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Re: FSB Consultation Document: Application of the Key Attributes of Effective Resolution Regimes to Non-Bank Financial Institutions

Re: CPSS-IOSCO Consultative report: Recovery of financial market infrastructures

Dear Secretariats:

Effective recovery, continuity and resolution mechanisms for financial market infrastructures (FMIs) are critical to the efficient operation and sustainability of the financial markets. It would be difficult, if not impossible, to maintain financial stability if essential services provided by financial-market infrastructure entities (FMIs) were to cease.

Accordingly, the International Institute of Finance (IIF), the International Swaps and Derivatives Association (ISDA), The Clearing House, and the Global Financial Markets Association (GFMA) welcomes the guidance provided by the Financial Stability Board (FSB) and by the Committee on Payment and Settlement Systems (CPSS) and International Organization of Securities Commissions (IOSCO) (together, "CPSS-IOSCO") on the recovery and resolution of FMIs. This letter provides comments, primarily on the FSB consultation paper dealing with the resolution of FMIs issued on August 12, 2013 (especially Appendix 1 (the "Appendix"))[1] and secondarily on the CPSS-IOSCO consultation paper on recovery planning for FMIs issued on August 12, 2013.[2] For more detailed comments on the CPSS-IOSCO consultation paper, the associations refer to the ISDA letter;[3] this submission is intended to be consistent with those views but is offered as a more direct response to the FSB paper.

I. Introduction

1. FMIs and G-SIFIs are closely linked

[1] FSB, "Application of the Key Attributes of Effective Resolution Regimes to Non-Bank Financial Institutions," available at http://www.financialstabilityboard.org/publications/r_130812a.pdf.

[2] CPSS and IOSCO, "Recovery of financial market infrastructures," available at http://www.bis.org/publ/cpss109.pdf.

[3] *See* letter from ISDA to CPSS and IOSCO Secretariats (Oct. 11, 2013) (on file with CPSS-IOSCO).

As the principal participants in major FMIs are in most cases G-SIFIs, recovery and resolution planning for FMIs and G-SIFIs should be closely linked. An FMI should be robust, with procedures reasonably designed to protect it in the event of the failure of participants to meet their obligations to the FMI. This is required to prevent the FMI from becoming a "single point of failure" (e.g., an FMI failure resulting from the failure of one G-SIFI could have a contagion effect on other G-SIFIs and market participants).

The FSB also emphasizes, in Part II of the Appendix, that FMIs play a critical role in assuring the resolvability of G-SIFIs. Techniques such as bail-in can strengthen a G-SIFI's capital structures so that a G-SIFI undergoing a resolution and its subsidiaries can meet minimum capital requirements. However, in order for a G-SIFI in resolution to function effectively and thus avoid disrupting the financial markets, the G-SIFI or its subsidiaries would need access to various FMIs. Without such access, the G-SIFI, for example, may not be able to make or receive payments, settle securities or repo transactions, or transact in derivatives or foreign exchange markets.[4] Nevertheless, if an FMI is to continue to provide services to a G-SIFI in resolution or its subsidiaries, it will have to satisfy its own risk-control and operational standards; for example, an FMI will have to be assured by the resolution authority that the failed G-SIFI or its relevant subsidiaries will continue to meet its obligations to the FMI and the remaining participants and that it will continue to have access to linked FMIs or central banks (including linked FMIs operated by central banks and central bank liquidity facilities) if necessary to meet these obligations.

2. Key Principles to ensure an effective and viable recovery and resolution framework

We suggest the following Key Principles be considered when evaluating recovery and resolution proposals for FMIs:[5]

a) There should be a clear boundary between recovery[6] and resolution of an FMI. In particular, the criteria for entry of an FMI into resolution, and for who will make the determination that such criteria have been met, should be clearly defined.[7] Although rapid decision-making may be

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[4] In order for a G-SIFI in resolution to have access to an FMI, such access must be in accordance with the terms of the relevant agreements, and must not impose a material increase in risks to the FMI or to its ability to manage its risks and operate in an orderly fashion, in the reasonable judgment of the FMI.

[5] An entity operating multiple FMIs for different products should be able to define an individual product-focused service as a separate FMI for these purposes, where its supervisor agrees that it has sufficient risk-management capability, capitalization, governance, and (where applicable) clearing-fund provisions to sustain designation as a separate FMI.

[6] Paragraphs 1.1.1 of the CPSS-IOSCO Consultative Report contain a thorough definition of *recovery* for FMIs. As noted therein, FMIs generally have extensive, ex-ante recovery arrangements established by contract that are adapted to their particular business models. Especially for those FMIs that involve novation and assumption of risk, such recovery plans include detailed financial arrangements that are carefully designed to cover all reasonably foreseeable risks to the FMI as important market utilities, with careful allocation of financial responsibility among the owners and direct participants of the system, depending on its structure. Such recovery plans are subject to close regulation in most jurisdictions, and can be expected to conform to the CPSS-IOSCO *Principles for Financial Market Infrastructures* (April 2012).

Such recovery plans should be subject to implementation by the FMI itself, subject of course to supervision, which would likely be intensified if a recovery plan were triggered. Recovery plans should be administered by the FMI itself (which may include participation of participants if this is provided for in the FMI's rules), and if it becomes necessary for the resolution authorities to intervene, they should have a strong mandate to work through the FMI's agreed procedure, unless and until it has manifestly failed to meet its purposes, and all resources contemplated by the plan have been exhausted. This would include a general principle that resolution authorities should not intervene to disturb agreed end-of-waterfall procedures (including auctions, voluntary tear-ups, etc.) until such procedures have manifestly failed or are unlikely to proceed successfully.

[7] Aside from incorporating the general principles of the *Key Attributes* neither the CPSS-IOSCO Consultative Report nor the Appendix provides clear and specific guidance as to when an FMI's resolution should be triggered. As a matter of fairness and predictability for all actors in an FMI's ecosystem, especially its participants and creditors, clear triggers for resolution should be provided.

necessary, it should be recognized that too-early intervention by the resolution authorities could disrupt market confidence and the expectations of participants.

b) There should be an affirmative obligation on the home supervisor of the FMI to work closely with the authorities of other jurisdictions with a direct interest in the operation of the FMI in reviewing its recovery and resolution procedures, and to give prior notice to such authorities as well as to the supervisors of the principal participants in the FMI, if the FMI is entering resolution.

c) Where a given FMI is material to the currency or market regulated by authorities in jurisdictions other than where the FMI is headquartered, such authorities should be given an appropriate and proportionate role in the FMI's supervision and resolution. Failure to do this will create incentives to fragmentation of markets.[8]

Upon entry of an FMI into resolution, as the Appendix clearly recognizes, it is essential for the affected national authorities to coordinate their actions to attain an orderly resolution process and avoid the potential disruption of markets and destruction of value that could arise from application of traditional national bankruptcy codes. Similar coordination is also necessary in order to prevent inconsistent direction to the FMI.

As a rule, other authorities should defer to the supervisors in the jurisdiction of the FMI's head or home office both during recovery and resolution planning and if a recovery or resolution occurs.

Consistently with the September 2009 G20 and FSB statements, the public sector should take all necessary steps to maximize the ability of authorities to cooperate and act in a coordinated fashion in case of an FMI recovery or resolution, including by enacting legislation, where

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Paragraph 4.3 of the Appendix defines entry into resolution as when "an FMI is no longer viable or likely to be viable (before balance-sheet insolvency) within a reasonable timeframe through other actions taken by the FMI …" Paragraph *4.3 (i) and (ii)* are helpful, but the reference to balance-sheet insolvency, though correct, may be somewhat misleading.

The appointment of a resolution authority is likely to be at the point where (i) the authority decides that it has lost confidence in the ability of management to carry out a successful recovery; (ii) market confidence is lacking, (iii) there has been a grave failure to meet legal or regulatory requirements, especially as to risk management, or (iv) recovery resources have manifestly been exhausted. It may in fact be the case that the appointment of resolution authorities would most likely occur when the management of the FMI determines that it either does not have or predictably will not have the resources to meet its obligations.

For these reasons, as discussed further below, a bright-line financial test may not be the most useful method of triggering recovery; however, rules and guidance available to the resolution authority should make it as clear to the FMI, its participants, other concerned supervisors, and the market as possible (a) the conditions under which it would decide to intervene and (b) the "presumptive path" for resolution of a particular FMI, where a choice of resolution tools is possible. While not locking the resolution authority in to a particular set of choices in unpredictable circumstances, the final guidance should provide clear triggers and should include statements to the effect that the waterfall and business-continuity provisions of the FMIs relevant agreements would be respected insofar as possible, consistently with the recommendations of this letter.

Moreover, a resolution should be triggered only when resolution tools would be useful to address the FMI's issue(s) or necessary to ensure the continued provision of the FMI's critical services. Operational problems, such as a breakdown of operations caused by a cyber-attack or systems failures, will often not be solvable by the tools envisioned to be available to resolution authorities under the *Key Attributes*. Such problems will need to be solved by action of the affected FMI itself and its participants in close collaboration with all relevant supervisors, in consultation if need be with the resolution authorities.

[8] This might require, for example, prior agreement of such authorities pursuant to the last sentence of *paragraph 4.12 on transfer powers; see also paragraphs 3.3, 3.4, 8.2, 10.2 and 11.5.*

necessary, to make possible recognition of, or reliance on, the authorities in the relevant FMI's head or home offices. Legislation should also ensure that losses would be fairly shared among participants and other creditors without regard to their location or jurisdiction and ensure that all necessary information exchange among authorities can take place on a confidential basis.[9]

d) Although the point is clear in the *Key Attributes*, it should be emphasized that recovery and resolution planning requirements should focus only on the critical functions of the FMI and that the determination of what is critical will depend on the purpose of the FMI and the importance of the service it provides. Ancillary functions need not be addressed in the context of recovery and resolution regimes, tools or plans (and may be subject to normal insolvency proceedings). Alternatively, it may be that ancillary functions that are related to the critical functions of the FMI could be substituted relatively easily by other providers and therefore do not need extensive analysis. Participants of the FMI should be consulted as to which of the FMI's functions are critical and which are not.

e) Provision should be made for temporary liquidity during an FMI's resolution, either to be provided to the FMI itself or, possibly, to the direct participants in the FMI as a market-wide facility to enable such participants to meet their obligations to the FMI. Any resolution regime should contain appropriate measures to assure that the provider of such liquidity is protected.

f) There should be a clear distinction between the FMI and its direct participants.

g) There should be a clear distinction between the direct participants and indirect participants. In particular, the obligations of a direct participant to or from the FMI should be clearly distinguished from any obligations of the FMI to or from indirect participants.

   Indirect participants' connections with an FMI are typically established by contracts with direct participants. These contracts may allocate losses to indirect participants or to indirect participants' underlying beneficial owners – or may include pricing that takes into account the risks that indirect participants bring to the direct participants. In general, any loss at the FMI should be allocated in accordance with applicable contractual arrangements.

h) Liabilities of participants to the FMI must be predictable and limited. No financial entity can support nor would such an entity be authorized by its prudential regulator to participate in an activity where exposures are unlimited and unquantifiable.

i) Recovery mechanisms to ensure the FMI's continuity must be economically viable for the FMI itself as well as its direct and indirect participants. This outcome is more likely if FMIs include participants in their recovery and resolution planning processes. It is also more likely to occur if the resolution authority respects the roles assigned thereby to participants in the resolution process (e.g., on valuation assessments, running auctions, etc.) insofar as possible. Should the supervisor(s) of the FMI have reservations about such roles for participants, the time to change such roles is not during the resolution itself, but while the FMI is operating normally as a going concern and in consultation with participants.

j) Recovery and continuity mechanisms must not challenge accounting or regulatory capital criteria to net cleared exposures; any provision that would undermine participants' ability to attain

[9] *Sections 9 and 10* are fine as far as they go on cooperation, but should be reinforced by more binding commitments as stated above, including new legislation where necessary. Particular consideration should be given to the concerns of emerging market and developing economies because it is in the interest of all that they have the option of allowing their instruments to be included in international FMIs, including CCPs, but their concerns in doing so should be taken into account. Ex-ante cooperation agreements between authorities with respect to the supervision of an FMI should be respected in event it is taken into resolution, subject to allowable discretion in accordance with such agreements.

netting or set-off in accordance with market practice would render participation in the FMI unviable.[10]

k) Recovery and resolution procedures for FMIs must avoid creating adverse incentives for participants. In particular, rules governing resolution should not create potential liabilities that are unlimited or unquantifiable; doing so would undermine risk management in the system and create incentives to "run" from a given system or the products it supports. In circumstances of discretion or uncertainty, there is an increased risk that participants may "game" the likely outcome rather than act responsibly within the parameters of the default management arrangements established in the context of the FMI's recovery and resolution procedures.

l) Should a FMI enter resolution, the resolution authority for the FMI should respect the waterfall and the arrangements that the FMI has made with its participants. If the authorities have an issue with the waterfall or other arrangements of the FMI, they should raise it during their review of the FMI's recovery or resolution plan, rather than impose a change during the resolution process itself.

m) Transparency and certainty for direct and indirect participants is essential as to (i) the nature and operation of the default management process and any default waterfall, (ii) the nature of loss allocation in all circumstances including the exhaustion of the default waterfall, and (iii) the relevant decision makers (i.e., Risk Committee, FMI management, or the resolution authority) at each step of any default management process or recovery and resolution measures.

3. Risk profiles of FMIs: implications for recovery and resolution

FMIs engage in diverse activities that can be analysed in five broad categories: (i) trade data repositories (TDRs), (ii) payment systems (PSs), (iii) securities settlement systems (SSSs), (iv) central securities depositories (CSDs), and (v) central counterparties (CCPs).

TDRs differ from other FMIs in that they record, store and update data about financial transactions, but they do not actually conduct financial transactions, nor do they hold securities accounts. From a recovery and resolution perspective, the key aspect of TDRs is that the data remain available to financial market participants and official authorities. The best way to accomplish this is to assure that a TDR has adequate back-up/redundancy arrangements with a capability to shift operations to a different system or provider, should the TDR fail due to operational and/or financial reasons.

In contrast, PSs, SSSs, CSDs and CCPs actually process financial transactions, and hereinafter this letter will use the term FMI to refer to a PS, SSS, CSD or CCP. Within these classes, there are also substantial differences of business model, legal vehicle structure,[11] different types of risk encountered, and the extent of loss mutualization.

Section 2.1 of the Appendix should clarify that not all "elements" of resolution discussed therein apply in the same way to all types of FMIs.

One clear distinction is between FMIs that are parties to the transactions that they process and those that are not. For example, a PS may merely provide a method for a participant to transmit payment orders to another receiving participant and a mechanism for settling the sender's payment to the receiving bank in respect of the order without the FMI's taking any financial responsibility for that obligation. Resolution of these kinds of FMIs will be very different from resolution of an FMI, such as a CCP, that actually

[10] To net cleared exposures, direct participants must demonstrate that a *right to setoff* exists, consistently with accounting standards; otherwise the participant must report all cleared exposures gross for financial statement and regulatory capital reporting. *See also* the ISDA letter.

[11] The term "FMI" is defined in Section I of the Appendix without regard to legal-entity form. Resolution procedures will need to be tailored to the legal form of the FMI.

becomes a party to transactions. Resolution regimes will need to take account of such differences.

In several ways, neither the Appendix nor the parallel CPSS-IOSCO FMI document adequately differentiates between CCPs and other FMIs (notably those that take credit risk but do not mutualize risks).[12] It is difficult to generalize about recovery and resolution for these types of FMIs, and it is understood therefore that FMIs with divergent business and risk models will provide comments directly, whereas this letter addresses general considerations and considerations primarily applicable to CCPs.

The systemic risk that the failure of an FMI could pose depends principally on two factors:

i. How the loss that led to the failure of the FMI is limited[13] and then (if appropriate for the nature of the FMI) how it is allocated among the participants and the FMI itself, in accordance with the FMI's rules; and

ii. Whether the FMI can continue its operations and provide its critical functions to its participants (or restart operations after an operational problem).[14]

Loss limitation and allocation matters, since the imposition of loss from the FMI to a direct or indirect participant (if applicable) can adversely affect the capital and liquidity of the participant (whether the loss accrues to it directly or indirectly). While it is important for the business models of certain FMIs that losses be mutualized, such adverse effects need to be limited in accordance with the terms and conditions of the FMI, lest the failure of the FMI cause one or more of direct or indirect participants to fail, and possibly set off a chain reaction that could cause the financial system to implode.

FMIs can limit potential losses by limiting their open positions, or by limiting the open positions that participants are allowed to maintain with the FMI, even if the FMI operates on a DVP basis. Depending on the structure of the relevant markets and the specific requirements of each FMI, this might entail:

- Strict rules establishing legal finality of transactions as to both parties and the FMI.
- Compression of the interval between trade date and settlement date insofar as appropriate for market conditions.
- Matching of confirmations and straight-through processing to assure that all transaction instructions entering the FMI are accurate.
- Reducing settlement risk. This can be accomplished by a variety of techniques, including without limitation,
    - Real-time gross settlement (used in payment systems to settle payments against cash, usually in the bank's reserve account at the central bank);

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12 A CCP's exposures can be extensive but are not related to transactional business decisions of the CCP's management and arise from transitions of participants, which may or may not be difficult to value. Where a CSD provides credit directly to participants without mutualization, any related exposures are very short term (usually intraday), fully collateralized, and transactional, and the CSD itself decides upon the credit it is willing to extend pursuant to a specific credit-decision process.

13 Note that the failure of a direct participant is not the only potential cause of loss to the FMI. Losses may also arise from a number of other sources, including from operations and investments. Rules governing the FMI will determine the responsibility for such losses (e.g., the extent of availability, if any, of the loss allocation waterfall, which in some cases may be designed for losses arising from the default of a direct participant) and capital requirements for the FMI.

14 The ability to recover after financial failure is distinct from the ability of the FMI to maintain business continuity in the wake of external events, such as power failures, terrorist or cyber-attacks. The FMI should certainly maintain business continuity policies and procedures that protect the FMI against such risks, including and adverse financial effects that may result from interruptions to the FMI's operations.

- Real-time final settlement systems (used to describe payment netting or hybrid systems that provide for final settlement of payments without necessarily resorting to gross settlement);
- Payment versus payment (used in foreign exchange settlement systems);
- Delivery versus payment (used in securities settlement systems); and
- Novation (used in CCPs where the CCP accepts transactions).

- Frequent netting of gross exposures. This is particularly effective, if combined with settlement of such exposures.

- Requiring participants to post margin with the FMI, where the FMI acts as a CCP by novation, or otherwise becomes directly exposed to participants.[15]

Where an FMI operates on a novation basis, the FMI should seek as a general principle first to recover any loss caused by the failure of a direct participant to meet its obligations to the FMI from margin that the participant has posted with the FMI or otherwise in accordance with its rules, and the FMI should calculate such margin so that it is likely to be sufficient to meet the participant's obligations. Only then should recourse be made to the FMI's default fund and/or to the FMI itself.

Such recourse should be in accordance with previously agreed (and approved) rules governing the waterfall (i.e., the order in which losses would be allocated). Particular attention should be paid to assuring that default funds and resources of the FMI itself are liquid, so that the FMI can make any payments that would be required to participants. If the waterfall agreement envisions replenishment of the default fund, measures should be in place to assure that such replenishment can be accomplished rapidly (even over a weekend).

Carrying out a resolution. There should be a strong presumption in favor of carrying out a resolution in accordance with the FMI's agreed rules in order for market participants to sustain confidence in the FMI, both in normal circumstances and in resolution. This is the best way to achieve the continuity goals of the Appendix, *Section 1*.

Accordingly, we believe that the mandate to the FMI resolution authority should be significantly stronger that a mere exhortation to "take account of the loss allocation arrangements under the rules" (as stated at page 5 of the Appendix), but instead should include a general presumption that the resolution authority will respect and adhere to the rules of the FMI.[16]

The residual discretion necessary for the resolution authorities to deal with specific, unanticipated situations that may arise in an actual resolution is complementary to the type of strong mandate suggested above. An FMI resolution carried out through the agreed-upon procedures should run reasonably smoothly, and should be at least as predictable as a bank resolution; it is therefore hard to envision circumstances under which the authority should deviate from such procedures.

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15 *See* CPSS-IOSCO, "Principles for financial market infrastructures" ("PFMI"), April 2012.

16 Furthermore, where there is a resolution by transfer to a bridge or other FMI, it will be important to follow the loss allocation agreements within the failed institution; transferred functions should presumably be free of further loss allocation uncertainties (in the way liabilities are left behind in the transfer of bank functions to a bridge), except insofar as the creditors and other claimants on the failed FMI may have entitlements based on subsequent revaluation. Claims or entitlements of management or owners of the failed FMI should be treated in accordance with standard hierarchy of claims, which include subordinating equity to debt and subordinating the claims of insiders, subject to the NCWOL principle. *See also* Key Attribute 5.1.

It should also be made clear (as is not the case in the present text of either the CPSS-IOSCO consultative document or the Appendix) that appropriate loss-allocation arrangements depend very much on the nature and business model of the FMI and agreements sustaining it. This includes respecting limitations on allocation of losses to participants that are part of the structure of the FMI.

If the resolution authorities need to confront the failure of the agreed-upon waterfall procedures, losses should be allocated in accordance with the relevant agreements with participants and between participants and their clients. In general, the goal should be to achieve the fairest, most efficient possible allocation of losses, but, because of the centrality of FMIs to many networks, may need to take into account the systemic consequences of the allocations made, including possible effects on the viability of CMs or other financial institutions.

Finally, it should be clear that the resolution authority, regardless of the tools it chooses to use, should be understood to work within the available resources of the FMI, including those included in its recovery arrangements, *but not the power to create unlimited assessments on participants or impose additional obligations to replenish an FMI's resources.* Despite the importance of continuity of critical services, there may be cases where orderly wind-down is the only practical option.

Presumably, where an FMI has completely failed and resort has to be made to wind-down, market participants would have a strong incentive to create a replacement FMI, but where there is no alternative to wind-down of the original one, origination of a *de novo* FMI should be beyond the scope of the resolution authority's mandate.[17]

Continuity of critical functions. We agree strongly with the statement made at page 5 of the Appendix that the resolution regime for an FMI should give "particular priority to maintaining continuity of the critical functions that the FMI perform[s] in financial markets and take account of the loss allocation arrangements under the rules of certain kinds of FMI." As a general principle, for an FMI to be considered "resolvable," it should ideally be able to accept new business transactions from the opening of business on the business day following the entry of the FMI into resolution, drawing a line under previous business, and continuing the critical functions uninterrupted.[18]

This will require participants in the FMI and the market at large to have confidence that the resolved FMI can fulfill its functions without jeopardizing the condition of its participants. In our view, generating such confidence and maintaining continuity will be much more feasible, if

- The resolved FMI continues or restarts operations with a clean slate, so that "old" losses incurred prior to the entry of the FMI into resolution would be allocated separately from any losses that might arise under the resolved FMI.

- The resolved FMI (as paragraph 4.5 of the Appendix recommends) maintains all necessary licenses, recognitions, authorizations and relevant agreements held by the "old" FMI.

- The resolved FMI has clear loss allocation procedures. In principle, these would be the same loss allocation procedures as those utilized by the "old". The rules and contractual agreements between the original FMI and its participants should be transferred to the resolved FMI by operation of law. It is difficult to imagine that a resolved FMI could develop and gain acceptance for new rules rapidly enough to be able to continue operations and gain the confidence of participants on an expedited basis.

II. Answers to Specific Questions raised in the Consultation Paper

Question 3 (paragraph 1.1). It is essential to provide for continuity of critical functions. It is implicit in the Appendix and clear in the *Key Attributes* that the FMI, in agreement with its regulators, must clearly determine which of its services are critical and which are not. Therefore, more guidance would be helpful on how the critical functions of an FMI should be determined. The guidance provided for identification

[17] This of course does not apply where there is a transfer to a bridge institution or to another FMI.

[18] As discussed above, it is important for recovery and resolution planning to distinguish between critical functions and other functions of an FMI that are not of critical importance to continue in resolution.

of critical functions of banks is helpful in that context but similar guidance for the very different issues raised by FMIs may be warranted. The Appendix does not recognize clearly enough that, depending on business model and form of corporate organization, an FMI may have associated functions or other commercial functions that need not be considered critical, and which need not be supported through loss-allocation mechanisms in recovery or in resolution.

Question 5 (paragraphs 4.8, 4.9): write-down of initial margin. Initial margin haircutting is discussed extensively in the ISDA letter. It is sufficient here to state that admitting the principle of initial margin haircutting is highly likely to have very negative effects on FMIs, participants, and markets during normal times, and less predictable and potentially more disruptive effects in resolution, and therefore should be explicitly disfavored.

In any case, unless otherwise agreed to by a CCP and its participants in participant rules or other contractual arrangements, the method of posting initial margin, the manner by which it is held and segregated and limits on a CCP's rights to rehypothecate the initial margin should be structured so that the initial margin is bankruptcy remote from the CCP. The resolution authority should respect such segregation or bankruptcy remoteness under all circumstances. Margin held in a bankruptcy-remote structure should not be considered part of the estate of the FMI or part of available resources under any circumstances.[19] Establishing such a principle for resolution purposes would be consistent with other regulatory efforts to move initial margin to bankruptcy-remote status, where such is not already the case.

Where initial margin is not bankruptcy remote, but a resolution has been commenced, initial margin should not be considered appropriate for use in the resolution, unless otherwise agreed to by a FMI and its participants in participant rules or other contractual arrangements. As a matter of principle, initial margin should be considered to have the highest level of preference in resolution, only accessible after all other resources are exhausted, and hence to be generally protected except in the most extreme circumstances in resolution (except insofar as it may be available to cover obligations other than the obligations of the direct participant that posted it pursuant to the applicable rules of the FMI).

Paragraph 4.8(v) should be revised in accordance with the foregoing discussion.

Paragraph 4.9, last indent, regarding initial margin where a participant has not fulfilled its obligations secured thereby should be modified to make clear that such initial margin would be usable in resolution only when the FMI would be entitled to take control thereof under applicable agreements and law.

More broadly, power of bail-in pursuant to *paragraph 4.8(iii)* should be understood to include unsecured debt of the FMI for funding purposes only (including intra-group obligations where the FMI sits under a broader umbrella corporate structure), in accordance with the *Key Attributes.* "Debt" for such purposes should not include other obligations of the FMI to direct or indirect participants in connection with FMI functions.[20] Equity or equity-equivalent resources provided to the FMI through its ownership structure should of course be written down in accordance with applicable agreements and the *Key Attributes.*

Question 6 (paragraph 4.10), respecting netting rights. The ISDA letter provides a full discussion of the interaction of recovery procedures and accounting and regulatory capital issues regarding essential netting functions in the market. It also addresses issues of impact on participants' risk management, accounting, and regulatory capital requirements. It is equally important that the legal provisions and regulations regarding *resolution* be designed carefully to protect netting and other risk-mitigation arrangements and

[19] This principle does not exclude calculation of distribution of losses proportionately, including IM in the calculation, if such is the rule of the relevant FMI; however, such a rule would not give the resolution authority any claim to bankruptcy-remote IM.

[20] Where the FMI is a service that is ring-fenced for exposure and risk-management purposes within a broader corporate structure, it would be necessary to identify the debt instruments available for bail-in for the specific FMI.

default procedures that are part of the normal functioning of the FMI and the market, and not to create legal doubts or issues that might call them into question.

Unless provided for in the rules of the FMI, imposed partial (or complete) tear-up of contracts is not compatible with the purposes of a CCP or similar FMI, with the continuity of services, with the confidence of markets, or with fair outcomes from resolution. Resort to tear-up or forced close-out of contracts other than per the pre-existing recovery plans of the FMI should be avoided in all circumstances, unless there is absolutely no other way to resolve the FMI. Any resort to tear-up in extremis should require a careful balancing of the interests of all direct and indirect participants (taking into account the interests of underlying clients) and avoid any solution that would be unfair in the sense of posing disproportionate burdens on any class of participant.

It follows that the Appendix should also be modified to restrict resolution authorities from interfering with the netting rights of FMI participants, for example by splitting netting sets through partial transfer of positions or partial "tear up" of contracts. If necessary in the context of a resolution approaching exhaustion of other possibilities, the authority should be required to respect netting sets and should not be able to "cherry pick" contracts out of netting sets.

Question 8, paragraphs 4.3, 4.6, conditions for entry into resolution. See the discussion in part I above on recovery and resolution.

Paragraph 4.6 is correct that the entry of an FMI into resolution should not lead to the "automatic restriction, suspension, or termination of its participation in, or link with, another FMI (wherever located)"; however, the text should be modified to provided that linked FMIs should have an affirmative duty to maintain such links, in accordance with the terms of the relevant link agreements, absent material increase of risks to the linked FMIs or to its ability to manage its risks and operate in an orderly fashion as a result of doing so, in the reasonable judgment of the linked FMI. The supervisors of linked FMIs should be required to consult with each other before taking any action of restriction, termination or suspension of links.

Question 9, paragraphs 4.4, 4.8, 4.9, interaction of contractual loss-allocation arrangements under FMI rules and exercise of statutory resolution powers. See the general discussion in part I above.

Paragraph 4.4 is correct that the resolution authority should have the right to enforce implementation of loss-mutualization or allocation rules if the resources available through such rules are not already exhausted; however, in accordance with the discussion above, it should go further and state that the resolution authority should not deviate from such rules where it is still possible to follow them.

With respect to variation margin (*Paragraph 4.9)*, see the ISDA letter.

Question 10, paragraphs 4.11, 4.12, should contractual porting arrangements be recognized?

It is of course important for the resolution authority to have the option of carrying out a resolution by transfer of the essential functions of an FMI to a bridge FMI or to another FMI.

Where contractual porting arrangements exist, they should be respected on the same basis that recovery provisions of the FMI constitutive agreements are respected; however, if the activity of an FMI can be transferred to a third party or bridge FMI, such transfer should be accomplished on the basis of the authority's resolution power. In transferring contracts to a bridge or third party FMI, the resolution authority should presumably attempt to transfer the porting rights of participants thereunder; however, it may need to exercise its powers to modify or terminate such rights if necessary to achieve the most effective continuation of critical functions at the least cost to all stakeholders possible under the circumstances.

Question 12, paragraph 5.2, temporary stay on the exercise of early termination and set-off rights. This power should be considered only as a last resort. There will typically be sufficient safeguards in place to ensure

that a clearing member cannot resign from a CCP in a disorderly manner, in which case a temporary stay on early termination rights will not be necessary. Clearing members should have the right to manage their business risk, including the terms under which it withdraws from CCP. Any resolution powers that prevent a clearing member from resigning will discriminate against clearing members.

Question 13, paragraph 6.1, No Creditor Worse Off than in Liquidation. Paragraph 6.1 seems appropriate; however, it should be made clear that the principle should apply to all claimants, regardless of jurisdiction; there should be no priority or advantage based on the jurisdiction either of a claim or of a claimant, nor any other form of discrimination amongst direct or indirect participants based on jurisdiction or location.

Resolution regimes for FMIs with creditors or assets in more than one jurisdiction should make provision for coordination of the treatment of creditors and the division of assets consistently to ensure that creditors (including direct participants) are treated fairly, insofar as possible in accordance with ex-ante agreements, with application of the NCWOL principle in extremis in accordance with the *Key Attributes.*

The principle of NCWOL would apply with respect to all prior claims against an FMI that continues to operate while in resolution. In other words, participants using the FMI's services for new transactions while in resolution or thereafter should not be exposed to losses that need to be allocated as a result of failure in the prior period.

Applicable law for the resolution of FMIs should make it possible for the resolution authority to follow the recovery rules of the FMI where possible, as recommended in this letter. Thus, it may need to be specified that the normal insolvency rules that would set aside contractual provisions such as recovery rules do not apply to FMIs when in resolution in accordance with the Key Attributes, but that the resolution authority would have the power to apply the normal recovery rules of the FMI. As a result, the application of the NCWOL principle would be deemed modified in accordance with this principle, so that the resolution authority would not be prohibited from applying haircuts or other applicable loss distribution rules of the FMI, but that NCWOL would apply to judge the fairness of the disposition of any residual losses and assets of the FMI, after application of the loss distribution rules.

The loss distribution rules of an FMI may permit compensation of losses imposed on direct participants (and, as applicable, passed to indirect participants) by attribution of warrants, convertible debt, or equity of a successor FMI where the FMI has been reorganized, transferred, or re-launched. In such cases, the NCWOL calculation would take into account the value represented by such compensatory instruments.

Question 14, paragraphs 10.3 and 10.4, additional considerations for resolvability of classes of FMIs.

Paragraph 10.3 on resolvability requirements should make clear that assessment of the recovery plans of an FMI (covered by the CPSS-IOSCO consultative report) is essential, in addition to covering resolution strategy and plans.

Legal and technical barriers to transfer of critical functions should be assessed, but it is not realistic to expect that all FMIs will be readily transferrable; hence it must be possible for an FMI to pass the "resolvability" test despite lack of likely prospects for transfer to a third party FMI.

When requiring measures to improve the resolvability of an FMI, authorities should, in addition to taking into account the issues mentioned in the text, be required to assess the effects of any such measures on the normal functioning of markets, effects on CMs' and all direct and indirect participants' incentives to make use of the FMI, and effects on market liquidity. As the ISDA letter points out, it is especially important not to undermine the legal requirements for netting or other risk-mitigation measures available to market participants.

As discussed above, resolvability assessments of FMIs should include careful analysis of critical vs. non-critical functions (see the discussion of question 3).

In addition, recovery and resolution plans should address whether assets pledged or available to the FMI in recovery or to the resolution authority in resolution would be available for such use, and not subject to residual interests of underlying clients whether resulting from rehypothecation or otherwise that would interfere with the use of such collateral or transfer of functions to a bridge or a successor FMI.

Question 15, paragraphs 11.6, 11.7, specific issues for resolution plans.

It is especially important for FMIs that Crisis Management Groups be closely aligned with the FMI's supervisory college, in accordance with the broader need for close cooperation discussed above. Additional cooperation agreements should be established between an FMI's resolution authorities and those of its critical service providers and systemically important participants when necessary.

Paragraph 11.6, in particular *paragraph 11.6(iv)* regarding collateral, should take into account effects on direct and indirect participants' incentives, market liquidity, and normal-state legal issues, as discussed under Question 14 above. Especially given the central role of FMIs in the market and their multiple implications for participants' legal, accounting, and regulatory management, resolution plans of FMIs cannot focus only on resolution, but need to take full cognizance of their implications for the normal functioning of the FMI, direct and indirect participants, and markets.

Questions regarding Part II of the Appendix: Resolution of Systemically Important FMI participants.

Question 18, balancing the orderly resolution of FMI participants and the FMI's ability to manage its risk effectively.

See the general comments above about the importance of respecting underlying contractual arrangements between CMs, other direct and indirect participants, and their underlying clients.

The general principles stated about the rules and procedures governing a participant's default are appropriate and should be implemented, especially as set out in *Paragraphs 1.2 and 1.3 of Part II.*

Paragraph 3.1 of Part II is very important and appropriately creates a duty for FMIs and their supervisors to correct any rules or other aspects of an FMI that may appear to create obstacles to the orderly resolution of FMI participants. The same principles should extend to considerations regarding all direct and indirect participants, not just direct FMI participants.

It is important, however, for the principles stated in Part II to focus not just on the need for FMI rules and procedures, in addition to making adequate provision for extreme events, also to take into consideration going-concern needs of markets and direct and indirect participants: an appropriate balancing of risk, costs and benefits, including attention to incentives or disincentives to use the services of a given FMI, is essential to maintaining the efficiency and risk-reduction benefits that FMIs can provide.

In addition, it should be expressly recognized that FMIs must continue to comply at all times with the PFMI, and that the continued participation of an institution subject to resolution in the FMI, if permitted by the FMI, must not compromise the ability of the FMI to comply with the Principles, including "Principle 1: Legal Basis."

III. Conclusion

The associations appreciate the opportunity to comment on the complex and challenging issues posed by an FMI resolution, and on the equally complex issues of FMI recovery planning and loss allocation. It is inevitable on a subject of this complexity that written comments become complex as well. The associations would welcome the opportunity to organize a concerted discussion among experts with

the FSB, if that would be helpful in finalizing the proposed guidance.

Very truly yours,

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