Post-trade made easy

**28 December, 2012**

# Euroclear Response to the European Commission consultation on a possible Recovery and Resolution framework for financial institutions other than banks

This response is provided on behalf of the Euroclear group of companies ("Euroclear"). Euroclear comprises the International Central Securities Depository ("ICSD") Euroclear Bank ("EB"), based in Brussels, as well as the national central securities depositories ("CSDs") Euroclear Belgium, Euroclear France, Euroclear Nederland, Euroclear UK & Ireland Limited, Euroclear Finland, and Euroclear Sweden. It also includes Xtrakter, a provider of trade matching and transaction reporting services based in the UK. Euroclear is registered on the European Transparency Register (ID number 88290282308-75).

Any comments on this document should be addressed to paul.symons@euroclear.com

**Key messages**

- Any legislative proposal for Recovery and Resolution ("R&R") for FMIs should not treat CSDs in the same way as CCPs, nor should it copy the R&R arrangements for banks. CSDs do not mutualise risk and (unless they have a banking licence) are not exposed to their customers/clients.
- All FMIs recognised under EMIR, or to be recognised under the forthcoming CSD Regulation, including those taking credit and liquidity risks, should be explicitly exempted from the provisions of the R&R regime for banks and covered by a separate and specific R&R framework for FMIs.
- The prime driver of any R&R regime for CSDs should be continuity of service for their 'core' services, (including those required for the operation of monetary policy) and must respect the continuing availability of DVP settlement, the certainty of asset holding and the continuing application of the Settlement Finality Directive ("SFD") and the Financial Collateral Arrangements Directive ("FCD").
- We believe that, depending on the group structure, there should be some flexibility on the level at which the recovery plans should be maintained. Where a group contains only national and international CSDs, the regulators should allow one single recovery plan at group level, provided that such a plan adequately covers all significant entities of the group.

**Introduction**

We welcome the Commission's consultation and its recognition of the differences between the various types of infrastructure, particularly CCPs and CSDs. (I)CSDs are focused on delivering essential infrastructure-style services to domestic (and increasingly international) markets. They are generally not exposed to their customers (other than for non-payment of fees) and do not issue debt securities to finance their business. Where CSDs do take credit or liquidity risk, those risks are extremely tightly controlled at all times and are currently mitigated in line with the CPSS/IOSCO Principles for FMIs and will be subject to the future CSD Regulation. They do not centralise risk nor do they mutualise risk; they act to remove risk from the market through DVP settlement and related services. Whilst unfortunately, there have been many examples of financial institutions failing, including some CCPs, we do not believe that a CSD has ever failed (certainly in the major world economies) precisely because of their extremely low risk profile. Many of them have been established with a significant number of *ex ante* measures in order to protect them against insolvency; these measures often include;

a. holding appropriate regulatory capital,

b. being exposed to legal and operational risk only,

c. restricting liability to instances of fraud or negligence only,

d. capping any such liability contractually,

e. holding insurance to cover any such claims,

f. loss-sharing mechanisms for securities losses (without any negligence committed by the (I)CSD),

g. providing services that reflect the CSD's restricted and risk-adverse purpose.

But even within CSDs that will be subject to authorisation and regulation under the CSD Regulation there are different risk profiles. Some CSDs, such as Euroclear Bank, are exposed to very limited credit and liquidity risks, which are tightly controlled and mitigated; and they may continue to be allowed to operate such a risk profile under the CSDR. Therefore, we believe that any Resolution and Recovery Regime implemented for CSDs needs to be flexible and proportionate in its application.

**a) General**

***Q1. Do you think that a framework of measures and powers for authorities to resolve CCPs and CSDs is needed at EU level or do you consider that ordinary insolvency law is sufficient?***

We support the idea of constructing appropriate powers that allow authorities to resolve an FMI, under which they would have an additional objective to ensure (at least for a temporary period) continuity of service. Such a regime might also allow unencumbered assets held in the FMI to be released immediately to ensure continued market liquidity. We note that the UK and Belgium already operate such a regime for certain utilities (such as energy and

water suppliers). Belgium has also given the authorities appropriate legal powers that enable them to take all necessary steps to resolve market infrastructures.

We believe that special resolution authorities are more appropriate to tackle the resolution of an FMI than a regular insolvency practitioner.

***Q2. In your view, which scenarios/events might lead to the need to resolve respectively a CCP and a CSD? Which types of scenarios CCPs/CSDs and authorities need to be prepared for which may imply the need for recovery actions if not yet resolution?***

The scenarios will differ depending on the specifics of the FMI and of the market it serves. The development of any R&R regime needs to differentiate between the different types of FMIs, since their risk profiles are extremely diverse. A CCP centralises risk for a market and mutualises the risk of default centrally on behalf of its participants. No CSD undertakes such a function or has such a risk profile. Even those CSDs that are banks and are exposed to credit risk in relation to some clients, do not centralise or mutualise risk. This needs to be recognised in any assessment of the types of scenarios which might imply the need for recovery.

We would suggest that the Commission looks at four broad categories of scenarios in relation to CSDs:

(i) **significant operational problems, materialisation of legal risk, and IT outages** (covering several days and/or happening repeatedly) which may (or may not) lead to financial claims from clients which, in turn, may have a negative economic impact on the CSD's finances or even viability;

(ii) **general business risk** (as a result of bad strategic outcomes) which affects the financial stability or viability of the CSD;

(iii) **loss resulting from credit, market, and liquidity risk events** (for CSDs with a banking licence only) and

(iv) **instances of fraud** or where the liability of the CSD might be unlimited, or where insurance does not cover the liability.

The R&R plans should provide a comprehensive framework with the flexibility to deal with all of these circumstances, including unexpected scenarios. Otherwise the objective of ensuring financial stability will not necessary be reached in all circumstances as a result of the activation of such plans.

***Q3. Do you think that existing rules which may impact CCPs/CSDs resolution (such as provisions on collateral or settlement finality) should be amended to facilitate the implementation of a resolution regime for CCPs/CSDs?***

We believe that it is too early to state whether the SFD or FCD would need amendment as a result of future R&R regimes. But we do believe that the provisions of the SFD and FCD should prevail at all times during the implementation of a recovery or resolution regime.

***Q4. Do you consider that a common resolution framework applicable to CCPs and CSDs is desirable or do you favour specific regimes by type of FMIs?***

Due to the very different functions and the very different risk profile of CSDs and CCPs (CSDs do not centralise counterparty risks and have a very low risk profile, often supported by liability caps and insurance, as discussed above), the R&R frameworks should facilitate different tools for CSDs and CCPs.

***Q5. Do you consider that it should only apply to those FMIs which attain specific thresholds in terms of size, level of interconnectedness and/or degree of substitutability, or to those FMIs that incur particular risks, such as credit and liquidity risks, or that it should apply to all? If the former, what are suitable thresholds in one or more of these respects beyond which FMIs are relevant from a resolution point of view? What would be an appropriate treatment of CSDs that do not incur credit and liquidity risks and those that incur such risks?***

Each CSD is regarded as systemically important at least in the domestic market which it serves. We believe therefore, that all CSDs should be subject to the forthcoming recovery and resolution framework, as all of them are important in their respective markets.

However, the particular treatment of individual entities should be proportional to their size and importance, as well as the support that they could receive from their holding companies (where relevant). Where CSDs belong to a group of entities with a similar risk profile, we believe it would be preferable to develop a group-wide vision of how to implement recovery and resolution measures, taking into account the group to which they belong. Working on stand-alone plans and recovery or resolutions tools would not seem to reflect adequately how potential financial difficulties faced by such entities would be addressed.

***Q6. Regarding FMIs (some CSDs and some CCPs) that are also credit institutions is the proposed bank recovery and resolution framework sufficient or should something in addition be considered? If so, what should the FMI-specific framework add to the bank recovery and resolution framework? How do you see the interaction between the resolution regime for banks and a specific regime for CCPs/CSDs?***

We believe that all EU SSSs should have an R&R regime corresponding to their risk profile and should be explicitly excluded from the EU directive on R&R for banks. CSDs as well as CCPs having a banking licence, should be treated as an FMI rather than as a regular bank falling under the R&R for credit institutions. The framework for banks does not emphasise enough the need for continuity of business; nor does it take into account appropriate safeguards linked to the need to protect DVP settlement, and the operation of monetary policy, and the need for continuity of access by clients to their cash and securities accounts. We have listed in our answer to Section 10 the sorts of issues that need to be taken into account in a specific R&R regime for CSDs (whether they take credit and liquidity risks or not).

CSDs with a banking licence should not be subject to two (potentially contradicting) regulations at the same time. And CSDs which are part of a group which includes a CSD with a banking licence should not be caught by the Bank R&R regime. We believe that these points need clarifying within the context of the existing legislative discussions on R&R regimes for banks.

**b) Objectives**

***Q7. Do you agree that the general objective for the resolution of CCPs/CSDs should be continuity of critical services?***

We agree that the general objective for resolution of CSDs should be continuity of critical operations.

***Q8. Do you agree with the above objectives for the resolution of CCPs/CSDs?***

We agree with the proposed general objectives of the R&R framework for CSDs, but complemented by our answer to Q10 below.

***Q9. Which ones are, according to you, the ones that should be prioritised?***

The over-riding objective of a CSD R&R regime should be the continuity of critical operations (particularly in relation to monetary policy operations) and the preservation of financial stability.

Prudential regulators and resolution authorities should first of all focus on prevention of the entry into recovery and further into resolution.

***Q10. What other objectives are important for CCP/CSD resolution?***

A CSD's Recovery Plan or the relevant Authority's Resolution Regime should also:

(a) have no effects on the DVP process nor on the application of the relevant settlement finality rules,

(b) be coordinated with the contractors and service providers to ensure continuity of operations (e.g. the operator of T2S[1]),
(c) allow all FMI participants to retain continuous access to the functions and services of the relevant CSD during the implementation of the Recovery Plan or during the Resolution phase,
(d) ensure that there is no disruption in the availability of client securities, or cash (for those CSDs with a banking licence),
(e) ensure that there is no disruption in the operation of links (particularly when used for monetary policy purposes),
(f) ensure that holding companies of CSDs (in case the group has no companies with different nature of services) are only subject to a similar recovery and resolution regime, to the extent it is required to ensure continuity of critical services,
(g) ensure that a CSD is not impacted by any default loss-sharing arrangements of another FMI (including, but not limited to CCPs) to which it is linked, or to which it participates directly or indirectly through a standard or interoperable link, to ensure that the failure of that institution does not spread financial contagion to the CSD,
(h) for the same reason, ensure that a CSD is not impacted by the implementation of recovery or resolution measures in respect of financial institutions, including through bail-in clauses or temporary stays,
(i) ensure that the enforcement of rights over collateral taken by the FMI (or taken by an FMI's settlement bank liquidity providers over their clients' assets) in case of a default by its counterparty can be maintained during the implementation of an R&R regime.

**c) <u>Recovery and Resolution plans</u>**

***Q11. What should be the respective roles of FMIs and authorities in the development and execution of recovery plans and resolution plans? Should resolution authorities have the power to request changes in the operation of FMIs in order to ensure resolvability?***

We make a clear distinction between Recovery plans (which will be drawn up by CSDs) and Resolution plans, which are the responsibility of competent authorities.

We recognise the role of authorities in assessing the adequacy of recovery plans prepared by a CSD and that in some extreme circumstances, resolution authorities should have the power to request changes in the operation of a CSD to ensure its resolvability. However, it should be recognised here that some member states (e.g. UK, Belgium and the Netherlands) already have extensive formal and informal 'pre recovery' oversight as well as informal and formal direction powers.

[1] In the context of the Framework Agreement signed by 23 European CSDs and the Eurosystem in mid-2012 for the operation of T2S, it is unclear how R&R regimes will apply in a scenario when the operation of a CSD's core settlement service is undertaken by an entity over which CSDs have no direct control (although they have influence) and which will not be covered by an EU R&R regime.

***Q12. To what extent do you think that CCPs/CSDs in cooperation with their users would be able to define efficient recovery and resolution plans on the basis of amendments to their contractual laws?***

We would not expect users to be involved in the drafting of the actual recovery (or resolution) plans except where those changes might require changes to the contractual relationship between client and CSD.

**d) <u>Resolution triggers – Q13-Q15:</u>**

***Q13. Should resolution be triggered when an FMI has reached a point of distress such that there are no realistic prospects of recovery over an appropriate timeframe, when all other intervention measures have been exhausted, and when winding up the institution under normal insolvency proceedings would risk causing financial instability?***

***Q14. Should these conditions be refined for FMIs? For example, what would be suitable indicators that could be used for triggering resolution of different FMIs? How would these differ between FMIs?***

***Q15. Should there be a framework for authorities to intervene before an FMI meets the conditions for resolution when they could for example amend contractual arrangements and impose additional steps, for example require unactivated parts of recovery plans or contractual loss sharing arrangements to be put into action?***

Clear standards and suitable indicators of 'distress' of a CSD and the failure of its Recovery Plan are needed.

Resolution Authorities should act early to ensure continuity of business and to avoid the appointment of a traditional liquidator or administrator to the CSD under ordinary insolvency law. But we believe that EU Commission should define what is meant by the 'distress' of a CSD. Recovery options should be designed and calibrated in respect of the management's judgment about the point of 'distress' of the CSD, which does not prejudge the actions of a regulator in the case of a crisis. The authorities should consult the management of the CSD in case of these latter actions.

An FMI should be able to demonstrate that it has options in its Recovery Plan to ensure a rapid recovery. "Rapid" will mean different things in different circumstances; in case of a loss requiring some form of recapitalisation, recovery may need to happen in a few days; in case of a wider and slower P&L issue (such as a longer-term structural business change) a recovery period might be several months, or longer, and be subject to informal and then formal directions from the authorities in advance of reaching a trigger point for entry into Resolution. Indicators should take into account that recovery measures may be implemented first at the level of the CSD and then at the level of the group to which that CSD is a part. Only if the group level Recovery measures have failed (or are failing) should the authorities consider activating a resolution regime.

**e) Resolution powers – Q16-Q19**

***Q16. Should resolution authorities of FMIs have the above powers? Should they have further powers to successfully carry out resolution in relation to FMIs? Which ones?***

***Q17. Should they be further adapted or specified to the needs of FMI resolution?***

We agree that Authorities should have a broad range of Resolution tools available to them in law. However, some of the tools require precaution, as discussed below.

**Appointment of administrator**

We support the idea of constructing alternative objectives and/or additional powers for an administrator appointed to a FMI under which that person would have a specific and over-riding objective to ensure (at least for a temporary period) continuity of service. Such a regime might also allow unencumbered assets held in the FMI to be released immediately to ensure continued market liquidity. We note that the UK and Belgium already operate such a regime for certain utilities (such as energy and water suppliers).

**Winding down entity's operations**

Given the importance of a CSD to its domestic (and sometimes international) markets and to the implementation of domestic monetary policy it, the winding-down of its operations does not seem a viable option. An alternative supplier would need to be constructed (since most CSD services are not easily substitutable); this would take a significant period of time (see below).

**Transfer or sell specified assets or liabilities to a third party entity and establish a temporary bridge institution to take over certain critical functions**

Some ancillary services could be transferred or sold to a third party as part of a CSD's financial recovery plan; but theses are not likely to be material parts of the CSD's business. And of course, such sales or transfers would be ineffective in resolving a significant long term operational outage.

But for the core services of the CSD, a transfer would be complex since all legal agreements necessary for the functioning of the CSD, its SSS status and relevant licences for the services performed would have to be transferred/sold to the new entity.

In the context of a CSD with inbound and outbound links to other FMIs (including CCPs), close links to NCBs for monetary policy purposes, and a key role in delivering settlement services for domestic markets, it is unclear whether a temporary bridge is needed, or could realistically be constructed. The CSD might be subject to a specialised administration or liquidation regime (as described above) or it might be transferred directly to the control of the Resolution Authority, or it might be bought by a third party, subject to the approval of the relevant competent authorities. But we are unclear what value a bridge institution would add.

However, should an authority decide that such a transfer is necessary then the conditions described in (a) – (j) in response to the question 10 should be respected.

**Separation of non-performing assets into a distinct vehicle**
It is unclear how this tool could be applied to those CSDs which are not exposed to their participants and who do not run investment books.

A **temporary public ownership**, which can be perceived as an alternative to the temporary bridge allowing for substitution of ownership without impacting the provision of services and other legal arrangements in force, should also be considered as one of the tools which may be appropriate in certain circumstances and with certain safeguards. This is in line with the ECON draft report on R&R for banks and is also explicitly mentioned by the Commission on pages 14 and 15 of its current consultation.

Particular powers in respect of **certain critical service providers** to the FMIs should be considered, in order to ensure that those critical suppliers continue to serve the CSD that is in recovery or resolution.

**Q19. Do you consider that moratorium on payments could be a relevant tool for all FMIs or only some of them? If so, under what conditions?**
Any moratorium on payment flows must not interfere with the operation of DVP and other settlement operations.

**f) <u>Resolution tools – Q20- Q23</u>**
***Q20. Which reorganisation tools could be appropriate for resolving different types and CSDs and CCPs? What would be their advantages and disadvantages?***
***Q21. Which loss allocation and recapitalisation tools could be appropriate for resolving different types of CSDs and CCPs? Would this vary according to different types of possible failures (e.g. those caused by defaulting members, or those caused by operational risks)? What would be their advantages and disadvantages?***
***Q22. What other tools would be effective in a CCP/CSD resolution?***
***Q23. Can resolution tools based on contractual arrangements be effective and compatible with existing national insolvency laws?***

Reorganisation and re-financing tools should not be the same for CCPs and for CSDs.

The consultation looks at a number of options for the authorities and FMIs in relation to **recapitalisation and loss-sharing**. We believe that a lot more dialogue is needed on this issue with all CSDs. In particular, and if the authorities were to choose to impose loss-sharing, discussion would be needed on whether and if so how any recapitalisation plan should be calculated; on to whom the burden of any possible loss sharing should fall (creditors? all clients of a CSD including individuals and public sector institutions, such as central banks? Indirect clients?

Issuers served by the CSD? etc). We believe that the securities of clients deposited with a CSD must not be endangered in the case of a loss-sharing arrangement.

We do not believe that default funds are appropriate for CSDs (regardless of whether they are exposed to credit risk, or not); CSDs do not centralise risk for a market and the valuation of their credit and liquidity exposures (where relevant) is clear at all times.

In addition, the potential for regulatory arbitrage as a result of such loss sharing mechanisms should be carefully examined by the authorities before introducing R&R regimes, because some activities of FMIs can compete with those of other financial market participants. Such arbitrage could lead to the transfer of business away from very low risk FMIs to other entities.

**g) Group resolution**

***Q24. Do you consider that a resolution regime for FMIs should be applicable to the whole group the FMI is a part of? What specific tools or powers for the resolution authorities should be designed?***

As mentioned above, there should be some flexibility over whether recovery measures should be implemented first at the level of the CSD and then at the level of the group to which that CSD is a part. Only if the group level measures have failed (or are failing) should authorities activate a resolution regime.

**h) Cross border resolution - Q25-Q29.**

***Q25. In your view, what are the key elements and main challenges to take into account for the smooth resolution of an FMI operating cross-border? What aspects and effects of any divergent insolvency and resolution laws applicable to FMIs and their members are relevant here? Are particular measures needed in the case of interoperable CCPs or CSDs?***

***Q26. Do you agree that, within the EU, resolution colleges should be involved in resolution issues of cross border FMIs?***

***Q27. How should the decision-making process be organized to make sure that swift decisions can be taken? Alternatively, do you think that responsibility for resolving FMIs should be centralised at EU-level?***

***Q28. Do you agree that a recognition regime should be defined to enable mutual enforceability of resolution measures?***

***Q29. Do you agree that bilateral cooperation agreements should be signed with third countries?***

For those CSDs that have a significant percentage of their activities on a cross-border basis, closer cooperation of resolution authorities should be required. But, this cooperation must be manageable and effective; for instance, operating in multiple currencies should not automatically warrant the involvement of all of the relevant NCBs of issue in the resolution of the relevant entity. However we believe that the R&R regimes should leverage on the

existing regulatory structures for CSDs (and those that will be put in place through the implementation of the CSD Regulation); they should not create new and specific colleges or regulatory structures solely for R&R purposes.

We also believe that measures should be contemplated to ensure that a CSD is not impacted by any loss-sharing arrangements of another FMI (including, but not limited to, CCPs) to which it is linked, or to which it participates directly or indirectly through a standard or interoperable link, to ensure that the failure of that institution does not spread financial contagion to the CSD.

Bilateral treaties or cooperation agreements with third countries could help ensure legal certainty and enforceability of the resolution of an EU CSD, and prevent the adverse affects of a potential domino effect caused by the resolution (or failure) of a third country CSD.

**i) <u>Safeguards- Q30</u>**

***Q30. Do you agree that the resolution of FMIs should observe the hierarchy of claims in insolvency to the extent possible and respect the principle that creditors should not be worse off than in insolvency?***

Insolvency law should apply wherever it does not conflict with the resolution regime. Insolvency law might however, need to be amended and/or harmonised in order to avoid any incompatibilities which could hamper the orderly resolution of CSDs and other FMIs. It could also be amended so as to improve the speed with which client assets can be transferred out of an insolvent institution.