London Stock Exchange Group response to CPSS-IOSCO consultative report on recovery of financial market infrastructures

14/10/13

1. London Stock Exchange Group plc (LSEG) welcomes the opportunity to respond to CPSS-IOSCO's consultative report, and supports the aim of developing recovery frameworks for financial market infrastructures (FMI). LSEG is well placed to respond to this consultation. As Europe's leading diversified exchange group, we operate four CCPs (CC&G and three within LCH.Clearnet Group), a CSD (Monte Titoli), and regulated markets and multilateral trading facilities within London Stock Exchange, Borsa Italiana, Turquoise and MTS.

2. This document sets out LSEG comments on the report. Part 1 outlines our key points and part 2 offers broader discussion around our positions.

Part 1 – Key points

3. There is not a common recovery regime that would fit all FMI. it is important to ensure that recovery regimes are appropriately designed for the FMI in question.

4. We welcome the report's discussion on the dividing line between recovery and resolution. Moreover it is important that a common understanding of 'default management', recovery, and resolution is adopted across the industry, and CPSS-IOSCO is well positioned to offer clarity in this area. Particularly in the case of CCPs, where losses are triggered by a member default, the use of prefunded financial resources precedes any recovery measures, and CCPs should be able to implement their recovery plan before resolution is initiated by authorities (unless is clear from the outset the loss allocation provisions within the recovery plan will be insufficient to recover the CCP).

5. We welcome the recognition in the report that FMI should have flexibility in the design and implementation of recovery plans, and in particular:

   (i) the option for CCPs to develop segregated default waterfalls for specific product lines;

   (ii) that the recovery tools described in the report may be exercised in a sequence best determined by the FMI itself;

   (iii) and that the list of tools is not exhaustive and FMI may incorporate other tools within their recovery plans as best determined for their market.

6. We support the position in the report that an appropriate balance should be struck between the degree of automation of the recovery plan and the FMI's own flexibility in implementing the recovery plan. An overly automated recovery plan would risk limiting the FMI's ability to respond to an unforeseen event in recovery, while an approach that accorded too much flexibility to the FMI would reduce the degree of certainty in the market as to how recovery would unfold.

7. We encourage CPSS-IOSCO to underline the importance of a harmonised, proportionate and flexible approach to FMI recovery across jurisdictions. While different jurisdictions are at different stages of development in this area, a harmonised global approach to FMI recovery is of systemic global importance.

Specific remarks on recovery tools:

8. It is important that recovery regimes address FMI losses occurring for reasons other than member default.

9. Recovery regimes should not give rise to open-ended liability.

10. Position-based loss allocation arrangements may be more appropriate for CCPs than CSDs.

11. The transfer of core FMI services to a bridge institution should have consideration for cross-border differences in corporate, civil and insolvency laws.

We acknowledge that this response may be published.

Contact

Martin Batty
Regulatory Strategy
London Stock Exchange Group
0044 207 797 3449
mbatty@lseg.com

Paola Fico
Regulation and Post Trading
Borsa Italiana
London Stock Exchange Group
0039 027 242 6285
paola.fico@borsaitaliana.it

Perrine Herrenschmidt
LCH.Clearnet
London Stock Exchange Group
0044 207 426 7246
Perrine.herrenschmidt@lchclearnet.com

Part 2 – Background

There is not a common recovery regime that would fit all FMI

12. It is important to note that it will not be possible to devise a common recovery regime that will fit the full range of FMI within the scope of the report.

13. CCPs, CSDs, payment systems and settlement systems all perform different activities and according to their specific role within the financial system. Therefore, we suggest that recovery regimes will need to take into account, and deal with, the specific risk profile of different FMI.

14. This approach is currently reflected in the FSB's application of the Key Attributes to resolution of FMI, and we recommend that the same proportionate and differentiated approach is maintained for FMI recovery.

15. In line with the points above, we also stress that recovery regimes should distinguish between FMI that take credit risk and those that do not. CCPs are exposed to credit risk, while CSDs and payment systems generally are not. This distinction is important because it may determine the timeframe of a possible FMI failure and the extent to which recovery measures are needed.

16. In a similar manner, we also consider that certain position-based loss allocation tools may not be effective for CSDs. For instance, the tools described in the report for loss allocation caused by participant default assume that all remaining losses should be allocated among non-defaulting participants. The position-based loss allocation tools described in sections 3.5.9 and 3.5.13 of the report have usually been considered in relation to CCPs, and we are not aware of precedents setting their use for CSDs. CSD participants are not generally expected to bear losses that could result from member default. The CPSS-IOSCO paper states that 'indirect participants' may need to be considered within loss allocation arrangements. However, this could raise a number of legal and operational difficulties given that CSDs only have contractual relationships with direct participants. This consideration can be reasonably extended to other FMI, such as CCPs, and therefore further consideration should be given to the ways in which loss allocation tools would apply to indirect participants when in recovery.

We welcome the report's discussion on the dividing line between recovery and resolution

17. We welcome the report's discussion on the dividing line between recovery and resolution, as it is important that a common understanding exists across the industry and across jurisdictions. A common understanding reduces the potential for uncertainty and delay in an FMI recovery situation. We set out in the paragraphs below our views on the distinction between default management, recovery and resolution applicable to CCPs in cases where losses are triggered by a member default.

18. In the case of a member default the FMI is allocating losses according to the pre-funded and agreed loss allocation methods within its rules. This is managed by the CCP alone, and these resources and monitored and updated using daily risk management assessment as part of the FMI's core risk management activity.

19. This approach is in line with European Union market infrastructure regulations (EMIR and forthcoming CSD-R) that explicitly provide for "default procedure" requirements besides plans to recover FMI resources and activities.

20. Recovery starts at the point where all pre-funded financial resources set out within the CCP's default management procedures are exhausted. In this context it is not clear as to the extent to which the CCP's own capital is considered a pre-funded financial resource for the purposes of the CCPS-IOSCO paper. The same applies to collateral posted by non-defaulting participants, apart from their respective contributions to the default fund. Recovery is managed by the CCP itself, according to the ex-ante recovery plan agreed between the FMI, its members and the competent authority.

21. Resolution occurs at the point where all applicable loss allocation arrangements within the recovery plan are exhausted, or the resolution authority has determined they will not be sufficient to address outstanding losses, and thus there is no scope for recovery of the CCP without systemic disruption. Resolution is managed by the resolution authority.

We welcome the acknowledgment in the report that FMI should have flexibility in the design and implementation of recovery plans

22. We welcome the recognition in the report that FMI should have flexibility in the design and implementation of recovery plans. A flexible approach is most likely to achieve a successful recovery since it is the FMI itself that is best able to determine which tools would be the most appropriate in specific circumstances.

23. We support the point that CCPs should have the option (though not obligation) to develop segregated default waterfalls for specific product lines. In some circumstances, CCPs with segregated default funds may be more able to limit contagion and therefore reduce the impact of recovery measures on CCP members that are not clearing that particular asset class.

24. We welcome the report's assertion that the recovery tools described in section 3.5 may be exercised in a sequence best determined by the FMI itself, rather than in a pre-determined order. Again, it is this flexible approach that will enable the FMI to determine the most appropriate recovery tool based on the recovery plan agreed ex ante with members and regulators.

25. Similarly, we welcome the report's recognition that the list of tools set out in section 3.5 is not exhaustive and that FMI may incorporate other tools within their recovery plans, according to the needs of the particular market in which they operate.

We agree that an appropriate balance must be struck between automation and flexibility when implementing an FMI recovery plan

26. In line with our points above, we support the view in paragraph 2.3.7 of the report that an appropriate balance should be struck between the degree of automation of the recovery plan and the FMI's own flexibility in implementing the recovery plan.

27. We agree that an overly automated recovery plan would risk limiting the FMI's ability to respond to an unforeseen event in recovery, while an approach that accorded too much flexibility to the FMI would reduce the degree of certainty in the market as to how recovery would unfold. In this regard, 'certainty', in terms of the market's understanding of how losses would be allocated in recovery, is a key factor in preventing contagion and panic during the stressed environment that is likely to exist during a member default.

We encourage CPSS-IOSCO to underline the importance of a harmonised approach to FMI recovery across jurisdictions

28. Considering that different jurisdictions are at different stages of development in this area, we would like to stress that a harmonised global approach to FMI recovery is of systemic global importance. Currently, progress varies across jurisdictions and this risks creating an un-level playing field for FMI in relation to recovery planning requirements. This may also pose the risk of uncertainty in relation to cross-border recovery management for FMI with international members, given the global nature of most FMI participants.

It is important that recovery regimes address FMI losses occurring for reasons other than participant default

29. While a participant default is the most common risk anticipated for FMI, it is important that FMI recovery plans address losses occurring for reasons other than participant default. We recommend that the recovery arrangements between an FMI and its members distinguishes between losses arising from a member default, and those arising from losses made by the FMI itself, whether they are operational risk, legal risk or investment risk. Ex ante agreements in this respect will reduce delay in recovery scenarios and support market certainty in how losses may be allocated in recovery.

Specific comments on recovery tools:

Access to central bank liquidity

30. Access to central bank liquidity, on a secured basis, would be an effective way to address a CCP's potential liquidity shortfall in a period of financial instability. The benefit of this approach is that it could be deployed at the very onset of recovery, and potentially avoid the need to resort to other recovery measures, therefore reducing the market impact of a recovery scenario.

Recovery regimes should not give rise to open-ended liability

31. In our view, recovery regimes should not give rise to an open-ended liability for stakeholders such that they must indefinitely wholly or substantially recapitalise an FMI in recovery. It is important for the different stakeholders in an FMI (members, shareholders, indirect participants) to know that they do not have an unlimited liability placed upon them in the event of recovery, as this could create conflicts with their associated requirements for holding capital against liabilities.

Inter-company cash pooling may be an effective recovery tool for liquidity shortfalls

32. In relation to FMI that are part of broader groups, it is possible that a certain degree of inter-company pooling of treasury cash surpluses may also be a possible tool to address liquidity shortfalls in a recovery scenario. Such arrangements may be considered at the point that third party contributions are not available, or alongside contributions from non-defaulting participants on a secured basis.

Arrangements for transfer of core FMI services must have consideration for cross-border differences in company and civil law

33. We support in principle the transfer of core services to a bridge institution as a recovery tool to preserve operational continuity. However, it is important that the transfer of core FMI services to a bridge institution takes into account the fact that there will be cross-border differences in corporate, insolvency and civil laws, and bilateral agreements between the parties; ideally a process for managing these differences to achieve maximum certainty should be established beforehand.