SG Group answer to CPSS – IOSCO Consultative Report "Recovery of FMIs », August 2013

SG Group welcomes the proposed consultative report on Recovery of Financial Market Infrastructures issued on August 12, 2013, and would like to thank CPSS-IOSCO for the opportunity given to comment on the document.

We would like to introduce our note on the above report with a few macro-relevant considerations.

First of all, we have noted in the past two years a sustained activity among regulators in publishing surveys, consultations, reports and regulation or directive proposals regarding all types of Financial Institutions. As SG Group, we welcome these initiatives aimed at defining a global regulatory framework and at ensuring a better worldwide financial stability. However, we are concerned that fragmented approaches in the publications issued by different global or regional regulators could eventually create a distortion of interpretation and application among the various jurisdictions. While renewing our Group's commitment to a total respect of the new regulatory frameworks, we would like to keep advising the supervising authorities to concert at the highest level and make sure that the new draft regulations under study will be harmonised so as to avoid any risk of conflict or unbalance among themselves (see, as a mere example, article 45.4 of the European EMIR Regulation which states that "A CCP shall not use the margins posted by non defaulting clearing members to cover the losses resulting from the default of another clearing member").

As already discussed in the previous consultations regarding FMIs, the SG Group confirms its position in favour of a strict global "level playing field". In our view, and because the existence of competition between the different systems cannot be ignored, it is of the utmost importance that the new guidelines on the Recovery of FMIs distinguish appropriately between private-sector and public-sector FMIs. In this respect we would particularly highlight the consultative report's recommendation that "*FMIs should not expect public funds to be made available to maintain their viability" (*see for instance consultative report article 2.1.3). This assertion seems to suggest that public-sector FMIs (notably those run by central banks) would either have to find sources of capital and liquidity on their own and outside of the public sphere, or that they would not at all be considered in the scope of recovery planning - which would not be compatible with the objective of a global level playing field. Similarly, we recommend the report clarify that all FMIs, irrespective of their licensing status (e.g. FMIs licensed as banks), should have comprehensive and effective recovery plans.

Finally, as we note that many of the issues raised by the Consultative Report are of particular relevance only to certain specific types of FMIs such as CCPs, we would recommend that in its final document the CPSS-IOSCO provide greater guidance and segmentation with regard to the applicability of individual requirements. For example, the references to "contract tear-ups" are inappropriate for Payment Systems since they would contradict rules establishing legal finality of transactions and suggest that, under given circumstances, all FMIs would be entitled to tear-up legally binding contracts, which could be problematic in countries having strict unfair contract terms legislation. Similarly, a more precise segregation in the report between the different types of CCPs could also prove useful since CCPs' products cleared scopes are very large and the tools indicated in the consultative report may not be appropriate for all CCPs (cf. efficiency, impacts, readiness to implementation …).

You will find thereafter our more specific comments on the aforementioned report consultation.

- Definition of the beginning of "recovery" for an FMI: referring to article 2.4.4 "Triggers": the consultative report should provide more guidance as to when a FMI can be considered as being effectively in recovery and to who is entitled to "pull the trigger" which will lead to an effective implementation of the recovery plans. Notably, an FMI should not be considered to be in recovery so far as a defaulting participant's guarantee funds posted with the FMI are sufficient to recover any loss caused by the default. Recovery begins when it is necessary to draw on mutualised guarantee funds, without the need to define ex-ante quantitative and qualitative criteria that will trigger the implementation in whole or in part of the recovery plan.

- Replenishment (see also article 3.3.1 of the consultative report): the report should provide greater clarity as to the time constraints in restoring an FMI's financial resources to at least the minimum level required by regulation. In our view, replenishment measures and rules should be defined ex ante to assure a quick and effective resources restoring within a predefined and agreed timeframe. The "rebooting" of critical activities would thus be better assured.

- In the various Recovery and Resolution consultations and documents that have been issued, when an FMI enters in recovery, a distinction is usually made between FMI recovery processes due to participant default and recovery processes due to other causes, with an aim to ensuring that recovery tools be appropriately designed. Regarding recovery cases due to a participant default, we believe that a further sub-distinction should be made depending on whether the defaulting participant is only a participant of a core service of the FMI (i.e. the critical services that should be maintained via a recovery planning) or if it is also a user of ancillary services offered by the FMI (i.e. services for which the FMI implicitly takes the risk). There is indeed a difference between FMI whose core function is to concentrate risks, such as CCPs, and FMI which, by providing ancillary services to their participants, accept to bear risks not strictly related to their FMI role (e.g. CSDs which would have developed

securities lending services). For the same reason that we support the idea of having separate clearing funds (one per type of product cleared) within a given CCP in order to avoid having a participant of a given segment of activity to pay for the default of a member active in another segment, we recommend that such a distinction be made between critical functions participants and risk-bearing ancillary activities participants. In this respect, a more precise guidance about the identification of critical services for each type of FMI, in accordance to the CPSS IOSCO PFMIs published in April 2012, would be helpful as it would help providing a <u>common and homogeneous</u> framework across the various jurisdictions. In this respect, we consider that it should not be left to an FMI's discretion to decide which service should be considered critical.

- As Trade Repositories' role is to keep records on all transactions on derivatives, they should not face any credit or liquidity risks. It is also unlikely that business risks be directly tied to their core functions. But it is to be noted that like other FMIs, they might want to offer risk-bearing ancillary services, and that defaulting TRs could bring systemic risks to the CCPs they serve. TRs should therefore be sufficiently capitalized, and since a defaulting TR's participant could not be the cause of a TR entering in a recovery phase, participants should not be called for any loss allocation.

- Allocation processes for losses and liquidity shortfalls should, in accordance with Principle 23, be predictable ex-ante for all participants in order to allow them to assess the risks they could incur by participating in the FMI (see item 3.3.3 of the consultative report). Appropriate loss-allocation rules can vary widely depending on the nature and business model of the FMI and of the FMI's stakeholders' underlying arrangements.
  In the context of recovery planning, we believe that participants' liabilities should be contractually capped for any given type of risks 1) because a financial institution would not be authorised by its prudential regulator to participate without having any control on its potential exposures, 2) in order to avoid giving incentives to participants to clear or settle outside the FMI and 3) in order to avoid contagion and further participants' default. However, in case of a major FMI incident, there could be a probability that the sum of participants capped liabilities could not be sufficient enough to absorb the totality of FMI's losses. Consequently, we think that references to the concept of "allocating losses fully" (see for example point 1.1.3 of the consultative report) should be removed from the recovery of FMI report. We also understand that this situation could trigger the FMI move to a phase, and further guidance on this topic (notably clarity on when resolution should be pursued instead of recovery) would be appreciated.
  Finally, we also recommend the sentence "*In order to allow effective implementation of recovery plans, recovery tools should, to the maximum extent practicable, be agreed and established as binding ex-ante*" (see the first page of the consultative report) be amended to exclude the "to the maximum extent practicable" item. In our view, FMI participants have indeed the necessity to know ex ante the <u>precise scope of the tools</u> that could be used in the course of a recovery phase in order to assess and

manage the risks they incur when becoming participants. And as recalled in the Consultative Report introduction, *"…, 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, 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.*"; there is therefore no room for uncertainty when it comes to the recovery tools a FMI may use CCP recovery methodologies should not invalidate the criteria for accounting and prudential exposures netting. Should this netting principle be no longer applicable, central compensation would result economically non viable for participants. In this light, we are not in favour of the suggested "forced allocation" and "forced tear up" measures outlined in the Consultative Document.

- With reference to resolution, FSB states that "early termination rights should not be exercisable by any participant in an FMI or other counterpart under a financial contract solely by virtue of the entry into resolution of an FMI" (see EN 4.1 g of FSB's draft document "assessment methodology for the Key Attributes of Effective Resolution Regimes for Financial Institutions" issued in August 2013). We think that further guidance on early termination rights in the recovery process would also prove helpful in CPSS-IOSCO consultative report. Indeed, in the case of FMIs, the entry in resolution might be almost immediate after a short recovery period. There is therefore a need to ensure that CPSS-IOSCO recovery guidelines be perfectly coherent with FSB resolution key attributes so as to avoid potential participants' exit strategies between the FMIs' recovery and resolution phases which could have negative side-effects and could lead to systemic risks.

- Creditors' treatment in a recovery and in a resolution phase should be consistent with the treatment of individual creditors in an insolvency in order to facilitate risks management and abide by the "no creditor worse off than in liquidation" rule.

- The Consultative Report should clarify that in a recovery process which does not derive from participant default, deposited margins (whether initial margin or variation margin) should not be submitted to margins haircuts. Regulatory FMI capital ought to ensure that such possible losses be absorbed.

- In the event of a recovery process deriving from a participant default which would be so critical that the pre-defined waterfall should prove insufficient, we consider that, when permitted by the law, haircutting of the variation margin gains cumulated since the relevant default would be the most appropriate of the tools envisaged by the Consultative Report in the light of the principles outlined in the Report and in our response above. On the contrary, we are strongly opposed to the initial margins haircutting tool since it entails neither predictable nor manageable risks.