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## LSEG RESPONSE TO CPSS-IOSCO CONSULTATION 'RECOVERY AND RESOLUTION OF FINANCIAL MARKET INFRASTRUCTURE'

Submitted to: cpss@bis.org, fmiresolution@iosco.org

1. The London Stock Exchange Group (LSEG) welcomes the opportunity to respond to CPSS-IOSCO's consultation 'Recovery and resolution of financial market infrastructure'. This submission represents the views of the London Stock Exchange Group and the companies within it.

2. LSEG is well qualified to respond to this consultation. We operate a CCP and central securities depository in Italy, alongside our other market infrastructures in the UK.

3. Cassa di Compensazione e Garanzia S.p.A. (CC&G) manages the Central Counterparty Guarantee System (CCP) for Italian securities, acting as guarantor of the final settlement of contracts; Monte Titoli S.p.A offers post-trading services and centralised administration of financial instruments providing competitive, efficient and secure services in a framework of international co-operation.

4. Italian domestic legislation already addresses crisis management and is aligned with the current CPSS-IOSCO proposals on recovery and resolution. Specifically, the Bank of Italy's resolution powers include acting in the place of the managers of the systems and services of the Financial Market Infrastructure (FMI). In the event of an FMI insolvency, the Government can issue a decree ordering that the company be placed under compulsory administration. The administrator will have all the powers needed to address the crisis.

5. In the UK, HM Treasury has consulted on recovery and resolution measures for a range of systemic FMIs[1]. The consultation discusses systemic investment firms, CCPs, other FMI and insurance companies, and the framework of powers and measures that might be required, covering many of the same issues as this consultation.

6. The scope of our response covers CCPs, CSDs, and trade repositories but in many areas we focus primarily on CCPs as we see them as key at this stage. Trading venues are out of scope of the consultative report.

[1] http://www.hm-treasury.gov.uk/consult_financial_sector_resolution_broadening_regime.htm

7. Our response to this consultation is in two parts:

   - Part 1 – general principles underpinning our approach to recovery and resolution as discussed in this consultation
   - Part 2 – responses to some of the specific questions in the consultation

8. In Part 2 we have applied a sub-heading indicating which types of FMI are in scope for the particular response. Although the questions in the consultation are not numbered, we have numbered them in this document for ease of reference.

9. We acknowledge our comments may be published on the BIS and IOSCO websites.

## PART 1 – GENERAL PRINCIPLES

10. In this section we set out some of the key principles that we believe must be taken into account when considering recovery and resolution arrangements. They inform the responses we give to particular specific questions in Part 2.

### 1. There is not a common recovery and resolution regime that would fit all FMIs

11. We acknowledge that recovery and resolution plans for all types of financial institutions, including financial market infrastructures, are essential tools for preventing and mitigating the effects of financial crises, and a necessity for strengthening the safety and soundness of global financial markets.

12. However, there will not be a common resolution regime that will fit the full range of all types of MFIs. Although CCPs can be broadly grouped into an industry standard business model, other FMIs, as described in the scope of the consultative report, are more diverse. For instance, CSDs maintain a low risk profile and are structured and regulated in a way which mitigates risk to the greatest extent possible. The likelihood of a CSD failure is extremely low, thanks not only to its risk management practices but also the use of liability caps and comprehensive insurance arrangements used to cover potential losses. Therefore we suggest that resolution regimes will need to take into account, and deal with, the specific risk profile of different FMIs, particularly as between those that take credit risk and those that do not.

13. As a result, the focus should be on establishing recovery arrangements that are most appropriate for the particular FMI in question and ensure operational continuity, and we suggest that it will be difficult to establish an over-arching framework that applies to all, except in some principles at the highest level. It will be important to establish the range of powers available, but it is also useful for the resolution authority to have some flexibility in terms of when and how to act in the best interests of the market, participants and the FMI. As with the Italian conservatorship regime, the administrator has a suite of resolution and stabilisation powers, which could include, for example, various resolution tools

such as bail-in, transfer to a third party and creation of a bridge institution. It also allows for the freezing of the debts of the FMI (which could be commercial or legal debts) for a period of time to find the best suitable solutions to address the crisis, depending on the circumstances at the time.

14. We believe that in all cases, the focus should be on FMI having detailed and firm recovery plans, to ensure operational continuity and on a principle of certainty in the way powers may be exercised.

## 2. The resolution authority should not have an automatic power to place a moratorium on payments

15. While a moratorium on operational payments (i.e. operational costs of doing business as opposed to critical systemic activities) may be important in order to prioritise resolution of the FMI's critical or systemic functions, resolution authorities should not have an automatic power to place a moratorium on payments relating to the critical system activities, payments or payments on settlements/exercise. For CCP FMIs, calling and paying margin to/from different participants are their critical function as a CCP, and applying a moratorium on these payments would increase systemic risk by causing contagion to other financial institutions, and defeat the very purpose of resolution measures. One such model is the Italian conservatorship regime, where the conservator has the ability to freeze operational, non-critical debts for a temporary period whilst the FMI is in recovery/resolution.

## 3. Margin and collateral should not be included in any 'bail-in' measures

16. Initial margin, variation margin and all other types of client margin would not normally be available to administrators of a CCP in an insolvency, and it is not appropriate that they should be included within any proposed bail-in arrangements. If implemented, these bail-in provisions should be limited to owners and members in terms of capital and mutualised guarantees. Furthermore, it is critical that, at a time of high market stress, action should not be taken that adversely affects the open positions and margin/collateral of non-defaulters; their assets should not be used to cover the losses of defaulters or the potential failure of the CCP. In our view, this would risk causing substantial systemic risk and a loss of market confidence, and in the CCP, to the point of rendering resolution efforts ineffective and having an impact on the broader market and economy.

17. We would also suggest that, in relation to CCPs in the EU, we would expect that the regulatory standards in EMIR should specify risk management procedures such that a recovery scenario including bail-in should be a remote possibility.

## 4. Loss allocation should not extend to the margin funds of surviving participants in a CCP

18. Similarly, for the reason as outlined in point 3 above, the margin and collateral of non-defaulting participants should not be used in any loss allocation arrangements. Allocating losses to non-defaulting participants' margin funds would undermine their ability to calculate their exposures and lead to a fundamental collapse in market confidence. This would be counter-intuitive for resolution measures to prevent systemic disruption. Participant margin pools should be ring-fenced and allocated only for the specific purpose of default management. This approach would also have the merit of establishing rules that are certain, which is a key requirement in times of market stress, defaults and CCP/FMI recovery.

## 5. In both member default and CCP recovery/resolution, a CCP should operate on the basis that its first priority is to re-allocate or transfer positions, and if this cannot be achieved for whatever reason, to cancel and cash settle, using defaulter's available margin, default fund, insurance and guarantees to cover liabilities

19. We refer to 'tear-up' as cancellation and cash settlement. This forms part of the recovery and resolution process in the same way that it should form part of standard default procedures employed by a CCP, whether or not resolution powers have been initiated.

    - In the event of a default, the CCP will first establish whether positions can be transferred to another participant(s), either via 'auction' or otherwise.
    - For positions that no participant is willing or able to take on, the CCP will then cancel and cash settle the positions based on margin payments due to/from members.

20. No haircuts should be applied to the margin of non-defaulting members to cover the losses from tear-up, as we suggest that this would have the highly undesirable effect of damaging market confidence and significantly increasing systemic risk. Non-defaulting participants need to have confidence that their open positions and the margin/collateral that supports them will continue to exist and be available for application as part of their on-going risk management activities.

21. If, despite the application of the relevant capital and other regulatory/prudential measures, a CCP finds itself in a potential failure situation, where losses are so extensive that substantial replenishment of funds is required from owners and members/users, then the situation more generally in the market is likely to be so severe and unstable that it may not be realistic or feasible to achieve recovery. It may be that the final option for CCP resolution may be to require a close out and cash settlement of all remaining open positions within the CCP.

## 6. Recovery and resolution regimes should not give rise to open-ended liability

22. In our view, recovery and resolution regimes should not give rise to an open-ended liability for members or owners to indefinitely recapitalise a failed CCP. Any recapitalisation requirements should be subject to a limit such that owners', members', and shareholders' liability to refresh capital and guarantees is limited to a maximum of the amount they previously provided and to only one re-provisioning. We suggest that an open-ended requirement to recapitalise would be inconsistent with the principle of corporate limited liability. Owners and members of a CCP need to be able to assess their maximum possible liabilities in order to manage their exposures and capital effectively; an unlimited liability would have the effect of preventing or inhibiting this.

23. We also question whether an approach that assumes an indefinite and uncapped liability fails to recognise the extent of market and general financial instability that would probably pertain where a CCP has failed to the extent that it requires such continuous support.

24. Furthermore, as shown by recent market crises, it may not be possible to ensure full loss replenishment in a failed FMI. For this reason, a nationally appointed resolution authority (such as the conservatorship regime in Italy) may offer the best approach in allowing the application of powers, depending on specific FMI and market circumstances.

## 7. Assessment of systemic status – resolution authorities should undertake periodic systemic assessments and inform FMIs that are deemed systemic

25. We suggest that resolution authorities will need to undertake periodic systemic assessments of FMIs and inform the institutions that are deemed systemic. This will be important for a number of reasons:

    i. So that systemic FMIs can put in place effective resolution plans, as would be required under a foreseeable resolution regime
    ii. So that systemic FMIs can meet their transparency requirements to their regulators, members, users and owners
    iii. So the FMIs that are, or are part of, listed companies can comply with any applicable requirements under the listing requirements of their jurisdiction

## PART 2 – CONSULTATION QUESTIONS

### Q1: In what circumstances and for what types of FMI can a statutory management, administration or conservatorship offer an appropriate process within which to ensure continuity of critical services?

26. As described in paragraph 12 of Part 1, we suggest it will be difficult to establish an over-arching framework that applies to all FMIs, except in for some high level principles. Therefore, the appropriate approach would need to be tailored for each type of FMI and address the different market functions that are particular to them. We outline in our response to question (2) a number of considerations we think would be relevant when formulating resolution regimes for systemic FMIs.

### Q2: Are there powers beyond those of a standard insolvency practitioner that a statutory manager, administrator or conservator would require in these circumstances?

27. In certain resolution circumstances, it is possible that the resolution authority would require powers beyond those of a standard insolvency practitioner in order to achieve effective resolution without systemic disruption. As with the Italian conservatorship regime, the administrator has a suite of resolution and stabilisation powers, which could include, for example, various resolution tools such as bail-in, transfer to a third party and creation of a bridge institution. It also allows for the freezing of the debts of the FMI (which could be commercial or legal debts) for a period of time to find the best suitable solutions to address the crisis, depending on the circumstances at the time. We discuss some of these below:

- **Freezing of payments** – As discussed in the context of the Italian 'conservatorship' model, a resolution authority will need powers in some cases to freeze payments in non-critical activities

- **Transfer to alternative provider** – In cases where an FMI is conducting a commercial or fee-paying service, insolvency practitioners may be able to find alternative providers willing to acquire for some consideration, all or part of the service.
- **Temporary public ownership** – In other cases, an insolvency practitioner may not be able to find an alternative provider, because it is not financially attractive or no alternative exists, and this may require a framework that includes resolution by taking the entity into public ownership.
- **Service/activity substitution** – In some areas, no action may be necessary because the service is provided in a highly competitive or fragmented environment where activities migrate easily and rapidly to other providers (for example, trading instruments between MTFs).

28. **Third party assets**
    The type of approach may depend on whether the FMI has custody or control of assets of third parties (e.g. payment systems and CSDs) or performs a record keeping function (e.g. trade repositories), or services that do not entail holding or controlling any client assets (e.g. trading venues). Similarly, any FMI undertaking a banking type business as part of its activity will require a different regime to other, non-bank entities.

29. **Entity or service resolution/transfer basis**
    Any framework would have to allow for managing entire FMI entities or a relevant part.

30. Finally, we stress careful consideration be given should any proposed recovery and resolution regime require a change to existing insolvency law. This should be based on public consultation and include an appropriate timeframe for companies of all types to prepare for its introduction.

**Q3: Is tear-up an appropriate loss allocation arrangement prior to resolution of a CCP? If so, in what circumstances?**

**Q4: To what extend should the possibility of a tear-up in recovery be articulated in ex ante rules**?

**Q5: Should there be a limit to the number of contracts that are eligible for tear-up?**

**Q6: How should the appropriate haircuts be determined?**

31. We offer a combined response to questions 3, 4, 5, and 6, and restrict the scope of our response primarily to CCPs.

32. It is suggested that further detailed discussion will be required in this areas based upon more detailed proposals from CPSS-IOSCO. This is because it is likely that the circumstances in which tear-up or cancellation and cash settlement might be used may vary between CCPs, since some CCPs do not operate an auction process that would in itself lead to tear-up as a resolution tool. If it is considered that tear-up, following auction, should form part of the tools available to a resolution authority, we would suggest further consultation with CCPs in order to understand how tear-up could be applied amongst a range of different operating models in use.

33. However, would also repeat our points in our statements of principle that no haircuts should be applied to the margin/collateral of non-defaulting CCP participants as this would create a loss of confidence in the market, and that tear-up (or cancellation and cash settlement) should be considered as part of the standard default procedures available to a CCP.

**Q7: What qualitative indicators of non-viability should be used to determining the trigger for resolution for different types of FMI?**

34. We would suggest that, since the conditions determining the trigger of resolution powers are such a critical element of an effective resolution regime, more detailed consultation would be required in this area. However, we outline below some broad principles that may be considered as part of the trigger conditions for an effective resolution regime.

- The competent authority should have deemed the FMI to be breaching its regulatory threshold conditions; or, the competent authority must have deemed that the FMI is likely to breach it regulatory threshold conditions,
- The likely breach of conditions should be based on qualitative and quantitative criteria based on consultation with FMIs
- No action, other than resolution action, would restore the FMI to viability
- The FMI has been deemed systemic based on periodic assessment as part of the resolution regime

35. It is likely that there will be advantages and disadvantages with any design for a resolution regime trigger. For instance, consideration would need to be given to the extent of involvement of the competent authority/resolution authority in the period prior to the triggering of the resolution powers. We would suggest that the general approach seeks to ensure that the competent authority has sufficient flexibility and independence to assess the trigger conditions in a crisis situation. For example, any trigger condition that includes 'likely failure' may need further definition in order for an FMI to understand the point at which the competent authority would, or would likely, initiate the resolution process.

36. Assessment of the verification of trigger indicators should be detailed and impartial. There may be a need for guidelines around the trigger for resolution to assist resolution authorities. For instance, it is possible that it could be complicated to assess when exactly a default waterfall has been exhausted and the operational capital of the FMI has been affected as a result of unpaid credits.

37. We offer these parameters as broad starting point for the development of principles for the trigger of a resolution regime, and would welcome further consultation in this area.

**Q8: What loss allocation methods must be available to a resolution authority, and for which types of FMI? Could or should these resolution powers include tear-up, cash calls or a mandatory replenishment of default fund contributions by an FMI's direct participants? Does it make a difference if the losses are from a defaulting member or are made up of other losses (e.g. losses in investments made by the FMI)? In what circumstances, and by what methods, should losses be passed on beyond the direct participants – e.g. to the clients or FMI shareholders – in resolution?**

38. We repeat the points we made in Part 1 as a framework for the response to this question:

- Recovery and resolution regimes should not give rise to open-ended liability
- Margin and collateral of non-defaulting participants should not be included in bail-in or loss allocation measures for CCPs
- a CCP should operate on the basis that its first priority in the event of default is to re-allocate positions, and if this cannot be achieved, cancel and cash settle, in both member default and CCP failure/resolution scenarios
- the resolution authority should not have an automatic power to place a moratorium on payments

39. When developing resolution regimes, it is critical that there is certainty about how FMI loss allocation would take place, in order to preserve market confidence. Any sense of confusion or uncertainty in the market with regard to allocation of losses or calculation of liabilities would lead to contagion and greater systemic risk.

40. We would also suggest that FMI resolution plans should not stipulate procedures for the allocation of losses to clients of members, as it may be inappropriate to introduce a duty of care for an FMI towards firms with whom it does not have a contractual relationship.

**Q9: What, if any, special considerations or methods should be applied when allocating losses whose maximum value cannot be capped (e.g. when allocating potential losses that might arise from open and uncapped positions at a CCP)?**

41. Again, as outlined in our response to question 8, we believe that the market will look for certainty with regard to loss allocation. Recent experience tends to suggest that any scope for debate or argument as to, for instance relative liability for reconstituting an entity, will cause delay and lead to market uncertainty. This has the potential to lead to increased systemic risk and contagion. On that basis, we would suggest that the requirement to bear losses/reconstitute should provide for certainty if they are to be successful.

**Q10: How should equity in FMIs be treated in resolution scenarios: should it be written down in all circumstances?**

**Q11: Are there any circumstances in which loss allocation in resolution should result in a different distribution of losses to loses borne in insolvency? Does it make a different if the losses stem from a defaulting member or are made up of other losses (e.g. losses in investments made by the FMI or resulting from operations risks)?**

**Q12: should an FMIs rules for addressing uncovered losses be taken into account when calculating whether creditors are no worse off in resolution than in liquidation?**

42. We offer a combined response to questions 10, 11 and 12, and frame our response in the context of our statements of principle:

- Recovery and resolution regimes should not give rise to open ended-liability
- Loss allocation should not extend to the margin funds of surviving participants

43. We also repeat the point from our response to question 9, that the market will look for certainty with regard to loss allocation, and on that basis, we would suggest the requirements to bear losses and/or reconstitute should provide for certainty if they are to be beneficial.

44. Finally, drawing on our principle in paragraph 15 of Part 1 that resolution authorities should not have an automatic power to apply a moratorium on payments, in order to safeguard systemic payment activities, equally, it would be prudent to allocate a hierarchy of creditors whereby systemic unsecured creditors of the FMI are prioritised in order to support financial stability. This would, for example, include the margin posted by CCP members. It would be prudent, in order to preserve market confidence, that this principle should apply whether the FMI is in resolution or recovery.

**Q13: Are there any circumstances in which the ability to exercise termination rights as a result of the use of resolution powers should outweigh the objective of ensuring continuity?**

45. We suggest that there is the potential that the exercise of termination rights by critical third parties could exacerbate CCP failure in a resolution scenario. Therefore, it should be considered important that certain key suppliers are required to maintain a level of service even when resolution powers are launched. An example would be Regulation 14 of the UK Special Administration Regime for Investment Firms which adapts the provisions of section 233 of the Insolvency Act 1986, requiring continuity of supply of IT and other services in the event of resolution. As a result, it is suggested that there are unlikely to be many circumstances where the ability to exercise termination rights would outweigh the objective of ensuring continuity.

**Q14: Are there any circumstances in which a temporary stay on exercising termination rights should apply for any event of default and not just where triggered by the resolution authority?**

46. We find some difficulty in responding to this question, as we are not clear whether ‘event of default’ refers to the default of an FMI member firm, or the FMI

being in default in breaching its contract in some with a supplier, client or provider in more general terms.

47. However, we will respond with reference to an FMI member default. It is possible to take the view that member default should not necessarily lead to a stay on termination rights. CCP regulatory requirements under EMIR, for example (when considering CCPs in the EU), already ensure that a CCP can effectively manage a member default based on its capital reserves and risk management parameters. Therefore, it is possible that applying a stay on termination rights may suggest to the market that the CCP is unsure of its ability to meet its on-going obligations, which would be detrimental to market confidence and financial stability. As a result, it is unlikely that there may be many circumstances in which a temporary stay on termination rights would apply for any event of default.

**Q15: Are there any circumstances in which a moratorium with a suspension of payments to unsecured creditors may be appropriate when resolving an FMI? Should this be limited to certain types of FMI and /or certain types of payment?**

48. In response to this question, we repeat our point from our statements of principle that the resolution authority should not have an automatic power to place a moratorium on payments. However, we would offer to two further points for consideration:

- **Systemic creditors**: for example, member firms that have provided initial or variation margin at an FMI or are otherwise dependent on its services for continuity. We would suggest that there should be no moratorium on payments to these creditors since the FMIs' activity in this respect is systemic, and a moratorium would go against the aims of a resolution regime.

- **Operational creditors**: for example providers of day-to-day operational functions of the FMI. We would suggest that when developing a resolution regime, consideration is given to the possibility of allowing a moratorium on payments to these types of unsecured creditors if it is in the interest of ensuring financial stability and market confidence. We would suggest that any proposed moratorium powers are based on careful consultation and are publically available prior to any resolution scenario, in order to provide as much certainty as possible.

**Q16: If so, should resolution authorities retain the discretion to apply a moratorium and, if so, what restrictions (if any) on its use would be appropriate (e.g. scope, duration or purpose)?**

49. As outlined in question 15, we suggest that there are certain circumstances where such powers may be desirable. With regard to their scope, duration or purpose, this should be based on consultation with the market, though we would

suggest that it would be sensible if the powers lasted, at most, no longer than the length of time that the FMI is within the resolution regime.

**Q17: Should the bail-in tool be available to collateral, margin (including initial margin) and other sources of funds if they would bear losses in insolvency?**

50. In this response, we refer to paragraph 16 in Part 1.

51. Margin and collateral should not be included in any 'bail-in' measures. Initial margin, variation margin and all other types of client margin would not normally be available to administrators of a CCP in an insolvency, and it is not appropriate that they should be included within any proposed bail-in arrangements. If bail-in were to be implemented, these measures should be limited to owners and members in terms of capital and mutualised guarantees. Furthermore, it is critical that at a time of high market stress, action should not be taken that adversely affects the open positions and margin/collateral of non-defaulters; their assets should not be used to cover the losses of defaulters or the potential failure of the CCP. In our view, this would risk causing substantial systemic risk and a loss of market confidence, and in the CCP, to the point of rendering resolution efforts ineffective.

52. We would also stress that the best solution will vary between FMIs. As stated in Part 1, there is not a common resolution regime that would fit all FMIs. Therefore it is likely that the feasibility of using bail-in as a resolution tool would vary depending on the systemic FMI in resolution.

**Q18: In what circumstances and for what types of FMI should wider loss recovery arrangements exist beyond the FMI's own rules and the resolution powers of the resolution authority?**

53. As a result of most FMIs having capital requirement regimes explicitly designed to cope with a wide variety of market impacts, it is difficult to imagine how a particular risk could cause the systemic failure of an FMI that stretched beyond the capacity of not only the FMIs rules but also the capacity of the resolution authority's powers.

54. However, when considering any such possible arrangements, the overriding priority should again be providing the market with certainty. We would suggest that the solution should be predictable and quantifiable for all market participants.

**Q19: In conducting a resolvability assessment of an FMI, what factors should authorities pay particular attention to?**

55. It is likely that there are more factors that should be taken into account when authorities are conducting resolvability assessments than could be included within the scope of this consultation response. However, we would suggest that

the following factors should be included, within the broader range of assessments, when a resolution authority is undertaking a resolvability assessment:

- Resolution authority performs regular systemic assessment of FMIs and informs FMIs whether they have been allocated systemic status
- Assess the possible impact of competition law on resolution plans should these include the sale of an FMI to a commercial party
- Assess the impact of FMI systemic status on the disclosure and transparency rules should an FMI be, or be part of, a company that is publically listed
- Assess the interaction between insolvency law and the resolution regime to assess how they will interact and how the resolution regime accommodates insolvency law

**Q20: In addition, is the summary of the application of the Key Attributes to FMIs provided in the annex sufficiently detailed to support the development of recovery and resolution regimes for FMIs? Are there specific areas where more detail could be provided? If so, which areas and what additional detail should be provided? Are any of the key attributes not applicable to a particular type of FMI? If so, which key attribute(s) and why not?**

56. We refer back to paragraph 12 in Part 1, that there is not a common recovery and resolution regime that would fit all FMIs. Similarly, we suggest that the FSB Key Attributes, when applied to FMIs, are also too high-level to address the different types of FMI in scope. Given our view on some of the resolution measures described in this document, such as bail-in, payment moratoria and CCP resolution, it is likely that even some of the key attributes of the Financial Stability Board may need to be revised or amended in those areas in order to provide for a flexible enough set of Principles.

## CONTACT

**Martin Batty**
Regulatory Strategy
London Stock Exchange
London Stock Exchange Group
T +44 20 7797 3449
mbatty@londonstockexchange.com

**Paola Fico**
Regulation & Post Trading
Borsa Italiana
London Stock Exchange Group
T +39 027 242 6285
paola.fico@borsaitaliana.it