bankenverband

Comments

of the Association of German Banks on the CPSS-IOSCO consultative report "Recovery of financial market infrastructures"

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We welcome the opportunity to comment on this consultative report. As participants in, and users of, financial market infrastructures (FMIs), we strongly support measures and guidance aimed at preserving the critical services of ailing FMIs. It is therefore with great interest that we studied the ideas set out by CPSS and IOSCO in their joint report.

Unlike in the July 2012 consultation on this issue, these proposals relate only to the recovery of FMIs. The proposals concerning resolution have evidently been incorporated into the consultation document of the Financial Stability Board (FSB) entitled “Application of the Key Attributes of Effective Resolution Regimes to Non-Bank Financial Institutions”, which was also published on 12 August 2013. This approach makes excellent sense, in our view, since as an annex to the “Key Attributes of Effective Resolution Regimes for Financial Institutions” (Key Attributes) offering special guidance for FMIs, this document can be integrated into, and complement the already established and accepted principles for the resolution of banks. The inclusion in the Key Attributes reflects the close relationship between the two types of institution. It shows the interdependencies and the potential systemic importance of FMIs and their participants while respecting the special characteristics of FMIs compared to banks. We would nevertheless like to stress that recovery and resolution are issues which are closely linked to one another, so it is absolutely essential that the FSB and CPSS/IOSCO principles use the same terminology and ascribe the same meaning to the terms utilised, that processes are coordinated, that there is the same understanding of the triggers for the various stages and that the competent authorities consult and coordinate with each other.

We especially welcome the fact that CPSS and IOSCO have refrained from setting any further standards and have instead provided guidance in the form of interpretation assistance and suggestions on how recovery planning might be organised in line with the “Principles for financial market infrastructure” (PFMI). We appreciate the discretion this will allow market participants within the special regulatory environment governing the individual FMI involved.

We would nevertheless like to draw attention to the following key concerns:

- There is no mention of **involving** or **coordinating** with the **participants** in FMIs or with other parties which would be affected in the event of a crisis.
- The report does not address the consequences that the application of tools is likely to have for those affected by them. In particular, the **impact on the capital requirements** of (direct or indirect) participants should be investigated and evaluated. The possible involvement in the losses of an FMI will generate new risk for its participants. See also Section II.4 below.
- Unless only the owners of the FMI are to be involved in the recovery, the guidance should not just consider how to allocate losses. Arrangements and mechanisms should be discussed for repaying these amounts once the crisis has been overcome. In other words, guidelines on a kind of “**debtor warrant**” are needed.
- **Participants’ liability** should be clear, predictable and limited.
- The **principle of proportionality** should always be followed when applying all tools.

- Adequate account needs to be taken of differences in national legal frameworks governing the posting and protection of collateral. In particular, it should be ensured that these differences do not result in the unequal treatment of creditors and competitive distortion.
- The “hierarchy” of the measures to be applied needs to be clear and unambiguous. In particular, it must be immediately apparent which measures are general principles and which address special cases and, under certain, clearly defined conditions, permit or provide for deviation from these general principles. With this in mind, the approach should be to proceed from the general to the particular and to describe the relationship between the measures and tools in a manner that leaves no room for misinterpretation. The starting point should be the allocation of losses arising as a result of general risks (losses not specifically related to participant default). The solutions and tools discussed here, as well as the parties to be involved (owners, insurers, creditors in general), should be available for all kinds of loss allocation. Only then should special circumstances be considered (e.g. losses caused by participant default) to which additional solutions and tools may need to be applied. The final step should be to formulate even more specific guidance relating only to certain types of FMI, such as CCPs. A **systematic approach** of this kind is lacking as things stand.
- We have reservations about the **variation margin haircutting** and **initial margin haircutting** tools described in Section 3.5. These tools should be applied if, and only if, there are no other tools or options available and there is no chance of other participants getting into financial difficulties as a result (i.e. as a **last resort**). For details, see our comments in Section II.5 below.
- The guidance relates to FMIs and is intended to help interpret the PFMI. If the FMI also has a **banking licence** which is necessary for operating the critical service, there should be no blurring of the distinction between FMI recovery planning and the recovery planning of banks. The dividing line between the two regimes should be clear and predictable in terms of applicable measures and tools.

We will go into these points in more detail below.

I. General comments on the consultative report

1. Involvement of affected parties

Given the special systemic importance of the services provided by FMIs, it is envisaged that, under certain circumstances, participants which are merely recipients of these services but not necessarily owners of the FMI will also bear losses in the interests of maintaining the FMI’s critical services. It is absolutely essential, in our view, to involve these potentially affected parties in the recovery planning process as well.

With this in mind, participants should be consulted not only on the choice of tools and on the type and extent of their liability, but also on the identification of the critical services, stress

scenarios and triggers for the recovery plans. In particular, participants' needs and ideas on the question of which services they consider "critical" should play a major role in the identification process. This cannot be decided by the FMI and its supervisors alone (paragraph 2.3.9 mentions coordination with the relevant authorities when identifying critical services).

As far as tools are concerned, we believe it is necessary to involve the affected parties both in the selection and design of individual tools and in deciding on the composition, hierarchy, interaction and coordination of tools comprising a set. The same goes for determining the time frame and financial extent of liability when tools are applied. The tools contained in the FMI's recovery plan on will have enormous consequences and repercussions for participants. This applies particularly to the assessment and assumption of risks which may have implications for participants' own capital requirements. Owing to the monopoly-like status that FMIs frequently have, participants do not have the option of simply choosing another supplier if they do not like the terms and conditions on offer.

2. Need for a systematic approach

We were somewhat surprised to note that, when addressing the question of how to allocate losses, particular cases are considered first and general cases only subsequently.

It is essential, in our view, to follow general principles when allocating losses. We therefore believe it would be more appropriate to start by formulating general rules for loss allocation. This goes both for the parties to be involved in the recovery and for the tools. The next step would then be to proceed to the particular and consider specific causes of loss, which may require specific tools to be applied in addition to the general instruments.

The tools referred to in Section 3.8 should always be available also to deal with losses caused by participant default. By contrast, the tools mentioned in Section 3.5 can only be used in addition to those in Section 3.8 in the event of specific circumstances occurring or certain types of FMI experiencing difficulties. For details, please see our comments below in Section II.7 and 8.

3. Debtor warrant

All tools involving other participants in the recovery contain an element of "debt relief" in the interests of overcoming the crisis. Some tools do not only forgive debt but may even generate payments (claims to repayment) in certain circumstances which participants would ordinarily be under no obligation to make. The situation is consequently comparable to that of debt relief, in which case the FMI would normally be required to issue a debtor warrant. We believe it would be desirable to address this issue and, in particular, to consider the question of when the FMI might start to make repayments, from what revenue, to which groups of participants or other creditors, in what relation and in what order. If these questions were settled, it might set a not-to-be-underestimated incentive for participants to involve themselves in the recovery process.

4. Dividing line between recovery plans for FMIs and banks

Some FMIs have a banking licence relating to the critical services or to other services they provide. If they are subject as a result to the regime for the recovery and resolution of banks, there will be problems deciding which rules to apply. It should therefore be made clear that the rules for FMIs are always more specific and consequently take precedence over the regime for banks when the objective is to maintain critical services.

Furthermore, it should be considered to include further guidance concerning the necessary consultation and coordination between supervisors (of banks/FMIs) and the application of the tools under the relevant regulatory regime applicable to the FMI/banks in questions.

II. Specific comments on the consultative report

1. The guidance related to recovery plans and recovery planning

All in all, we consider the proposed guidance comprehensive and balanced. As mentioned above in Section I.1, however, we would like to see mention of the importance of involving participants and other parties affected by the measures. Recovery planning should not take place without the involvement of those who would be affected by the plan. What is more, the involvement of affected parties would massively increase the acceptance and enforceability of plans.

2. The guidance related to recovery tools

The proposed guidance on the selection of specific recovery tools is also generally well-balanced, in our view. We strongly support the approach taken in paragraph 3.1.2, namely that the recovery tools and measures presented in the report are not intended to be exhaustive but are only examples of possible solutions. We would like to stress, in this context, that tools should always be chosen and applied with the principle of proportionality in mind and should only be used to maintain services which can really be classified as critical. (The first sentence of subparagraph 3.3.1 (i) could therefore be amended to read "…to continue to provide critical services***, and critical services only,*** in all relevant circumstances.")

3. The guidelines used to judge the appropriateness of recovery tools

Along with the above-mentioned principle of proportionality, the importance of which is expressed in paragraph 3.3.1 of the consultative report, the question of legal enforceability is rightly raised. The third bullet point in subparagraph 3.3.2 (ii) states that "each tool should be consistent with the FMI's rules, membership agreements, contracts, and the regulatory and legal frameworks in all relevant jurisdictions." If indirect participants are to be involved, however, legal obstacles to enforceability will need to be eliminated. These obstacles will not only be of a

general nature: can the cost of payments be passed on to customers? Can this be ensured by inclusion in general terms and conditions or, if not, what kind of contractual arrangement is necessary? Though this problem is mentioned in paragraph 2.3.4, the report refrains from calling on lawmakers or supervisors to make it legally possible to pass on the cost of payments. CPSS and IOSCO should formulate more concrete proposals in this area.

There is also the question of the extent to which third parties which are not direct participants can be indirectly involved in recovery measures. The discussion of variation margin haircutting in paragraph 3.5.14 ff. is primarily influenced by the question of whether assets are the affected participant's own or client assets. In cases in which client collateral is segregated, it is particularly important that it is legally feasible to pass on haircuts to clients even if they are not direct participants in the CCP and thus not directly subject to the FMI's terms and conditions.

4. The impact of recovery tools on direct participants and indirect participants

The report's views on the legal enforceability of tools on indirect participants are sound and well-argued (see also our comments in Section II.3 above). We also agree with the calls for tools to be predictable and have clear limits and with the assessment of the impact that different designs of tools would have on the behaviour and risk appetite of participants (cf. paragraphs 3.5.2 and 3.5.3). A tool carrying an inherent uncontrollable risk will invariably pose a threat of systemic contagion.

By contrast, we do not agree with the conclusion in paragraph 3.5.7, which suggests that participants could simply leave the FMI if liability risks were unacceptably high or prohibited by regulators. This is because actual or de facto obligations to use FMIs (in the form, for instance, of mandatory clearing requirements or the monopoly-like status of most CSDs) make such a step, though theoretically logical, unfeasible in practice.

We also believe the report should address the impact that the design and use of certain tools would have on participants in terms of increasing capital requirements or requiring the additional risks to be handled in other ways.

5. The description of the pros and cons of specific recovery tools, including the manageability and controllability of the exposures associated with each recovery tool

The pros and cons of individual tools would need to be assessed by participants and other affected parties in light of the exact details of their design when a recovery plan is drawn up. The report's general descriptions, though sound, are no substitute for a concrete, case-by-case assessment.

When considering the manageability and controllability of exposures, it is vital to respect the **“no creditor worse off” principle**. A participant or creditor can be involved in the FMI’s recovery only to the extent that it would otherwise have to expect a loss in the event of the FMI’s insolvency. We would have welcomed a clear commitment to this principle in the consultative report.

This applies particularly to the variation margin haircutting and initial margin haircutting tools as described in paragraph 3.5.14 ff. Margining is a cornerstone of the risk mitigation mechanism designed to protect not only the CCP but also other participants from financial difficulties.

It is therefore understandable that, as mentioned in paragraph 3.5.19, many jurisdictions protect initial margin against any use other than for securing obligations of the party having provided the initial margin. If this risk mitigation mechanism no longer functioned reliably, the danger of systemic contagion would increase immediately (cf. also paragraph 3.5.23). We also share the view expressed in paragraph 3.5.24 that the objective of expanding clearing would be undermined if interference in the use of margin was so serious that participants were unwilling or unable to participate in a CCP.

If haircuts relating to margins are considered, it should be ensured that– unlike in the scenario set out in paragraphs 3.5.20 to 3.5.23 – these are not applied to the margin itself, i.e. the collateral posted and serving as security but only to the (possibly fictitious) repayment claims in relation to initial and/or variation margin. These repayment claims would also be at risk in the event of the CCP’s insolvency following the close-out netting of all positions (including collateral). A participation in losses to this extent could therefore basically be justified. This would also help to avoid the risk of underprotection of a CCP described in paragraph 3.5.23.

The points made in paragraphs 3.5.14 and 3.5.15 about precisely what would be subject to the haircut and about a 100% cap are, however, at least ambiguous in this respect. We would therefore welcome an express clarification to the effect that haircuts could only ever affect possible repayment claims and not the margin / collateral as such.

If participation in losses is to be as objective and “fair” as possible, the following further principles also need to be observed:

- Margin haircutting should only be a very **last resort**.
- Haircutting should always be on a **combination of initial margin and variation margin** (that is any repayment claims in respect thereof) since the burden on participants would otherwise be random and prospects of recovery would not be promising in the absence of sufficient funds.
- In the event of haircuts in respect of initial margin, however, the use of pledges (with no transfer of title or ownership) or collateral posted in a similar manner which ensures that is “insolvency remote” within the meaning of applicable regulatory requirements, would of

course need to be respected in this connection. As paragraph 3.5.23 rightly points out, classifying initial margin as not insolvency remote would generate significant additional capital charges for participants.

- In the event of haircutting variation margin, the **time element** should be considered and a **fixed period of time** should be specified for the measure in the recovery plan. Otherwise, as paragraph 3.5.15 is correct to mention, participants might reject the measure. To avoid the possibility of manipulation, consideration should also be given to the most suitable time to begin the haircut. For instance, the ex-post determination of the timing of the default of a defaulting participant could be the deciding factor in calculating the in-the-money (net) position. Otherwise the difficulty will arise that the repayment claims which should be available to rescue the CCP have already been set off or, depending on the classification of the CCP's terms and conditions, are subject to legal uncertainty (novation, market value or alleged market value of the margin). A related question in this case, however, would be whether payments already made or offset could be reversed.
- The activities and the actual use of the ailing CCP by each participant and the market movement should be taken into account by looking at the **length and volume of its business relations**. Otherwise, loss allocation would be random instead of being determined by risk weighting. Participants which were seldom active or happened, exceptionally, to have a large position would bear disproportionately high losses. The same goes for new participants which were required to post a margin premium. Of the terms proposed in paragraph 3.5.20 (pro rata, position-based, activity-based), we therefore have a clear preference for activity-based haircutting.

6. The discussion of incentives created by specific tools

We agree that the selection of certain tools can create incentives or disincentives. In the interests of creating incentives, we believe it is particularly important, as described above in Section I.3, that an FMI which has overcome its difficulties should pay back amounts received during the period of crisis.

7. The completeness and appropriateness of the set of recovery tools to address participant default and liquidity shortfalls discussed in the report

and

8. The completeness and appropriateness of the set of recovery tools to address losses not created by participant default discussed in the report

We assume that, like the tools to address losses caused by participants, the tools discussed in the report to address liquidity shortfalls and losses not created by participant default are not intended to be exhaustive.

As mentioned above in Section I.2, we see no obvious logic or system in the approach taken by the report. In particular, it is not clear which circumstances are to be considered general circumstances with universally valid legal consequences and which circumstances are to be considered special circumstances with correspondingly specific legal consequences.

We therefore believe it would make good sense to begin by addressing loss allocation without considering who caused the losses. For some FMIs – trade repositories, for instance – participant default can simply represent the materialisation of general loss exposures. In these cases, there can be no question of involving other participants in the allocation of losses.

The situation may be different for other FMIs: the business model and the extent to which a participant default represents the realisation of a risk inherent in this business model will determine how justified it is to involve other participants. In the case of a CCP, it will most certainly be justified, since the default of a participant constitutes the realisation of a risk typical of this business. The question becomes more difficult if a CSD is involved. If the CSD merely performs settlement functions, the default of one participant does not necessarily have implications for other participants because only the delivery obligations of the defaulting participant are affected. But if the CSD also engages in securities lending or grants credit – for the settlement of the cash leg in other currencies, for example (commercial bank money instead of central bank money) – then the CSD takes on risks which will typically be realised if a participant defaults.

So the involvement of participants will probably be most appropriate if, in the event of the FMI's insolvency, there is a danger of their defaulting with claims directly linked to the FMI's critical services.

With this in mind, we believe the report should start with a description of general arrangements for allocating losses – "tools to allocate losses (not specifically related to participant default)" – which can, in principle, also be applied to specific cases. The tools described in Section 3.8 belong in this category, in our view. This should be followed by further general principles for dealing with liquidity shortfalls and replenishing financial resources (such as the tools discussed in Sections 3.6 and 3.7). Only then should the report consider specific cases, such as "losses caused by participant default" and describe special and/or additional tools to deal with them (e.g. the tools outlined in Section 3.5). Differences between the various types of FMI should also be addressed. As we see it, the tools described in Section 3.9 for the reestablishment of a matched book are a sub-category of tools to be used by a specific type of FMI and should be dealt with in the same section.