Investment Management Association

ima

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CPSS-IOSCO Consultative report on Recovery of financial market infrastructures

Dear Mr Wright and Mr Löber,

The Investment Management Association (IMA) is the trade body for the UK asset management industry, representing around USD5 trillion of funds under management. Its member firms include managers of a wide range of asset classes for a wide range of clients, including institutional funds, authorised unit trusts and open ended investment companies.

We welcome the opportunity to comment on the latest consultations.

Our engagement with banks, broker/dealers and financial market infrastructures are multiple: shareholders, lenders (by way of buying their bonds), wholesale depositors and users of their services (detailed in an annex).

Key messages

The IMA supports the initiative and generally endorses the approach of CPSS and IOSCO in defining guidelines for the recovery of financial market infrastructures (FMIs).

Regulations 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.

We believe that the Financial Stability Board (FSB) consultations published in August 2013, detailed below, appropriately meet the objective of providing guidance to FMIs on how to develop and implement recovery plans. There should be a clear distinction between recovery, resolution and waterfall process when relevant.

- The recovery planning process and recovery tools should be tailored to the different types of FMIs, although there is still no clear distinction between the specific types of

FMIs and no classification according to the different categories (CCPs, CSDs, SSSs, TRs, payment systems and others) – it would be useful in a further report for distinctions to be made where relevant;

- The recovery planning process and recovery tools should in the first place address the services of an FMI which are defined as systemically important, with the main objective of ensuring the continuity of these critical services, although the report remains vague on which are those services;

- The loss allocation arrangement should differ if the difficulty of the 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 – we expand on this and other loss allocation issues below;

- Loss allocation should take into consideration the cause of the loss;

- CCPs should have separate guarantee funds for separate asset classes;

The IMA agrees with CPSS and IOSCO that FMIs should have rule-based, ex-ante arrangements which include the definition of a trigger in order to activate the execution of a recovery plan. However, the pre-defined plan could however be overruled by the competent authorities if a concrete emergency situation suggests a different and more appropriate response.

We note that the report 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"* (section 3.3.2 on page 14). It would be difficult to assess how recovery arrangements, made under domestic law, would be treated under a foreign law. There would be even less predictable legal certainty in a crisis situation which is usually without precedent.

Loss allocation in CCPs

We suggest that it is important to develop a higher level conceptual framework for considering the tools. This is because it is not merely a question as to whether something is an appropriate tool, but how those tools interact and how they reflect governance of the CCP. There are three sets of assets which can bear loss, and each is owned by a different group, with different incentives and responses to risk of loss and actual loss, and each can impact wider financial stability differently.

The three broad sets of assets which can bear losses are:

1. The Intrinsic Capital of the business: – provided by the owners and given it is equity it must be expected to bear loss. They should have a keen incentive to ensure the business is not run riskily and in relation to whom total loss may or may not lead to wider contagion (since the beneficial owners need not be financial institutions). There is likely to be a relatively low turnover in the identity of the owners which should operate to maintain their ability to demand appropriate behaviour from management.

2. The Default fund: – provided by the participants for the very purpose of dealing with loss. The participants also have an incentive to consider the overall risk management of the CCP. There is likely to be a very low turnover in the identities of this group given the cost of entry. Both these characteristics mean they should therefore be provided with tools to demand changed behaviour – as in EMIR with their role on the risk committee. Total loss of the default fund is likely to impact other financial institutions but equally they are likely to be a source of the most significant loss (outside of management's poor behaviour).

3. The aggregate of the transaction-related assets: - essentially the margin supplied by users and indirect participants. These funds are provided for transaction-related losses by a constituency with the highest turnover. Initial margin should not be considered to be available for losses that are the fault of the CCP's management, but, even where there are discussions about subjecting variable margin to a haircut, it must not be forgotten that the providers of these assets can do little to influence good behaviour at the CCP. Total loss is likely to impact the wider financial system but these players can choose to change their behaviour and not transact business (at least in theory though mandatory clearing on to monopolistic CCPs means many have little alternatives).

   We offer this framework to allow a consideration of how the relative sizes of each set of assets should be agreed and why. We suggest the traditional position that a business should have capital to bear losses to which it may be subject is valid for CCPs. Indeed, there could be a range of capital instruments used, including bail-inable capital.

   We look forward to further discussing these ideas which we have presented to you already.

Conclusion

The IMA looks forward to working with the international standard setters to develop a framework that is appropriate and effective for all stakeholders.

The annex summarises the critical functions that are essential for the asset management industry.

We hope that you will find our comments useful. Please contact us by way of e-mail (gsears@investmentuk.org and ihenry@investmentuk.org) or telephone on (00 44) (0) 20 7831 0898 should you require further information.

Yours sincerely,

Guy Sears

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Prudential Specialist

Investment Management Association

Annex

As per the key messages, the functions that are of importance to the fund management industry are as follows:

1) Payments, clearing and settlement

These services are provided by banks to their clients. Some services may be provided by a non-bank entity of the firm, e.g. broker-dealers. Such services are often on a cross-border basis, e.g. foreign exchange clearing and cash management.

The drivers of criticality are market concentration and the availability of substitutes, geographical footprint, complexity of services and asset classes for clearing, links to ancillary services (transaction accounts (including collateral for transactions), deposits and custody) and the reliance of financial market infrastructure (FMI) providers on banks.

2) Wholesale activities

This refers to lending and borrowing in the wholesale markets between financial counterparties. Stress can lead to funding and liquidity strains if the firms are of systemic importance (e.g. major providers of liquidity and/or funding by short-term deposits (net stable funding ratio)).

The drivers of criticality are systemic importance and interconnectedness, market concentration, maturity transformation and leverage.

3) Clearing activities

This is about the issuance and trading of securities, often related to advisory services and prime brokerage. Such activities rely on payment, clearing and settlement functions.

The drivers of criticality are market concentration and the availability of substitutes, whether services are bundled, and the portability of client accounts across providers and markets.