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**By e-mail**

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Brussels, 15 October 2013

**Subject: CPSS-IOSCO Consultative report on Recovery of financial market infrastructures**

Dear Mr Wright and Mr Löber,

The European Banking Federation (EBF) welcomes the opportunity to comment on the above mentioned consultative report. The EBF fully supports the initiative and generally endorses the approach of CPSS and IOSCO in defining guidelines for the recovery of financial market infrastructures (FMIs). 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 means 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 regimes are properly defined to ensure the continuity of critical services in all relevant circumstances, including in case of default.

Representing European banks in their capacity as users of financial market infrastructures, the EBF believes that the report published for consultation on 12 August 2013 generally meets the objective of providing guidance to FMIs on how to develop and implement recovery plans. The EBF notes with satisfaction that the consultative report takes into consideration some of the comments and recommendations made by the Federation in its response to the July 2012 report on *Recovery and resolution of financial market infrastructures*, namely that:

- There should be a clear distinction between waterfall procedure, recovery and resolution when relevant; however the report submitted for consultation would benefit from greater definition of the trigger points and the role of authorities.

- The recovery planning process and recovery tools should be tailored to the different types of FMIs, and quite rightly the consultative report focuses mainly on CCPs clearing OTC derivatives; however the report would benefit from clearer distinction between the specific types of FMIs (clearing houses, central securities depositories, securities settlement systems, trade repositories, payment systems and others), by notably addressing the case of CSDs, especially when a CSD is authorised to provide some banking services.
- The recovery planning process and recovery tools should in the first place address the FMI's services which are defined as systemically important, with the main objective of ensuring the continuity of the critical services performed by an FMI; however, the report would benefit from further work on the criteria for deciding which services are "critical" (section 2.4.2), and on the question of which parties are involved in the identification of the critical services of a specific FMI (section 2.3.9).
- The loss allocation arrangement should differ if the difficulty of an FMI is due to a participant's default or whether it is due to financial or operational failure that would be under the direct responsibility of the FMI, its owner or operator; however the report would benefit from strengthening the responsibility of owners/shareholders.

While the report generally goes in the right direction, the EBF believes that further adjustment could improve its content significantly, namely that:

## **1. Transparency and certainty of recovery plans and tools towards FMI participants should be enhanced**

Transparency and certainty of recovery plans and tools is essential for FMI participants in order to assess their risks in using and participating in FMIs and therefore avoid disincentives to use FMIs. The EBF notes that the consultative report currently limits such transparency to loss-allocation arrangements while it should cover recovery plans and tools at large.

Furthermore, transparency should be ensured vis-à-vis all relevant authorities, all types of clients and linked service providers. Finally, recovery plans should be updated every time an FMI provides a new type of services or is subject to a modification that may impact the recovery plan as defined initially.

## **2. Recovery plans should be established in close cooperation with FMI participants**

Recovery plans need to be comprehensive and workable, even if approved, reviewed and overseen, in case of implementation, by the competent supervisory or oversight authorities. According to the EBF, this can only be guaranteed if these plans are established in close cooperation with FMI participants, as well as with other infrastructure providers an FMI is linked to. Furthermore, if recovery plans involve a financial assessment of FMI participants, then there is an additional rationale for FMI participants to be involved.

As recovery plans should be based on a thorough assessment of the critical services performed by an FMI, the identification of these critical services and the definition of trigger points for recovery (and resolution) plans also need to be conducted in close cooperation with FMI participants. For instance, CCPs have in the past drafted effective business continuity plans in cooperation with other interoperable CCPs, marketplaces CCPs provide services to and CCPs' clearing members.

As the identification of critical services is a key requirement in order to establish recovery plans, all parties involved (public authorities, FMIs and FMI participants) would benefit from greater clarity as to the criteria for determining whether specific services of specific FMIs are critical; in particular, all parties would benefit from a more precise understanding as to the applicability to FMI recovery and resolution of the FSB July 2013 document on *Guidance on Identification of Critical Functions and Critical Shared Services*.

In order to ensure suitable involvement of FMI participants, the EBF recommends that section 2.3.3 (on governance) of the report includes a requirement for FMIs to articulate how they will consult and involve all direct participants (including all clearing members in the case of CCPs) in the development of the recovery plan and loss-allocation rules to ensure they are well-understood and established ex-ante as binding. Users' participation differs from one FMI to another and it is important to guarantee that users are associated in the governance of recovery planning.

### **3. The focus of recovery planning should be on continuity of critical services**

To ensure that the focus is on continuity of critical services performed by an FMI, the EBF believes that section 2.3.1 of the report should be amended to reflect this aim and to include a clearer definition of what viability is, e.g. restoration of authorisation requirements or market confidence. As mentioned above in point 2, section 2.4.2 (on critical services) of the report should also be more explicit as to the applicability of the FSB *Guidance on Identification of Critical Functions and Critical Shared Services*. It should also be clear that ancillary/non-FMI activities should not usually be considered critical and should be able to be restructured/wound down/sold as necessary to restore viability of core FMI-related functions.

### **4. Recovery tools should not provide for unlimited liability of FMI participants**

The EBF is of the strong opinion that recovery tools should not provide for unlimited liability of FMI participants as this would create moral hazard and may dis-incentivise the use of FMIs. There should be a clear relation between the service that caused the need for recovery and who uses those services.

In this respect, the consultative report does not sufficiently acknowledge that regulators and legislators worldwide seek to expand the use of FMIs in order to reduce risk and create more transparency in the financial system. As a consequence, FMIs have not only become providers of critical services but also growing businesses. It is therefore logical that any

losses should first fall under the direct responsibility of the FMI or is allocated to its owners/shareholders. Non-defaulting participants should be required to participate in the loss sharing only as a measure of last resort (i.e. in a resolution phase).

In addition, as owners of FMIs generally benefit from the profits of the FMIs, the EBF believes that the tools to strengthen the capital situation (as listed in section 2.4.8 e.g.) and to transfer some activities which are identified as critical services should be recommended in all recovery plans and, in principle, be considered prior to loss allocation to non-defaulting participants and clients. Only with a high level of transparency and involvement in the decision making procedure and recovery planning of FMIs can the non-defaulting participants be required to participate in loss sharing arrangements. In any event, participants' liability must be clear, predictable and limited.

## **5. Using auctions as a recovery tool has limits**

In several cases, auctions are proposed as a tool for recovery. While these are often well suited for returning the FMI services to its traditional course after a participant default, the report may lead to disincentives for participants who do not bring in successful bids. However, in several European markets, different types of participants use FMIs' services directly. The EBF therefore does not believe it to be in the interest of markets' stability that participants without the capability to take on new positions or bids in the auction are forced to do so.

The Federation is also of the opinion that, in limited cases, where the commitments from participants may be proposed, this needs to be capped or limited. In this respect, and considering the different size of participants, the cap or limit needs to be proportional to the risk that is being added by the participant to the FMI.

## **6. More attention should be given to the importance of record keeping**

Efficient risk management being a pre-requisite for recovery plans, the report should stress the need for continued good record-keeping even in extreme stress situations (a key directors' responsibility) in order to ensure effective reconciliation in case recovery (or resolution) occurs. Often record keeping lapses in the final days and weeks of an entity's autonomous existence. The EBF therefore believes that continuity and quality of record-keeping should be discussed and ensured already in the drafting of recovery plans.

## **7. FMI participants should have no liability for non-critical services**

In case an FMI provides banking services (as it is already the case for some CCPs and some CSDs in Europe), the guidance for the recovery of FMIs should prevail over the guidance for the recovery of banks but the guidance should only apply in relation to the critical services of the FMI. The EBF believes that for the ancillary, non-FMI services, the FMI should be prepared to sell/restructure/wind them down if necessary to preserve the continuity of critical services. This is essential in the case of CSDs settling in central bank money while also

providing banking services. In addition, no losses originating in the non-FMI services should be crystallized for FMI participants.

There should, wherever possible and appropriate, be alignment and coherence between the regime applicable to banks and the regime applicable to FMIs. Where there are differences, there should be a clear rule setting out which regime should prevail.

## **8. Competition between FMIs may bring opportunity of substitution**

The EBF believes that the report could emphasise the need to foster competition in the FMI services that still show monopolistic features in several markets, as one of the key safeguards highlighted by the report to ensure continuity of critical services is to have several service providers providing quality services in a competitive environment.

In this respect, competition between FMIs, especially in Europe, may bring opportunity of substitution and may thus avoid FMIs, in particular CSDs, enter into recovery and resolution scenarios. But this implies that we need to have recovery plans for CSD, including CSD links.

In addition, the EBF would like to make the following remarks as regards the content of the consultative report:

- CCPs should have separate guarantee funds for separate asset classes; this is essential for securing that specific areas of risk remain linked to the participants who are active in that area.
- The rights and obligations of indirect participants of an FMI (where applicable as for a CCP) are established primarily by the contracts they have with direct participants through which they act.
- The report remains silent on how the contributions for the recovery of an FMI can be paid back to the participants after the recovery (for instance as a warrant); debtors will indeed more likely participate in the recovery plan if they get the assurance of getting paid back later.
- The interaction of the proposals contained in the report with existing insolvency procedures and the implications for existing providers of loan capital should be considered further and set out; additionally, when identifying the cause of the problem (see section 2.4.10), it is essential to assess rapidly whether the problem is one of illiquidity (recoverable) or insolvency (usually fatal).

Finally, from the perspective of payments systems, the main concern of the EBF relates to section 3.7.2 (cash calls on participants) if this is meant to relate to all types of FMI, which appears to be the case. Interpretation of the term “contract tear-ups” would presumably fall to the courts given it is not defined in the document, which itself creates uncertainty. However, it

appears to imply that CPSS and IOSCO may be suggesting that FMI should create ex-ante powers to tear-up legally binding contracts. This is not only highly undesirable in relation to payments systems but could lead to unforeseen implications related to legal enforceability and potentially infringe mandatory provisions of law, particularly in jurisdictions with strong “unfair contract terms legislation”. Another concern is whether it may affect finality<sup>1</sup>.

In conclusion, let me once again underline our readiness to provide constructive feedback on the future development of this important topic for the banks in their capacity as users of and participants in FMIs. If you require any further information on the points raised in this letter, please do not hesitate to contact my colleague Christophe Bonte ([c.bonte@ebf-fbe.eu](mailto:c.bonte@ebf-fbe.eu)).

Yours sincerely,



Guido Ravoet

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<sup>1</sup> The EBF refers to the note produced by the TARGET Working Group (TWG) for more detailed comments concerning payment systems (see our reference 004745).