11 October 2013

Euroclear response to the CPSS-IOSCO consultative report on Recovery of Financial Market Infrastructures

This response is provided on behalf of the Euroclear group of companies ("Euroclear"). Euroclear comprises the International Central Securities Depository Euroclear Bank, based in Brussels, as well as the national central securities depositories Euroclear Belgium, Euroclear France, Euroclear Nederland, Euroclear UK & Ireland, Euroclear Finland, and Euroclear Sweden.

Summary:

1. **We welcome the high quality of the report. We also welcome the proposal of a recovery regime for Financial Market Infrastructures (FMIs) and the recognition that it needs to preserve the continuity of critical services to the market.**
2. **But we note that the report remains primarily focused on Central Counterparties (CCPs). It does not differentiate enough between various types of FMIs, particularly between CCPs and other FMIs (such as Central Securities Depositories (CSDs) with a banking licence) which might take credit risk but do not mutualise risk and have very different end-to-end risk management.**
3. **We welcome the degree of discretion given to the FMIs in defining and selecting appropriate tools to be used to maintain financial viability under stress. Other elements of decision-making in recovery (e.g. implementation of recovery options following activation of triggers) should be left to the judgement of the FMI's Management and Board as well. For this reason we believe that the final report should be explicitly formulated as Guidance to Management and Boards.**
4. **An FMI should not be required to fully allocate losses (i.e. unlimited allocation) to the FMI's stakeholders, irrespective of the FMI's specific characteristics. Nor should it be expected that FMIs be equipped to face any type of stress, but rather only the stress covered in the scenarios agreed with the competent authorities.**

5. **Some tools proposed in the report (i.e. loss allocation to participants, requirement for *ex ante* commitments from the owners or third parties) could create <u>inappropriate incentives</u>, potentially leading to further pro-cyclicality, the sale of the FMI's shares, a refusal to continue providing liquidity to the FMI, or a move towards indirect participation. This would go against authorities' current efforts to put more business through FMIs in order to mitigate systemic risk. Hence, the tools may result in creating new risks for the FMIs and for the market. Furthermore, the tools should not <u>create moral hazard by transferring the risks from the FMI's management or owners</u> (in respect of their existing participation) to other creditors and stakeholders. For these reasons, <u>we are firmly against requiring CSDs to implement a mandatory allocation of losses to participants and shareholders as a recovery measure.</u> We would encourage CPSS & IOSCO to examine the extent to which the proposed loss allocation is economically optimal for the market and analyse the potential effects of the proposed provisions on market structure.**
6. **Ex-ante limited loss allocation tools (such as default or other funds) should be viewed as an alternative to capital in excess of regulatory requirements, not solely as a complement to regulatory capital. Furthermore, by requiring loss allocations, legislators may incentivise FMIs to decrease their available capital. The balance between available and regulatory capital serves the same purpose as other loss allocation tools, with the benefit of not transferring the risks to the market during the crisis.**
7. **Finally, the EU directive for Bank Recovery and Resolution (BRRD) will apply to those FMIs that have a banking licence or are part of a banking group. The CPSS/IOSCO and FSB initiatives (which apply additional binding *ex ante* tools, safeguards, and adopt different provisions on funding) are not consistent with the BRRD, which is more advanced in the legislative process. <u>We would welcome swift policy efforts to avoid inconsistencies between the global and regional/national frameworks.</u>**

<u>I. Guidance related to recovery plans and recovery planning</u>

Degree of discretion

We **agree with the overall content of the recommendations**, in particular with respect to the need to define critical activities, recovery triggers, a recovery governance and process, stress scenarios and, most importantly, appropriate recovery options. FMIs' recovery plans should be drafted in a way that allows swift and complete return to viability and be sufficiently transparent. However, we find the executive summary and certain other parts of the report **too prescriptive** (which contrasts with the overall more balanced analyses contained in the body of the report). Crises always show unpredictable characteristics; FMIs models and governance can also differ significantly. **Therefore, the report should create a general framework for recovery plans and recognise that FMIs need to retain discretion in determining which recovery options to identify, analyse and describe in the plan.** They need similar discretion in deciding (even if in consultation with competent authorities) which recovery options to activate in case of need and how to apply them. FMIs would take these decisions on the basis of their specific characteristics and of other available recovery options. Management and Boards should be able to take into account the particularities of the crisis they would be facing. Most importantly, recovery plans should contain all relevant information for

ensuring rapid decision-making and implementation. The recovery governance should also allow timely and appropriate decisions to be taken.

Definition of Recovery

Before expressing our views on the distinction between recovery and resolution, we would like to comment on the definition of recovery in the report (p. 3). **We consider recovery *measures* to be "actions by the FMI to address any loss [whether caused by a credit or operational event], liquidity shortfall, capital inadequacy, or business loss that threaten its short to medium-term viability".**

Tools to address structural weaknesses

In this context, we find the inclusion of a reference to the remedy of structural weaknesses, in particular operational weaknesses, confusing. Addressing operational weaknesses and drawing lessons from major incidents should be part of normal risk management processes, geared towards maintaining an adequately control environment in the FMI. It seems that the chapter on structural weaknesses (2.4.10-2.4.13) groups together actions of a very different nature, which do not all belong in a recovery plan:

- **Business Continuity/Day to day Risk Management:**

  Measures to improve the overall risk and control environment: any additional such measures may be identified during the recovery planning exercise, but their place is not in the recovery plan. These are not measures that would be implemented in case of crisis, but rather would be put in place structurally to improve the FMI's overall resilience. This applies to measures to reduce risks and interconnectedness. This can also include measures to address control failures having led to important operational losses. (A difference between the operational problems themselves and the threat to the viability that they represent should be clearly made. The measures addressing the immediate viability concerns caused by the operational issues should be the only ones to belong to recovery.) The purpose of these measures is to prevent the next crisis from hitting the FMI too hard, but such measures are not designed to allow the FMI to recover.

  Measures to facilitate the continued provision of services in the face of an event that would not (necessarily) threaten the viability of the FMI. This is true for the example given on p.10 concerning the failure of a settlement or correspondent bank. The FMI needs to ensure it has a solution in place preventing any disruption in the provision of market-critical services. Rather than recovery tools we would qualify such actions as business continuity measures (which would be: switching to an alternative settlement bank/cash correspondent in times of crisis). What distinguishes these measures from financial recovery tools is that taking the FMI in resolution would not facilitate the process.

- **Recovery: Measures to ensure continued viability under stress**. These include business measures (mostly to be taken if the FMI's Profits & Losses balance deteriorates in such a way that its viability is threatened) and divestments (which can be executed to get rid of less profitable business units, or to recapitalise core businesses under threat).

Distinction between recovery and resolution

A clearer distinction between recovery and resolution, and their respective objectives is necessary. An orderly wind-down should be considered as a resolution measure, not a recovery objective. Such a decision will be most effectively implemented by the resolution authorities.

In theory, the FMI should not be taken into resolution for as long as it would be able to implement recovery measures effectively and restore its financial viability without regulatory intervention. Resolution has been introduced in banking legislation with a view to avoiding disorderly liquidation in insolvency. In contrast to resolution, insolvency does not seek to preserve financial stability. As a consequence, **resolution should only be launched once insolvency cannot be avoided**.

In practice, however, we understand that regulators may wish to retain some discretion in that respect and be able to put an FMI into resolution if they believe the FMI will not be able to restore its financial health in a timely manner.

Role of authorities in the design, approval and implementation of FMIs' recovery plans

The role of competent authorities should be to assess if the coherence and comprehensiveness of a recovery plan, together with overall risk framework fully achieves the recovery objectives[1] and allows for a timely return to financial viability.

Critical services[2]

The report effectively argues that, as FMIs are offering critical services to the market, their viability is of major importance, and therefore a recovery plan is needed. We believe that the identification of critical services can be used to determine whether recovery tools are appropriate or whether additional safeguards would need to be taken when these tools are exercised. It is useful to distinguish two categories of criticality from the point of view of importance of services for the market and the urgency of finding a solution:

- Can the service be stopped abruptly without endangering financial stability?
- Can the service be unwound over a short to medium timeframe? (E.g. Is it substitutable?)

Where no alternatives exist, ensuring recovery tools are effective and comprehensive seems essential. Where alternatives are easily available, a lower degree of comprehensiveness may be envisaged.

Triggers

In line with other international guidance in this area (in particular from the FSB and the EBA) triggers (2.4.4) should not automatically lead to implementation of the recovery plan. Activation of a trigger should mandate a meeting of an appropriate governance body, which would then assess whether activating recovery tools would be needed.

II. Guidance related to recovery tools

The report's emphasis on participant default seems excessive, in particular for those FMIs that are not exposed to their participants directly (such as most CSDs). As a consequence, the classification of recovery tools (p.17, point 3.4.3) is too focused on losses resulting from a default and is therefore not consistent: the first three - (i) to (iii) and partially (v) - are mainly designed to handle a specific scenario of a participant default. Point (vi) covers other causes of loss at the FMI).

[1] Restoring the financial health of the FMI in order to ensure continuity of critical services, timely settlement of obligations, continuous access of participants, and unhampered operation of links (cf. resolution objectives set out in the FSB Key attributes and the Consultation on resolution of FMIs).
[2] We note that, in comparison with the provisions for Banks, the objective of FMI's recovery is to restore only the provision of critical services and not the provision of core business lines. We agree with this approach for FMIs.

We would suggest re-classifying recovery tools in line with their objectives:

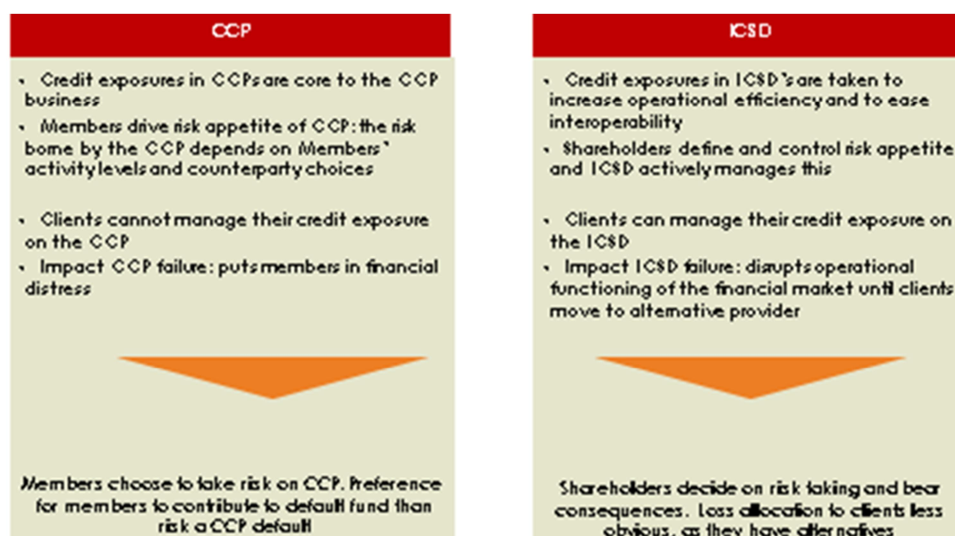
i. Ensuring the FMI retains sufficient capital: (i) by absorbing losses (related or not related to credit risk, on participants or any other relevant counterparties) or (ii) by recapitalising;
ii. Ensuring the FMI is able to respond to liquidity issues (for CSDs with a banking licence only; already covered by the CPSS/IOSCO Principles for FMIs[3]);
iii. Ensuring the profitability of the FMI is restored.

Allocating uncovered losses caused by participant default and tools to replenish financial resources[4]

The consultation mostly focuses on issues related to CCPs. The report does not recognise that risks related to participant defaults are not equally material for all FMIs. This is particularly true for (most) CSDs that do not provide credit risk. Their exposure on participants is limited to the non-payment of fees, which is a non-issue from a recovery planning perspective.

The purpose of CCPs is very different from that of CSDs, as they have been set up to mutualise risks. Their exposures can be very long-term, not related to business decisions of the CCP itself and are the result of complex transactions that are often difficult to value. It is difficult for a CCP to decide on the exposure it takes on its participant. Where a CSD provides credit, any related exposures are very short-term (often intra-day), fully collateralised, transactional and the CSD itself decides upon the credit it is willing to extend. Therefore, while loss allocation to (non-defaulting) participants seems to be a logical solution to protect a CCP from a threat that it was unable to prevent, for a CSD, the allocation of losses – that it was able (but failed) to prevent – to its participants cannot be justified.

The assumption for position-based allocation tools that "any shortfall or loss resulting from a participant default cannot exceed the associated amount owed to non-defaulting participants" (3.5.10) is not true for all FMIs. While it is obviously applicable to CCPs, it is not always the case for CSDs providing credit to their participants. Indeed, credit is provided by CSDs to allow participants to buy securities and execute payments to other participants who in turn, buy other securities with that cash, or wire the cash out of the system. There is no *natural* compensating position that would be maintained throughout the day.



[3] Principle 7 of the CPSS/IOSCO Principles for FMIs states: "*An FMI should effectively measure, monitor, and manage its liquidity risk. An FMI should maintain sufficient liquid resources in all relevant currencies to effect same-day and, where appropriate, intraday and multiday settlement of payment obligations with a high degree of confidence under a wide range of potential stress scenarios that should include, but not be limited to, the default of the participant and its affiliates that would generate the largest aggregate liquidity obligation for the FMI in extreme but plausible market conditions.*"

[4] We understand that variation margin haircutting is an example of position-based loss allocation, which is a subset of cash calls. These tools do not seem to be mutually exclusive. This is confusing for the reader.

Tools to replenish financial resources or allocating losses not relating to participant default

As a result of the nature of the risks that they take (see above) CSDs (whether they have a banking license or not) do not generally operate default funds, unlike CCPs. Consequently, the resource which may require to be replenished is the FMI's capital and/or liquidity facilities used. The amounts of capital at risk as a result of the default of a participant are not material for those CSDs that do not take credit risk, and they would barely impact the capital of the relevant CSD. And the available capital of CSDs with a banking licence should cover any loss resulting from a participant default. In case of a severe financial loss (related to participant default or not), recapitalisation is one of the possible tools to be used. It should however not be made a mandatory recovery tool and be entirely left at the discretion of FMIs owners, including for user-owned FMIs, in order to avoid moral hazard and ensure a level playing field with other institutions not having similar tools.

Different options for raising capital may be considered, depending on whether the exercise is to be performed *ex ante* or *ex post* in response to a viability concern. Taking *ex ante* actions is particularly useful when the level of FMI's capital is not sufficiently high. It is less necessary to add such layers of diversified capital, if the available capital is already significant: any capital or any limited loss allocation will be similarly insufficient in addressing uncapped losses. Capital is, however, immediately available and can be used significantly quicker than the majority of other recovery tools.

Some other tools that have already been proposed for banks, such as intra-group financial support, can also be valid for FMIs.

Tools addressing uncovered liquidity shortfalls

The list includes two tools: obtain liquidity from third-party institutions and obtain liquidity from non-defaulting participants. We believe this adequately identifies possible tools. However, the implementation and use of this recovery tool should be left to the discretion of the FMI (as with other recovery tools). When taking a decision to call for liquidity, the FMI must consider any detrimental impact on the market and potential amplification of systemic disturbances that a call on participants may create and the type of liquidity needed.

Insurance

In the majority of cases, insurance is already in place to cover losses not related to counterparty failure (mainly operational risks). Insurance agreements are reliable, effective and timely for covering operational risks, provided the amounts insured are appropriately defined and the insurance counterparties appropriately selected (often it is a "syndicated" insurance shared across several insurance companies). Insurance can also be considered as a recovery option.

III. Guidelines used to judge the appropriateness of recovery tools

The need for additional loss allocation in FMIs must take into account the end-to-end view of risk management and the entire loss allocation waterfall of the respective FMI. The FMI's ability to absorb losses is a key factor. This may include loss allocation to the defaulting participant, to non-defaulting Participants, to owners and, for operational risks, to third parties (for CSDs, insurance). The CPSS/IOSCO guidance is largely capital neutral; it does not differentiate between FMIs which may hold capital significantly in excess of the regulatory minimum requirements. Some CSDs may operate default funds or loss allocation funds as a complement to relatively low levels of capital in comparison to other FMIs. The report assumes that whatever capital an FMI holds, any significant loss must be replenished. We believe that this approach will encourage shareholders in infrastructures to commit the minimum amount of regulatory capital to the FMI in the knowledge that any capital shortfall will

have to be replenished by other creditors and clients. The Proposals, therefore, would lead to a transfer of risk from shareholders to other creditors.

An FMI should not be required to fully allocate losses (i.e. unlimited allocation) to the FMI's stakeholders, irrespective of the type of FMI and its risk profile and capital adequacy. Moreover, capital should be deemed a valid recovery resource, which can be used in situations of the highest urgency and should not be replaced by any other recovery tools.

We believe that the appropriate mix of different tools (including available capital) and the criteria for determining which parties (participants, owners or other parties) should bear losses shall depend on the following elements:

i. The type of losses to be allocated (e.g. insurance is particularly useful to cover operational losses).
ii. The type of FMI: tools should be crafted in line with the FMI's profile and the role it plays, and consequently require different approaches towards CCPs, CSDs and other FMIs.
iii. The competitive environment: are there alternative providers? Can participants defect to competitors if requirements to participate in the FMI are excessive? Can participants switch to alternative providers if the FMI appears unable to continue providing services to its participants?
iv. The incentives that the tools may create: asking participants or service providers to commit to a loss allocation scheme is likely to significantly reduce their number, which may become a sort of structural weakness and exacerbate systemic risks in a crisis (due to limited mutualisation) (for more examples, please see below).

IV. Incentives and impacts of recovery tools on direct and indirect participants

We are particularly concerned by the **moral hazard** created by the loss allocation through removing responsibility from the FMI's management (and owners) and transferring FMI's risks to clients and other creditors. **We believe that the loss allocation is not appropriate for CSDs.**

Impacts of loss allocation to participants

The tools to allocate uncovered losses caused by participant defaults assume that all remaining losses related to participant defaults should be allocated to non-defaulting participants. For CSDs, we believe that this disregards the well-balanced discussion on p.16 concerning the role of incentives. The key characteristics of CSD's differences with CCPs include:

- While loss allocation for CCPs prevents an uncontrolled return of bilateral risks to the market, it would create inappropriate incentives for CSD participants who might be tempted to become indirect participants. This would increase tiering. And it would be impossible to extend loss-allocation to indirect participants since CSDs do not have any contractual arrangements with such indirect participants, nor do they know their identity.
- Furthermore, it is clear to CCP participants that they bring risks to CCPs, while it is a far less clear-cut for CSDs with a banking licence. Indeed, CSDs provide credit solely to facilitate smooth (sometimes multi-currency) settlement.

Impacts of tools addressing liquidity shortfalls

CSDs clients often hold assets in excess of what is required for settlement purposes on their CSDs' securities and cash (for CSDs with a banking licence) accounts. Allocating liquidity shortfalls to participants may create incentives to reduce participants' holdings of liquid assets at the FMI to the bare minimum, or to suddenly remove such assets from the FMI in times of crisis. This would defeat the purpose of the tool.

The funds that participants are owed by the FMI are the balances that they maintain with the FMI for settlement purposes. Such balances are the result of received payments or of the pre-funding of future expected transactions. Consequently, if they do not retrieve their cash timely, **a sudden cash call may create systemic impacts**, as participants are likely to need this cash to fulfil other obligations. In times of crisis, when the interbank market is already at a standstill and market participants struggle to get liquidity to the right place and at the right time, blocking participant liquidity at the FMI would not be welcome. One of the key objectives of participants' FMI usage is the possibility to reduce and when possible foresee the risks that they are facing. By introducing commitments which may result for the participants in difficulties to control or to foresee the risks that they are taking by using the FMI, we remove their major incentive to do so.

The use of the tool should also not result in eventual difficulties of FMIs to find service providers, as these may also be required to participate in loss allocation.

V. Completeness and appropriateness of the sets of recovery tools

Recovery options can be deemed effective, if they lead to a material and timely improvement in the FMI's capital, liquidity or profits & loss position.

In addition to the suggestions made earlier in the text, the set of tools could be further completed by selected other tools that have already been proposed for banks, such as intra-group financial support, which can be a valid recovery tool for the FMIs which are part of a group.

Questions on this response should be addressed to Paul Symons (paul.symons@euroclear.com), Anna Kulik (anna.kulik@euroclear.com), or Elisabeth Ledrut (elisabeth.ledrut@euroclear.com).