

# FMI STANDARD 4: CREDIT RISK

FS4



## DOCUMENT VERSION HISTORY

1 March 2024	First issue date
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## INTRODUCTION

### Application

- i. This standard applies to every operator of a designated FMI that was specified in its designation notice under section 29(2)(f) of Financial Market Infrastructures Act 2021 (the **Act**) as falling within one or more of the following classes of designated FMIs:
  - (a) a pure payment system; or
  - (b) a securities settlement system; or
  - (c) a central counterparty.

### Legal powers

- ii. Under section 8 of the Act the regulator is defined as the RBNZ and the FMA acting jointly (or the RBNZ acting on its own in relation to pure payment systems).
- iii. Section 12 of the Act provides the regulator's functions. These include regulating designated FMIs, dealing with designated FMIs that are distressed, and other functions under the Act.
- iv. Subject to certain statutory prerequisites, section 31 of the Act empowers the regulator to make standards for designated FMIs.
- v. Section 34 sets out the matters that standards may deal with or otherwise relate to. Section 34(1)(e)(iii) and (h) provides that a standard may deal with, or otherwise relate to, the management by operators of credit risk.

### Interpretation

- vi. The words and phrases used in this standard have the same meaning as in the Act.
- vii. **Complex central counterparty activities** means central counterparty activities that have a more complex risk profile, including activities such as clearing financial instruments that are characterised by discrete jump-to-default price changes, or that are highly correlated with potential participant defaults.
- viii. **Simple central counterparty activities** means central counterparty activities that are not complex central counterparty activities.

### Commencement

- ix. This standard comes into force on 1 March 2024.

## REQUIREMENTS

- 1) An operator must effectively measure, monitor, and manage the FMI's credit exposures to participants, and those arising from the FMI's payment, clearing, and settlement processes. The operator must maintain sufficient financial resources to cover the FMI's credit exposure to each participant fully and with a high degree of confidence.
- 2) An operator must ensure that:
  - a) the FMI has a robust framework to manage its credit exposures to its participants, and the credit risks arising from its payment, clearing, and settlement processes. This includes credit exposures arising from both current exposures and potential future exposures; and
  - b) in relation to the FMI, it identifies sources of credit risk, routinely measures and monitors credit exposures, and that it uses appropriate risk management tools to control these risks.

### Rules and procedures addressing credit risk

- 3) Further to the requirements in clauses (1) and (2) and in accordance with the requirement to have contingency plans in section 47 of the Act and *Standard 17A 'Contingency plans'*, an operator (where it bears credit risk) must establish explicit rules, policies, and procedures that fully address any credit losses it may face as a result of any individual or combined default among participants, with respect to any of their obligations under the rules of the FMI. These rules, policies, and procedures must:
  - a) address how potentially uncovered credit losses would be allocated, including the repayment of any funds that an operator or FMI may borrow from liquidity providers; and
  - b) indicate the process to replenish any financial resources that it may employ during a stress event, so that the FMI can continue to operate in a safe and sound manner.

### Payment systems and securities settlement system

- 4) Further to the requirements in clauses (1) and (2), either an operator of a pure payment system or an operator of a securities settlement system must ensure that:
  - a) it covers current and, where they exist, potential future exposures to each participant fully with a high degree of confidence using collateral and other equivalent financial resources (see *Standard 5: 'Collateral'*); and
  - b) the FMI maintains sufficient resources to cover the exposures of the two participants and their affiliates, who create the largest aggregate credit exposure in the system.
- 5) Clause (4) applies in a situation where the FMI operates with deferred net settlement in which there is no settlement guarantee, but where the FMI participants face credit exposures arising from its payment, clearing, and settlement processes.

## Central counterparties

- 6) Further to the requirements in clauses (1) and (2), an operator of a central counterparty must ensure that:
- a) it covers current and potential future exposures to each participant fully with a high degree of confidence using margin and other prefunded financial resources (see *Standard 5: 'Collateral'* and *Standard 6: 'Margin'*); and
  - b) it maintains additional financial resources to cover a wide range of potential stress scenarios that must include, but are not limited to:
    - i) where the operator is an operator of an FMI engaging in simple central counterparty activities, or the FMI is not systemically important in multiple jurisdictions (including in New Zealand), the default of the participant and its affiliates that would potentially cause the largest aggregate credit exposure in extreme but plausible market conditions; and
    - ii) where the operator is an operator of an FMI engaging in complex central counterparty activities, or the FMI is systemically important in multiple jurisdictions (including in New Zealand), the default of the two participants and their affiliates that would potentially cause the largest aggregate credit exposure in extreme but plausible market conditions; and
  - c) it determines the amount, and tests on a monthly basis, the sufficiency of the FMI's total financial resources available in the event of a default, or multiple defaults, in extreme but plausible market conditions through rigorous stress testing; and
- 7) Further to the requirements in clauses (1) and (2), an operator of a central counterparty must ensure that the results of all its stress tests are reported to the board of directors or senior managers of the operator or FMI and to use these results to evaluate the adequacy of, and adjust, the FMI's total financial resources. In addition, the operator must:
- a) on a daily basis, perform stress tests using standard and predetermined parameters and assumptions; and
  - b) on a monthly basis, perform a comprehensive and thorough analysis of stress testing scenarios, models, and underlying parameters and assumptions used to ensure that they are appropriate for determining the FMI's required level of default protection in light of current and evolving market conditions; and
  - c) on an annual basis, perform a full validation of a central counterparty's FMI's risk management model; and
  - d) in conducting stress testing, consider the effect of a wide range of relevant stress scenarios in terms of both defaulters' positions and possible price changes in liquidation periods. Scenarios must include:
    - i) relevant peak historic price volatilities; and
    - ii) shifts in other market factors such as price determinants and yield curves; and
    - iii) multiple defaults over various time horizons, simultaneous pressures in funding and asset markets; and
    - iv) a spectrum of forward-looking stress scenarios in a variety of extreme but plausible market conditions.

- 8) The analysis of stress testing in clause 7(b) should be done more frequently when the products cleared or markets served display high volatility, become less liquid, or when the size or concentration of positions held by a FMI's participants significantly increases.

*(See Guidance for Standard 4: 'Credit Risk', in Guidance for the FMI Standards for more detail).*