

October 11, 2013

CPSS Secretariat
Bank for International Settlements
4002 Basel
Switzerland
cpss@bis.org

IOSCO General Secretariat
C/ Oquendo 12
28006 Madrid
Spain
fmi@iosco.org

Re: Consultative Report, *Recovery of Financial Market Infrastructures*

Dear Sirs and Mesdames:

The Clearing House Association L.L.C. ("Association") and The Clearing House Payments Company L.L.C. ("PaymentsCo" and, together with the Association, "The Clearing House")¹ appreciate the opportunity to provide comments to the Committee on Payment and Settlement Systems of the Bank for International Settlements ("CPSS") and the Board of the International Organization of Securities Commissions ("IOSCO") in response to their consultative report on *Recovery of Financial Market Infrastructures* ("Consultative Report"). This Consultative Report is a follow-up to CPSS and IOSCO's earlier consultative paper on recovery and resolution of financial market infrastructures, which was released last year.² In our response to that consultative paper,³ The Clearing House commended CPSS and IOSCO for taking on the important topic of recovery and

¹ Established in 1853, The Clearing House Association L.L.C. is the nation's oldest banking association and payments company. It is owned by the world's largest commercial banks, which collectively employ 1.4 million people in the United States and hold more than half of all U.S. deposits. The Association is a nonpartisan advocacy organization representing through regulatory comment letters, *amicus* briefs, and white papers the interests of its owner banks on a variety of systemically important banking issues. Its affiliate, The Clearing House Payments Company L.L.C., provides payment, clearing, and settlement services to its member banks and other financial institutions, clearing almost \$2 trillion daily and representing nearly half of the automated-clearing-house, funds-transfer, and check-image payments made in the U.S. See The Clearing House's web page at <http://www.theclearinghouse.org> for additional information.

² CPSS-IOSCO, *Recovery and Resolution of Financial Market Infrastructures* (Jul. 31, 2012).

³ Comment letter of The Clearing House (Sept. 28, 2012) available at <http://www.theclearinghouse.org/index.html?f=074392>.

resolution planning for FMIs and increasing awareness of these issues by FMIs, their regulators, and the wider range of market participants. In our comment letter we made a number of suggestions, one of which was to

urge CPSS and IOSCO to adopt a more long-term project plan and analyze the comments received; hold a series of meetings with commenters, including major FMIs, their owners, participants, and other interested parties; and then issue a new consultative report that summarizes the comments, gives an indication of how CPSS and IOSCO believe the comments should be addressed, and seeks another round of comments on the revised paper.⁴

We are pleased that CPSS and IOSCO have adopted this approach, with this new consultative report limited to recovery and with the recent meeting in New York to discuss these issues with interested parties in North America.

Like our 2012 comment letter, this letter will not attempt a comprehensive exploration of all aspects of the recovery of all kinds of FMIs, nor will we attempt to analyze these issues from different points of view (e.g., participants in CCP-type systems); rather we will address the portions of the Consultative Report that apply to systemically important payment systems ("SIPS") from the view of a SIPS operator. Again, our comments are informed by our more than 40 years' experience in operating a large-value funds-transfer system. The Clearing House Interbank Payments System ("CHIPS") has been in operation since 1970 and currently processes more than \$1.5 trillion (U.S.) in payments on an average day. The Clearing House pioneered many of the techniques that later became standard risk-mitigation procedures for SIPS, including bilateral credit limits, sender net debit caps, and collateralized loss-sharing agreements. Moreover, CHIPS has been in compliance with the CPSS's *Core Principles for Systemically Important Payment Systems* ("Core Principles") since their adoption in 2001, as it was in compliance with the "Lamfalussy Standards" when they were adopted in 1990. We therefore have considerable experience not only in operating a SIPS, but in meeting all applicable standards for the safe and sound operation of such a system.

Last year, PaymentsCo was designated a systemically important financial market utility by the Financial Stability Oversight Council ("FSOC") under Title VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act because of its operation of CHIPS.⁵ As such PaymentsCo is subject to regulation of by the Board of Governors of the Federal Reserve System. Because the Federal Reserve Board has announced its intention to seek public comment on a proposal to adopt the rules set out in the CPSS

⁴ *Id.* at 4.

⁵ Financial Stability Oversight Council, *2012 Annual Report* at 146-51.

and IOSCO's recent paper *Principles for Financial Market Infrastructures* ("PFMI") for the organizations it regulates, the CPSS and IOSCO's final reports on recovery and resolution planning will almost certainly be an important guide for interpreting the sections of the PFMI and may ultimately be applied to PaymentsCo. This fact gives The Clearing House a keen interest in any final report that CPSS and IOSCO will issue on these topics.

SUMMARY

1. The Clearing House strongly supports the overall proposition that FMIs should be required to have in place comprehensive and effective recovery plans to recover from threats to their viability and continue to provide essential services.

(a) The Clearing House supports most aspects of the recovery plan that are set out in the Consultative Report, but we believe that stress testing should be done on an as-needed basis rather than according to a regular schedule.

2. Tools for recovery should be tailored to meet the particular circumstance of individual FMIs, including the risks they face and their organizational and ownership structures.

(a) We are opposed to any requirement that owners of FMIs must pay in additional capital over and above what they agreed to in advance when they joined the FMI. Rather recovery plans should identify sources of funds that the FMI could appeal to if it does need to recapitalize.

(b) Insurance should be at the discretion of the FMI, and regulators should not require specific insurance coverage.

3. While continuity of service is important, an FMI should not be forced to continue in business against its will.

DETAILED COMMENTS

1. The Clearing House strongly supports the overall proposition that FMIs should be required to have in place comprehensive and effective recovery plans to recover from threats to their viability and continue to provide essential services.

(a) The Clearing House supports most aspects of the recovery plan that are set out in the Consultative Report, but we believe that stress testing

should be done on an as-needed basis rather than according to a regular schedule.

The Consultative Report is intended to provide guidance to FMIs on the development of “comprehensive and effective recovery plans” that will allow them to address threats to their ability to maintain their viability as a going concern “without requiring the use of resolution powers by authorities.”⁶ The Consultative Report thus stops short of resolution of FMIs,⁷ although it recognizes that “[t]he line between recovery and resolution is not fixed and is likely to vary from jurisdiction to jurisdiction.”⁸

The Clearing House agrees that FMIs should have strong and comprehensive risk-management practices and that recovery planning should be integrated into the risk-management framework. As part of its risk-management strategy and planning, an FMI should identify to the extent possible any threats to its ability to continue to provide its services and should also have plans to address those threats if they materialize.

The Consultative Paper states that recovery plans should

1. identify the FMI’s critical services, stress scenarios that could prevent the FMI from providing those services as a going concern, triggers for implementing the plans, and tools that would be used in executing the recovery plan;
2. assume that any stress can be met by the resources of the FMI, its owners, and participants and should not assume taxpayer or central bank support;
3. be approved by the board of directors;
4. identify a senior executive responsible for ensuring that the FMI observes its recovery-planning requirements and that recovery planning is integrated into the overall governance processes;
5. ensure that the recovery tools to be used are established as legally binding on all those involved;

⁶ Consultative Report at 3.

⁷ Resolution of FMIs is covered in Appendix I of Financial Stability Board, *Application of Key Attributes of Effective Resolution Regimes to Non-Bank Financial Institutions* (Aug. 12, 2013).

⁸ Consultative Report at 3.

6. be tested at least annually by simulation and scenario exercises;
and
7. contain a strategic analysis to address potential structural weaknesses in the FMI's business model.⁹

In general, The Clearing House agrees with most of these elements. We are concerned, however, that the insistence that the plans be tested at least annually by simulations and scenario exercises may be excessive and counterproductive.

Identification of risks is an indispensable part of any organization's risk-management procedures. In any business, new risks arise and old ones fade, but this does not happen on any particular schedule. A robust risk-management program for an FMI will continually scan all aspects of an FMI's business to identify risks to its continued viability. As new risks are identified, they will be integrated into the recovery plan, and the plan will be tested against a scenario that includes the new risk. These updates to the recovery plan should be done anytime the need arises and not on a regular schedule. On the other hand, nothing is gained from continually running stress scenarios if a diligent risk-monitoring system identifies no new conditions that would render an existing recovery plans obsolete. Indeed, continual repetition could be counterproductive in that it could breed complacency in an FMI and its supervisors.

We therefore suggest that FMIs test their recovery plans on an as-needed basis as determined by the FMIs and their supervisors.

2. Tools for recovery should be tailored to meet the particular circumstance of individual FMIs, including the risks they face and their organizational and ownership structures.

The Consultative Report correctly notes a recovery plan should "identify appropriate recovery tools, indicate the necessary steps and time needed to implement them, and assess the associated risks,"¹⁰ and the report goes on to outline the tools that could be used to recover an FMI.¹¹ In general, we agree that recovery tools should be comprehensive, effective, transparent, and provide appropriate incentives (i.e., provide the owners and participants with the incentives to monitor the FMI's risk taking and management of those risks).

⁹ Consultative Report at 5-8.

¹⁰ *Id.* at 9.

¹¹ *Id.* at 12-26.

Most of the discussion of recovery tools set out in the Consultative Report deals with the kinds of tools that would be necessary to recover from specific kinds of losses that could be experienced by certain FMIs (e.g., tools for CCPs to re-establish a matched book). Since PaymentsCo does not become a party to its participants' transactions, it never incurs any financial obligation with respect to the payments it processes, and would therefore not suffer a loss should one of the participants default. Thus much of this discussion in the Consultative Report is of little or no relevance to PaymentsCo.

A recovery plan for PaymentsCo would require tools to address losses that are not related to a participant default, such as operational risk, general business risk, and investment risk. Tools that the Consultative Report recommends for these kinds of risks include recapitalization, insurance, and indemnities. Each of these tools has its uses, but they also have certain limitations that should be recognized.

- (a) We are opposed to any requirement that owners of FMIs must pay in additional capital over and above what they agreed to in advance when they joined the FMI. Recovery plans should identify sources of funds that the FMI could appeal to if it does need to recapitalize.**

Recapitalization may be required when an FMI must replenish its resources to continue its systemically important operations. The Consultative Report notes that the types of tools to be used for recapitalization would be dependent on the FMI's organizational structure, but could include *ex ante* arrangements to call on the owners for additional capital contributions and *ex ante* arrangements to take on new owners.

We are opposed to any requirement that owners of FMIs must pay in additional capital over and above what they have agreed to in advance when they joined the FMI. In many cases the owners of an FMI will themselves be regulated financial institutions. In those cases their supervisors will as a matter of course condition their approval of the banks' investment in the FMI on there being limited liability with no mandatory capital calls. This is a basic safety and soundness principle for the regulator—any investment that a bank makes must be predictable and limited. Moreover additional voluntary contributions to capital may also be subject to the supervisor's or approval, and thus the FMI may not be able to raise capital through this mechanism in an expeditious manner. While *ex ante* agreements to make additional capital contributions up to agreed-upon limits may be a useful tool for recapitalizing a troubled FMI, it is not clear that any bank supervisors would allow banks under their jurisdiction to enter into such agreements. Finally, it goes without saying that once the limits agreed to are reached, there can be no requirement for a bank to contribute additional funds to the FMI.

We are also skeptical of proposals for FMIs to be recapitalized by bringing in new owners in the event of a crisis. It does not seem likely that potential investors would

agree in advance to provide capital for an organization at the point where its viability could be called into question.

We do believe that an FMI's recovery plan should identify sources of funds that the FMI could appeal to if it did need to recapitalize.

(b) Insurance should be at the discretion of the FMI, and regulators should not require specific insurance coverage.

We agree that insurance is a useful tool for managing certain kinds of risk, but we believe that the kinds and amounts of insurance that an FMI should have should be a matter of judgment for the FMI. Regulators should not require FMIs to have certain kinds of insurance at preset limits. The kind of insurance needed will depend on the business that the FMI engages in and its risk tolerance, and it may make sense for an FMI to self-insure for certain kinds of risk where the premiums and deductibles are high and the coverage limited. Moreover, the claims process for insurance can be quite lengthy and may not be rapid enough for to allow an FMI to recover in time to meet regulatory expectations.

3. While continuity of service is important, an FMI should not be forced to continue in business against its will.

The Consultative Report briefly discusses the line between recovery and resolution, saying that if an FMI cannot recover to the point where it is a viable going concern, it may be forced into orderly wind down or resolution but that the authorities may find that orderly wind down is not appropriate because the FMI is the sole provider of critical services and there is no alternative provider. In those situations the paper says that "the supervisor's choice of resolution powers should be guided by the need to maintain continuity of critical FMI functions."¹² Nevertheless, an FMI should not be forced to continue in business against its will. If its business model no longer yields profits and it cannot reverse course, it should be permitted to wind down its affairs in an orderly manner to minimize any market disruption. If the authorities do believe that the services that the FMI are essential but the FMI cannot continue to provide them, the public sector should take those functions over itself rather than force a private concern to continue to provide them at a loss.

* * * * *

¹² *Id.* at 6.

We hope that these comments have been helpful. If you have any questions about any matter discussed in this letter please contact me at 212-612-9234 or joe.alexander@theclearinghouse.org.

Very truly yours,



Joseph R. Alexander
Senior Vice President, Deputy
General Counsel, and Secretary

cc: Ms. Louise L. Roseman
Board of Governors of the Federal Reserve System

Mr. Jeffrey C. Marquardt
Board of Governors of the Federal Reserve System

Mr. Jeff Stehm
Board of Governors of the Federal Reserve System

Mr. William C. Dudley
Federal Reserve Bank of New York

Ms. Sandra C. Krieger
Federal Reserve Bank of New York

Mr. James McAndrews
Federal Reserve Bank of New York

Mr. Lawrence M. Sweet
Federal Reserve Bank of New York

Mr. Sean Sullivan
Federal Reserve Bank of New York

Mr. Amias Gerety
U.S. Department of the Treasury

David J. Schraa, Esq.
Institute of International Finance