

CPSS/IOSCO consultative report on recovery plans for FMIs

AFTI and FBF contribution

I. General comments

Association Française des Professionnels des Titres ("AFTI") is the French association representing the post-trade industry. All 100 members of AFTI are players in the securities market and back office functions: **banks, investment firms, FMIs etc., acting in France and more generally in Europe.**

The French Banking Federation (FBF) represents the interests of the banking industry in France. Its membership is composed of all credit institutions authorised as banks and doing business in France, *i.e.* more than 390 commercial, cooperative and mutual banks. They employ 373,000 people in France and around the world, and serve 48 million customers.

AFTI and FBF welcome the CPSS/IOSCO consultation on the guidance report for FMIs recovery plans. 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 mean 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.

We believe that developing proportionate recovery and resolution plans is one of the key challenges to prevent crises by setting harmonised mechanisms at global level that may mitigate systemic risks, thereby contributing to financial stability and sustained economic growth.

As the voice of the French banks and post-trade market players, we would like to make comments on key aspects of the guidance report and give recommendations, on the one hand, from the perspective of users and participants to FMIs, and on the other hand, from the FMIs' viewpoint, since Euroclear France and L.C.H Clearnet SA are AFTI members .

Please find below a summary of our comments, our detailed contribution. In addition, some track changes to the guidance report will be sent to you in the coming days.

II. Summary of our contribution

1. The guidance report must emphasize more strongly that recovery plans should be tailored to each type of FMI to guarantee first and foremost the continuity of critical services/core functions. In the consultative report, most of provisions are relevant for CCPs only, especially in the sections related to recovery tools.

2. The identification of critical services/core functions should be determined by referring expressly to the PFMIs of April 2012 and the regulations locally applicable.

3. FMIs owned and/or managed by central banks should apply the same standards or standards with equivalent effects than those describe in the guidance report. These standards should be disclosed.

4. More attention should be paid to the situation of FMIs that run credit and liquidity risks such as CCPs and CSDs in order to deploy adequate buffers and to prevent the contagion risk.
5. Recovery tools should not prove for unlimited liability for the members of the FMI.
6. The guidance report should clarify the concept of participant by each type of FMIs.
7. The content of recovery plans should be reviewed at minimum each time that an FMI plans to perform new core functions or to offer new ancillary services.
8. Recovery plans and different stress scenarios should be disclosed to participants and public authorities on an ex ante basis.
9. Participants and public authorities should be informed by the Management board as soon as the FMI has entry into recovery plan and all along the recovery process (ex post basis transparency).
10. A clearer distinction between recovery and resolution phases has to be made. Especially, the guidance report should specify the criteria for entry of the FMI into resolution and who should pull the trigger.
11. Supervision cooperation mechanisms should be further assessed for FMIs considered as systemically important regarding their market size, the functions performed and the range of services offered, and their geographic presence in several countries or geographic zones
12. The guidance report should develop key principles regarding the use of tools and in particular that:

a) Common principles

Participants' liabilities should be transparently capped ex-ante for any given type of risks such as to avoid moral hazard and not create disincentives for members /participants to the FMIs except in extreme situations falling under the resolution stage and therefore depending on the competent authorities.

In addition to the dialogue with regulators, participants and users should be highly involved in the determination of recovery plans by FMIs. They should notably be associated to the definition of core/critical functions and they should be provided ex ante with a comprehensive list of tools that a FMI may use in order to know when and to what extent they could be asked to contribute in any recovery scenario.

A same tool cannot be used for both the recovery phase and the resolution phase if it occurs.

A clear distinction should be made between the different types of losses that may cause entry into recovery, as proposed in the consultative report.

Distinction between a loss caused by a participant's default and a loss due to the FMI itself has to be done. Participants should not be called to cover a loss resulting from a failure at the FMI level and responsibility of owners/shareholders should prevail in such a case.

Where the loss is due to a participant's default, sub-distinction between a loss related to core function performed by the FMI and participant loss related to an ancillary service offered by the FMI has to be done. At a minimum, participants should not be called for covering investment or business risks linked to ancillary banking services offered by an FMI.

As explained in the PFMI, an FMI should not only detail the recovery tools it may use but also the sequencing of financial resources (3.13.3 of PFMI).

b) Specific common principles for CCPs

In addition to all common principles mentioned above, specificities of CCPs should be taken into consideration when determining recovery tools that may be applied for CCPs.

In relation to waterfall processes which have been introduced in regulations about CCPs, we consider that the entry into recovery should be triggered as soon as contributions of non-defaulting participants to the default funds are used.

Most of recovery tools proposed in the report should be considered as resolution tools, at least as soon as they refer to further contributions by non-defaulting members. Own resources of the CCP and any other means to raise capital for the CCP should be considered in priority to resolve a recovery situation. More specifically cash calls from participants and haircutting of margins posted by clients (including variation margins) should be capped and deemed only as a last resort tool.

Notably the use of initial margins which are "bankruptcy remote" cannot be considered as recovery tools since it is prohibited by Article 45 of EMIR. In addition, FSB imposes the integrity of collateral end-user in the framework of the FSB report on resolution plans and clients' asset protection.

Some clarification would be welcome regarding the replenishment as the term may cover different significations (included in the waterfall process or not, done after the loss allocation or in parallel to, etc.).

The rights and obligations of indirect participants in a CCP are established primarily by their contract with the direct participants through which they act. Direct participants should keep the possibility to pass to their clients the loss resulting from implementation of some recovery tools where this mutualisation approach is the only way to avoid contagion effects.

A way to introduce some flexibility for CCPs is to design the waterfall process by types of products cleared by the CCP.

The report embraces different uses of the tear-up tool which, on our opinion, do not correspond to the same cases ; a tear-up may be triggered before a recovery phase as well as a last resort before entering into resolution.

c) Specific common principles for CSDs

As mentioned previously the report does not cover the specific case of a CSD. A dedicated section or annex at the end of the report should be included to address recovery tools which may be relevant for CSDs. In this respect, the prompt set –up of an expert group

for identification of recovery tools specific to CSDs would have a great added value to improve the efficiency of these mechanisms and to achieve the objectives set by the G20.

The issue regarding the specific case of CSDs is due to the possibility for CSDs to provide banking functions in some jurisdictions. Once again distinction between critical functions and other ancillary banking functions should be clearly established and any loss resulting from banking services should not be covered by “FMI recovery tools”. In such a case banking recovery plans should apply and should notably require that banking functions are appropriately isolated in a way that does not endanger maintenance of service for critical functions.

Moreover, in the specific case of CSDs, waterfall processes as for CCPs have not been developed. However there are already some tools available that may be considered as recovery tools:

- Loss sharing agreements which are included in the contracts signed between the CSD and its participants. Scope to be covered by such agreements should be clearly delimited and only refer to the core functions as mentioned above
- Insurance schemes are also already in place in a number of CSDs. It should be reviewed to what extent they can cover losses arising from a recovery situation and make sure that they are properly triggered prior to further participants’ contribution to the losses.

d) Specific common principles for TRs

As their role is to keep records on all the transactions on derivatives, they should not face any credit or liquidity risks and unlikely any business risk directly linked to their core functions. Of course, like other FMIs, they may wish to offer ancillary services which may bear risks.

Since, the default of TR’s participant could not lead to an entry into recovery for the TR, participants should not be asked for any loss allocation.

III. Detailed contribution

1. Identification of critical services and viability of recovery plans

From our point of view, recovery plans should be primarily designed to address the risks associated to the core functions of an FMI which correspond the best to the concept of critical services. It is fundamental to start from this assumption, since regulation authorities do not considered FMIs as “traditional” financial market players seeking to generate profits and being subject to more stringent requirements (namely recovery/resolutions plans for banks/SIFIS).

Indeed, we would like to recall that recovery and resolutions plans for FMIs must prevent first and foremost systemic disruptions. They are one of the two pillars ensuring the financial stability of these entities at global level, the other pillar being their proper regulation, authorization and supervision.

Saying that, AFTI & FBF consider that elaboration of recovery plans should be fully focused on the identification of solutions that would prevent contagion effects to other participants and consequently to the preservation and the continuity of critical services as it is highlighted in the consultative report.

In this respect, AFTI & FBF are concerned by the fact that any clear definition of critical services by type of FMI is given in the guidance report. This issue is crucial because, in case of recovery, only critical functions should be preserved whereas, more and more entities present on the FMIs market sector are engaged or plan to be engaged in commercial and banking, resulting a significant increase of business and investment risks.

It is clearly recognized that some major FMIs –depending on the range of ancillary services they offered- manage risks similar to those run by banks whereas they are not subject to the same level of supervision. Regarding these type of FMIs that run with credit and liquidity risks, AFTI & FBF consider they must develop and set up mechanisms of avoidance of risks contagion disclosed not only in the recovery plans but also on the governance policies of the structure, with a minima the need to isolate clearly banking activities from critical services and the risks associated when required. The most optimal solution in this respect would be to split activities between two different legal entities because no financial entity can support nor would be authorized by its prudential regulator to participate in an activity where exposures are uncontrollable, unlimited and unquantifiable. In any case, would the entry into recovery result from banking activities, banking recovery plans should apply instead of FMI recovery mechanisms.

Thus why, we do not agree with the section 2.4.2 of the consultative report which points out that *“if and FMI provides ancillary services judgment will be needed as to whether recovery plans need to assure continuity of these services”*. AFTI & FBF members believe that all other products/services proposed by an FMI, whatever the business model of the entity, should be clearly excluded from the recovery plans as the identification of critical services have been already specified in the CPSS/IOSCO principles on FMIs (“PFMIs”) published in April 2012. Users and participants should be highly involved in the definition of services that should be covered from a recovery and resolution point of view, all along the dialogue with regulators on this part.

Finally, we do not see clearly why FMIs operated and/or owned by central banks should be excluded from the scope of the CPSS/IOSCO guidance report. It is fundamental to introduce standards with equivalent effects for those entities to guarantee their continuity and to avoid financial instability. At minimum, the report should explain what kind of measures with

equivalent effects than those deployed for private structures should be developed and that central banks will have to implement for the FMIs they manage.

2. Transparency /certainty and updating of recovery plans

Globally we consider that transparency and certainty of the recovery plans are crucial for FMIs participants to be able to assess their risks. Members need to know which tools could be triggered in case of recovery, to what extent they could be asked to contribute and agree on an ex-ante basis on any binding rules to be applied in case of recovery. **In this respect, tools that may be triggered to allocate some losses or cover liquidity shortfalls should, in accordance with Principle 23 of PFMI, be disclosed to all participants in order to allow them to assess the risks they could incur by participating in the FMI (see item 3.3.3).**

Accordingly, (i) participants 'contribution should be capped (all references in the guidance report to "*fully allocation of losses*" may be removed) and (ii) no room should be left to uncertainty on the scope of tools a FMI may wish to apply (references in the guidance report to the terms "*the maximum extent practicable*" do not suit such principle).

Transparency and certainty are also pre-requisite for regulators to better understand where main sources of risks stem from and which areas need to be ultimately closely monitored / regulated.

Furthermore, transparency to investors is also a key tool that needs to be deployed as in many other areas to inform them properly on the location of their assets and which operations are performed.

In addition to measures proposed in the guidance report, we think it is important to clarify that recovery plans should be reviewed on a regular basis **and at minimum each time that an FMI decides to invest in or to propose new services/products.**

3. Distinction between the recovery plan and the resolution plan

AFTI & FBF fully agree that there should be a clear demarcation between recovery at an FMI and resolution of the FMI. In particular, the criteria for entry of the FMI into resolution should be defined as well as a designation of who should pull the trigger.

The report identifies recovery tools for FMIs which looks more like resolution tools if we compare with the banking recovery and resolution regime. **It is crucial that a clear distinction between each category of tools is made and that tools identified as applicable in case of recovery could not be used for a resolution situation.**

In addition, there should be an obligation on the supervisor of the FMI to inform the supervisors of the principal participants in the FMI, and the authorities of other jurisdictions with a direct interest in the operation of the FMI, that the FMI is entering recovery

4. Recovery tools

As a first comment, we agree with all guidelines for determination of appropriate recovery tools as mentioned in § 3.3, i.e. comprehensive, effective, transparent, provide appropriate incentives and minimum negative impacts.

As a general comment, we also noted that in the various recovery and resolution consultations and documents that have been issued, a distinction is usually made between FMI recovery processes due to participant default and recovery processes due to other

causes, with an aim to ensuring that recovery tools be appropriately designed. Regarding recovery cases due to a participant default, we believe that a further sub-distinction should be made depending on whether the defaulting participant is only a participant of a core service of the FMI (i.e. the critical services that should be maintained via a recovery planning) or if it is also a user of ancillary services offered by the FMI (i.e. services for which the FMI takes implicitly a risk).

AFTI & FBF members are of opinion that there should be a better segregation the consultative report's parts which are clearly restricted to particular types of FMIs, e.g. the CCPs, the CSDs and the TRs. This would make the report's consultation easier and would ensure a more efficient readers' access to the document. A matrix as the one in Annex E of PFMI "*Matrix of applicability of key considerations to specific types of FMIs*" would be very helpful.

In this respect, we believe that Section 3 related to recovery tools should distinguish as much as possible the appropriate tools for each category of FMIs.

Furthermore, an FMI should not only detail the recovery tools it may use but also the sequencing of financial resources (3.13.3 of PFMI)¹.

Due to the activities performed by its members, AFTI & FBF contribution only covers the definition of appropriate tools for CCPs, CSDs and TRs.

a) Specific case of CCPs

According to AFTI& FBF, most of the proposed recovery tools should not fall under recovery but rather resolution. Indeed we consider that the waterfall mechanism for CCP becomes a recovery mechanism as soon as participants' contributions to the default fund are used by the CCP.

Any failure of the waterfall mechanism should be viewed as a signal that resolution powers might need to be applied: dismissal of the management team, appointment of an administrator, write-off of equity, etc.

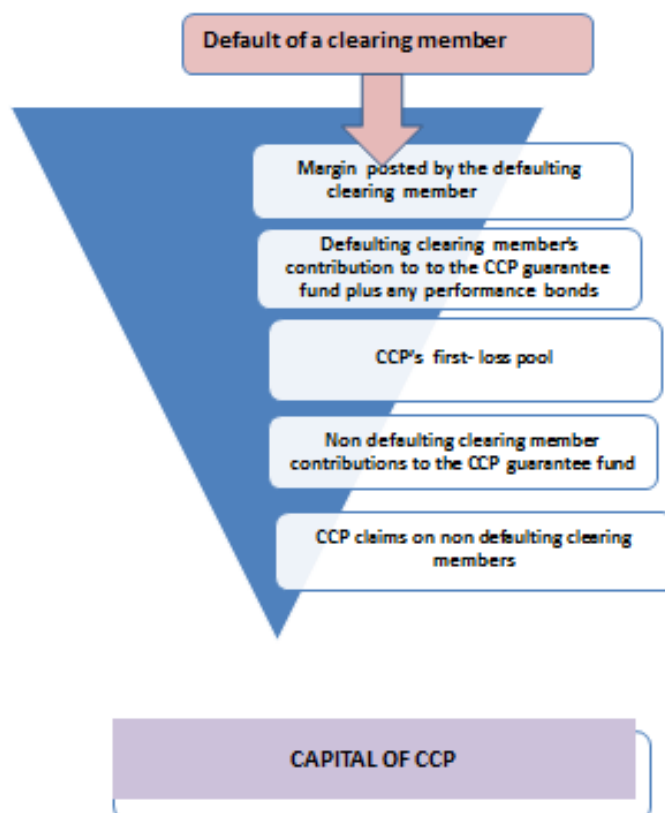
¹ An FMI's default rules and procedures should enable the FMI to take timely action to contain losses and liquidity pressures, before, at, and after the point of participant default (see also Principle 4 on credit risk and Principle 7 on liquidity risk). Specifically, an FMI's rules and procedures should allow the FMI to use promptly any financial resources that it maintains for covering losses and containing liquidity pressures arising from default, including liquidity facilities. The rules of the FMI should specify the order in which different types of resources will be used. This information enables participants to assess their potential future exposures from using the FMI's services. Typically, an FMI should first use assets provided by the defaulting participant, such as margin or other collateral, to provide incentives for participants to manage prudently the risks, particularly credit risk, they pose to an FMI.¹¹⁹ The application of previously provided collateral should not be subject to prevention, stay, or reversal under applicable law and the rules of the FMI. An FMI should also have a credible and explicit plan for replenishing its resources over an appropriate time horizon following a participant default so that it can continue to operate in a safe and sound manner. In particular, the FMI's rules and procedures should define the obligations of the non-defaulting participants to replenish the financial resources depleted during a default so that the time horizon of such replenishment is anticipated by non-defaulting participants without any disruptive effects.

The defaulting participant's assets do not include segregated customer collateral; such segregated collateral should not be used to cover losses resulting from a participant default, except in the case of a potential close out of segregated customer positions. See Principle 14 on segregation and portability.

If a CCP is likely to fail, due to its key role in the functioning and stability of the financial markets, plus the potential systemic dimension of its activities, a quick and orderly recovery process should be implemented. **As mentioned previously, we disagree with the principle that recovery plans should fully allocate to members losses or liquidity shortfalls caused by participant default that are not covered otherwise.**

In order to identify the most relevant approach for addressing a recovery situation, the preliminary step is to describe the waterfall process and sequence clearly the different phases. We consider that the waterfall process should be deployed as described in Article 45 of EMIR:

EMIR Waterfall against the default of a clearing member



1. The first loss pool is an initial level of funds contributed by the CCP, which even if absorbed would still allow the CCP to continue to function.

In addition the waterfall process should take into account the specificities and nature of products (equities, listed derivatives, OTC derivatives, commodities...) which are cleared and should be adapted accordingly.

The set-up of distinct default funds for different is also a good way to ensure that a stressed situation will be managed efficiently

When considering the various recovery tools as presented in the consultative report, we have the following comments:

- We agree that different types of situations should be identified. We consider that the different cases as described by the CPSS-IOSCO report are the right ones, i.e. distinction between losses resulting from the default of a participant and those not resulting from a participant's default; losses resulting from credit exposures versus liquidity shortfalls ; and need to restore a matched book.
- Participants should only be required to support the CCPs in case of a participant default. In **case of another event triggering the recovery of the CCP, participant should**

not be required to participate only the shareholders should be impacted. If the shareholder contribution is insufficient the CCP should move to resolution and participants could be called but only to support the essential functions.

When considering the tools themselves as presented in the report, a number of tools are definitely “resolution tools” and not recovery tools:

- ✓ **Cash call from the CCP’s participants should be considered as resolution tool only as it goes beyond the waterfall process as explained above.**
- ✓ **Initial margin haircut is an unacceptable tool as it contradicts the spirit of initial margin in the first place, where regulation is pushing to ensure initial margins to be bankruptcy remote (see EMIR article 45).**
- ✓ **Variation margin haircutting should be considered only as last resort measure.**

Regarding the need to re-establish a matched book in case of a participant’s default, this step should not be considered as part of a recovery situation. Actually such an action should be undertaken by the CCP prior the triggering of the waterfall process as first mechanism to restore a sound functioning of the CCP and to have an idea of the amount of the losses to be covered.

If the issue is a pure liquidity risk (identified as liquidity shortfalls in the consultation), central banks should intervene to sustain the CCP activity and ensure that a sound functioning of the CCP is promptly restored.

The tear-up is considered as partially limited to the contracts linked to the defaulter by the guidance report. However, the market practices show that it can be also:

- partially limited to a class of assets : which sounds like a resolution tool since it concerns a broader perimeter than the defaulter’s contracts, or ;
- complete which sounds once again like a resolution tool since if all the contracts are closed there is nothing to be left to be cleared.

Such different cases have to be taken in to account by the guidance report.

b) Specific case of CSDs

First of all, a distinction should be made between CSDs without banking activities and those with banking activities.

For CSD without banking activities (and hence with neither credit nor liquidity risk) recovery tools should focus on disaster and business continuity planning. This planning should be clearly documented and include effective, reliable and timely measures that would allow to maintain the CSD activity in an efficient way in case of major operational disruption. The BCP should be communicated by the CSD to its competent authorities and approved accordingly.

For CSD that develop banking activities in direct competition with their members, the members should not be impacted by any recovery tools. Only shareholders should support the loss. Participants could be called only in a resolution situation and only to sustain the essential services identified (users should be involved in their identification).

At the European level, given that CSD Regulation will allow CSDs to develop banking services within the same legal entities, it is key that regulators impose that critical functions can be fully isolated into another company that the participants could sustain. In no case the participants should be required to sustain banking services which are not essential to the

CSD function. The use of a separate entity in such a case or sale/transfer of these activities to another entity should be considered as relevant recovery tools.

In the specific case of CSDs, waterfall processes as for CCPs have not been developed. However there are already some tools available that may be considered as recovery tools:

- Loss sharing agreements which are included in the contracts signed between the CSD and its participants. Scope to be covered by such agreements should be clearly delimited and only refer to the core functions as mentioned above
- Insurance schemes are also already in place in a number of CSDs. It should be reviewed to what extent they can cover losses arising from a recovery situation and make sure that they are properly triggered prior to further participants' contribution to the losses.

More globally we highly recommend that a dedicated working group, with representatives from the authorities and from the industry with the sufficient level of expertise, is promptly set up to address the specificities of CDSs and identify reliable solutions that could be applied in case of entry into recovery and resolution where relevant.

c) Specific case of Trade Repositories

As their role is to keep records on all the transactions on derivatives, they should not face any credit or liquidity risks and unlikely any business risk directly linked to their core functions. Of course, like other FMIs, they may wish to offer ancillary services which may bear risks.

Since, the default of TR's participant could not lead to an entry into recovery for the TR, participants should not be asked for any loss allocation.

7. Allocations of losses

AFTI & FBF members believe that appropriate loss-allocation rules can widely vary depending on the nature and business model of the FMI and of the FMI's stakeholders' underlying arrangements. In the context of recovery planning, **we believe that participants' liabilities should be transparently capped for any given type of risks because**, as mentioned in our comments regarding viability of recovery plans, financial institution would not be easily authorised by its prudential regulator to participate without having any control on its potential exposures.

The objective of the above proposal is to avoid giving incentives participants to clear or settle bilaterally.

However, in case of a major FMI incident, there could be a probability that the sum of participants capped liabilities could not be sufficient enough to absorb the totality of FMI's losses. Further guidance on this topic would be appreciated.

8. Interaction between the Board of the FMI and the users/participants

Users/participants committee should be more closely associated to the board management decisions. Indeed, participants and users should be highly involved by FMIs in the determination and in the implementation phase of their recovery plans.

They should notably be associated to the definition of core/critical functions and they should provided ex ante with a comprehensive list of tools that a FMI may use in order to know when and to what extent they could be ask to contribute in any recovery scenario.

Furthermore, **users/participants as well as competent authorities of course should be regularly informed about the progress of the recovering plan** when an incident triggering it occurs.

9. Cooperation mechanisms between competent authorities for systemic FMI

Past years and the crisis have shown the need to strengthen the cooperation between supervisory authorities. In this respect, we regret the report does not explore sufficiently the cooperation mechanisms regarding FMIs considered as systemically important regarding their market size, the functions performed and the range of services offered, and their geographic presence in several countries or geographic zones.