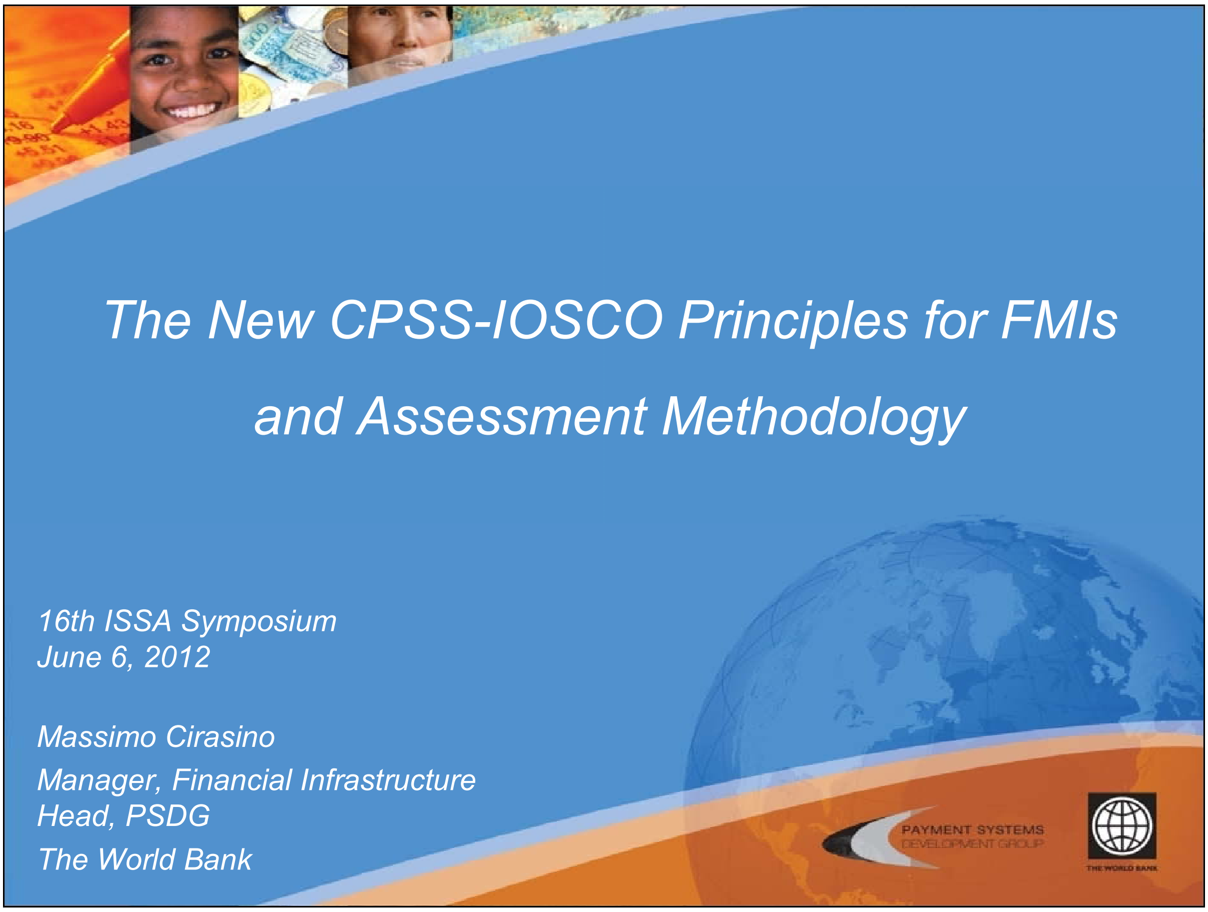
The New CPSS-IOSCP Principles for FMIs and Assessment Methodology

This presentation was a talk on the CPSS-IOSCO Principles for Financial Market Infrastructures and the Assessment Methodology by Massimo Cirasino, Manager for Financial Infrastructure and Head of the World Bank Payment Systems Development Group. Areas covered included the new principles / standards to make infrastructures more robust and better able to withstand financial shocks. The 24 new principles replace 3 existing sets of interrelated standards intended to help ensure consistent risk management. The new principles distinguish between credit and liquidity risks, which the previous standards did not. Also covered was an overview of the responsibilities of Authorities overseeing FMIs as well as the use of the Disclosure Framework and Assessment Methodology.



The New Principles: Scope and Objective

- Issued by the CPSS and IOSCO, the new standards (called "principles") are designed to ensure that the infrastructure supporting global financial markets is more robust and thus well placed to withstand financial shocks. *Published on April 16, available at www.bis.org + Assessment Methodology and Disclosure Framework for public consultation*
- The principles replace the three existing sets of international standards set out in the *Core principles for systemically important payment systems* (CPSS, 2001); the *Recommendations for securities settlement systems* (CPSS-IOSCO, 2001); and the *Recommendations for central counterparties* (CPSS-IOSCO, 2004). The need for a single set of principles lies in the need to ensure consistent risk management amongst infrastructure that more and more are interdependent
- The main objective of this review of existing standards is to incorporate the lessons drawn during the Lehman crisis and in particular "raise the bar" of the existing requirements in some critical areas
- The Principles aim at ensuring consistency among requirements to different FMIs while reflecting the "unique" role of certain infrastructure (e.g. CCPs or TRs), i.e. some room for specific requirements for some FMIs only

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2

"FMI": definition, organization, and function

- An FMI is defined as a multilateral system among participating institutions, including the operator of the system, used for the purposes of clearing, settling, or recording payments, securities, derivatives, or other financial transactions
- FMIs can differ significantly in organization, function, and design. FMIs can be legally organized in a variety of forms, including associations of financial institutions, non-bank clearing corporations, and specialized banking organizations. FMIs may be owned and operated by a central bank or by the private sector. FMIs may also operate as for-profit or not-for-profit entities
- The definition of an FMI includes five key types of FMIs: payment systems, CSDs, SSSs, CCPs, and TRs

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3

Definitions of CSD and SSS

- A CSD
  - holds securities accounts;
  - in many countries operates an SSS (see definition below)
  - Provides central safekeeping and assets services (including co-productions and redemptions)
  - Help ensuring the integrity of the issue (for assets held at the CSD)

- An SSS enables securities to be transferred and settled by book entry according to a set of predefined multilateral rules

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4

Principle	PSs	CSDs	SSSs	CCPs	TRs
1. LEGAL BASIS	x	x	x	x	x
2. GOVERNANCE	x	x	x	x	x
3. FRAMEWORK FOR THE COMPREHENSIVE MANAGEMENT OF RISKS	x	x	x	x	x
4. CREDIT RISK	x		x	x	
5. COLLATERAL	x		x	x	
6. MARGIN				x	
7. LIQUIDITY RISK	x		x	x	
8. SETTLEMENT FINALITY	x		x	x	
9. MONEY SETTLEMENTS	x		x	x	
10. PHYSICAL DELIVERIES		x	x	x	
11. CSDs		x			
12. EXCHANGE-OF-VALUE SETTLEMENT SYSTEMS	x		x	x	
13. PARTICIPANT-DEFAULT PROCEDURES	x	x	x	x	
14. SEGREGATION AND PORTABILITY				x	
15. GENERAL BUSINESS RISK	x	x	x	x	x
16. CUSTODY AND INVESTMENT RISK	x	x	x	x	
17. OPERATIONAL RISK	x	x	x	x	x
18. ACCESS AND PARTICIPATION REQUIREMENTS	x	x	x	x	x
19. TIERED PARTICIPATION ARRANGEMENTS	x	x	x	x	x
20. FMI LINKS		x	x	x	x
21. EFFICIENCY AND EFFECTIVENESS	x	x	x	x	x
22. COMMUNICATION PROCEDURES AND STANDARDS	x	x	x	x	x
23. DISCLOSURE OF RULES AND KEY PROCEDURES	x	x	x	x	x
24. DISCLOSURE OF MARKET DATA					x

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5

New elements - financial risk (credit and liquidity risks)

Definition of credit exposure	"Current" and "potential future exposure" Reference to exposure of all affiliated entities of same group
Definition of liquidity exposure	Current exposures also include intraday exposures Reference to liquidity problems arising/amplified by non default aspects (e.g. interdependencies)
Current exposure	100 % collateralisation of all current exposures (all FMIs) for FMI that guarantee settlement. For FMIs that do not guarantee settlement (e.g CSD/SSSs with model 2 or 3 DVP), in case of residual credit or liquidity risk: need for cover 2 or more depending on the results of the stress testing
Additional tools	Clear rules that indicate how any remaining uncovered losses would be allocated to non-defaulting participants (e.g. a survivor-pay arrangement)

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New elements - financial risk (credit and liquidity risks)

4. Credit risk	Identify, measure and manage credit risk; Full coverage of credit risk; transparent rules and procedures for uncovered losses (including replenishment)
5. Collateral	Appropriate eligibility standards, prudent evaluation and haircut, limit concentration of collateral, stable and conservative haircuts, use of cross-border collateral, well-designed and operational collateral management systems
7. Liquidity risk	Robust framework for liquidity risk, sufficient liquidity resources, ability of liquidity providers to fulfil their obligations, "eligible" liquidity resources, use of central bank services, stress testing, transparent rules and procedures for uncovered liquidity shortfalls

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New elements - general business risk and custody

15. General business risk	Business risk management; sufficient equity or equity capital; minimum benchmark for equity capital (xx months); cash, cash equivalent or securities position, plan for raising additional capital or achieving orderly wind down & reorganisation of operations & services
Custody risk	Custody risk in the CSD Principle (former RSSS12)

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New elements - access and participation requirements

18. Access & participation requirements	Clear reference to indirect participants; new notion of on-going review of compliance with access rules
19. Tiering participation arrangements	Understand risks in tiering; access to relevant information
20. FMI links	Legal basis of the links; manage and monitor additional risks stemming from use of an intermediary; indirect links and links with TRs

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9

Additional changes - general organization

2. Governance	Explicit disclosure requirement; definition of public interest; explicit reference to conflict of interest and to independent members; independence of risk management
3. Framework for comprehensive risk management	Comprehensive risk measurement, monitoring and management, including participants risk management, and Interdependencies
17. Operational risk	Requirement for "robust operational risk management framework"; more detailed and demanding requirement on roles and responsibilities and on BCP (secondary sites, resumption time). Critical providers, proportionality

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Additional changes - settlement

8. Settlement finality	Explicit requirement to consider adopting multiple batches for intra-day or intra-night finality; Define point in time before settlement when unilateral revocation can't occur
9. Money settlement	Strict monitor of liquidity providers, limited purpose bank status
13. Participant-default rules and procedures	Clear default procedures, (discretionary) ability to activate default procedures, transparency of default procedures, test of default procedures

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Overview of Responsibilities for Authorities

Responsibility A: Regulation, supervision, and oversight of FMIs	FMIs should be subject to appropriate and effective regulation, supervision, and oversight by a central bank, market regulator, or other relevant authority
Responsibility B: Regulatory, supervisory, and oversight powers and resources	Central banks, market regulators, and other relevant authorities should have the powers and resources to carry out effectively their responsibilities in regulating, supervising, and overseeing FMIs
Responsibility C: Disclosure of policies with respect to FMIs	Central banks, market regulators, and other relevant authorities should clearly define and disclose their regulatory, supervisory, and oversight policies with respect to FMIs
Responsibility D: Application of the principles for FMIs	Central banks, market regulators, and other relevant authorities should adopt the CPSS-IOSCO Principles for financial market infrastructures and apply them consistently
Responsibility E: Cooperation with other authorities	Central banks, market regulators, and other relevant authorities should cooperate with each other, both domestically and internationally, as appropriate, in promoting the safety and efficiency of FMIs

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Assessment Methodology: objectives

- Developed by a sub-group chaired by the World Bank and the IMF, provides a framework for assessing an FMI's observance of each of the 24 Principles and the relevant authorities' observance of each of the five Responsibilities *vs. DF as a tool to assist FMIs in providing the consistent and comprehensive disclosure that is expected of them under Principle 23*

- Is a tool to promote the implementation and ongoing observance of the principles and responsibilities and to help ensure objectivity and comparability across all relevant jurisdictions

- Draws from the methodologies that were developed for the CPSIPS, the RSSS and the RCCP, taking into account the lessons learned from the use of the existing approaches

- The AM was developed in parallel with and as an adjunct to the FMI Report. The AM and FMI Reports should be taken together as closely related and supporting documents. The AM avoids repetition of the discussions of the Principles and Responsibilities included in the FMI report

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Disclosure Framework

- Background. Principle 23, "Disclosure of rules and key procedures" requires an FMI to publicly disclose sufficient information to participants and prospective participants *so that they can understand the system's design and operations, their rights and obligations, and the fees and risks from participating in the system*
- Objectives. FMIs are expected to provide responses that are thorough and at an appropriate level of detail to:
  1) improve the transparency of FMI governance and operating and risk management structure
  2) provide the public with a comprehensive understanding of the FMI, its role in the market it serves and the range of its relationships, interdependencies and interactions
  3) describe key rules, risks, policies, procedures and controls on a principle-by-principle basis
- Relationship AM/DF. To reconcile the trade-off between level of comparability and burden for the FMI, instead of asking for a reply for each of the questions set in the assessment methodology, the disclosure framework asks for a narrative description per key consideration covering the key elements identified by the assessment methodology to ensure a consistent approach across FMIs

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Use of the Assessment Methodology

FMIs may have to conduct formal periodic full/partial self-assessments, where this is consistent with national practice

As part of their regulation/oversight Responsibilities, **national authorities** are expected to regularly assess observance of the Principles by FMIs. Authorities are also encouraged to conduct periodic self-assessments of their observance of the Responsibilities

The CPSS and IOSCO are encouraging external assessments of FMI observance of the Principles and authorities' observance of the Responsibilities, including assessments conducted by **IFIs, namely the IMF and WB**, in particular as part of FSAP

1. The AM is at the moment primarily intended for external assessors at the international level such as World Bank and IMF
2. The AM also provides a baseline for national authorities to assess FMIs under their oversight/supervision. National authorities should use the assessment methodology in its current format or develop an equally effective methodology for their national oversight/supervision processes

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15

FSAP FAQs

Q. How is an FSAP conducted?

A. The Financial Sector Assessment Program (FSAP) provides in-depth examinations of countries' financial sectors

A. Done jointly by WB and IMF in IBRD countries, by IMF alone in advanced economies

A. 2 components: the financial stability assessment and—in developing and emerging market countries—the financial development assessment. Assessed at the same time or at different times in separate stability and development "modules"

Q. Do all FSAPs include ROSCs?

A. Assessments of compliance with international financial sector standards (summarized in a Report on Observance of Standards and Codes or ROSC) are voluntary for the country, even in countries for which an FSAP stability assessment is a mandatory part of surveillance. They are an optional but potentially very useful component of the FSAP, *especially if standards have changed*. ROSCs can also be conducted outside an FSAP, on a stand-alone basis

Q. FSAPs outputs and confidentiality

A. Aide-Mémoire for the country authorities summarizing the main findings and recommendations of the mission. Confidential

B. Technical notes and detailed assessments reports (DARS) of compliance with international standards/codes are prepared as appropriate. Publication is voluntary

C. Financial Sector Stability Assessment (FSSA) report is prepared for discussion at the IMF Executive Board. Publication is voluntary but presumed. Where the World Bank is involved, it prepares a Financial Sector Assessment (FSA) for its Executive Board

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16

The "new" FSAP

Revisions Bank/Fund Boards '09

-Preserve and capitalize on the successes and wide acceptance of the Program

-Flexibility through modules (stability, development) focused and responsive to country circumstances

-Enhanced analytical tools for more comprehensive, consistent diagnostics

-Integrating assessments better with surveillance and World Bank operations

-Introduction of targeted (risk-based) ROSCs

Changes by Fund Board '10

-Mandatory FSAP stability modules every 5 years for 25 countries with systemically important financial sectors, focused on:

→Source, probability, potential impact of the main risks to macro-financial stability in near-term

→Country's financial stability policy framework

→Authorities' capacity to manage and resolve a crisis should the risks materialize

Impact of the new Principles

-Principles will be used for FSAP when endorsed by the IMF/WB boards

-Meanwhile, assessments against new Principles on a voluntary basis

-G20 countries have committed to publish their assessments

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17

Assessment Methodology: structure

The five steps involved in an assessment against the PFMI report are

(1)determining the appropriate scope of an assessment;

(2)gathering facts useful to evaluate the key considerations;

(3)developing key conclusions by key considerations;

(4)assigning a rating category to each principle or responsibility; and

(5)indicating an appropriate timeframe for addressing each identified issue of concern, including a discussion on priorities

- *The AM also provides assessment report templates for assessing an FMI against the 24 principles and authorities against the five responsibilities (Appendices 1 and 2) as well as supporting questions for assessing observance with the principles and responsibilities (Appendices 3 and 4)*

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18

Assessment Methodology: use of rating framework

- Different types of assessors may communicate the outcome of their assessments of FMIs differently, depending on their specific objectives
- The rating is built on the key conclusions and reflects the assessors' judgment regarding the type or impact of the risks, concerns, or other issues associated with each identified gap or shortcoming

Where consistent with national practice, **FMIs** should use the AM rating scheme

National authorities may choose to use the AM rating scheme or may choose to use another EQUALLY EFFECTIVE rating scheme, in particular when they are legally bound to use a different assessment methodology. The AM rating scheme is expected to be used in the context of cross-border cooperative oversight arrangements unless agreed otherwise

IFIs use the rating scheme presented in the AM in the context of the FSAP. Technical assistance (TA) assessors are not necessarily expected to use a rating scheme

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Ratings for Principles

The rating scale is built on the gravity and urgency to remedy identified "issues of concern". For the purpose of this scale, an "issue of concern" is a risk management flaw, a deficiency, or a lack of transparency or effectiveness that needs to be addressed

Observed	The FMI observes the Principle. Any identified gaps and shortcomings are not issues of concern and are minor, manageable, and of a nature that the FMI could consider taking up in the normal course of its business
Broadly Observed	The FMI broadly observes the Principle. One or more issues of concern have been identified that the FMI is encouraged to address and follow up to better manage risks or improve operations. The FMI should pursue such improvements in a defined timeline
Partly Observed	The FMI partly observes the Principle. The assessment has identified one or more issues of concern that could become serious if not addressed in a timely manner. The FMI should accord a high priority to address these issues
Not Observed	The FMI does not observe the Principle. The assessment has identified one or more serious issues of concern that warrant immediate action. Therefore, the FMI must accord the highest priority to timely address these issues
Not Applicable	The Principle does not pertain to the type of FMI being assessed because of the particular legal, institutional, structural or other characteristics of the FMI

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20

Assessment Methodology: request for comments

CPSS and IOSCO request comment on the proposed AM:

- *Is the assessment methodology appropriately comprehensive? If not, how should the assessment methodology be improved?*
- *Is the assessment methodology sufficiently clear (including on the guidance provided to deal with different types of FMIs)? If not, how can the assessment methodology be improved to ensure it is clearer?*
- *Does the assessment methodology include an appropriate level of detail? If not, what changes should be made?*

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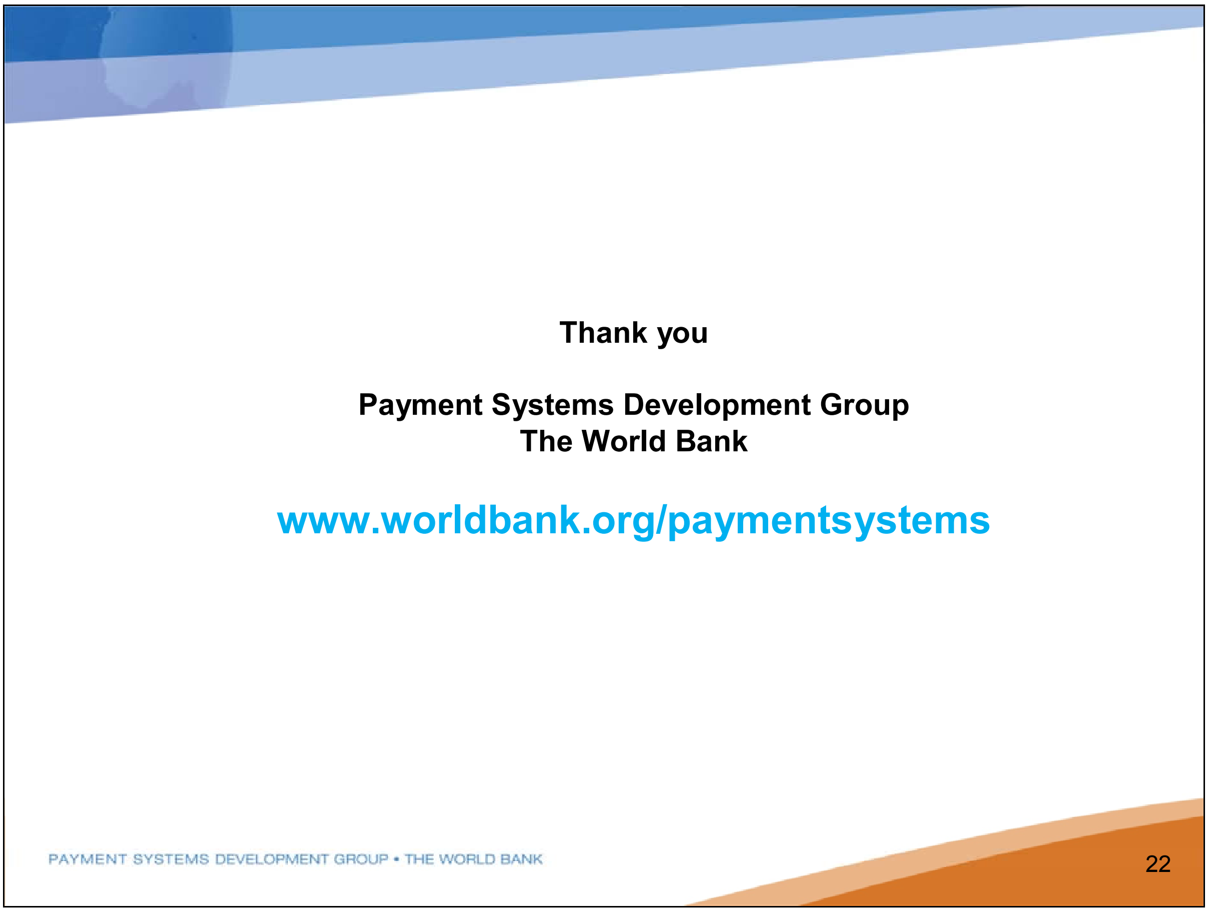
21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22