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VIA ELECTRONIC MAIL

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Re Consultative Report Recovery of financial market infrastructures

Ladies and Gentlemen

I am offering my comments as a risk management professional with a combination of bank and exchange/CCP experience and ongoing interest in the referenced standards and guidelines applicable to recovery and resolution of financial market infrastructures. I commend both FSB and CPSS-IOSCO in their respective efforts to address the important issues associated with the related standards and guidelines and in particular to the heightened attention that has been given to how to manage liquidity shortfalls associated with extreme situations and systemic risk events.

For ease of reference I have incorporated my feedback under the respective headings of the eight points emphasized in the cover letter to the consultation:

1. The guidance related to recovery plans and recovery planning.

Comment:

- No additional standards intended: The consultation emphasizes that "*it is not intended to create additional standards for FMIs, or authorities, beyond those set out in the CPSS-IOSCO Principles for financial market infrastructures (PFMI) but rather to provide supplemental guidance on and a menu of tools for, observance of the PFMIs*". While the stated intention is appreciated and for the most part applicable there are several areas where the references to what FMIs "should" do is extremely prescriptive which creates a risk that the guidance will be interpreted by different stakeholders as additional standards. To be fair the majority of the FMIs "should" references in the Executive Summary are quite broad and are therefore consistent with the intention of not creating additional standards, but stakeholders should be guarded against using the guidelines as the basis for applying different standards than already provided by the PFMIs.

2. The guidance related to recovery tools.

Comments:

- Development of FMI recovery plan: Subsection 1.1.4 appropriately identifies FMIs as having primary responsibility for the development and implementation of the FMI's recovery plan but includes specific reference to using own resources and those of its participants. As worded this seems to take liberty with FMIs assumed use of participant funds and also makes no reference to the use of the FMI owner resources. To be consistent with other guidance in the consultation on what resources may be at risk for being used (see subsections: 1.14; 2.31; 3.32 and 3.3.15) the reference should be clarified and amended as follows:

"1.1.4 The development and, if necessary, implementation of a recovery plan is primarily the responsibility of an FMI itself using its own resources and where applicable those of its owners, participants and third parties."

- Same point for broader stakeholder references for subsection 2.3.12 as follows:

"2.3.12 An FMI's governance arrangements should provide for timely and effective implementation of recovery plans, including documented decision making processes in a crisis. An FMI should also have the capacity to identify and provide to others involved in the recovery plans, including its owners, participants, and where applicable third parties the information they need in the FMI's implementation of the plans on a timely basis. This includes both the information needed ex-ante to enable others to prepare for implementation and the information needed once an FMI has initiated its recovery plans in order to enable implementation to take place as smoothly as possible."

- Same point for broader stakeholder references for subsection 2.4.3 as follows:

"2.4.3 As required by Principle 3 of the PFMI, an FMI should identify scenarios that may prevent it from being able to provide its critical services as a going concern.[10] These scenarios should take into account the various risks to which the FMI is exposed, which will vary across different types of FMIs and even across FMIs of the same type. These scenarios may include, but are not limited to, credit losses or liquidity shortfalls created by a participant default, a wide range of general business losses, or the realisation of investment losses (from financial assets the FMI holds at third parties). They should also include the risk associated with the failure of an owner, participant or third party to perform its critical functions (for example, the failure of a settlement bank, credit provider or other service provider)."

- While the failure of a settlement banks is a reasonable stress scenario to consider and reference in subsection 2.4.10, given the heightened attention being given to liquidity shortfall situations I think it appropriate to expand that reference as follows:

"2.4.10 In most cases the FMI will not only need to recover from the financial shortfall but will also need to identify and address the underlying cause of the problem if it is to continue operating as a going concern. In these cases, the recovery action taken will depend on the specific stress scenario that led to the problem. For example, if a settlement bank has failed, the FMI will need to have plans for an alternative method of settlement or if a credit provider were to fail to extend credit under a committed funding facility, alternative reliable funding would need to be arranged "

- FMI access to Central Bank Lender of Last Resort (LOLR) support: The guidance specifically references that FMIs "*should not expect that public funds to be made available to maintain their viability*". While in isolation that may be a valid it ignores the vital role Central Banks may inevitably need to assume in helping to manage systemic risk. While I support FMIs having access to CB support under strictly defined conditions I also support the access be conditional, not automatic. As a matter of transparency FMI recovery plans should specify to what extent the respective FMIs do (or do not) have access to Central Bank LOLR support and also if that access is available what conditions or restrictions apply.

  In many international markets, CCPs already do have conditional access to Central Bank liquidity (typically restricted to secured lending against predefined types of collateral and tied to specific other restrictions) but admittedly many FMIs do not have this benefit. I think all Central Banks should incorporate conditional access by all systemically important FMIs and address the issue of moral hazard, that is often raised by Central Banks as the largest obstacle, by making the conditions as prescriptive as Central Banks deem necessary and transparent.

  In many markets the terms and conditions for Central Bank Lender of Last Resort support (which in some markets includes CCPs) clearly provide for denial of support if the specific terms and conditions are not met. Moral hazard is a valid argument for providing transparent, prescriptive criteria for qualified access to Central Bank liquidity but it is not a valid defense for shutting the door completely to any systemically important institution.

  While there are some added complications due to the political, regulatory and legal frameworks in different markets (e.g. CCPs organized and regulated as banks in certain markets provide the means of qualifying for possible access) Central Banks should be able to manage those hurdles separately as part of their role in responding to systemic risk in their markets.

  In the meantime the markets where Central Banks do provide such qualified and conditional access to FMIs (including CCPs) should increasingly have a distinct advantage as preferred locations for CCPs and their participants to conduct business. This will be even more evident when the capital and liquidity implications associated with the changes in regulatory requirements specified by the Principles for FMIs and these guidelines are applied more comprehensively than they are today.

- The following reference from subsection 2.3.8 should be modified as shown as it is not enough to "consider":

  "The FMI should also ~~consider the degree to~~ identify which aspects of its recovery plan need to be shared with its participants and share those details with its participants in order to observe its transparency obligations in accordance with Principle 23 of the PFMI and so that participants can assess the risks they face by participating in the FMI."

- The following reference from subsection 2.3.8 should be modified as shown as having the capacity is not the same as being held accountable for actually doing and the broader range of stakeholders are also relevant to reference:

  "*An FMI should ~~also have the capacity to~~ identify and provide to others involved in the recovery plans, including its owners, participants~~,~~ and third parties the information they need in the FMI's implementation of the plans on a timely basis*."

- Defining trigger criteria: There appears to be duplication on the call for defining criteria (qualitative and quantitative) in subsections 2.3.10 and 2.4.4. Not sure if that is by design and if so, considered necessary. If so it may makes sense to assess whether there should be a duplication of the reference to discretion by the FMI.

- Transparency: Subsection 3.3.2 should be expanded to address not only transparency on "how" allocation of losses and liquidity shortfalls would be applied by respective FMIs but also ensure there is appropriate transparency on the amounts that are applicable for different stakeholders under normal and under approved stress testing scenarios.

- Liquidity Shortfall Waterfall: Waterfalls have traditionally been linked to illustrating how default loss coverage methodologies are applied by FMIs. While not as common the same concept is applicable to liquidity shortfall allocation and simply involve a different series of resources and stakeholders.

  Similar waterfalls should be drafted by FMIs in order to provide appropriate transparency to the relevant stakeholders on how liquidity shortfalls would be allocated (and ideally covered), referencing the amounts applicable to different stakeholders and reflecting eligible liquid resources which qualify under PFMIs and should be part of the default handling framework of FMIs.

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

No comment

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

Comments:

- Given the lack of responses provided by the participant stakeholders to the October 2012 market consultation under the same heading as the current consultation (only one bank offered publicly available feedback), I think this market consultation may be at risk for being overlooked by this same group. The prior consultation covered very different range of issues and questions but considering the material implications of the content of this consultation on participants, it would seem to be imperative that this stakeholder group's input be obtained.

  This is particularly true for the guidance being provided regarding arrangements for covering CCP' liquidity shortfalls which have the potential for material financial

commitments and liabilities and related capital requirements for participants (most notably direct participants) and to some degree their clients.

If a meaningful number of major international banks and brokerage firms from around the globe (particularly the major international banks who dominate the global derivatives markets) do not submit feedback to this consultation I would recommend CPSS IOSCO consider providing an extension of the consultation period and solicit specific feedback from this stakeholder group even if the extension is only for a brief period.

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.

- While technically accurate the references in subsection 3.6.3 to the advantages of obtaining (or requiring) liquidity only from non-defaulting participants who are owed funds from the FMI, even if it were limited to the extent of those obligations, offers a relatively simplistic assessment in a situation where a liquidity crunch or crisis is playing out.

  The advantages referenced in the consultation (see italic references) are followed by my added commentary on some of the consequences and potential disadvantages that should be considered. I am confident the participant stakeholders would have much more to offer on this point:

  1. *Requires no pay-in from participant* (but does not take into consideration the liquidity implications of the participants who are owed but will not receive the cash they are owed and will logically have factored into their own treasury and liquidity plans. In the extreme this could create heightened contagion risk and a race by FMIs to make margin calls to accumulate liquid resources ahead of other FMIs)
  2. *Could be executed immediately* (works from FMI perspective but it would also then immediately impact Participants liquidity resource and in effect transfer the problem from FMI to participant and may increase the risk of other Participant default)
  3. *Does not entail performance risk* (True from FMI perspective but heightens the subsequent performance risk of the Participants that are impacted)
  4. *Reliable* (May be easy for the FMI to hold back the cash but the uncertainty of when this might be applied would result in Participants inheriting the liquidity shortfall "immediately" and create a liquidity management challenge for the Participant which would likely be cascaded to their clients)
  5. *Timely* (Quick fix option for the FMI but simply transfers the pain and problem to participants and some may not be equipped to manage it creating increased risk of further defaults and escalation of the problem)
  6. *Size of the potential obligations is measurable and controllable* (Measurable but if implemented as outlined with "immediate effect" would not be as controllable from a Participant perspective)
  7. *Finally, participants are incentivised to monitor the FMIs liquidity risk-taking and management activities* (This exaggerates the extent that participants are

able to monitor and influence FMIs liquidity risk-taking. It would likely result in participants lobbying for FMIs to maintain cash reserves at the owner and/or FMI level (as opposed to investing their funds) and FMIs lining up considerably greater amounts of committed bank facilities.

- I find it odd that only advantages were referenced by CPSS IOSCO for above referenced option and I suspect participants will have a lot to say on this subject. That presumes participants have this consultation on their radar. As referenced earlier participant input on this consultation should be sought out directly, if necessary under an extended consultation period.

- The contagion risks associated with making any material and immediate liquidity demands on participants argues in favor of Central Bank collateralized lending to FMIs as a preferred path. Central Banks and their regulatory affiliates would be also be considerably better equipped to monitor and influence an FMIs liquidity risk taking compared to participants capabilities.

- Separately from the list of advantages referenced in the consultation for the option of holding back participant funds, which at least suggest that it could be structured as collateralized loan, Repo or swap, subsection 3.6.5 provides guidance that suggest "these loans could also take the form of uncollateralized loans". I find it extremely odd that CPSS IOSCO representatives would be providing this kind of guidance when Central Banks typically insist on collateral (meeting specific criteria) as only one part of their conditional LOLR programs. Once again, this kind of stress liquidity shortfall situation is best addressed by a Central Bank and as long as the criteria for access are sufficiently transparent and appropriately conservative the risk of moral hazard is addressed.

- It is worth pointing out that some FMIs already have the right to delay or discount distributions to their participants and/or compensate their participants in alternative currencies under certain extreme situations referenced in their Rules, just as some FMIs have access to Central Bank liquidity, so there are models in place which already provide guidance for other FMIs and for Central Banks wishing to apply such measures. The guidance provided in this consultation would not likely result in those FMIs giving up those benefits to their operating models but it will likely result in closer review of the impact considerations for participants.

6. The discussion of incentives created by specific tools.

Comment: I think the incentives that are referenced for Participants with regard to CCPs are overstated relative to the incentives of owners, regulators and credit providers. This is particularly true for dealing with arrangements for liquidity shortfalls.

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

Comment:

- There is a lack of guidance on the specific role that Central bank liquidity (lender of last resort LOLR) “should” play in dealing with systemic risk management where CCP markets are involved and some of the basic principles of LOLR lending appear to be ignored when assigning this role or a similar role to CCP’s Participants.

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

No comment

If there are any questions or comments on the above I am reachable at ktking.hongkong@gmail.com and/or +852-9323-8454.

Sincerely,

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