11 October 2013

ECSDA Response to the CPSS-IOSCO consultative report on Recovery of financial market infrastructures

ECSDA welcomes the CPSS-IOSCO Consultative Report on the Recovery of financial market infrastructures issued on 12 August 2013 and believes it provides useful guidance for CSDs and other infrastructures in their implementation of the CPSS-IOSCO Principles, and especially Principle 3 on risk management.

We especially support the "toolbox" approach of the report, which provides for a good overview of the various recovery tools available while acknowledging that each FMI will need a different set of tools depending on its specific situation. The present consultative report also contains many helpful clarifications compared to the July 2012 report, and we are grateful to CPSS and IOSCO for having taken into account the comments made by ECSDA and other respondents to the 2012 consultation.

1. Remarks on the definition of recovery

ECSDA suggests the following amendments to the definition of recovery proposed under section 1.1.1 (page 3) of the report:

"Recovery is defined as the actions of an FMI, consistent with its rules, procedures, and other ex-ante contractual arrangements, to address any uncovered credit loss, liquidity shortfall, capital inadequacy, or business ***loss~~, operational or other structural weakness, including the replenishment of any depleted pre-funded financial resources and liquidity arrangements~~****, as necessary to maintain the FMI's viability as a going concern."*

Indeed, we think that the "uncovered losses" mentioned in the definition can have a variety of causes, such as operational problems or structural weaknesses, whereas the default of a CSD participant will typically not result in any "uncovered losses" (with the exception of outstanding fees) for the CSD. Referring to "operational or other structural weakness" is confusing and unnecessary, especially since addressing operational weaknesses and drawing lessons from major losses should be part of normal risk management processes, geared towards maintaining an adequate control environment in the CSD.

Furthermore, the phrase *"including the replenishment of any depleted pre-funded financial resources and liquidity arrangements"* introduces an example in the definition which we believe is not indispensable.

Finally, we note that the phrase *"consistent with its rules, procedures, and other ex-ante contractual arrangements"* states the obvious and could also be removed as it goes without saying that recovery measures must be consistent with the CSD's rules, procedures and contractual arrangements.

2. Recovery plans and recovery planning

ECSDA fully supports the general approach of section 2 of the report on recovery planning, especially the focus on identifying and maintaining critical services in recovery.

- **Relationship between recovery and resolution**

In section 2.2, we believe that the report could stress more explicitly that resolution should only be launched once insolvency can no longer be avoided. There should be a clear distinction between recovery and resolution regimes. This is important so as not to create overlap and confusion between the CSD's normal regulatory and recovery regime under the supervision of its competent authority, and the special regime of resolution. The recovery regime will cover the actions set out in the recovery plan to be taken by the CSD itself in order to safeguard the continuity of the critical functions performed by the CSD and to prevent the CSD from entering into resolution.

In this regard, we appreciate the approach adopted by CPSS-IOSCO and the FSB to deal with recovery and resolution issues separately.

- **Balancing predictability with flexibility**

(a) Ex ante arrangements

ECSDA welcomes the flexible approach adopted by CPSS and IOSCO in section 2.3.4 recognising that ex ante binding arrangements on the replenishment of the CSD's financial resources are not always appropriate in recovery plans (for example, ex ante commitments from shareholders or from participants to raise additional capital). In the European Union, however, it should be noted that the forthcoming CSD Regulation is likely to include mandatory requirements on recovery plans that might partly override the flexibility allowed by CPSS and IOSCO standards.

(b) Sequence in the use of recovery tools

More importantly, we think it is essential that CSDs retain some discretion in determining the sequence with which recovery tools are used. Indeed, CSDs are different from CCPs in that they typically do not

have a “default waterfall”, and in case of a major crisis, it is important that recovery of a CSD is not hampered by a rigid sequence which might not be appropriate to the particular situation. We welcome the recognition by CPSS and IOSCO that tools and the sequence of tools should be adapted to the specific circumstances, but we think this point could be stressed further under section 3.1, to make it clear that the recovery and resolution plan (RRP) of a CSD should not necessarily include a prescribed sequence of events.

- **Transparency of recovery plan towards participants**

ECSDA fully agrees that the rules and contracts of a CSD should be transparent to its participants regarding risks that participants face directly from the execution of such contracts, including as a result of the CSD’s default and recovery procedures. In the case of CSDs operating with a banking license and granting short-term credit to participants against collateral, it is especially important that contracts be clear about the use of participants’ collateral and about the default allocation processes impacting defaulting and non-defaulting participants, if any such processes are in place.
We note however, that, as with other rules and processes of the settlement system, the recovery plan is not aimed to be a public document, and that some of the detailed processes involved should not be shared with participants or the general public.

- **Tools to address structural weaknesses**

Under the section entitled “Tools to address structural weaknesses” on page 10, we note that some of the measures mentioned under 2.4.11 relate to the overall risk and control environment of the CSD and thus do not really belong in a recovery plan. For instance, procedures to revise the risk management framework and the business strategy, as well as to reduce the complexity and level of interconnectedness of the CSD are structural and typically implemented in the normal course of business to improve the CSD’s overall resilience. The purpose of such measures is to prevent the next crisis from hitting the CSD too hard, but such measures are not designed to allow the CSD to recover.

Furthermore, we also note that some measures could be part of the business continuity or recovery plan, depending on whether or not events threaten the viability of the CSD. For example, the failure of a settlement bank used by a CSD for commercial bank money settlement would not necessarily threaten the viability of the CSD if the CSD does not have any exposure on the settlement bank (having a solution in place, such as an alternative settlement bank, as part of business continuity planning, protects the market). We thus recommend section 2.4 could distinguish more clearly between business continuity and recovery planning.

3. General comments on recovery tools

ECSDA believes it is essential that each CSD can determine which recovery tools are appropriate to its business model and particular situation. We thus fully support the recognition by CPSS and IOSCO that discretion is necessary in the selection of recovery tools.

- **More clarity on which tools can apply to which type of FMI**

While some recovery tools covered in the report will never be applicable in the case of CSDs, others are likely to apply in most cases to CSDs, and others again might only be relevant for a few CSDs, such as those operating under a banking licence.

To facilitate implementation, ECSDA suggests that CPSS and IOSCO might add a summary table, similar to the one contained in Annex E of the PFMI report, specifying which tools can (but do not always have to) be used by each type of FMI.

In the case of CSDs, ECSDA has made the following analysis (✘ means not applicable and ✓ means that measures could be relevant for CSDs):

Heading	Section and sub-sections	CSDs not exposed to credit risk	CSDs exposed to credit risk
Cash calls on participants	3.5.1 to 3.5.8 (pp.17-18 And 3.7.2 (p.22)	✘	✘
Position-based allocation tools	3.5.9 to 3.5.13 (pp.18-19)	?	?
Variation margin haircutting by CCPs	3.5.14 to 3.5.18 (pp.19-20)	✘	✘
Initial margin haircutting by CCPs	3.5.19 to 3.5.25 (pp.20-21)	✘	✘
Tools to address uncovered liquidity shortfalls	3.6.1 to 3.6.5 (pp.21-22)	✘	✓
Tools to replenish financial resources	3.7.1 (p.22)	✓	✓
Tools to allocate losses not related to participant default	3.8.1 to 3.8.9 (pp.22-23)	✓	✓
Tools for CCPs to re-establish a matched book	3.9.1 to 3.9.24 (pp.23-26)	✘	✘

- **The classification of recovery tools**

Regarding the classification of recovery tools proposed under section 3.4.3, ECSDA recommends a more consistent approach. Indeed, the first three sets of tools, (i) to (iii) and partially (v), are mainly designed to handle the scenario of a participant default. Point (vi) on the other hand covers various scenarios (any other causes for a loss at an FMI). We suggest classifying recovery tools along their objectives:

(a) Ensuring the FMI retains sufficient capital: (i) for absorbing losses (related or not related to credit risk, on participants or any other relevant counterparties) or (ii) for recapitalising;
(b) Ensuring the FMI is able to respond to liquidity issues (already covered by the PFMI);
(c) Ensuring the profitability of the FMI is maintained.

4. Recovery tools related to losses caused by a participant default

Most CSDs are not exposed to credit risk on their participants and their viability should thus not be affected by the default of a participant. In fact, a CSD's exposure to its participants is limited to the non-payment of fees, which is a non-issue from a recovery planning perspective. As stressed in section 3 above, many tools listed in the report focus on the effect of participant defaults, and will thus not be applicable to most CSDs.

Moreover, only some recovery tools related to losses caused by a participant default will be applicable for CSDs exposed to credit risk (and typically operating under a banking license). This is because CSDs exposed to credit risk are fundamentally different from CCPs. The purpose of a CCP is to mutualise risks within a market, which is not at all the case for CSDs. Where a CSD provides credit, any related exposures are by definition short-term, collateralised and transactional. CCPs' exposures on the other hand can be longer-term, not related to business decisions of the CCP itself and potentially related to complex transactions that are often difficult to value. This is why CSDs exposed to credit risk typically do not maintain default funds and do not have loss sharing rules similar to these of CCPs.

- **Loss allocation**

Regarding uncovered losses caused by a participant default, we would like to reiterate that the default of a participant will typically not result in any "uncovered losses" (with the exception of outstanding fees) for the CSD. The tools described in the report to allocate uncovered losses caused by a participant default assume that all remaining losses should be allocated to non-defaulting participants. For CSDs, we believe that this creates inappropriate incentives. Indeed, the requirement for participants to share in the losses caused by the default of another participant could lead these participants to reconsider their relationship with the CSD, potentially resulting in the usage of less regulated entities which are not subject to loss allocation for services similar to those provided by CSDs. Besides, asking service

providers to commit to a loss allocation could significantly reduce their number, lowering the degree of mutualisation of losses and increasing potential systemic impacts.
ECSDA thus recommends that measures on loss allocation, and the principle of full allocation, should not systematically be applied to CSDs exposed to credit risk, especially when other valid recovery arrangements are in place.

Regarding position-based allocation tools described under sections 3.5.9 to 3.5.13, ECSDA is not convinced about their applicability to CSDs, and in fact the concept so far has been associated with CCPs. Today, in case securities are lost or destroyed, market rules can foresee that the positions of the relevant CSD participants will be reduced in proportion to their holdings. The impact on participant holdings in such situations cannot be avoided as the CSD has to reflect the fact of the reduced overall amount in its nostro account as quickly as possible vis-à-vis its participants in order to prevent further transfers of “non-existing” positions. Irrespective of this unavoidable measure, CSD participants will usually try to claim compensation for the losses resulting from such reduction from the CSD or from any other third party which could be made liable for the destruction or loss. ECSDA however considers that such a scenario does not fall under the scope of “CSD recovery” and thus cannot really be considered as a “position-based allocation tool” in the meaning of the CPSS-IOSCO report.

Outside this specific context, CSD participants are not usually expected to bear the losses that could result from other events such as operational problems, structural weaknesses or the default of (an)other participant(s). Should regulators wish CSDs to apply loss allocation rules, the involvement of “indirect participants” in loss allocation would have to be considered to avoid discouraging direct participation in CSDs. This is however likely to raise a number of legal and operational difficulties given that CSDs only have contractual relationships with direct participants and given that they often do not have access to information on the clients of their participants.

- **Liquidity**

ECSDA agrees with CPSS and IOSCO that there are two main ways to obtain liquidity: (a) from third-party institutions or (b) from non-defaulting participants. Although mandating liquidity support from participants in case of crisis is attractive to protect the CSD, the inclusion of this tool should be left at the discretion of the CSD (as with other recovery tools). Indeed, such an obligation may have a detrimental impact on the market and, during a crisis, amplify systemic disturbances. Participants may be incentivised to reduce their holdings of liquid assets at the CSD to the bare minimum, or to suddenly retrieve such assets from the CSD in times of crisis. This is particularly true for ICSDs. In times of crisis, when the interbank market is already at a standstill and market participants struggle to get liquidity to the right place and at the right time, blocking participants’ liquidity at the CSD would not be welcome.

5. Recovery tools not related to a participant default

The recovery tools that are not related to a participant default will be most relevant to CSD recovery plans.

- **Recapitalisation options**

A possible ex ante measure that CSDs can take to ensure the replenishment of financial resources in recovery is the creation of an excess capital fund, which may be immediately available in case of distress. Another measure is the issuance of subordinated debt by the CSD, if deemed appropriate.

Any ex ante commitment from shareholders or participants to participate in recapitalisation should however not be too easy an option to exercise in a crisis, as it could create moral hazard by removing responsibility from CSD's management and transferring risks to the committed parties.

- **Intra-group financial support**

Section 3.7 does not consider intra-group financial support. ECSDA believes that such support can be a valid recovery tool for CSDs belonging to a corporate group and thus recommend its inclusion in the report.

- **Insurance**

Many CSDs have insurance arrangements in place that can contribute to recovery by covering relevant operational and legal losses. As mentioned in sections 3.8.7 to 3.8.9 however, insurance is likely to be a less effective tool for other types of losses.

6. Impact of a CSD recovery on third parties

The cover note to the CPSS-IOSCO consultative report calls for comments on the "impact of recovery tools on direct and indirect participants". ECSDA fully understands the need for CSD recovery plans to take into account the impact of recovery measures on CSD participants and the wider market, especially when determining which tool is most appropriate in a given situation. We would like to stress however that it is the responsibility of participants, owners, linked FMIs and any other stakeholders such as settlement banks to establish an aggregate view of the risks they take on all counterparties, including CSDs, and to monitor these risks against their risk appetite. It is also important to keep in mind that CSDs often have no control and no visibility on their clients' clients. They do not have the tools (legally, regulatory or operationally) to identify and gather information on indirect participants, and thus do not

always have sufficient information to assess the potential impact of recovery measures beyond direct participants.

Furthermore, section 2.4.14 refers to the impact of recovery on links between financial market infrastructures, but does not distinguish between different types of links. ECSDA would like to stress that the level of interdependence created by links between CSDs is much lower than that resulting from CCP links, and that the impact of recovery on standard CSD links is likely to be minimal, compared to other, more complex forms of links.

7. Issues not covered in the CPSS-IOSCO report

As suggested earlier, ECSDA believes intra-group financial support should be added to the report as a valid recovery tool.

ECSDA hopes that its comments will help CPSS and IOSCO in the finalisation of their report on the recovery of financial market infrastructures. Our association is committed to further raise awareness on the importance of recovery planning within the CSD community. For any questions on this paper, please contact the ECSDA Secretariat at +32 2 230 99 01 or email soraya.belghazi@ecsda.eu.