

Implementation of the PFMI: The Federal Reserve's Experience

Payment System Policy and Oversight Course
Federal Reserve Bank of New York
May 2016

The views expressed in this presentation are those of the speaker and do not necessarily reflect the views of the Federal Reserve Board or those of the Federal Reserve System.

Overview

- Background
- Risk management standards
- Board's risk management expectations
- Appendix
 - Links to implementation measures

BACKGROUND

Financial Market Infrastructures & Utilities

Financial Market Infrastructures (FMIs)	Financial Market Utilities (FMUs)
• Multilateral system	• Multilateral system
• Used by financial institutions	• Used by financial institutions
• Purpose: record, clear, or settle financial transactions (payments, securities, and derivatives)	• Purpose: transfer, clear, or settle payments, securities, or other financial transactions
• Scope: • Payment systems • Clearing systems • Securities settlement systems (SSS) • Central securities depositories (CSDs) • Trade repositories (TRs) • <i>Excludes trade execution systems</i>	• Scope: • Payment systems • Clearing systems • Central securities depositories • Securities settlement systems • Entities that have been designated as systemically important (DFMU) • <i>Excludes trade execution systems</i>
• Context: CPSS-IOSCO <i>Principles for Financial Market Infrastructures</i>	• Context: Title VIII of the Dodd-Frank Act

Key FMIs in the U.S.

Payment systems

- Fedwire Funds Service
- Clearing House Interbank Payment System* **(CHIPS)**
- National Settlement Service (NSS)
- Continuous Linked Settlement Bank* **(CLS)**

Securities Settlement Systems & Central Securities Depositories

- Fedwire Securities Service
- The Depository Trust Company* **(DTC)**

Trade repositories

- DTCC Data Repository, Ltd (DDR)

* **DFMU**

Clearing systems

- National Securities Clearing Corporation* **(NSCC)**
- Fixed Income Clearing Corporation* **(FICC)**
 - Government Securities Division
 - Mortgage-Backed Securities Division

-
- Chicago Mercantile Exchange Clearing* **(CME)**
 - ICE Clear Credit* **(ICC)**
 - The Options Clearing Corporation* **(OCC)**
 - LCH.Clearnet LLC (LCH)

Regulatory Landscape

- The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act)
 - Under Title VIII of Dodd-Frank, a designated financial market utility (DFMU) is an FMU that has been designated as systemically important by the Financial Stability Oversight Council (FSOC)
 - For purposes of carrying out the provisions of Title VIII, the statute defines “supervisory agency” (SA) as the Federal agency that has primary jurisdiction over a designated financial market utility under Federal banking, securities, or commodity futures laws
 - The Board is the SA for CHIPS and CLS
 - The Commodity Futures Trading Commission (CFTC) is the SA for ICC and CME
 - The Securities and Exchange Commission (SEC) is the SA for DTC, NSCC, FICC, and OCC
 - The Board has certain other authorities vis-à-vis all DFMUs for which it is not the SA
- Concurrent statutory authority
 - Under the Federal Reserve Act of 1913, the Board has direct authority to supervise the Reserve Banks (i.e., Fedwire and NSS) and FMUs organized as banks or trusts companies (e.g., DTC)
 - Under the Edge Act of 1919, the Board has direct authority to supervise Edge Act corporations (e.g., CLS)

Title VIII: Key provisions

- Title VIII has six key provisions
 - Designation of systemic importance
 - Standards for designated financial market utilities (DFMUs) and financial institutions engaged in designated payment, clearing, and settlement activities
 - Examination and enforcement
 - Review of material changes to a DFMU's rules, procedures, or operations
 - Regulators' requests for information, reports, or records
 - DFMU access to Federal Reserve Bank accounts, payment services, and emergency credit
- Core Fed responsibilities under Title VIII include
 - Promulgation of risk management standards
 - Examinations of DFMUs
 - Review of material change proposals
 - Assessment of DFMUs requesting access to Fed accounts and services

RISK MANAGEMENT STANDARDS

Title VIII: Risk management standards

- The Dodd-Frank Act states that the Board shall prescribe risk management standards, taking into consideration relevant international standards and existing prudential requirements, governing the operations related to the payment, clearing, and settlement activities of DFMUs
- The Act also authorizes (but does not require) the CFTC and SEC to prescribe regulations containing risk management standards for those DFMUs for which the CFTC or SEC is the SA under Title VIII
- The Board's risk management standards would apply to:
 1. DFMUs for which the Board is the Supervisory Agency under Title VIII (that is, CLS Bank and CHIPS)
 2. Any other DFMU for which neither the CFTC nor SEC is the Supervisory Agency under Title VIII (At this time, no DFMUs fall into this category.)

“Relevant international standards”

- International standards for FMIs have played an important role for more than two decades
 - November 1990: *Report of the Committee on Interbank Netting Schemes of the central banks of the Group of Ten* (Lamfalussy Report)
 - January 2001: *CPSS Core Principles for Systemically Important Payment Systems* (CPSIPS)
 - November 2001: *CPSS-IOSCO Recommendations for Securities Settlement Systems* (RSSS)
 - November 2004: *CPSS-IOSCO Recommendations for Central Counterparties* (RCCP)

Development of the PFMI

- A comprehensive review of standards was launched in February 2010 to
 - incorporate lessons learned from the recent financial crisis and to adapt to greater uncertainties and risks in financial markets
 - More severe stress scenarios than previously thought
 - Need for stronger governance and oversight of FMIs
 - Importance of reliable liquidity arrangements in stress events
 - support G-20 and FSB initiatives to strengthen core financial infrastructures and markets by strengthening existing standards and broadening their coverage (e.g., by including TRs)
 - promote consistency in global oversight and enforcement across different FMI types, different FMI designs, and different jurisdiction
- Final report: *Principles for financial market infrastructures* (PFMI)
 - CPMI and IOSCO members committed to strive to incorporate the PFMI into their respective legal and regulatory frameworks

General overview of the PFMI

- Published in April 2012: <http://www.bis.org/cpmi/publ/d101.htm>
- Establishes new international standards for FMIs
 - systemically important payment systems (SIPs)
 - central securities depositories (CSDs)
 - securities settlement systems (SSSs)
 - central counterparties (CCPs)
 - trade repositories (TRs)
- Updates, harmonizes, and strengthens previous risk-management and related standards for FMIs
- Revises responsibilities of relevant authorities in regulating, supervising, and overseeing FMIs

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

Comparison with previous standards

- Greater emphasis on the role and importance of governance (Principle 2)
- Introduces a new requirement to plan for recovery and orderly wind-down (Principle 3)
- Provides clearer guidance on managing credit and liquidity risks (Principles 4, 5, 6, and 7)
- Introduces a new standard on general business risk (Principle 15)
- Imposes stronger operational requirements (Principle 17)
- Requires management of risks from tiered participation arrangements (Principle 19)

BOARD'S RISK MANAGEMENT EXPECTATIONS

General Overview

- The Federal Reserve's risk-management and transparency standards for FMIs, including designated financial market utilities, are set out in two documents
 - **Regulation HH** – an enforceable federal regulation that contains the Board's risk management standards for certain DFMUs as required by Title VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act)
 - **Part I of the PSR Policy** – a policy statement that sets out the Board's views, and related standards, regarding risk management and transparency for a broader set of FMIs, including those operated by the Reserve Banks
 - Guides the Board when exercising its authority under various laws, supervising FMIs other than those subject to the Regulation HH risk-management standards, and cooperating with other central banks and market regulators
- The Board recently finalized amendments to Regulation HH and revisions to part I of the PSR policy to incorporate the PFMI

Regulation HH

- In considering different approaches to updating Regulation HH in light of the PFMI, staff was informed by its experience
 - Supervising financial market utilities (pre- and post-Dodd-Frank)
 - Developing and applying international risk management standards
 - Participating in Title VIII examinations
- The final rule is based on and generally consistent with the PFMI
 - Includes all relevant headline standards
 - Includes most of the key considerations
 - Draws on the explanatory notes to provide more specificity as needed
- Includes revisions to the text of the PFMI necessary to fit regulatory construct and provide greater specificity needed in an enforceable regulation

PSR Policy – Part I

- In revising part I of the policy, the Board made several key changes
 1. Clarified the scope by creating mutually exclusive categories of FMI types
 - Board-supervised DFMUs (CLS and CHIPS) are carved out explicitly because they are subject to Regulation HH
 - Federal Reserve Bank-operated FMIs (e.g. Fedwire Funds and Securities Services) continue to be within the scope and are required to meet or exceed the standards set forth in the policy (with certain allowances for central-bank operated systems)
 - Private-sector FMIs where the Federal Reserve has supervisory authority (e.g. Depository Trust Company (DTC)) are expected to meet or exceed the risk-management standards in the policy
 - Regarding all other FMIs for which the Federal Reserve does not have exclusive authority and those in which it has an interest (e.g. NSCC, FICC, CME, ICE, trade repositories, systemically important off-shore and cross-border payment systems), the Board will be guided by the policy in its cooperative efforts with other FMI authorities
 2. Expanded the scope to include trade repositories
 3. Incorporated all of the headline standards from the PFMI with no modification
 4. Replaced the self-assessment framework with broader disclosure expectations
 5. Recognized responsibility E, in addition to other relevant international guidance, as the basis for cooperation with other authorities

Effective and compliance dates

- Amendments became effective on December 31, 2014, and FMIIs were expected to comply with most standards by that date
- For several new or heightened requirements, the deadline for compliance was extended to December 31, 2015
 - establish plans for recovery or orderly wind-down
 - address uncovered credit losses
 - address liquidity shortfalls
 - maintain sufficient liquid net assets funded by equity and a viable capital plan
 - manage risks arising in tiered participation arrangements
 - provide comprehensive public disclosure
- With respect to the new or heightened requirements, FMIIs were encouraged to share with supervisors drafts of required plans, procedures, or documents in advance of December 31, 2015

Application of Regulation HH and part I of the PSR policy to specific FMIs

Category of FMI	Regulation HH	PSR Policy
Designated FMUs for which the Board is the Supervisory Agency under Title VIII of the Dodd-Frank Act	• Clearing House Interbank Payments System (CHIPS) • CLS Bank International (CLS)	
Other FMIs for which the Board has authority under the Federal Reserve Act		• The Fedwire Services • DTC (as a state member bank)
Designated FMUs for which the Board is not the Supervisory Agency but has other responsibilities under Title VIII of the Dodd-Frank Act		• Chicago Mercantile Exchange, Inc. (CME) • Fixed Income Clearing Corporation (FICC) • ICE Clear Credit L.L.C. • National Securities Clearing Corporation (NSCC) • The Options Clearing Corporation (OCC) • The Depository Trust Company (DTC)
Other FMIs where the Board may have an interest		Examples of FMIs of interest include: • Certain offshore USD payment systems • DTCC Data Repository (U.S.) LLC • LCH.Clearnet LLC

Status of U.S. Implementation

- The CFTC and SEC are separately developing regulations for FMIs that they regulate
 - The CFTC has completed its implementation of the PFMI
 - Final rules have been in effect since December 2013
 - The SEC published proposed rules for public comment in March 2014

APPENDIX

Links to implementation measures

Board final actions

Regulation HH: <http://www.gpo.gov/fdsys/pkg/FR-2014-11-05/pdf/2014-26090.pdf>

PSR policy – Part I: <http://www.gpo.gov/fdsys/pkg/FR-2014-11-13/pdf/2014-26791.pdf>

CFTC final rules (CME, ICC)

<http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2013-27849a.pdf>

SEC proposed rules (DTC, NSCC, FICC, OCC)

<http://www.sec.gov/rules/proposed/2014/34-71699.pdf>