European Banking Federation

Chief Executive

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By e-mail

Mr David Wright
Secretary General
IOSCO
Calle Oquendo 12
28006 Madrid
Spain
Email: fmiresolution@iosco.org

Mr Klaus M. Löber
Head of Secretariat
CPSS
Bank for International Settlements
4002 Basel
Switzerland
Email: cpss@bis.org

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Subject: ***CPSS-IOSCO Consultative report on recovery and resolution of financial market infrastructures***

Dear Mr Wright and Mr Löber, Dear David, Dear Klaus,

The European Banking Federation (EBF) fully supports the initiative and generally endorses the approach of CPSS and IOSCO in defining guidelines for the recovery and resolution of financial market infrastructures (FMIs). Various regulations in most parts of the world and in Europe in particular are reinforcing the role and use of infrastructures in financial markets as a means to reduce systemic risk globally. It is hence essential that these infrastructures are adequately regulated to limit their likelihood of default but also that recovery and resolution regimes are properly defined to ensure the continuity of services in case of default.

Although banks do not regard themselves to be the primary addressees of the consultative report, the EBF, as the voice of Europe's banks, would like to make some general comments on key aspects of the report and give recommendations from the perspective of banks in their capacity as users of financial market infrastructures. The Federation indeed believes that some elements in the consultative report need to be reconsidered.

The EBF refers to the note produced by the TARGET Working Group (TWG) for more detailed comments concerning payment systems (see our reference 0313).

Different recovery and resolution approaches for different types of FMIs

The EBF and its members have found it rather difficult to grasp some sections of the consultative report which are written in a very technical, and sometimes confusing, way. To some extent, this confusion is due to the insufficient distinction between the different types of financial market infrastructures and between recovery, resolution and waterfall process when relevant.

a.i.s.b.l
56 Avenue des Arts - B- 1000 Brussels
+32 (0)2 508 37 11 Phone
+32 (0)2 511 23 28 Fax
www.ebf-fbe.eu

In this respect, the EBF considers the determination if an FMI takes on credit risks or not an important distinction in order to classify different groups for the application of different recovery and resolution rules and the achievement of different results. However, the Federation would prefer a clearer distinction between the different categories and specific types of financial market infrastructures and to reclassify them into CCPs, CSDs, SSSs, TRs, payment systems and others. Of course, overlaps are possible, for example when a CSD operates an SSS, but by reclassifying the financial market infrastructures more specifically, all peculiar features, issues and characteristics of the respective FMI can be taken into account more accurately. The EBF believes that this is crucial because different characteristics may call for different approaches, treatments and also possibly different results.

The Federation feels that the division into two groups merely according to credit risks is too undifferentiated in this respect. Financial market infrastructures have completely different structures in respect of services, business models, assumed credit risks, participants, users, customers, ownership, jurisdictions and links to other financial market infrastructures, financial markets as well as market participants. The question is also, whether the credit risk is the essence of the infrastructure and contributes to a risk mutualisation mechanism for the benefit of the market (like in the case of a CCP for example), or whether the risk taking activity is only ancillary and is not part of the systemically important services provided by the infrastructure (like in the case of a CSD providing credit facilities for example). Therefore, it is essential to recognise through the future global standards that the content of the recovery and resolution plans depends on the type of services provided by the FMI and the type of risks to which the FMI is exposed. In this respect, the EBF notes that the consultative report is silent on the question of which of the services are deemed to be systemically important.

Recovery and resolution regimes should concentrate on the systemically important infrastructure services with the main objective of ensuring the continuity of these services, while disregarding any other services offered by the infrastructure provided that they are not related to the systemically important services. It could be made optional for non-systemically important financial market infrastructures although national authorities may find it appropriate to apply these regimes as well as best market practices. At all events, in order to reduce the probability of default, the EBF strongly recommends that, in the first place, systemically important financial market infrastructures do not take risks that are not absolutely necessary for their core infrastructure services as any other risk taking activity would create additional risk for the system and could make the recovery and resolution plan more difficult.

Recovery and resolution plans should also distinguish between the corporate structure and the infrastructure services. Financial market infrastructures have very different ownership and governance structures, being part of a for-profit listed group or owned by a public authority like a central bank for instance. The priority for the resolution authority should be to ensure continuity of the important infrastructure services and disregard the consequences in terms of corporate structure, i.e. the legal entity may well be liquidated as a consequence of the resolution plan whereas the services should still continue to be provided.

Loss allocation arrangements

The EBF also believes that the recovery and resolution regimes should distinguish the type of event that has created the FMI's difficulty. When looking at financial market infrastructures that take on credit risk, especially the various credit risks and their consequences need to be taken into account: losses that emerge from the respective business model need to be treated differently from losses stemming from other sources such as false investments, operational losses, fines etc. The loss allocation arrangement should thus differ if the difficulty of the FMI is due to a member's default and the waterfall procedure is insufficient leading the FMI to recovery and resolution or whether the difficulty is due to financial or operational failure that would be under the direct responsibility of the FMI, its owner or operator. In the first case the loss sharing arrangement should involve the members (and the clients of the members where relevant) whereas in the second case the loss should be first supported by the shareholders and creditors of the FMI.

The EBF and its members consider in general that the loss sharing models (essentially relevant for CCPs) should cover the possibility that the potential fundraisings would be borne proportionally by the FMI, their members and the clients members. Indeed, a FMI participant is protecting the FMI from the risk of its clients however it does not protect its client from the FMI's default.

As a consequence, the Federation is of the opinion that the main concerns for the financial market infrastructures mainly exposed to operational risks are the continuity of their activities and data portability. This is not only important for Trade Repositories, given their role in providing supervisory authorities with a complete view of market participants' risk exposures to derivatives transactions, but also for CSDs which, until now, operate under a monopolistic structure in most countries. As a result, the non-functioning of an essential part of the market infrastructures will have a significant impact on the functioning of the financial market. This may even be more critical as regards payment systems on which not only the financial markets but the whole economy is reliant. The recovery and resolution plans should hence focus on business continuity and how to ensure that the services can be transferred to another operator or maintained by the resolution authorities for a temporary period.

In respect to the recovery considerations for financial market infrastructures that take on credit risk - which seems to particularly aim at the recovery of CCPs even though paragraph 3.10 of the consultative report states that also other financial market infrastructures have a "waterfall" – the EBF would welcome a clarification that all mechanisms that are in place to protect the CCP and its members from losses or distress (like the "waterfall") should stay safe from being used for the allocation of losses. The proposals in paragraphs 3.13 and 3.14 of the consultative report give cause for concern that certain solutions intervene into the waterfall or protection mechanism ("haircutting of variation margins"). This could result in jeopardizing not only the viability of the CCP but also, and furthermore, the market participants which could lead to systemic contagion being created. Even if the proposed haircutting takes place in respect of in-the-money-

participants, this may be only one of several possible solutions (auctions, haircuttings, default-funds, replenishments, supplementary payments, limits etc.) which would have to be developed and then should be discussed in depth.

More generally, the EBF believes that financial market infrastructures which combine different services are more complex to resolve and should require additional safeguards to allow resolution by activity and not necessarily for the entire legal entity. For example, with regards to multi-assets CCPs, the Federation would strongly recommend that the CCP guaranteed fund should be segregated by type of activity and instrument (one guaranteed fund for the equity clearing, a different one for listed derivatives clearing and others for OTC derivatives clearing, etc.). Such a set up would facilitate the resolution of the CCP, allowing different solutions by type of activity (continuing the clearing of equity, closing down the OTC derivatives ones, etc.). In addition, if the default of the CCP is due to an insufficient waterfall procedure, the loss sharing arrangement should only apply to participants in the relevant activities and not necessarily to all members of the CCP.

In this respect, the Federation would welcome the possibility to participate in further discussions on alternative solutions and aspects of loss allocation, especially in the discussion of possible end-of-the-waterfall procedures. We believe that it is crucial to take into account the thoughts of all affected parties (e.g. direct and indirect participants, users, customers, owners, operators and others).

Finally, the EBF believes that the future global standards should provide transparency requirements in order to ensure appropriate information to all stakeholders in relation to the financial market infrastructures. Although the Federation acknowledges that a resolution plan may be specific and that any decision from authorities will have to be tailored to the actual situation of the concerned FMI, some degrees of transparency is necessary for participants to assess their risks in using and participating in financial market infrastructures.

In conclusion, the EBF appreciates the attempt of CPSS and IOSCO to interpret the FSB Key Attributes, which are already known and accepted by the financial services industry, and convey them onto the resolution of financial market infrastructures. However, this attempt risks not taking into account adequately the individual and particular specifics and variations of financial market infrastructures. CPSS and IOSCO acknowledge the differences of financial market infrastructures from banks in section 4 of the consultative report but it would be more reliable to have a resolution regime which is tailored for financial market infrastructures respecting their differences and specific issues while reclining to the ideas of the Key Attributes.

Yours sincerely,

Guido Ravoet