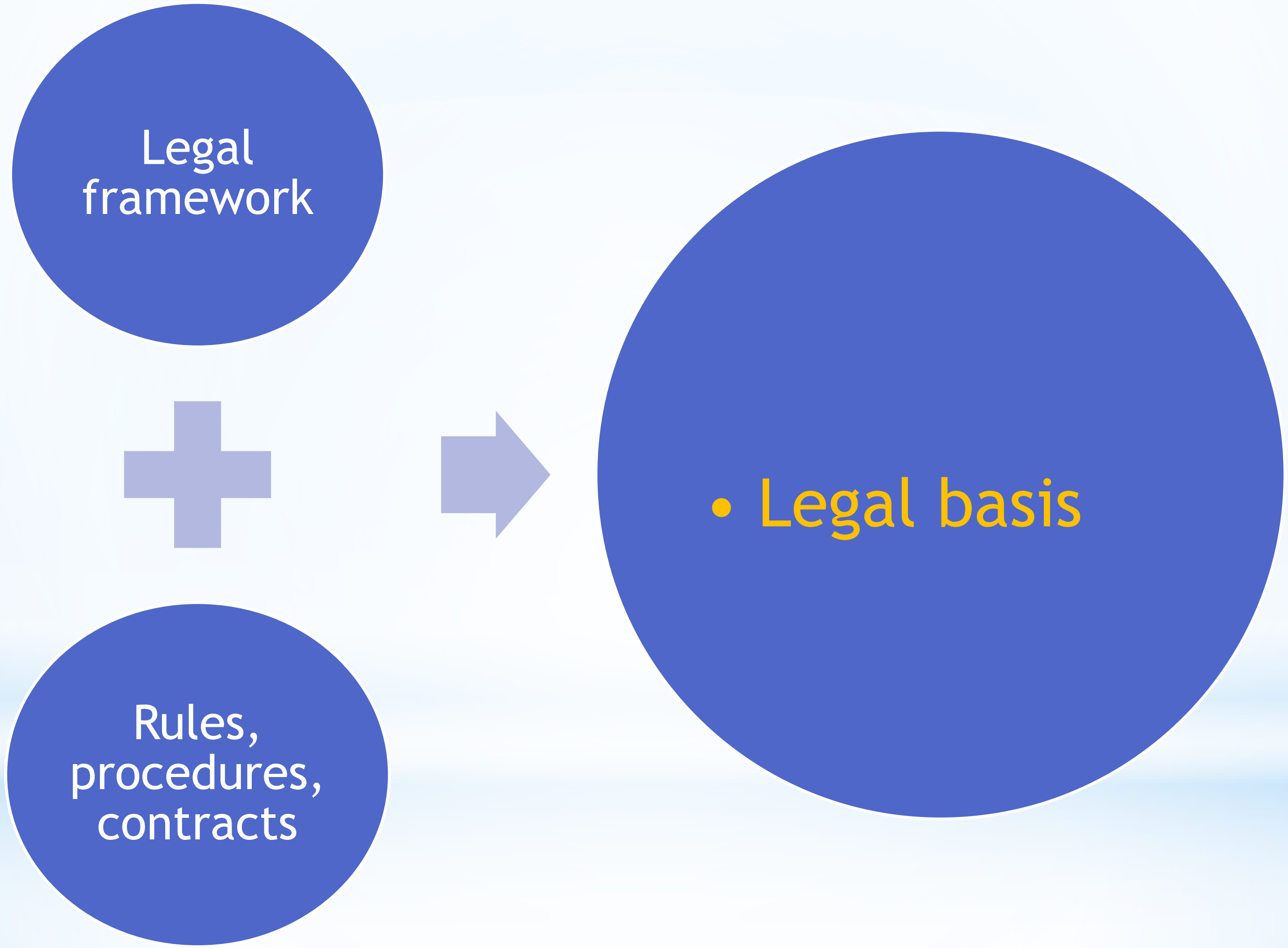
Importance of the Legal Basis

Legal basis defines and provides **the foundation** to define the **rights** and **obligations** of the FMI, its participants, and other relevant parties (e.g. participants' customers, custodians, settlement banks, service providers)

Most risk-management mechanisms are based on assumptions about the **manner** and **time** at which these **rights** and **obligations** arise in the FMI

So these parameters need to be established clearly to ensure risk management is effective!!

What is the Legal Basis?



What is the Legal Framework?

- Legal framework includes:
  - **Laws and regulations of general applicability**, governing, inter alia, property, contracts, insolvency, corporations, securities, banking, competition, consumer protection
  - **Laws and regulations specific to an FMI**: authorization and regulation of FMI, supervision and oversight; rights and interests in financial instruments; settlement finality; netting; immobilization/ dematerialization of securities; settlement arrangements; collateral arrangements; default procedures; recovery & resolution of an FMI [e.g. *CB Law, NPS Law, Securities Law*]

Legal Basis - Enforceability

- The **enforceability of rights and obligations** relating to an FMI and its risk management should be established with a **high degree of certainty**

✓ So both the legal framework and the rules, procedures, and contracts related to an FMI's operation should be **enforceable** …in **<u>all</u>** circumstances

✓ Rules, procedures, contracts
  - Clear, understandable, and consistent with the legal framework
  - Consistent with relevant industry standards and market protocols
  - Enforceability confirmed, e.g. through independent legal opinions or analyses

- The legal basis should support the enforceability of the **default rules & procedures** that an FMI uses to handle a <u>defaulting</u> or <u>insolvent</u> participant

Material aspects

The legal basis should provide certainty for each **material aspect**, in all relevant jurisdictions

Rights and Interests

- Define and protect rights and interests of all stakeholders, e.g. with respect to collateral, or assets held in custody, including in the event of insolvency (of FMI, or participant)
- Required for the FMI as well as participants and other stakeholders

Settlement Finality

- Legal basis on finality (timing) with no possibility to revoke transaction thereafter
- Address risks from insolvency law e.g. No zero-hour rules*

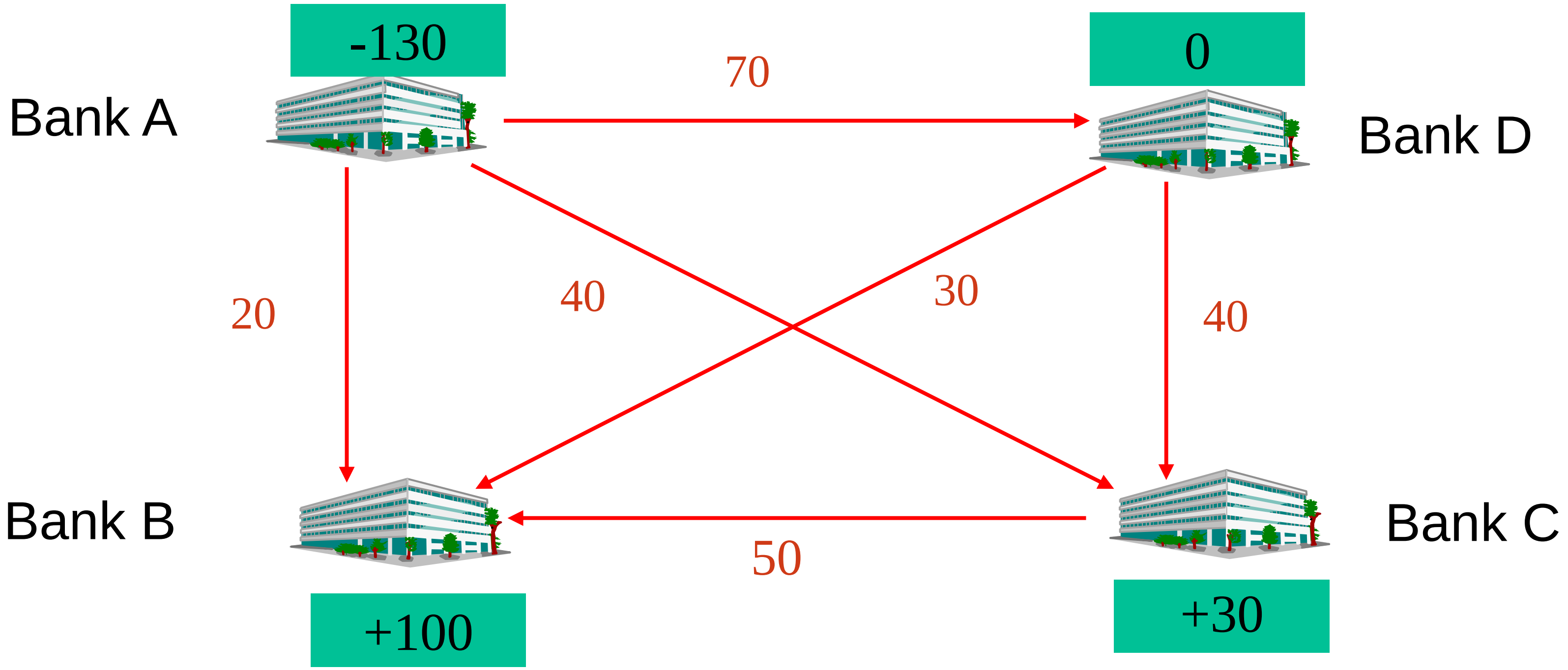
Zero-hour rule: A provision in the insolvency law of some countries whereby all transactions by a bankrupt participant are made void from the start ("zero hour") of the day of the bankruptcy. In an RTGS system, for example, the effect could be to reverse payments that have apparently already been settled and were thought to be final. In a DNS system, such a rule could cause the netting of all transactions to be unwound. This could entail a recalculation of all net positions and could cause significant changes to participants' balances, giving rise to credit and liquidity risks

Certainty becomes especially relevant in a bankruptcy or insolvency

Netting Arrangements

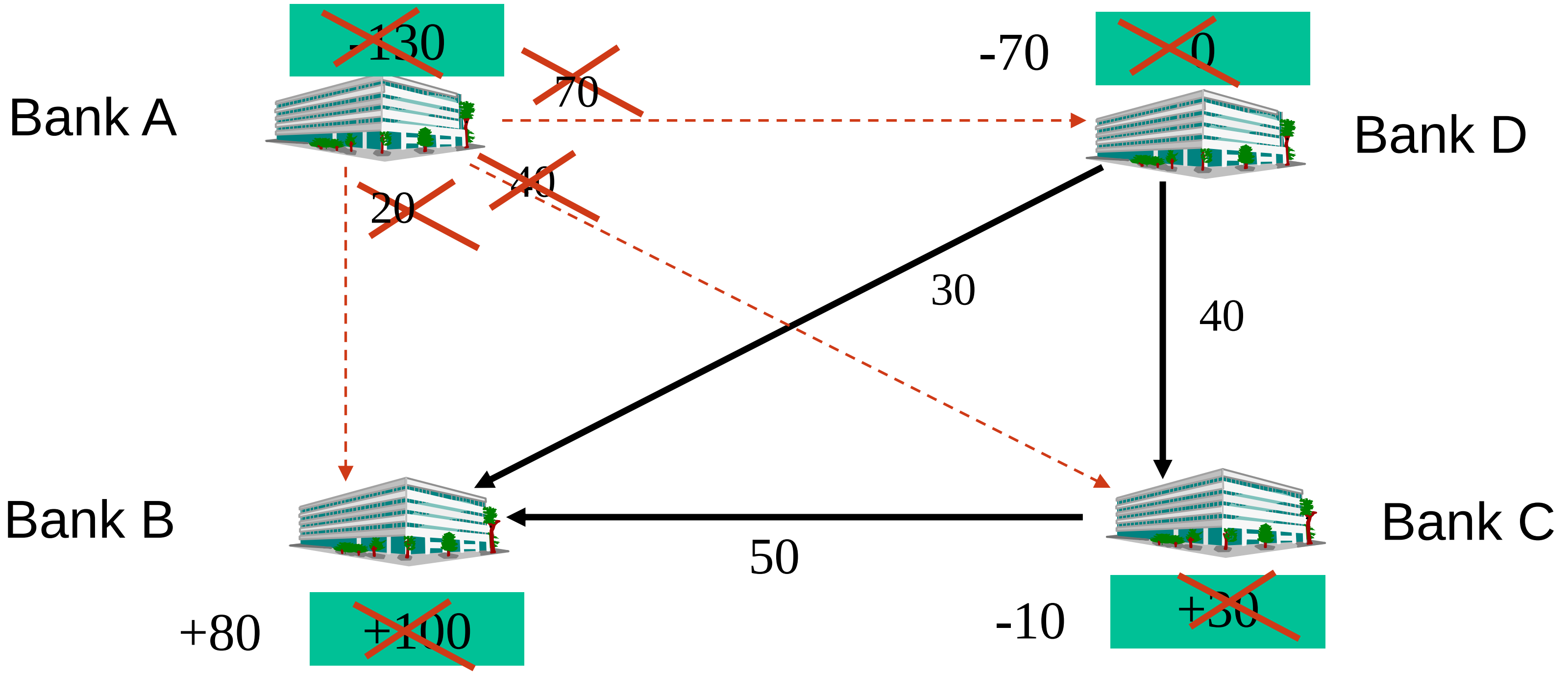
- Ensure netting is legally enforceable, otherwise risk of unwinding transactions to gross amounts due, creating liquidity and other problems

Risks in Deferred Net Settlement Systems



Risks in Deferred Net Settlement Systems

Effect of an unwind



Relevant jurisdictions

- The legal basis should provide certainty for each material aspect, in all **relevant jurisdictions**, e.g.

  - ✓ Where the FMI is conducting business
  - ✓ Where its participants are incorporated, located, or otherwise conducting business
  - ✓ Where collateral is located or held, and
  - ✓ Those indicated in relevant contracts

Conflict-of-laws issues

- Conflict-of-laws may arise if an FMI is subject to the laws of other jurisdictions
  - ✓ Its participants are established in those jurisdictions
  - ✓ Collateral (securities) held in multiple jurisdictions
  - ✓ Business is conducted in multiple jurisdictions
- Analyze potential conflict-of-laws issues and develop rules and procedures to mitigate this risk
  - ✓ Obtain reasoned and independent legal opinions and analysis in order to properly address uncertainty related to conflicting laws

Question

What <u>material aspects</u> may apply to each of these FMIs?

	RTGS	CSD
1. Settlement finality		
2. Netting		
3. Rights and interests in financial instruments		
4. Collateral		
5. Default procedures		
6. Dematerialization/ immobilization		
7. Direct/indirect holdings		

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.*

✓PS	✓CSD	✓SSS	✓CCP	✓TR

Governance: Key requirements (1)

1. FMI OBJECTIVES

High priority on safety and efficiency; **explicitly** support **financial stability** and public interest.

- Identify objectives (e.g., fair access, efficient and low-cost settlement, efficient markets) and explain how they are met

2. GOVERNANCE ARRANGEMENTS

Define the structure under which the board and management operate; document, disclose

- *For CB-operated systems, application of principle s.t. CB's internal governance arrangements and policy mandates;*
- *Address conflicts of interest*
- *Board composition, senior management structure, reporting lines, internal organization, ownership structure, procedures for appointment, performance review to ensure performance accountability*

Key Considerations (KCs)

3. ROLE OF BOARD OF DIRECTORS

Specify roles and responsibilities.
Review performance regularly.

- *Board sets strategy, monitors, oversees risk management, sets compensation, ensures compliance with internal risk requirements, regulatory and oversight reqts., etc.*
- *Includes Board Committees (several)*
- *Documented procedures for its functioning; declaration and resolution of conflicts of interest; performance review of board and individual members; maximum term*

4. BOARD COMPOSITION

Have suitable members with the appropriate **skills** and **incentives** to fulfil roles. Include non-executive member(s).

- *Ideally at least one non-executive independent Board member*
- *Experienced and with suitable mix of skills, including, for example. cybersecurity*
- *Periodic training for board members*
- *Engagement of consultants as experts*

Governance: Key requirements (2)

5. ROLES/RESPONSIBILITIES OF MANAGEMENT

Should be clearly specified. Experience, skills mix, integrity.

- *Reporting lines between mgt. and Board*
- *Mgt. authority, independence, resources, access to Board*
- *Mgt. ensures that the FMI's activities are consistent with the objectives, strategy, and risk tolerance set by the Board*
- *Procedures for appointment, performance evaluation, termination*
- *Compensation policies, based on L/T achievements*

Key Considerations (KCs)

6. RISK MANAGEMENT (RM) GOVERNANCE

Board should ensure:

- Clear, documented risk-management framework
- Ensure risk-management and internal control functions.
  - *Assign responsibilities and accountability for risk decisions, and address decision making in crises and emergencies*
  - *Regular monitoring of FMI's risk profile*
  - *Ensure that RM and internal control functions are effective*

7. PARTICIPANT & STAKEHOLDER INTERESTS

- FMI design, rules, and major decisions reflect interests of stakeholders (consultation process)
  - *Disclose major decisions to stakeholders and public*
  - *Explicitly support financial stability*.

Specific actions/ responsibilities of the Board

- Ultimately the buck stops with the board!!
- Establish clear strategic aims for the entity;
- Put in place management team with experience, suitable mix of skills, and integrity
  - Ensure effective monitoring of senior management (including documented procedures for appointment, setting objectives, evaluating their performance, and, where appropriate, removing them);
  - Establish appropriate compensation policies (which should be consistent with best practices and based on long-term achievements, in particular, the safety and efficiency of the FMI);
  - Foster a culture of risk awareness
- Establish and oversee the risk management function and material risk decisions;
- Ensure that **risk management** and **internal control** functions have sufficient <u>authority, independence, resources, and access</u> to the board so that these functions are effective

Key highlights in governance

- Policies and procedures should be **clear** and **documented**
- **Recognition of different approaches to governance arrangements**
  - Differences in national law (for example, two-tier board structure)
  - Differences in organizational structure (e.g. for-profit vs. not-for-profit)
  - Differences in ownership structure (e.g., central bank, participant, private investor; part of a group structure (focus on conflicts of interest, outsourcing, resolution, parent's gov. arrangements)
    - CB operated systems – application of P2 subject to CB governance arrangements and policy mandates, incl. with respect to access and participation; does not affect Board composition and CB roles/responsibilities
    - If a central bank is an operator of an FMI, as well as the overseer of private-sector FMIs, perceived conflicts of interest may arise between those functions
    - Decisions of affiliated organizations should not impede FMI's observance of this principle
- **Requirements for model validation**
  - Ongoing
  - Independently implemented
  - Independently reviewed
- **Requirements with respect to risk committees (independence, authority, resources, access)**
  - Chaired by an individual who is independent of the executive management
  - Comprises a majority of non-executive members
  - Have a clear and public mandate and access to external expert advice, where appropriate.

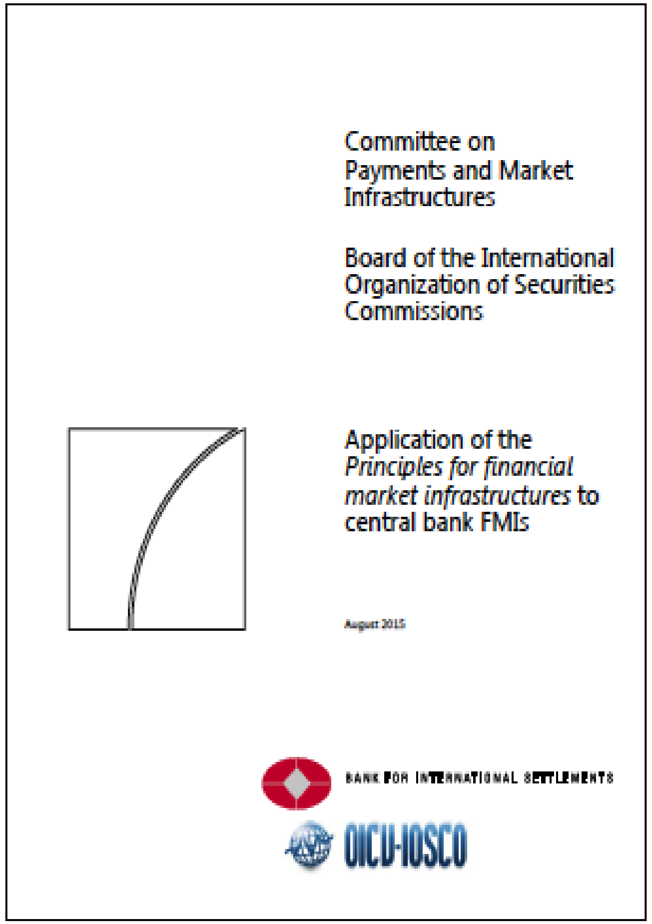
Application of the PFMI to central bank FMIs

Exceptions (several, see 2 examples)

- Where an FMI is operated as an internal function of the central bank, governance arrangements are not intended to constrain the **composition of the central bank's governing body/Board** or that body's roles and responsibilities…

- *KC3. The roles and responsibilities of an FMI's board of directors (or equivalent) should be clearly specified, and there should be documented procedures for its functioning, including procedures to identify, address, and manage member conflicts of interest. The board should review both its overall performance and the performance of its individual board members regularly.*

- *KC4. The board should contain suitable members with the appropriate skills and incentives to fulfil its multiple roles. This typically requires the inclusion of non-executive board member(s).*



Committee on Payments and Market Infrastructures

Board of the International Organization of Securities Commissions

Application of the *Principles for financial market infrastructures* to central bank FMIs

August 2015

BANK FOR INTERNATIONAL SETTLEMENTS

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Non-executive = independent board members?

- The principle does not specifically require the inclusion of non-executive or independent board members
- It recognizes that definitions of an *independent board member* vary and are often determined by local laws and regulations
  - Key consideration 4 states "The **board** should contain suitable members with the appropriate (mix of) **skills and incentives** to fulfill its multiple roles…."
  - The explanatory note states that board members should be able to exercise objective and independent judgment
  - Key characteristic of independence is "the ability to exercise objective, independent judgment after fair consideration of all relevant information and views and without undue influence from executives or from inappropriate external parties or interests"
  - "Independent" members would exclude parties with significant business relationships with the FMI, cross-directorships, controlling shareholdings, and employees of the organization
  - An FMI should publicly disclose the precise definition of independence it uses and those board members it regards as independent

Stakeholder input

- FMI should consider stakeholder interests
  - Participants
  - Indirect participants
  - External stakeholders, including those in other jurisdictions

- Mechanisms for stakeholder involvement in the Board’s decision-making process may include
  - Stakeholder representation
  - User committees
  - Public consultation processes

- A clear process for managing the diverse views and conflicts of interest

- Disclose outcome of major decisions

Questions to consider

- Who is responsible for governance arrangements?
- Is an FMI required to have independent or non-executive members on its board?
- How does the governance principle apply to FMIs owned or operated by a central bank?
- Where are governance arrangements likely to be specified?
- What are the requirements for an FMI's risk committee? Is the risk committee part of the board?
- What are the relevant public interest objectives that an FMI should consider?
- Access requirements…..do they impact on governance?

Extract from an assessment

Case Study: Reserve Bank Information and Transfer System (RITS), Australia

Key consideration	Arrangements to support observance
Safety and efficiency (KC 1)	The high-level objectives of RITS reflect those of the RBA, which include stability of the financial system.
Clear and direct lines of responsibility and accountability (KC 2)	RITS is not operated as a separate entity, so its management and operations fall under the wider governance and organisational structure of the RBA.
Risk management framework (KC 6)	Identification, assessment and treatment of all risks is undertaken within the RBA's wider risk management framework, as set out in the RBA's Risk Management Policy and overseen by the RBA's Risk Committee.
Participant and stakeholder interests (KC7)	The RBA ensures accountability and transparency to RITS members and other relevant parties.

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.

✓PS	✓CSD	✓SSS	✓CCP	✓TR

Requirements – Framework for the comprehensive management of risks

1. POLICIES, PROCEDURES & SYSTEMS

- Identify risks
- Have policies, procedures & systems
- Review and test regularly

- *Risks to or from participants, other FMIs, liquidity providers, etc.*

2. INCENTIVES TO MANAGE RISKS

Provide incentives to participants and customers to manage and contain risks they pose to the FMI.

Examples:

- *financial penalties to participants that fail to repay intraday credit by the end of the operating day*
- *use of loss-sharing arrangements proportionate to the exposures brought to the FMI*

Key Considerations (KCs)

3. MANAGE INTERDEPENDENCY RISKS

Review interdependency risks and develop appropriate tools to address these risks. [See P17, P20]

4. PLAN FOR FAILURE SCENARIO

- Identify scenarios that prevent FMI from providing critical operations as a going concern
- Assess effectiveness for recovery or orderly wind-down and prepare plans.

Framework for the comprehensive management of risks

Some Specific Issues

Identification of Risks

- Take broad perspective to identify risks

Interdependencies

- Consider impact of interdependencies – risks borne from and posed to others

Internal Controls

- Have layers of oversight and assurance, such as “three lines of defense”
  - *Operations, Risk Management, Internal Audit*

Extract from an assessment

Case Study: Reserve Bank Information and Transfer System (RITS), Australia

Key consideration	Arrangements to support observance
Policies and procedures (KC 1)	The functional area responsible for RITS compiles a Risk Register, specified at a granular risk level, that assigns a probability and impact to each identified risk.
Incentives (KC 2)	Member-level requirements are established to reduce the likelihood that an individual member could disrupt the system – e.g., member-level operational resilience requirements.
Interdependencies (KC 3)	Interdependencies are considered as part of the risk identification process and regular monitoring of the operating environment is undertaken.

Questions and discussion