

# Strengthening the Standards for Financial Market Infrastructures: Credit and Liquidity Risk

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*\* **Disclaimer:** The views expressed are the views of the presenter and do not necessarily reflect the views of the Federal Reserve Bank of New York, or any component of the Federal Reserve System.*

# Overview of financial standards

- Credit risk
  - Current requirements
  - Raising the bar
  - Extending the bar
- Liquidity risk
  - Current requirements
  - Raising the bar
  - Extending the bar
- Key strengthening: action by authorities
- Open questions

# Current requirements: credit risk

- All FMIs: current exposure coverage
  - Largest CE to a single participant
- CCPs: potential future exposure coverage
  - Largest PFE to a single participant
    - With 99% confidence, via margin
    - In extreme but plausible conditions, via default fund

# Raising the bar: credit risk

- All FMIs: current exposure coverage
  - CE to *all* participants, not just *single largest*
- CCPs : PFE coverage
  - PFE of a “*participant family*”, not just a *legal entity*
  - Coverage “plus”: additional resources required
    - Stress testing to identify/cover additional scenarios
    - E.g., multiple defaults, historic price moves

# Extending the bar: credit risk

- All FMIs
  - Rigorous collateral requirements for “coverage”
  - Must address/allocate uncovered credit losses
    - Including to repay liquidity providers
  - Rules/procedures to replenish used resources
    - To function in extreme but plausible conditions
    - Including the default of any two participant-families
- CCPs
  - Rigorous requirements for stress testing
    - Quality and governance
    - Reverse stress testing
    - “Feed-back” mechanism to augment resources
  - Rigorous PFE modeling requirements
    - Monthly back-testing
    - Annual validation

# Current requirements: liquidity risk

- All FMIs: liquidity risk coverage
  - No explicit liquidity resource requirement
  - Implied: largest pay-in of a single participant

# Raising the bar: liquidity risk

- All FMIs: new, explicit liquidity risk principle
  - Cover a “*participant family*”, not just a *legal entity*
    - *PS/CSD/SSS: to settle its pay-in obligation*
    - *CCP: to cover margin and close out/hedge its open position*
  - “Plus”: additional liquidity resources required
    - Stress testing to identify/cover relevant scenarios
    - E.g., multiple defaults, historic price moves

# Extending the bar: liquidity risk

- Rigorous requirements for stress testing
  - Quality and governance
  - Reverse stress testing
  - “Feed-back” mechanism to augment resources
- Rigorous requirements for liquidity resources
  - Strict standards to qualify as “highly reliable”
  - E.g., cash deposits and same-day committed liquidity lines
- Required due diligence on liquidity providers
  - Confirm each LP’s capacity to perform as required
  - Confirm each LP has information to manage its risks
- Must address/allocate uncovered liquidity shortfalls
  - Avoid unwinding, revoking, or delaying same-day settlement
- Rules/procedures to replenish used resources
  - To function even in extreme but plausible market conditions
  - Including the default of any two participant-families

# Key strengthening: action by authorities

- All CPSS and IOSCO members intend to apply the updated standards to the relevant FMIs in their jurisdictions to the fullest extent possible.
  - Relevant authorities will strive to include the principles as appropriate in their legal and regulatory framework by the end of 2012, in accordance with the G20 recommendations.
  - Authorities will be expected to apply the principles as part of their regulatory, supervisory and oversight activities as soon as possible.
  - FMIs will be expected to take appropriate and swift action in order to meet the principles.

# Open questions: CCP coverage “plus”

- Minimum “Cover 1” requirement for CCP stress testing?
  - The one participant-family with the largest PFE in extreme but plausible conditions
- Minimum “Cover 2” requirement for CCP stress testing?
  - The two participant-families with the largest aggregate PFE in extreme but plausible conditions
- “Cover 1” or “cover 2” minimum, depending on CCP characteristics?
  - OTC versus exchange-traded?
  - Mandatory versus voluntary clearing?
  - “Cash” versus “derivative”?
  - Duration, volatility, and degree of leverage?
  - Number and type of participants?
  - Degree of market concentration?
  - Availability and reliability of prices?

# Open questions: liquidity coverage “plus”

- Minimum “Cover 1” requirement for FMI stress testing?
  - The one participant-family that would cause the largest liquidity need in extreme but plausible conditions
    - *PS/CSD/SSS: to settle its pay-in obligation*
    - *CCP: to cover margin and close out or hedge its open position*
- Minimum “Cover 2” requirement for FMI stress testing?
  - The two participant-families that would cause the largest aggregate liquidity need in extreme but plausible conditions
    - *PS/CSD/SSS: to settle their combined pay-in obligation*
    - *CCP: to cover margin and close out or hedge their combined open position*
- “Cover 1” or “cover 2” minimum, depending on FMI characteristics?
  - OTC versus exchange-traded?
  - Mandatory versus voluntary clearing?
  - “Cash” versus “derivative”?
  - Duration, volatility, and degree of leverage?
  - Number and type of participants?
  - Degree of market concentration?
  - Availability and reliability of prices?