

ECSDA Response to the FSB consultative document on the application of the Key Attributes to non-bank financial institutions

Two years ago, ECSDA wrote to the Financial Stability Board to insist on the specificities of financial market infrastructures (FMIs), arguing that the *Key Attributes of Effective Resolution Regimes for Financial Institutions* needed to better distinguish between different types of “systemically important financial institutions”¹. We thus very much welcome the FSB efforts to produce specific guidance for FMIs in an Annex to the Key Attributes, as well as the opportunity to comment on the document prior to its release in final form.

ECSDA represents 41 international and domestic central securities depositories (CSDs) across Europe. Our response to the consultative document thus focuses on Appendix I, and the specific relevance of the guidance for CSDs as opposed to other types of FMIs.

1. Resolution of CSDs

1. Does the draft guidance adequately cover the principal considerations that are relevant to the resolution of each class of FMI (CCPs, CSDs, SSS, PS and TRs)? Would it be helpful if the guidance distinguished more between different classes of FMI? If so, please explain.

ECSDA believes that the report should allow for some flexibility when determining which resolution tools can be applied to which type of financial market infrastructure. Resolution regimes should take into account the specific risk profile of different FMIs in addition to distinguishing between those FMIs taking credit risk and those that are not exposed to credit risk. CSDs in particular maintain a low risk profile and the likelihood of a CSD failure is extremely low, due to their risk management practices and arrangements used to cover potential losses (such as insurance arrangements and liability caps).

¹ See the ECSDA Comments on the FSB Consultative Document “Effective Resolution of Systemically Important Financial Institutions” of 2 September 2011, available at: http://www.ecsda.eu/position_papers.html

2. Should any further distinction be made in the draft guidance, for the purposes of applying the Key Attributes, between types of FMI that assume credit risk through exposures to participants and those that do not? If so, for which provisions is that distinction relevant?

The draft FSB guidance rightly outlines that the risk profile of the FMI has to be taken into account. In this context, we would like to recall that the majority of CSDs do not assume credit risk.

Furthermore, ECSDA cautions against putting all FMIs exposed to credit risk in the same “basket”. In particular, CSDs operating under a banking license (and thus exposed to some credit risk) are fundamentally different from CCPs. The purpose of a CCP is to mutualise risks within a market, which is not at all the case for CSDs. Where a CSD provides credit, any related exposures are by definition short-term, collateralised and transactional. CCPs’ exposures on the other hand can be longer-term, not related to business decisions of the CCP itself and potentially related to complex transactions that are often difficult to value. This is why the resolution tools appropriate for CCPs will often not be the same as the ones appropriate for CSDs exposed to credit risk.

We support the FSB’s assessment under point 2.1 that these CSDs should be subject to the FMI-specific resolution regime to take into account the unique central and systemic role they play as infrastructures in the markets they serve.

3. Are the additional statutory objectives for the resolution of FMI (paragraph 1.1) appropriate? What additional objectives (if any) should the draft guidance include, relating either to FMIs generally or specific classes of FMI?

Yes, ECSDA believes the 5 statutory objectives listed under paragraph 1.1 are appropriate for FMI resolution.

4. Is it appropriate to exclude FMIs that are owned and operated by central banks from the scope of application of the Key Attributes and this guidance (paragraph 2.1)?

ECSDA does not count CSDs operated by central banks in its members and we do not have a strong view on whether such CSDs should be included in the FMI Guidance on the Key Attributes. However, we remark that under the upcoming CSD Regulation in the European Union, CSDs operated by central banks are likely to be subject to the same prudential requirements as other CSDs, including provisions on participant default rules² (they are, however, to be exempt from the authorisation requirements). Part II of Appendix I on the resolution of FMI participants might thus have some relevance to them.

² See article 38 of European Commission Proposal COM(2012) 73 final of 7 March 2012, available at: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52012PC0073:EN:PDF>

5. Should resolution authorities have a power to write down initial margin of direct or (where appropriate) indirect participants of an FMI in resolution (paragraph 4.8)? If so, should the power be restricted to initial margin that is not ‘bankruptcy remote’ and may be used to cover the obligations of participants other than the participant that posted it? What are the implications of such a power for FMIs and participants? Are any further conditions appropriate in addition to those specified in paragraph 4.9?

No comments (this question is only relevant for CCPs).

6. Should the Annex explicitly restrict resolution authorities from interfering with the netting rights of FMI participants (for example, by splitting a netting set through partial transfer of positions in a CCP or partial ‘tear up’ of contracts)? What is the possible impact on participants’ risk management, accounting reporting or regulatory capital requirements if netting rights can be interfered with in resolution, and how might any such impact be mitigated?

No comments (this question is rather relevant for CCPs).

7. Does the draft guidance (paragraphs 4.1 and 4.2) adequately address the specific considerations in the choice of the resolution powers set out in KA 3.2 to FMIs? What additional considerations (if any) regarding the choice of resolution powers set out in KA 3.2 that should be addressed in this guidance?

Yes, the draft guidance addresses the right considerations for the choice of resolution powers. Regarding paragraph 4.1, we remark that the consideration of risk profile should particularly take into account the difference between CSDs and CCPs and the difference in protection against the impacts of a participant’s default such as their total discretion on the extension of credit which is always fully collateralised and transactional.

In addition, the choice of any resolution power should avoid the rise of open-ended liabilities for stakeholders such that they must indefinitely wholly or substantially recapitalise a failed CSD. Indeed most CSDs are commercial organisations, or part of a commercial organisation. An open-ended requirement to recapitalise could lead to further systemic instability. Stakeholders need to be able to assess their maximum possible liabilities in order to manage their exposure and capital effectively; and unlimited liability would prevent this.

8. Are the conditions for entry into resolution of FMI (paragraph 4.3) suitable for all classes of FMI? What additional conditions (if any) would be relevant for specific classes of FMI?

ECSDA generally agrees with the conditions for entry into resolution covered under paragraph 4.3. We think that it should be possible to trigger resolution when recovery has failed to return the CSD to viability or when the relevant authorities determine that such measures will not be sufficient to return the CSD

to viability in a timely manner. In certain cases, the resolution authorities should however continue to closely cooperate with the management of the CSD even after entry into resolution, e.g. especially in situations when the losses threatening the CSD's viability result primarily from an IT or other technical problem. The circumstances in which the resolution authority needs to overturn an existing and ongoing recovery plan need to be carefully delineated in an objective manner, perhaps according to qualitative and quantitative parameters.

9. Does the draft guidance (and paragraphs 4.4, 4.8 and 4.9 in particular) deal appropriately with the interaction between the contractual loss-allocation arrangements under the rules of certain classes of FMI and the exercise of statutory resolution powers?

CSDs typically do not have contractual loss-allocation arrangements, such as a default waterfall, with their participants, and so paragraphs 4.4, 4.8 and 4.9 will in most cases not apply. What should be clear for the CSD is how it will make good any loss, including the tools for potential re-capitalisation.

10. Should contractual porting arrangements be recognised in the draft guidance on the transfer of critical functions (paragraphs 4.11 and 4.12)?

ECSDA agrees with the guidance contained in paragraphs 4.11 and 4.12. The transfer of critical activities should result in no disruption of the CSDs' legislative environment, which would require the resulting entity to be recognised as a legal successor in the corresponding sale/transfer legal documentation. This should be enforceable in the relevant jurisdictions. However, some CSD services depend on specific agreements with foreign authorities that cannot be assigned and which are not governed by the laws of the CSD. If these services are critical, the continuity of these agreements and the recognition of an eventual successor may therefore require to be reinforced by additional (non-entity specific) agreements of competent authorities or appropriate modification of such agreements.

However, the transfer of a CSD's existing business to a successor institution may not be immediately possible, since most CSDs enjoy a unique and central position in their domestic market. In such cases, the resolution authority may be faced with the choice of either (i) leaving the existing management in place and allowing it to continue to run the CSD; or (ii) dismissing the management and attempting to run the CSD itself.

Moreover, ECSDA suggests that the legal constraints that could rise in connection with the use of powers to transfer CSDs activities as central maintenance to foreign bridge entities subject to a different legal framework should be carefully assessed.

11. Are there any other FMI-specific considerations regarding the application of any of the resolution powers set out KA 3.2 that should be covered in this guidance?

Paragraph 4.15 refers to the payments due by FMIs to participants or to any linked FMI. In addition to participants and other FMIs, CSDs can also do external transfers, which should not suffer from a moratorium if they are related to the settlement function or other critical CSD services. This is for instance the case of transfers towards “operational creditors”, i.e. providers of day-to-day operational functions of the FMI. Indeed, such systemic payments should be maintained precisely to prevent system disruption. We suggest that when developing a resolution regime, the possibility of allowing a moratorium on payments to these types of unsecured creditors should be carefully balanced with the interest of ensuring financial stability and market confidence.

12. Does the draft guidance (paragraphs 5.1 and 5.2) deal appropriately with the considerations that are relevant to the decision whether to stay the exercise of early termination and set-off rights by FMI participants on the entry into resolution of the FMI? Should the guidance distinguish between different classes of FMI in this regard?

For the same reasons outlined in response to question 11, it is important that specified key suppliers are required to maintain a certain level of service, even when resolution powers are launched. Therefore any decision to stay early termination rights should be carefully evaluated also with reference to those kind of key suppliers.

13. Are loss-allocation arrangements under FMI rules reflected appropriately in the application of the “no creditor worse off” safeguard in FMI resolution (paragraph 6.1)?

No comments (loss-allocation arrangements are typically not relevant for CSDs).

14. What additional factors or considerations (if any) are relevant to the resolvability of FMIs, or particular classes of FMI (paragraphs 10.3 and 10.4)?

No comments.

15. Are there additional matters that should be covered by resolution plans for FMIs or particular classes of FMI (paragraphs 11.6 and 11.7)? If yes, please elaborate.

No.

16. Are the proposed classes of information that FMIs should be capable of producing (paragraph 12.1) feasible? Are any of the proposed classes of information unnecessary, duplicative or redundant? What additional classes of information (if any) should FMIs be capable of producing for the purposes of planning, preparing for or carrying out resolution?

ECSDA supports the rationale behind paragraph 12.1 and we understand the importance for CSD information systems to be well maintained and to allow for a prompt access to key information prior to and in resolution.

Regarding the “list of stakeholders”, we however wish to stress that CSDs will often not have access to information on their participants’ clients (“indirect participants”) due to legal and commercial restrictions.

17. Are there any other issues in relation to the application of the Key Attributes to FMIs or particular classes of FMI that it would be helpful for the FSB to clarify in this guidance? If yes, please elaborate.

No comments.

2. Resolution of systemically important CSD participants

ECSDA believes that the notion of “systemically important participant” should be clarified. Indeed, we wonder whether this section of the FSB report refers to participants that are “systemic” vis-à-vis the CSD, or rather “systemic” in the market as a whole, based on the SIFI designation applicable in the relevant market.

We would also like to emphasise that CSD participants should at all times continue to meet the criteria for participation in the CSD. Such criteria are mostly risk-based and ensure that the client’s participation does not result in inappropriate risks for other CSD participants.

Finally, in keeping a balance between the orderly resolution of CSD participants and the CSD’s ability to manage its risks effectively, it will be important to take into account the fact that some CSD participants are also service providers to the CSD.

3. Client asset protection in resolution

Regarding Appendix III of the consultative document, ECSDA agrees with the FSB approach aiming to prevent the unavailability of client securities and the negative consequences this could have on investors.

Importantly, the constraints in ensuring full traceability of client assets and collateral throughout the holding chain should be taken into account by future standards on the protection of client assets in resolution, in particular in so-called “indirect holding” models. The requirements on clients’ identity, collateral location and clients’ consent could indeed be difficult to implement in practice in cases where

the CSD (or another actor in the chain) has no direct access to information on the beneficial owner of the securities.

Furthermore, Client Asset Protection (CAP) in resolution should fit into a broader framework of measures. It is a transversal matter, which has to be made effective in the day-to-day management of any deposit-holding institution. Therefore, CAP provisions also need to be incorporated in legislation dealing with the management of client custody risk by these institutions.

In case of a CSD which operates the dematerialisation or immobilisation records, prompt access to the client's assets is the most relevant objective, whereas a transfer or a return of assets may not be possible (because the CSD's account holder already has the most direct right possible over the security).

Differently from some other types of institutions offering securities accounts, CSDs already have extremely strong CAP provisions as part of requirements applicable to them as part of day-to-day risk management, in line with the CPSS-IOSCO PFMI and the upcoming CSD Regulation in the European Union. We thus think there should be a continuity of reflection for the different types of institutions, and that the two approaches should be more coherently aligned:

- (1) the "functional" framework for crisis management (CAP in resolution);
- (2) the "institutional" framework based on the PFMI, the CPSS-IOSCO guidance on FMI recovery and the future FSB guidance on FMI resolution.

ECSDA thanks the Financial Stability Board for the opportunity to comment on the applicability of the Key Attributes to non-bank financial institutions. For any questions on this paper, please contact the ECSDA Secretariat at +32 2 230 99 01 or email alexander.westphal@ecsda.eu.