October 31, 2014

First take A publication of PwC's financial services regulatory practice

# *Ten key points from the FRB's revised SIFMU risk management standards*

On October 28th, the Federal Reserve Board (FRB) finalized revisions to its risk management standards for systemically important financial market utilities (SIFMUs). This final rule (which was originally proposed in January 2014) generally aligns the FRB's existing risk management standards with the Principles for Financial Market Infrastructures (PFMIs) issued jointly in 2012 by the Basel Committee on Payment and Settlement Systems and the International Organization of Securities Commissions (CPSS-IOSCO).

Although the final rule is directly applicable only to the two SIFMUs that are primarily regulated by the FRB,[1] our observations suggest that the FRB – through its role as the back-up supervisor – will continue to influence the other six SIFMUs' practices as well. Therefore, all SIFMUs should take a closer look at their current corporate governance and risk management practices to facilitate alignment with the final rule. Compliance with the rule is expected by December 31, 2014, but certain heightened standards (e.g., around recovery and resolution plans, and uncovered credit losses and liquidity shortfalls) do not take effect until December 31, 2015.

1. **Heightened standards for boards of directors:** The final rule requires a SIFMU's board to include a majority of independent directors (i.e., they cannot be employees of the SIFMU or its affiliates), similar to the January 2014 proposal. The FRB stops short of requiring a specific percentage of independent directors, or that the board chair also be an independent director, pointing out that robust governance could be achieved via alternative structures such as appointing a "lead independent director." The board is also required to periodically review its own performance and the performance of individual directors.[2] Although the final rule does not prescribe how the board should structure its committees to oversee the audit and risk management functions, it does recommend that the risk management function have a direct reporting line to a board committee to ensure sufficient independence. Given the regulators' heightened attention to board governance, SIFMUs should review their current governance practices, especially when it comes to setting the appropriate tone at the top, ensuring accountability, and demonstrating effective challenge to management.
2. **Comprehensive risk management framework expected:** The final rule requires that SIFMUs have a comprehensive framework for managing key risks (e.g., legal, credit, liquidity, and operational), including policies, procedures and systems that are subject to periodic review. Although the final rule retains the flexibility of the proposal by not prescribing a frequency for periodic reviews, we recommend that SIFMUs conduct a review at least annually to ensure that risk management processes are appropriate for the SIFMU's risk profile.

3. **Recovery <u>and</u> resolution plans required:** SIFMUs must prepare *both* a recovery and a resolution plan, which clarifies the proposal's language that required recovery *or* resolution plans.[3] In addition, the FRB expects better integration of recovery and resolution plans to ensure a smooth transition from recovery efforts to resolution efforts if necessary (e.g., by ensuring that the firm is sufficiently capitalized to enter orderly resolution at the end of the recovery phase). This expectation is further evidence of the FRB's heightened focus on recovery planning, and echoes the FRB's recent recovery guidance provided to the eight US G-SIBs.[4] The final rule also adds the requirement for SIFMUs to have a viable plan for raising additional equity should the SIFMU's equity fall below the amount needed for recovery or resolution. To assist firms with these heightened expectations, the rule encourages firms to share drafts of their recovery and resolution plans with the FRB to receive regulatory feedback in advance of the December 31, 2015 deadline for finalizing the plans. In addition, the final rule provides some relief by requiring that the plans be reviewed every two years (or if there are changes to the firm's systems or operating environment), rather than the proposal's annual review requirement.

4. **Liquidity is key:** The proposal required that a SIFMU maintain an amount of liquid assets equal to the greater of (a) the cost of implementing the firm's recovery or resolution plan, and (b) six months of current operating expenses.[5] The proposal additionally required SIFMUs to hold at least the same amount in equity, and to have a plan (subject to annual review) to raise additional capital before equity levels fall below the required amount. While the final rule generally maintains these requirements, the FRB has clarified that SIFMUs may include some expected revenue streams that are likely to continue during the recovery or resolution process (e.g., critical services fees), subject to haircuts based on expected adverse market conditions. The final rule also reduces the frequency of required reviews of the plan to raise additional equity to every two years, similar to the relief provided for recovery and resolution plans.

5. **Liquidity risk management includes a new category of qualifying liquidity resources:** The proposal also required that SIFMUs set aside sufficient liquid resources to meet their payment obligations under a variety of stress scenarios (including default by a member and its affiliates, which would generate a large liquidity obligation for the SIFMU). This requirement could be met either with cash holdings at central banks or creditworthy commercial banks, or with committed highly liquid assets (e.g., collateralized lines of credit and repo agreements). The final rule provides some relief by adding uncommitted highly liquid assets (that are subject to prearranged agreements to be converted to cash on a same-day basis) to the list of qualifying liquidity resources. However, in order to be recognized as highly liquid (and thus eligible to be included as qualifying liquidity resources), these prearranged uncommitted assets must be highly reliable under extreme but plausible market condition (e.g., US Treasuries), as determined by the FRB.

6. **Rules and procedures needed to address liquidity shortfalls:** The proposal also addressed enhanced liquidity risk management by requiring SIFMUs to have rules and procedures around (a) covering the firm's liquidity shortfalls without unwinding, revoking, or delaying the same-day settlement of payment obligations, and (b) the

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[1] The FRB is the primary supervisor for two of the eight SIFMUs currently designated as systemically important (the Clearing House Payments Co. and CLS Bank International). The other six SIFMUs (Chicago Mercantile Exchange, the Depository Trust Company, Fixed Income Clearing Corp., ICE Clear Credit, National Securities Clearing Corp., and the Options Clearing Corp.) are primarily supervised by either the Commodity Futures Trading Commission (CFTC) or the Securities and Exchange Commission (SEC). See PwC's *Regulatory Brief*, *More scrutiny for financial market utilities* (May 2013).

[2] These requirements are consistent with the recently proposed revisions to the Basel Committee on Banking Supervision's (BCBS) corporate governance principles for banks, covering board governance, risk governance framework, and compensation. Given this alignment, we believe US regulators are likely to incorporate proposed board governance principles into their regulatory frameworks for banks and other financial institutions.

[3] See PwC's *Regulatory Brief*, *Systemically important derivatives clearing organizations: The CFTC proposes recovery and wind-down plans* (September 2013).

[4] This recent recovery guidance closed the timeline gap that previously existed between the end of recovery efforts and the start of resolution actions by requiring that firms consider a broader array of recovery options including those that would only be considered when the firm is nearest to entering resolution. See PwC's *Regulatory Brief*, *Recovery planning: Until the last gasp* (October 2014).

[5] This FRB requirement is significantly less stringent than similar liquidity requirements for SIFMUs that are primarily regulated by the CFTC and must maintain liquid assets sufficient to cover operating expenses over a 12-month period.

process to replenish liquid resources that are depleted during a stress event. The FRB is expecting SIFMUs to clearly think through potential liquidity issues and have reliable plans in place to ensure they can meet their settlement obligations without causing instability in financial markets.

7. **More clarity comes at a high price:** To better address credit risk, the proposal required SIFMUs to have policies and procedures that specify how the firm would (a) allocate credit losses that exceed the SIFMU's financial resources during a stress event (e.g., member default), and (b) replenish its financial resources that are depleted after the stress event. Commenters had pointed out that setting out exact policies and procedures for replenishment of depleted resources would be challenging given the unpredictable circumstances of future stress. In response, the FRB in the final rule clarifies that the rules and procedures must be as specific as possible, and (acknowledging the unpredictable nature of future stress event) must address a wide range of potential scenarios. While firms certainly appreciate this added clarity around the required level of specificity, we expect this provision to lead to higher compliance costs.

8. **Broader risk management requirements:** SIFMUs were required under the proposal to manage material risks to the SIFMU arising from indirect use of the SIFMU's services by firms that are not members of the SIFMU but utilize its services (i.e., payment, clearing, and settlement) through their contracts with member firms. The final rule expands this requirement by broadening the scope to cover material risks posed by non-members not only to the SIFMU, but also to its member firms. Under the final rule, SIFMUs must conduct an analysis to identify material risks at least bi-annually, and mitigate or manage identified risks, if any.

9. **Fees and discount policies need not be publically disclosed:** The final rule requires that SIFMUs disclose relevant information about their operations and risk management, as well as their rules and key procedures, to their participants and the public. However, disclosure of information about fees and discount policies to the public (which had been contemplated by the proposal) is not required under the final rule.

10. **Enhanced disclosures for more FMIs:** Along with finalizing the rule (that is directly applicable only to the two SIFMUs that are primarily regulated by the FRB), the FRB also adopted revisions to its policy on Payment System Risk (PSR) that applies directly to more financial market infrastructures (FMIs). Finalized revisions expand the scope of FMIs previously covered by the policy to include central securities depositories, securities settlement systems, central counterparties, and trade repositories. In addition, similar to the final rule, the revised PSR policy aligns the FRB's risk governance requirements with the PFMIs. Most notably, the revised policy raises the disclosure bar for FMIs by requiring that firms adopt CPSS-IOSCO's 2012 disclosure framework. This provision replaces the less-prescriptive requirements that FMIs perform a self-assessment against the PSR policy (and release the results publically as they deem appropriate).

# *Additional information*

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