Comment on the IOSCO consultative report on the recovery and resolution of financial market infrastructures

Introduction

On the 31st of July 2012, a consultative report on the *Recovery and Resolution of Financial Market Infrastructures* was issued by the Committee on Payment and Settlement Systems (CPSS) and the International Organization of Securities Commissions (IOSCO).

Subsequently the Financial Services Board (FSB) has requested the SAFEX Clearing Company (Pty) Limited (SAFCOM) and Strate Limited to provide feedback and commentary on the report. This report serves as a consolidation of Strate Limited's and SAFCOM's views on the contents of the document.

Background

Strate Limited is a licensed Central Securities Depository (CSD) for the electronic settlement of financial instruments in South Africa.

Strate handles the settlement of a number of securities including equities and bonds for the Johannesburg Stock Exchange (JSE) as well as a range of derivative products such as warrants, Exchange Traded Funds (ETFs), retail notes and tracker funds. It is also responsible for the settlement of money market securities to its portfolio of services. It provides services to issuers for their investors in terms of the Companies Act and Securities Services Act (SSA), 2004.

SAFEX Clearing Company (Pty) Limited operates as a clearing house for the Johannesburg Stock Exchange derivatives markets. It was incorporated in 1987 and is based in South Africa. As of October 2008, SAFEX Clearing Company (Pty) Limited operates as a subsidiary of the JSE.

Annexure A

Strate Limited's responses to the questions raised in the CPSS-IOSCO consultative paper on Recovery and Resolution of FMIs

General Comment

In compiling a response to the request for comment by CPSS-IOSCO, Strate has reviewed the Consultative Report, the Key Attributes of Effective Resolution Regimes for Financial Institutions (issued by the Financial Stability Board) as well as the Principles for Financial Market Infrastructure and the associated recommendations for Regulators.

Strate believes that the Consultative Report has been generally well thought out and represents a comprehensive assessment of the likely impacts in the event of FMI default or failure as well as an effective guideline to assist individual FMI's in the development of an appropriate and effective Recovery and Resolution plan. The broad differentiation between those FMI's that assume credit risk and those that do not is also considered most appropriate to take into account the different roles and responsibilities of individual FMI's.

It is, however, very clear from this exercise that a comprehensive review of the Resolution Regimes contained in current and proposed future legislation will need to be undertaken to ensure that the ideals contained in the referenced documents are suitably entrenched and understood.

Specific responses to questions raised:

The following responses and comments have been put forward for each of the specific questions raised in the *Recovery and Resolution of Financial Market Infrastructures* report.

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

The consideration as to whether statutory management, administration or conservatorship would offer the most appropriate process within which to ensure the continuity of critical services is, in our opinion, directly linked to the speed with which such an arrangement could be effectively implemented within the framework provided in local legislation rather than the type of FMI. This does, however, also link to question 2 below.

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

Potentially, yes. This assessment can, however, only be completed with a full legislative review in the particular jurisdiction to ensure that the appointed authority has the necessary authorities already outlined in the Consultative Paper. Key to this assessment will be the ability to ensure the speedy assumption of control by the appointed authority.

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

   Unable to comment – not applicable to Strate

4. To what extent should the possibility of a tear-up in recovery be articulated in ex ante rules?

   Unable to comment – not applicable to Strate.

5. Should there be a limit to the number of contracts that are eligible for tear-up?

   Unable to comment – not applicable to Strate.

6. How should the appropriate haircuts be determined?

   Unable to comment – not applicable to Strate.

7. What qualitative or quantitative indicators of non-viability should be used in determining the trigger for resolution for different types of FMI?

   Key to this decision is the role of the particular FMI. In the case of non-credit risk bearing FMI's the indicators would tend to be qualitative rather than quantitative once the primary measurement of adequate reserves has been addressed. In the case of Strate, this would include many elements assessed by its lead regulator in terms of the annual licence renewal process (including such things as competencies, quality of service delivery, operational capacities, robustness of existing technology etc.).

8. 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?

To the extend applicable to Strate, losses in investments made by the FMI would be allocated directly to its shareholders rather than to its participants in any way.

9. 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)?

Unable to comment – not applicable to Strate.

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

From a Strate perspective, and given the nature of the risks borne by the CSD, no need for differentiation in the treatment of equity write-downs could be identified.

11. Are there circumstances in which loss allocation in resolution should result in a different distribution of losses to losses borne in insolvency? Does it make a difference 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 operational risks)?

Given the profile of Strate it is not envisaged that there should be any difference in the loss allocation regardless of whether by resolution or insolvency.

12. Should an FMI's rules for addressing uncovered losses be taken into account when calculating whether creditors are no worse off in resolution than in liquidation?

Unable to comment – not applicable to Strate.

13. 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?

Given the profile of Strate this would only apply to contracts for services from third parties and to the extent that the ability to exercise termination rights relates to non-core services, this may assist in minimizing the immediate negative financial impacts on the FMI. It is unlikely that one would wish to invoke the early termination of core services as part of a resolution process.

14. 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 measures?

As with 13. above, the profile of Strate reduces the need to exercise, or indeed temporarily stay, termination rights whether as a result of default or resolution.

15. 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?

The benefit of introducing a suspension of payments to unsecured creditors to assist in the resolution of an FMI such as Strate would be minimal and, given the specific nature of the role that Strate plays in the market, is unlikely to affect (either positively or negatively) its ability to continue settling or processing transactions which are processed directly between counterparties through the Central Bank payment system or, as is the case with Corporate Events processing, through Trust accounts which could effectively be ring-fenced from the FMI itself.

16. 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)?

Given the response to 15 above, this is not considered relevant to Strate other than to the extent that the Resolution Authority may wish to defer payment on non-core services in terms of existing powers. No special powers are considered necessary.

17. 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?

Unable to comment – not applicable to Strate.

18. 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?

Not applicable to Strate as it does not assume principal risk in any of the transactions it processes. The CSD Rules already cover the CSD adequately in this respect.

19. In conducting a resolvability assessment of an FMI, what factors should authorities pay particular attention to?

The assessments outlined in Annexure II of the Key Attributes of Effective Resolution Regimes for Financial Institutions issued by the Financial Stability Board are considered sufficiently comprehensive to conduct a resolvability assessment.

20. 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?

Other than those areas already identified in the Annex as being not applicable to an FMI like Strate, no additional areas could be identified and no additional detail is considered necessary to assist Strate, in consultation with its Lead Regulator, in the development of an appropriate Resolution Plan.

Annexure B

SAFEX Clearing Company (Pty) Limited (SAFCOM)'s responses to the questions raised in the CPSS-IOSCO consultative paper on Recovery and Resolution of FMIs

Introduction:

As part of its review of the *Recovery and Resolution of Financial Market Infrastructures* report, SAFCOM consulted a number of content matter experts within its organisation to gather a variety of perspectives on the considerations put forth in the document - this consultative approach was necessary in light of the broad impact these concepts would have on areas within the CCP, including (but not limited to) our Operations, Legal and Surveillance divisions.

This response aims to provide 2 levels of feedback: initially we would like to put forward some general comments on the overall Recovery and Resolution framework elements described in the report, before providing specific responses to the various questions presented in the document.

General Comments:

Based on our overall review of the report, the following points have been raised:

- SAFCOM is supportive of a recovery and resolution regime that is formulated on broad-based principles and standards - but these need to be considered in a context-specific basis. The underlying differences between a developed and developing world economy are absolutely significant, and market infrastructures and regulators should not apply a uniform, one-size-fits-all approach to their design and implementation.

- The notion of a resolution authority is interesting when considered in the South African context: This principle would be easier to implement in larger, foreign markets that may have a number of competing CCPs operating in a single jurisdiction – whereas ours is an emerging economy that does not have an abundance of resources capable of providing the function of an alternative CCP (should such a situation ever come to fruition, such as in the case of curatorship). With this in mind, restoration of the CCP should be of paramount concern, and while our regulatory structure may allow for an alternative mechanism for the provision of clearing and settlement services, the practicality and viability of implementing this option is highly questionable.
- A number of underlying considerations need to be contemplated as part of the design of an effective recovery and resolution structure for FMIs. These include:
    - Basis for the quantification of the default fund;
    - Evaluation for the liquidity requirements for CCPs;
    - Definition of the capital adequacy requirements for CCPs; and
    - The manner in which collateral is to be treated and managed (i.e. haircut guidelines, principles for eligibility, liquidity considerations as they relate to collateral, optimal ratios for cash vs. non-cash collateral etc.)

  While we would be hesitant to support a highly dogmatic and mechanical approach to these items, we do believe that there should be more broad guidance (in the form of position papers) to assist with the proper consideration of these topics. CCPs are hampered by a lack of international benchmarks and global precedents in this area, which has forced them to adopt (for better or worse) niched, non-standardised methodologies. A balance should be maintained between solutions that reflect the idiosyncrasies of the local ecosystem, and broad unified global standards.
- In addition, South Africa has distinctive account level margin segregation and bankruptcy remoteness of margin assets which should be preserved in any CCP default management or resolution arrangements.
- The recovery and resolution framework should be harmonized with other financial markets regulations: The impact of the BASEL lll and CPSS-IOSCO (together with G20 recommendations), should be considered in an holistic manner, and moreover, the impact of these regulations on common points of reference (such as liquidity and collateral) should be evaluated through a quantitative impact study (QIS), in order to align these more carefully.
- The embryonic state of the transition from an Over-The-Counter (OTC) market to a centrally-cleared environment brings about unique risk which differs substantially from the current on-exchange risk landscape. This report should acknowledge this state of transition and make provision to capture the structural change that the introduction of OTCs will inevitably bring about to a centrally-cleared environment. Furthermore, the new treatment of OTCs will create substantial complexity in the realms of cooperation and extraterritoriality between the authorities, and specifically legal enforceability across jurisdictions. A revision of these recommendations is

suggested once the OTC market reformation is more established, and the full extent of the changes it introduces is known.

Specific responses to questions raised:

The following responses and comments have been put forward for each of the specific questions raised in the *Recovery and Resolution of Financial Market Infrastructures* report. Because no numbering system was included in the original document, we have included section numbers in the table below for cross-referencing purposes:

Section	Question	SAFCOM Response
3.1 to 3.7	<u>Considerations specific to the South African Environment:</u> The "resolution authority" referred to in this section is the Registrar of Securities Services or, the supervisory authority established in terms of the *Securities Services Act* (SSA) or another custodian such as a curator, trustee or liquidator that may be appointed in terms of empowering legislation. In terms of section 11 of the SSA, the Registrar may assume responsibility for any of the functions of the FMI if it fails, or is unable to fulfill its regulatory duties and responsibilities. In particular, the Registrar may do all things that are necessary for, incidental or conducive to the proper operation of an exchange. In addition hereto, a clearing house and an exchange are financial institutions as defined in the *Financial Institutions (Protection of Funds) Act,* which provides that the Registrar may apply to the High Court for the appointment of a curator to take control of and to manage the whole or any part of the business of such an institution (section 5). The curator could therefore be tasked to perform all the regulatory duties, functions and responsibilities of the FMI.	
	In what circumstances and for what types of FMI can a statutory management, administration or conservatorship offer an appropriate process within which to ensure a continuity of critical services?	See above - South African environment. The FMIs that are applicable here are those that do not take on any credit risk, namely Trade Repositories, Payment Systems and CSDs etc.

	Are there powers beyond those of a standard insolvency practitioner that a statutory manager, administrator or conservator would require in these circumstances?	The Protection of Financial Institutions Act allows the Registrar the powers to appoint a curator, whom in turn will have whatever powers (deemed appropriate) bestowed on them, to ensure the orderly management of the FMI's business affairs as a going concern.
3.8 to 3.14	Selective tear-up appears to be a deep *out–of-the-money* option held by a CCP to repudiate its obligations at an undefined strike price. It creates, rather than resolves, uncertainty about the enforceability of obligations cleared through a CCP, and its use at a time when large defaults have threatened the CCP's viability would spread contagion and uncertainty to non-defaulting counterparties affected by the tear-up. Selective tear-up as a resolution option will also skew competition among CCPs clearing the same product segment. A large diversified CCP can subsidise the risks of a product segment, encouraging volumes to concentrate in the CCP, by setting initial margin lower than the product segment might merit if evaluated independently. The same is true in the case where a CCP relies on cross-margining correlations between product segments which are then invalidated by the problem product segment going into the tear-up. CCPs that maintain higher margin demands would be competitively disadvantaged. In addition, where one CCP tears up a product segment but other CCPs continue to clear that product segment, there is potential for imbalance and contagion effects. Selective tear-ups may make a CCP resolution more credible and feasible, but they also make it uncertain of scale and impact on non-defaulting participants, especially if haircuts on variation margin are transmitted through clearing members to clients and beneficial owners. Variation margin haircuts impose losses and portfolio imbalances on non-defaulting participants in ways that they cannot anticipate or control, and so will likely be met with wider market instability.	
	Is tear-up an appropriate loss allocation arrangement prior to resolution of a CCP? If so, in what circumstances?	Selective tear-up should only be permitted as a loss allocation mechanism where the management of a CCP has passed from its shareholders to a resolution authority (e.g., conservator, receiver or liquidator) to counter any incentive for management to divert losses from the default waterfall to wider market participants.

	To what extent should the possibility of a tear-up in recovery be articulated in ex ante rules?	As a selective tear-up is effectively the grant of a call option to the CCP to repudiate its obligations at an undefined strike price, it is essential that participants be aware of the potential losses in the rules of the CCP. Limited liability and contractual liability are important principles. To the extent that selective tear-ups invalidate assumptions about CCP limited liability and participant contractual liability (resolution from only its own resources or contractually committed resources), then the proposal threatens to undermine confidence in the principles on which all financial markets rely for public confidence.
	Should there be a limit to the number of contracts that are eligible for tear-up?	Rather than limited tear-ups by number, it might make more sense to prioritise tear-ups so that losses are borne first and foremost by those CCP participants with the most influence on CCP governance, and so fall first on general clearing member contracts, next on direct clearing member contracts and only on end user clients as a last resort.
	How should the appropriate haircuts be determined?	Being too prescriptive on this point may encourage market participants to attempt to influence or game the scope of selective tear-ups and the haircut determination process. A resolution authority invoking selective tear-ups should be required after the fact to substantiate the process by which contracts for tear-up were identified and for determining the variation margin haircuts imposed on the market. Selective tear-ups have the potential to be used in anti-competitive ways that target losses at particular market segments or participants, and therefore represent a very grave risk of abuse.

3.15 to 3.18	*What qualitative or quantitative indicators of non-viability should be used in determining the trigger for resolution for different types of FMI?*	Relevant qualitative or quantitative indicators of non-viability would include: • Stress Testing; • Historical experiences of nonpayment of variation margin; • Funding constraints (fulfillment of Initial, Variation and Settlement obligations); • Counterparty / liquidity / concentration risk considerations; and • Margin close-out periods.
	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?	SAFCOM would respond in the positive to all 3 questions: In terms of loss allocation methods, we feel that the CCP should have at its disposal whatever methods necessary and appropriate for the proper operation of the CCP (i.e. porting of positions, tear-up etc.). With regards to the second part of the question (*mandatory replenishment of default fund contributions by an FMI's direct participants),* if SAFCOM loses its invested initial margin, we should have the ability to call for top-up margin from the rest of the market. With regards to the last question: These losses should not be passed on beyond the *direct* market participants. All direct market participants (i.e. all of those with open positions in the market) should be required to increase their margin contributions to cover the overall loss caused by the defaulting member.

	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)?	The risk of uncapped losses has the potential to spread contagion of default risk and illiquidity beyond a troubled CCP to those participants who can have no voice in risk management or governance of the CCP. Uncapped losses, if permitted at all, should be limited to general clearing members who can be presumed to influence a CCP's governance to incentivise scrutiny of risk management on a continuing basis.
3.19 to 3.21	*How should equity in FMIs be treated in resolution scenarios: should it be written down in all circumstances?*	This is not applicable to SAFCOM due to its current corporate structure.
	Are there circumstances in which loss allocation in resolution should result in a different distribution of losses to losses borne in insolvency? Does it make a difference 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 operational risks)?	Yes, the CCP's right to recovery of losses associated with an open position (based on their rules), should take precedence over the insolvency rules and provisions. With regards to the second question, Yes, defaulting member losses should be held separately, and should not be contaminated by other losses.
	Should an FMI's rules for addressing uncovered losses be taken into account when calculating whether creditors are no worse off in resolution than in liquidation?	The FMI process for addressing losses should take into account only those transactions within the remit of the FMI, and any other transactions or claims should be addressed independently by creditors under normal insolvency practice.
3.22 to 3.23	*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?*	SAFCOM believes that no such circumstances should exist - ensuring continuity of the FMI should always be the overwhelming priority.

	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 measures?	Yes, the temporary stay on exercising termination rights should apply to any event relating to either default or resolution measures.
4.1 to 4.8	*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?*	It is believed in the case of default of a large clearing member it will be appropriate to create such a moratorium, i.e. while positions are being verified, and determining who owes what to whom. In terms of the second part of the question, the moratorium should be limited to CCPs, and should be applied specifically to variation margin.
	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)?	Yes, restrictions should be applied – it should only be until positions can be verified, and where applicable, until positions can be ported to either another trading member or clearing member
4.9 to 4.14	*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?*	Although we do not think the bailout tools are a necessity for South Africa (due to the implementation of our default waterfall), we do agree that globally this would be imperative to the ongoing sustainability of the CCP.
4.15 to 4.22	*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?*	These recovery arrangements should exist, and should allow for the recovery of all costs incurred as part of maintaining the going concern, or the orderly wind-down of the CCP. Furthermore, this should possibly be included in the working capital of the CCP.

4.23 to 4.26	*In conducting a resolvability assessment of an FMI, what factors should authorities pay particular attention to?*	This does not necessarily apply to SAFCOM (due to its size in comparison to global players), but we do believe that regulators should pay close attention to the following: • Legal agreements between parties; • Legal certainty in that particular jurisdiction; • Asset segregation; • Inter-operability; and • Audit and report requirements.

Conclusion:

SAFCOM acknowledges the fundamental role a regime for recovery and resolution plays in ensuring the ongoing sustainability of our financial ecosystem, and is committed to ensuring that the framework eventually adopted is robust and appropriately structured to satisfy the needs of the South African market. It is hoped that the insights shared here will go some way to assist in the development of a system to resolve any potentially debilitating systemic disruptions in the future.