

Policy guidance on the Bank of Canada's risk-management standards for designated financial market infrastructures

Standard 2: Governance

Vertically and Horizontally Integrated FMIs

Context

The Bank of Canada adopted the [Principles for Financial Market Infrastructures](#) (PFMIs) into its risk-management standards for designated financial market infrastructures (FMIs) in 2012. This guidance was prepared by the Bank of Canada, l'Autorité des marchés financiers (Quebec), British Columbia Securities Commission and Ontario Securities Commission to provide additional context and clarity on certain aspects of these new standards in the Canadian context.

Consolidation, or integration, of FMI services may bring about benefits for merging FMIs; however it may also create new governance challenges. The PFMIs contain some general guidance regarding how FMIs should manage governance issues that arise in integrated entities. This note provides supplementary regulatory guidance for Canadian FMIs that either belong to an integrated entity or are considering consolidating with another entity to form one. The guidance applies to both vertically and horizontally integrated entities.

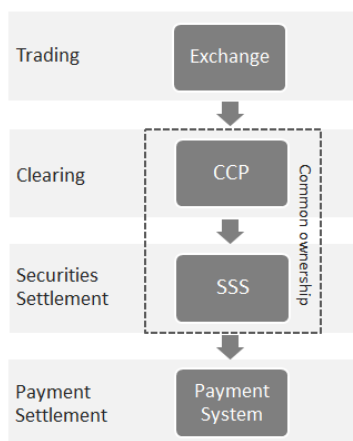
Vertical and horizontal integration in the context of FMIs

CPSS defines a vertically integrated FMI group as one that brings together post-trade infrastructure providers under common ownership with providers of other parts of the value chain (for example, one entity owning and operating an exchange, central counterparty (CCP) and securities settlement system (SSS)) and a horizontally integrated group as one that provides the same post-trade service offerings across a number of different products (for example, one entity offering CCP services for derivatives and cash markets).¹ Examples are shown in Figure 1.

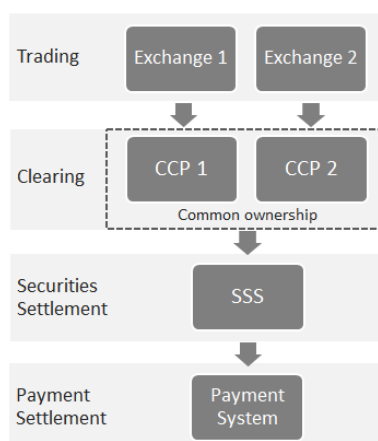
¹ CPSS-IOSCO 2010. "Market structure developments in the clearing industry: implications for financial stability." CPSS-IOSCO Paper No 92. Available at: <http://www.bis.org/publ/cpss92.htm>.

Figure 1: Examples of FMI integration in the value chain

a) Example of vertically integrated FMIs



b) Example of horizontally integrated FMIs



Guidance within the PFMI

The following text has been extracted directly from the PFMI. The pertinent information is in bold italics.

PFMI paragraph 3.2.5: Depending on its ownership structure and organisational form, an FMI may need to focus particular attention on certain aspects of its governance arrangements. ***An FMI that is part of a larger organisation, for example, should place particular emphasis on the clarity of its governance arrangements, including in relation to any conflicts of interests and outsourcing issues that may arise because of the parent or other affiliated organisation's structure. The FMI's governance arrangements should also be adequate to ensure that decisions of affiliated organisations are not detrimental to the FMI.² An FMI that is, or is part of, a for-profit entity may need to place particular emphasis on managing any conflicts between income generation and safety.***

PFMI paragraph 3.2.6: An FMI may also need to focus particular attention on certain aspects of its risk-management arrangements as a result of its ownership structure or organisational form. ***If an FMI provides services that present a distinct risk profile from, and potentially pose significant additional risks to, its payment, clearing, settlement, or recording function, the FMI needs to manage those additional risks adequately. This may include separating the additional services that the FMI provides from its payment, clearing,***

² If an FMI is wholly owned or controlled by another entity, authorities should also review the governance arrangements of that entity to see that they do not have adverse effects on the FMI's observance of this principle.

settlement, and recording function legally, or taking equivalent action. The ownership structure and organisational form may also need to be considered in the preparation and implementation of the FMI's recovery or wind-down plans or in assessments of the FMI's resolvability.

Supplementary guidance for designated Canadian FMIs

An FMI that is part of a larger entity faces additional risk considerations compared to stand-alone FMIs. While there are potential benefits from integrating services into one large entity, including potential risk reduction benefits, integrated entities could face additional risks such as a greater degree of general business risk. Examples of how this could occur include the following:

- losses in one function may spill-over to the entity's other functions;
- the consolidated entity may face high combined exposures across its functions; and
- the consolidated entity may face exposures to the same participants across its functions.

For a more extensive discussion of potentially heightened risks that integrated FMIs may face, see CPSS-IOSCO, "[Market structure developments in the clearing industry: implications for financial stability](#)" (2010).

If an FMI belongs to a larger entity, or is considering consolidating with another entity, it should consider how its risk profile differs as part of the consolidated entity, and take appropriate measures to mitigate these risks.

In addition, FMIs that either belong to an integrated entity or are considering merging to form one should meet the following conditions.

1) Measures to protect critical FMI functions

- FMIs fulfill critical functions for the markets they serve. Therefore, FMI functions should be legally separated from other functions performed by the consolidated entity in order to maximize bankruptcy remoteness of the FMI functions.
- If an FMI performs multiple functions with distinct risk profiles, the operator should effectively manage the additional risks that may result. The FMI should hold sufficient financial resources to manage the risks in all services it offers, including the combined or compounded risks that would be associated with offering the services through a single legal entity. If the FMI provides multiple services, it should disclose information about the risks of the combined services to existing and prospective participants to give an accurate understanding of the risks they incur by participating in the FMI. The FMI should carefully consider the benefits of offering critical services with distinct risk profiles through separate legal entities.

- Central counterparties (CCPs) take on more risk than other FMIs, and are inherently at higher risk of failure. Therefore, the FMI must either legally separate its CCP functions from other critical (non-CCP) FMI functions, or will need to satisfy its regulators that additional risks are managed appropriately to ensure the FMI's financial and operational viability.
- Legal separation of critical functions is intended to maximize their bankruptcy remoteness and would not necessarily preclude integration of common organizational management activities such as IT and legal services across functions as long as any related risks are appropriately identified and mitigated.

2) Independence of governance and risk management

- FMIs and non-FMIs may have different corporate objectives and risk management appetites which could conflict at the parent level. For example, non-FMI functions, such as trading venues, are generally more focused on profit generation than risk management and do not have the same risk profile as FMI functions. A trading venue in a vertically integrated entity may benefit from increased participation in its service if its associated clearing function lessens its participation requirements.
- To mitigate potential conflicts, in particular the ability of other functions to negatively influence the FMI's risk controls, each FMI subsidiary should have a governance structure and risk management decision-making process that is separate and independent from the other functions and should maintain an appropriate level of autonomy from the parent and other functions to ensure efficient decision making and effective management of any potential conflicts of interest. In addition, the consolidated entity's broad governance arrangements should be reviewed to ensure they do not impede the FMI function's observance of the CPSS-IOSCO principle on governance.

3) Comprehensive management of risks

- Although risk management governance and decision-making should remain independent, it is nonetheless necessary that the consolidated entity is able to manage risk appropriately across the entity. At a consolidated level, the entity should have an appropriate risk management framework that considers the risks of each subsidiary and the additional risks related to their interdependencies.
- An FMI should identify and manage the risks it bears from and poses to other entities as a result of interdependencies. Consolidated FMIs should also identify and manage the risks they pose to one another as a result of their interdependencies. Consolidated FMIs may have exposures to the same participants, liquidity providers, and other critical service providers across products, markets and/or functions. This may increase the entity's

dependence on these providers and may heighten the systemic risk associated with the consolidated entity compared to a stand-alone FMI. Where possible, the consolidated entity and its FMIs should consider ways to mitigate risks arising from shared dependencies. The consolidated entity and its FMIs should also consider conducting entity-wide operational risk testing related to identifying and mitigating these risks.

4) Sufficient capital to cover potential losses

- Consolidated entities face the risk that a single participant defaults in more than one subsidiary simultaneously. This could result in substantial losses for the consolidated entity which will then also need to replenish resources for the FMIs to continue to operate. FMIs should consider such risks in developing their resource replenishment plan.
- Consolidated entities may face higher or lower business risk than individual FMIs depending on size, complexity and diversification across affiliates. Consolidated entities should consider these impacts in their general business risk profiles and in determining the appropriate level of liquid assets needed to cover their potential general business losses.³

Request for comments

Comments on this draft guidance should be sent by 18 March 2014 to the Bank of Canada at PFMI-consultation@bankofcanada.ca.

A copy should also be provided to l'Autorité des marchés financiers (Quebec) at consultation-en-cours@lautorite.qc.ca, British Columbia Securities Commission at dmackay@bcsc.bc.ca and Ontario Securities Commission at comments@osc.gov.on.ca.

³ Liquid assets held for general business losses must be funded by equity (such as common stock, disclosed reserves, or retained earnings) rather than debt.