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Euroclear response to the consultation by CPSS and IOSCO on Recovery and Resolution of FMIs

This response is provided on behalf of the Euroclear group of companies ("Euroclear"). Euroclear comprises the international central securities depository ("ICSD") Euroclear Bank ("EB"), based in Brussels, as well as the national central securities depositories ("CSDs") Euroclear Belgium ("EBe"), Euroclear France ("EF"), Euroclear Nederland ("ENL"), Euroclear UK & Ireland Limited ("EUI"), Euroclear Finland ("EFi"), and Euroclear Sweden ("ES").

Euroclear welcomes the opportunity of providing comments on this CPSS/IOSCO consultation. Our response is focused on the issues raised by the consultation in respect of CSDs, both those which have a banking license and take credit and liquidity risk, and those which are exposed only to legal and operational risks. As the consultation focuses on CCPs we have not answered each question posed, but rather we have taken a more holistic approach to the issues raised in respect of CSDs.

Executive Summary

- We believe that it is extremely important that a more detailed dialogue is held with CSDs globally before establishing the precise framework within which CSDs should be covered by Recovery and Resolution ("R&R") regimes. Many of the techniques proposed (such as "tear-up", and "bail-in" of creditors, collateral, margin or other sources of funds) have been designed for CCPs and are difficult, if not impossible, to apply to a CSD. See Section 1.
- Given the very low risk profile of CSDs, we would question whether the application of the FSB's "Key Attributes of Effective Resolution Regimes for Financial Institutions" ("the Attributes") is appropriate. See Section 1(i).

- We believe the construction of R&R regimes for CSDs (including those that take credit risk) should be governed by specific principles (or new Attributes) such as, "ensuring the enforcement of rights over collateral taken by the FMI in case of a default by its counterparty can be maintained during the implementation of an R&R regime". This and other principles are discussed and described in Section 1(ii).
- CSDs, irrespective of whether or not they grant credit, do not centralise risk for their participants. If the authorities were to choose to impose some form of loss-sharing, much greater discussion would be needed on how such a model could work; particularly given the diverse client base of CSDs (ranging from central banks to individuals). See Section 3(ii).
- In principle, the aim of insolvency proceedings is to ensure as much as possible the payment of creditors. We support the idea of constructing additional powers for an insolvency practitioner or administrator or public authority appointed to a FMI, under which that practitioner would have an additional objective to ensure (at least for a temporary period) continuity of service. See section 3(iv)

1 GENERAL COMMENTS

(i) Scope and Application of R&R regimes

We set out below a number of general comments in relation to the Scope and application of R&R regimes to CSDs.

(a) We recognise and support the need for a detailed dialogue on recovery and resolution plans for CSDs and accept that the financial crisis has led to a greater focus on the need to protect taxpayers from the costs of failing financial institutions. In addition, we believe that the current CPSS/IOSCO consultation represents an improvement on the framework for FMIs in comparison with the one drafted for (other) SIFIs by the Financial Stability Board. We note however, that the Consultation, although directed at all FMIs, is focused almost exclusively on the Recovery and Resolution Regime for CCPs. While we understand and support this focus, given the increasing systemic significance of CCPs, we believe a more detailed dialogue is needed with CSDs globally before establishing the precise framework within which CSDs should be covered. Even within the text of the current (short) consultation, CPSS/IOSCO recognise that many of the techniques proposed (such as "tear-up", and "bail-in" of creditors, collateral, margin or other source of funds) are difficult, if not impossible, to apply to a CSD.

(b) In addition, we would question whether the application of the FSB's "Key Attributes of Effective Resolution Regimes for Financial Institutions" ("the Attributes") to all FMIs is appropriate. We suggest that a specific and new set of Attributes should be developed for CSDs (see below). This is because the focus of the proposed resolution mechanisms for Financial Institutions ("FIs") is very different from that which is required for CSDs (regardless of whether they take credit or

liquidity risk). Not least because it is difficult to find a substitute service provider and, consequently, many of the tools described in the Attributes cannot be applied without significant modification.

(c) The R&R regime for FI's rightly focuses on the orderly wind-down or transfer of business, the potential separation of a 'good institution' from a 'bad institution', and the mechanisms for "bail-in" to protect the tax payer from shouldering the burden of losses at an FI. The FMI R&R proposals for CSDs however, require a very different emphasis; namely on ensuring the continuity of business and continuity of operation of the infrastructure. CSDs are focused on delivering essential infrastructure-style services to domestic (and increasingly international) markets. They are generally not exposed to their customers (other than for non-payment of fees) and do not issue debt securities to finance their business. They do not centralise risk nor do they mutualise risk; they act to remove risk from the market through DVP settlement and related services. Whilst unfortunately, there have been many examples of financial institutions failing, including some CCPs, we do not believe that a CSD has ever failed (certainly in the major world economies) precisely because of their extremely low risk profile. Many of them have been established with a significant number of "ex ante" measures in order to protect them against insolvency; these measures often include
    a. holding appropriate regulatory capital
    b. being exposed to legal and operational risk only
    c. restricting liability to instances of fraud or negligence only
    d. capping any such liability contractually
    e. holding insurance to cover any such claims
    f. loss-sharing mechanisms for securities losses (without any negligence committed by the (I)CSD)
    g. limiting their settlement and related services in order to reduce risk

(ii) Additional Principles that should guide the establishment of R&R regimes for CSDs

We support the concept that continuity of operations of CSDs is vital for the efficient functioning of European capital markets including the continued operation of monetary policy (in which CSDs play an indispensable role). But we believe the construction of R&R regimes for CSDs (including those that take credit risk) should also be governed by the following specific principles (or Attributes)

In order to ensure continuity of business, a CSD's Recovery Plan or the relevant Authority's Resolution Regime, should;

(a) have no effects on the DVP process nor on the application of the relevant settlement finality rules,
(b) be coordinated with contractors and service providers to ensure continuity of operations (e.g. the operator of T2S),

(c) allow all FMI participants to retain continuous access to the functions and services of the relevant CSD during the implementation of the Recovery Plan or during the Resolution phase,
(d) ensure that there is no disruption in the availability of client securities or cash,
(e) ensure that there is no disruption in the operation of links (particularly when used for monetary policy purposes),
(f) ensure that holding companies of CSDs are subject to a similar recovery and resolution regime, to the extent it is required to ensure continuity of critical services,
(g) ensure that a CSD is not impacted by any loss-sharing arrangements of another FMI (including, but not limited to, CCPs) to which it is linked, or to which it participates directly or indirectly through a standard or interoperable link, to ensure that the failure of that institution does not spread financial contagion to the CSD,
(h) for the same reason, ensure that a CSD is not impacted by the implementation of recovery or resolution measures in respect of Financial Institutions ("FIs"), including through bail-in clauses or temporary stays (see also point (i) below), and
(i) ensure that the enforcement of rights over collateral taken by the FMI (or taken by an FMI's settlement bank liquidity providers over their clients' assets) in case of a default by its counterparty can be maintained during the implementation of an R&R regime.

2 OBSERVATIONS ON RECOVERY FOR FMIs

We believe that the maintenance of adequate Recovery Plans by FMIs can contribute positively to the continued operation of key financial infrastructures and to the smooth functioning of financial markets. Given the extremely remote probability of a CSD default, we believe that the emphasis in these plans needs to be on the operational and business continuity of the CSD.

However, CPSS/IOSCO requires all FMIs to develop Recovery Plans to manage circumstances in which reserves prove inadequate "for example by raising additional resources from participants or shareholders ….". These obligations should be "clear, understood and legally binding". We believe that Recovery Plans for FMIs should also elaborate on alternative options, some of which are mentioned, but not detailed in the text. These could include references to,

(a) raising new capital from new or existing shareholders. This would imply amendments to applicable legislation (e.g. pre-emption rights, legal deadlines for organisation of assembly, use of permitted capital, etc),
(b) increasing fees (subject to strict compliance with Competition law),
(c) reducing costs significantly and quickly,
(d) disposing of some business lines,
(e) suspending dividend payments to the shareholders of the FMI,
(f) establishing strict liability caps and imposing insurance obligations on all CSDs.

The Consultation requires FMIs that take credit risk to have in place procedures to manage a participant default and to allocate losses that might result. But, the Consultation (as noted above) focuses almost exclusively on CCPs. A CCP centralises risk for a market, managing the risk of default centrally on behalf of all of its participants. Those CSDs that are banks are exposed to credit risk in relation to some of their clients, but they do not centralise risk for a market. The granting of credit by the CSD (usually intraday only and fully collateralised) is designed to reduce systemic risk by greatly reducing settlement fails, particularly in a multi-currency environment. Where a participant defaults, Euroclear Bank (for instance) already has in place strict risk management procedures based on a participant's collateral, conservative haircuts and the bank's own resources if eventually needed; these procedures already create a form of so-called "default waterfall". There is no reason to believe that this would be insufficient to meet a potential loss.

3 OBSERVATIONS ON RESOLUTION POWERS AND REGIMES

(i) Trigger point for Entry into Resolution

Clear standards and suitable indicators of 'non-viability' of an FMI and the failure of its Recovery Plan are needed. Resolution Authorities should act early to ensure continuity of business and to avoid the appointment of a traditional liquidator or administrator to the FMI (see below). But we believe that CPSS/IOSCO should define what is meant by the 'non-viability' of an FMI. Recovery options should be designed and calibrated in respect of the management's judgment about the point of non-viability of the FMI, which does not prejudge the actions of a regulator in the case of a crisis. An FMI should be able to demonstrate that it has options in its Recovery Plan to ensure a rapid recovery. "Rapid" will mean different things in different circumstances; in case of a loss requiring some form of recapitalisation, recovery may need to happen in a few days; in case of a wider and slower P&L issue (such as a longer-term structural business change) a recovery period might be several months, or longer, and could be subject to informal (and then formal) directions from the authorities in advance of reaching a trigger point for entry into Resolution.

(ii) Loss sharing

The consultation looks at a number of options for the authorities and FMIs in relation to recapitalisation and loss-sharing. We believe that a lot more dialogue is needed on this issue with all CSDs. In particular, and if the authorities were to choose to impose loss-sharing, discussion would be needed on whether and how any recapitalisation plan (or contribution to any default fund, see below) should be calculated; on to whom the burden of any possible loss sharing should fall (creditors? all clients of a CSD including individuals and public sector institutions, such as central banks? Indirect clients? Issuers served by the CSD? etc). We believe that the securities of clients deposited with a CSD must not be endangered in the case of a loss-sharing arrangement.

In addition, the potential for regulatory arbitrage as a result of such loss sharing mechanisms should be carefully examined by the authorities before introducing R&R regimes, because some activities of FMIs can compete with those of other financial market participants. Such arbitrage could lead to the transfer of business away from very low risk FMIs to other entities.

(iii) Bail-in

We believe that the option of a bail-in regime is not relevant for FMIs which do not issue debt or have no margin to haircut. Should bail-in of intra-group loans be required then it should not put another entity in the same group at risk. The application of the bail-in tool in case of intra-group loans also raises significant company law questions that should be scrutinized. Where liability is triggered through a negligence or breach of contract claim, it is unlikely that the creditor would accept equity in the FMI.

(iv) Administrator

We support the idea of constructing additional powers for an insolvency practitioner or administrator appointed to a FMI under which that practitioner would have an additional objective to ensure (at least for a temporary period) continuity of service. Such a regime might also allow unencumbered assets held in the FMI to be released immediately to ensure continued market liquidity. We note that the UK and Belgium already operate such a regime for certain utilities (such as energy and water suppliers).

(v) Default Funds

Default Funds are designed to cover excess losses in a default that occurs under "extreme but plausible" market conditions. Generally, CCPs operate on a "pooled" basis, meaning that non-defaulting clearing participants may be required to share any losses due to a default of another clearing participant. We do not believe that default funds are appropriate for CSDs (regardless of whether they are exposed to credit risk, or not); CSDs do not centralise risk for a market.

(vi) Transfer to a Bridge Institution

CPSS/IOSCO suggests that a resolution authority could choose to use a bridge institution as an interim solution to maintain the operation of an FMI's critical operations and services while a permanent solution is sought.

We agree that Authorities should have a broad range of Resolution tools available to them in law. However, in the context of a CSD with inbound and outbound links to other FMIs (including CCPs), close links to NCBs for monetary policy purposes, and a key role in delivering settlement services for domestic markets, it is unclear whether an intermediary bridge is needed, or could be constructed. The CSD might be subject to a specialised administration or liquidation regime (as described above) or it might be

transferred directly to the control of the Resolution Authority, or it might be bought by a third party, subject to the approval of the relevant competent authorities. But we are unclear what value a bridge institution would add.

However, should an authority decide that such a transfer is necessary then the conditions described in (a) – (i) on pages Section 1(ii) should be maintained.

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