AFME response to the European Commission Consultation on a Possible Recovery and Resolution Framework for Financial Institutions other than Banks

AFME's position on key topics of the consultation document

Introduction

AFME is a trade association whose members conduct domestic and cross-border securities operations in the EU/EEA area in their capacity as financial institutions, in a wide range of banking activities for their customers and for their own account. AFME's members are securities account providers in the context of European and national regulated activities. The AFME Post Trade Division is the European post trading centre of competence of the Association for Financial Markets in Europe (AFME). Its members are the major users of international securities markets. The Post Trade Division acts as an agent for change, providing and supporting solutions in securities clearing, settlement and custody, to reduce risks and increase efficiency for market participants, representing its members' views towards market infrastructure organisations and public authorities. AFME shares the overriding objective of a single and integrated post trading system in Europe through harmonisation and competition.

These comments were prepared by the Post Trade Division in co-operation with AFMEs Prudential Regulation Division (Resolution and Crisis Management).

Of the broader AFME membership (see www. afme.eu) the following members – investment banks, global custodians and universal banks – actively participate in the Post Trade Division: Banco Santander; Bank of America Merrill Lynch; Barclays; BNP Paribas; BNY Mellon; Citi; Credit Suisse; Deutsche Bank; Goldman Sachs; HSBC; J.P.Morgan; Kas Bank; Morgan Stanley; Nomura; Nordea; RBS; Société Générale; UBS; UniCredit.

Overview

We strongly support the efforts of the European Commission to enhance the mechanisms for dealing with the failure of systemically important financial institutions other than banks (including financial market infrastructures or FMIs). It is clear that any disorderly failure of a variety of different types of non-bank institutions could lead to significant, systemic disruptions in the financial markets, domestically and globally. The design of any EU recovery and resolution regime for FMIs will need to take into account both other EU rules (such as CSDR and EMIR, as well as the resolution and recovery regime for banks, as certain EU FMIs may well be part of the same corporate group as a bank), as well as international rules and principles relating to recovery and resolution regimes, as EU FMIs may well be part of a non-EU corporate group.

It is important that all such rules be compatible, so as to minimise the risks of double regulation, and conflicts between different regulatory regimes.

FMIs will vary considerably with respect to their size and systemic importance, and with respect to their competitive situation, and the ease by which their participants can switch to an alternative provider. Accordingly, it is important that the future EU FMI recovery and resolution regime is sufficiently flexible to allow regulatory authorities to tailor its specific regulatory approach to the specific situation of a particular FMI.

For purposes of this response, references to recovery mean those mechanisms utilised to stabilise an FMI and restore its financial strength and viability when the FMI comes under severe stress and to ensure continued provision of critical operations and services. References to resolution mean those processes established to deal with the closure of an FMI entity without severe systemic disruption and with minimal cost to the tax payer while preserving systemically important functions.

We agree as a general matter with the Financial Stability Board's (FSB) *'Key Attributes of Effective Resolution Regimes* [Key Attributes],' endorsed by the G20, that resolution regimes be put into place for all systemically important financial institutions and for FMIs[1]. We believe that the appropriate regime for FMI recovery and resolution depends on the infrastructure concerned. It is important to differentiate the FMIs from the banks and subsequently the Recovery and Resolution Directive (RRD). As a matter of fact, CCPs and CSDs have different profiles, including capital use, risk profile and strategic positioning. While at a high level, there can be key common features for CCP and CSD recovery and resolution regimes, we would suggest that detailed regimes would need to be tailored to the specific type of FMI.

Our comments on the Consultation Paper will focus on FMIs responsibility for the clearing and settlement of cash securities. Our comments on FMIs are drawn from GFMA's response, which was submitted on 28 September 2012, to the Committee on Payment and Settlement Systems (CPSS) and the Technical Committee of the International Organisation of Securities Commissions (IOSCO) regarding the Consultation Report on Recovery and Resolution of Financial Market Infrastructures (the CPSS-IOSCO Report). In relation to the consultation's application to non-bank financial institutions more broadly and in other financial markets, we endorse what we consider to be complimentary positions outlined in the response of the International Swaps and Derivatives Association, Inc. ("ISDA").

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[1] In that regard, we note the Dodd-Frank Act's broad scope that allows the US to use stabilisation powers over any financial institution if, among other things, its failure under insolvency law would have a serious adverse impact on financial stability.

Consultation Questions

General: Q 1-6

Questions considered here:

1)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?

AFME agrees with the Commission that a framework of resolution measures and powers for CCP and CSDs is needed as ordinary insolvency law can be insufficient in managing the failure of a CCP or CSD. We believe that such a framework should be established at an EU level as it is common for European CCPs and CSDs to operate across Member State borders.

AFME welcomes the Commission's proposal for a continued improvement in the framework for measures that ensure FMIs are correctly regulated and monitored. As outlined in the Consultation Paper, steps have already been taken to reduce the likelihood of risks building up in CCPs and CSDs and therefore the development of a resolution framework should be complementary to existing measures. Involvement on an EU level is vital in ensuring that all FMIs work under the same regulations and a harmonised and safe framework. In particular, as with the bank recovery and resolution framework, a common EU understanding of what the point of resolution is essential - which should be as close to the point of insolvency as possible. The Consultation Paper highlights that ordinary insolvency law would be unsatisfactory in managing the failure of a systemic financial institution and we are unaware of harmonisation in insolvency law at this point in time. Specific attention should also be given to the international implications of such regulation. The involvement of independent expert advisors in the development and execution of a recovery and resolution framework would aid in establishing which way would be best for that particular FMI to resolve and to ensure that the correct technical knowledge is present when assessing the situation and next steps for that FMI.

2) 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?

We agree with the analysis set out on pages 11 to 14 of the risks incurred by CCPs and CSDs.

Some of the key scenarios or events that can lead to resolution of a CCP include:

- the default of one or more clearing members;
- severe operational issues;
- severe operational issues of related entities (e.g. exchange-based failures);
- severe losses on the CCP's investments; and
- severe liquidity issues.

Similar scenarios or events can lead to resolution of a CSD. Uniquely, for those CSDs that are also banks, severe bank liquidity issues (e.g. withdrawal of uncommitted credit lines) can become resolution events.

Once a CCP or CSD:

1) reaches a point of default or likely default;

2) the default is determined to pose a significant threat to the financial system;

3) and it is determined that no private sector solution is available; then resolution actions should become available to resolution authorities.

A number of scenarios may occur prior to a resolution scenario or event that will require action on the part of a CCP or CSD. Such scenarios should be identified and planned for by FMIs directly. It may be useful, however, for supervisory authorities to provide some guidance with respect to some common assumptions and scenarios.

We do note that it is impossible to identify in advance all possible scenarios. Any recovery and resolution regime should be able to manage a wide range of different scenarios.

We do, however, have some comments relating both to the risks incurred by CCPs and CSDs, and to the design of appropriate recovery and resolution regimes.

(i) Legal Risk and Cross-border Context

We do agree that - as identified on page 14 - legal risk is an important risk for CSDs, and that this risk is in particular relevant in a cross-border context.

We note that the services of European FMIs are being provided in an increasingly cross-border context, notably as a result of legislative initiatives such as CSDR and EMIR, but also as a result of infrastructure initiatives such as TARGET2-Securities.

We agree that there may well be risks with relation to settlement finality and to netting. We would also like to highlight that CSDs may well act as investor CSDs (i.e. as intermediaries in a chain of custody) and may well be subject to risks if - for securities held through a chain of intermediaries - the legal regime of the country of

issuance of the securities does not fully recognise the role of intermediaries, and thereby creates the risk of a loss of securities.

We acknowledge that it is not the mandate of FMI recovery and resolution to provide a full answer to such risks, but we believe that there is a role for public authorities to eliminate, or to minimise, such risks.

(ii) Regulatory Obligations - Legal and Regulatory Risk

We do note that some national regulatory regimes place additional duties and obligations on FMI legal entities, beyond the obligation to provide their core services in an appropriate manner. Such duties and obligations may, for example, relate to the collection of transaction taxes, or to the supervision of the activity of the participants of the FMI. Such additional duties and obligations may create additional risk both for the FMIs and for their participants. Legal and regulatory risk may arise if the FMI performs its obligations inappropriately, or if the tools available to the FMI do not allow it fully to meet its regulatory obligations.

We believe that regulatory regimes for CCPs and CSDs should concentrate on their core services, on the safety and soundness of the legal entity, and in general should not impose on the FMI regulatory duties and obligations that affect outside parties (such as the underlying trading parties and their trading relationship, or the relationship between participants in the FMI and their clients) which will have an immediate effect on their risk profile and ability to focus their resources on the core responsibilities.

Given the complexity of the global financial markets, it is impossible to identify in advance all of the possible circumstances that might lead to or consequences of the failure of an FMI. With respect to the preparation of recovery and resolution plans, however, regulators should consider the following:

- The interconnectedness of FMIs, the reasons for those connections, whether alternative resources are available to those other FMIs and the possible effects of the loss of those connections;
- Other service providers (if any) that offer comparable functionality, their ability to manage a large-scale migration to their platforms, and the speed at which such a migration could be accomplished;
- Which service providers to the FMI are critical to its continued functioning and consider how to ensure uninterrupted provision of such services during a resolution procedure;
- Circumstances that create heightened risk of contagion throughout the financial system, such as cross-collateralisation or cross-netting across FMIs, significant exposures of systemically important financial institutions (SIFIs) to the FMI, and potential effects on regulatory capital for SIFIs and other entities with credit exposure to the FMI; and

- The potential spill over effects of even a short-term disruption to the continued functioning of an FMI, including a decrease in value to financial assets held in custody, direct losses on participants and their customers, and a reduction in credit generally.

- The Rules of the FMI itself, including the triggers and stress scenarios and potential recovery actions identified in its recovery plan

3) Do you think that the 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?

For the most part, consequential amendments to existing rules will be dependent upon what an EU-wide resolution framework looks like.

We do believe that there are issues with, and inconsistencies between, national transpositions of the Settlement Finality Directive. We note that in the context of the TARGET2-Securities project there is discussion on this question.

We believe that there may be issues in the implementation of a resolution regime for CSDs in the event that a national transposition of the Settlement Finality Directive goes beyond the core objective of ensuring that once settlement occurs at the CSD it is final, and tries to institute obligations on parties to ensure settlement.

4) 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?

At a high level, the overarching resolution framework for CCPs and CSDs could be similar but differences in the type or nature of a CCP or CSD would need to be addressed. There are different risks associated with different types of FMI and, as such, stress events can affect different FMIs in divergent ways. A regime would need to be sufficiently flexible such that key differences could be addressed in subordinate legislation and in the planning and execution of the resolution of a specific CCP or CSD. Work done in the resolution planning phase will help authorities identify certain default events that may pose a significant threat to the financial system for a specific FMI. Further, such work will identify appropriate proposed paths to resolution.

Resolution authorities should be afforded with sufficient powers and discretion in the face of a resolution event to ensure that the specific FMI can be resolved effectively.

CSDs, on the other hand, intervene at the final layer when ownership of the securities is transferred and are primarily concerned with operational risk.

Jurisdictional disputes, or a lack of cross-border cooperation and coordination, as they apply to both FMIs and other financial institutions, may interfere with the ability to execute recovery or closure of an FMI entity's plans. It is therefore critical that resolution frameworks for FMIs provide for cross-border cooperation and there is clarity in the situation that the ownership of an FMI is in a Third Country which may have its own framework. The FSB emphasises in its key attributes: "jurisdictions should ensure that no legal, regulatory or policy impediments exist that hinder effective cross-border resolution" before requiring costly or structural changes to institutions.

5) 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 sustainability, 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 CDs that do not incur credit and liquidity risks and those that incur such risks?

Whilst AFME believes that all FMIs which fall under the same framework should be treated equally with respect to recovery and resolution plans, it is also important to ensure that the need to a comply with the requirements of a resolution framework, such as developing and maintaining detailed recovery plans does not become a barrier to entry and reduce competition in the market. Whilst some consideration is required in this area, a phased approach for particular requirements for new entrants to the market, dictated by the regulator granting the FMI their authorisation could be appropriate. We would agree, however, that the decision of a resolution authority to implement execution resolution actions should be, in part, contingent upon the impact the failure of the firm would have on market stability.

6) 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 he 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?

It is important that the principles of both regimes are aligned: that the primary objective is to avoid significant adverse effects on financial stability and ensure the continuity of critical functions, while minimising reliance on public financial support. As such, the broad structure of any recovery and resolution framework should also be aligned: preparation through recovery and resolution plans; recovery phase where responsibility remains in the hands of the institution's management; and the resolution phase where the authorities can deploy tools to ensure the objectives are met.

Many aspects of the proposed EU bank recovery and resolution framework are appropriate to be replicated for an FMI recovery and resolution framework. For example:

- Recovery planning should be the domain of FMIs themselves whereas resolution authorities would play a key role in resolution planning;
- High-level objectives for resolution are effectively the same (e.g. continuity of critical services, avoidance of moral hazard, avoidance of taxpayer losses);
- Resolution tools would be similar (e.g. transfer to a commercial entity or bridge institution);
- Equity holders would take losses first.

Hence we would expect that the bank recovery and resolution framework could be used as a starting point for a CCP and CSD framework. The framework, however, would need some features that are specific to CCPs and CSDs. For example, details surrounding resolution triggers would need to be tailored to specific types of FMIs. In the event that a CSD is also a credit institution (therefore an ICSD), the FMI framework alone should apply to the recovery and resolution of the CSD entity of the FMI only, to ensure that requirements and efforts are not duplicated and features of the framework that are CSD specific can apply to the CSD part of the FMI only.

Objectives Q7-10

Questions considered here:

7) Do you agree that the general objective for the resolution of CCPs/CSDs should be continuity of critical service?

FMIs play an essential role in the global financial system. The disorderly failure of an FMI can lead to severe systemic disruptions, if the failure causes markets to cease to operate effectively. Ensuring that the critical operations and services of an FMI continue as expected in a financial crisis is therefore central to the recovery plans

they formulate and the resolution regime that applies to them[2]. The important nature of FMIs and their systemic risks mean that where possible continuity is vital in order to avoid the possible risks imposed on the financial market, contagion to other FMIs and the potential risk to investors and participants should the FMI enter into resolution. An FMI's recovery plan should be sufficiently comprehensive and robust such that it can effectively address all stress scenarios prior to the point of failure, or likely failure, at which point resolution actions would kick in as a last resort. Even then, ensuring continuity of service should not mean preserving the entity but rather the services being provided - when a firm is no longer operationally viable, regulatory intervention should not be aimed at its rescue, but at its orderly resolution.

A critical component of resolution ensuring continuity of an FMI - and one of the obstacles which the industry will encounter when trying to create a new framework is in the realm of substitutability. Substitutability is key in ensuring that participants can access their securities and continue with their transactions without incurring losses beyond their control. The realm of recovery actions for FMIs should be much broader than is currently the case with banks and for this reason it is important to secure what the FMIs provide for their members. Substitutability is not something which has historically been 'tested' and therefore this would take considerable planning and cooperation from the FMIs to ensure that it is possible to efficiently, safely and harmoniously substitute the activities of FMIs should the need to do so arise. As for banks, the notion of an FMI being 'too big to fail' needs to be eliminated and can be prevented by a harmonised European framework could prevent by providing clear and transparent triggers and indicators which could indicate a need for substitutability of an FMI.

Substitutability would be enhanced by way of a competitive environment. CCPs and CSDs are increasingly being placed in a more competitive environment. This increases the risks incurred by individual legal entities, in particular as - if there is an event or loss that results in a loss of market confidence - there is the risk that market participants will move business away from that legal entity, thereby reducing the effectiveness of recovery measures.

However, the very fact of a competitive environment does mean that it is easier to move activity to an alternative provider of services, thereby reducing the systemic importance of individual legal entities.

Having discussed the matter of substitutability AFME members would like to draw attention to a further matter which should be addressed principally that of what would happen to all of those trades which are open at the time the FMI enters resolution procedures. A clear understanding of the consequences/next steps

[2] See http://www.iosco.org/library/pubdocs/pdf/IOSCOPD388.pdf Page 1

under these conditions needs to take place i.e. would the FMI continue to operate to ensure their indemnity for continued operations and where would the FMI obtain sufficient funding to allow continued operations. In the case of CCPs this matter is being addressed in the realm of segregation and portability, as the potential for open trades to continue to be sent for clearing exists even though the CCP may be in a phase of resolution.

Although we recognise the general objective under recovery and resolution of maintaining critical service, current insolvency procedures are generally designed primarily to protect creditors. The change of emphasis to maintenance of critical service may therefore disadvantage some creditors who would have been favoured by existing insolvency procedures, and care may be needed to control the extent of this effect.

8) Do you agree with the objectives for the resolution of CCPs/CSDs?

AFME members generally agree with the high-level objectives as expressed by the Commission but suggest that a further high-level objective of guarding against moral hazard should be included (please see our response to Q10).

AFME members welcome the listed operational objectives proposed by the Commission in its Consultation Paper but would characterise these more as 'features' or 'attributes' of a resolution regime rather than as 'objectives'.

9) Which ones are, according to you, the ones that should be prioritised?

AFME's members believe that all of the 'objectives' are important but stress below a few points on two of the 'operational objectives':

- **Triggers -** Triggers are essential in indicating at which point an FMI can no longer feasibly continue as it should. It is vital that these triggers are clear, precise and transparent in order to ensure each framework which can be used and put into practice by relevant authorities for specific types of FMI. It is also important to ensure that the FMIs themselves become more transparent in their activities and in their risk profiles in order to provide participants with information on potential risk. Please also see our response to Question 13.
- **Cross-border coordination -** The appropriate coordination mechanisms among different jurisdictions and authorities are of paramount importance. In a resolution scenario appropriate, quick and efficient decision making is vital and where various authorities in different jurisdictions are involved this can be difficult to achieve. Agreeing resolution strategies and "likely paths" in advance may allow for more speedy decisions to be made in times of crisis.

10) What other objectives are important for CCP/CSD resolution?

Another important objective for CCP/CSD resolution is the minimization of moral hazard. This objective can only be met if (1) the directors and management responsible for the condition of a CCP/CSD in resolution are dismissed and are subject to losses consistent with their responsibility and (2) shareholders bear the losses of the CCP/CSD.

There is a profound tension between this objective and the objectives of ensuring continuity of critical services and preserving financial stability. Liquidation upon insolvency furthers the goal of reducing moral hazard risk, but ordinary insolvency proceedings are unsatisfactory for managing the failure of a systemic financial institution. However, if the focus of a resolution regime (or recovery framework) is only upon the continuity of critical services, the result could be a mutated version of too-big-to-fail, in which management of a CCP/CSD is not held accountable for poor risk management practices. A properly structured resolution regime will balance minimising moral hazard against ensuring the continuity of critical services.

The bank resolution model achieves such a balance, and for this reason, at a high level it should be the basis for a CCP/CSD resolution regime. In a bank resolution, the receiver is able to transfer the "good" bank assets and liabilities and liquidate the "bad" bank assets in a manner that ensures continuity of critical services, but also holds management and shareholders accountable for the bank's failure (by dismissing the board and senior management and writing down equity). A systemically important CCP/CSD could be resolved in a similar fashion (although considerations would have to be made to account for different types of ownership structures). A resolution authority should have the power to dismiss the board and management of a failing CCP/CSD, transfer its systemically critical operations to an acquirer or a bridge (for subsequent recapitalization by the private sector) so that there is no interruption of systemically critical services and pursues the orderly liquidation of non-critical assets and liabilities and functions whereby we suggest to have a clear definition of critical functions similar to those issued by the Financial Stability Board earlier this year, which are performed by a CSD / CCP which should be rescued in comparison to non-critical functions.

Recovery & Resolution Q 11 &12

Questions considered here:

11) 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?

AFME members welcome and would support the notion of cooperation between FMIs and the authorities in establishing and developing recovery and resolution plans for FMIs. The CPSS-IOSCO Report provides that in terms of recovery and its implementation it is the responsibility of the FMI itself and that involvement of the authorities at this stage would rest with the FMIs regulators. AFME members support this notion as it is consistent with the FSB Key Attributes and the bank recovery and resolution regime. We also support the fact of ensuring such measures are in place would be continually assessed and as the report states *"where deficiencies exist, authorities must have the necessary powers to enforce observance of the (CPSS-IOSCO) Principles"*[3].

Resolution planning and implementation should be in the domain of the resolution authorities with input from the FMI itself. Clarification and further detail is sought, however, in relation to the idea of 'resolution authorities'; who these would be in specific circumstances, what their powers would be and to whom these authorities would be accountable. Unlike most banks, a CCP or CSD may be established in a jurisdiction that differs from where the bulk of the impact of its failure would be felt. As such, in some circumstances, the designation of a resolution authority may need to be made based on considerations other than the place of establishment of the FMI. Clarity will also be required with respect of central European authorities, supervisory colleges and potential resolution colleges in the context of a cross-border resolution. The relevant authorities should routinely (ideally annually) assess its plans for recovery or resolution and require that the FMI proactively address any vulnerability that would increase its risk of a disorderly failure. We believe that identifying those aspects of an FMI's operations that would impede recovery or closure of an FMI entity, and working with the FMI to address those aspects prior to insolvency, will help reduce the risk that the insolvency of the FMI would lead to broader systemic harm. In particular, we note some considerations which should be taken into account when assessing how the different types of FMIs should be assessed and evaluated. Each FMI will have unique issues that depend on its functions and its interconnectedness with other FMIs and financial institutions, as well as its operations, agreements, credit exposures, management, systems and employees. The ownership structures of the FMIs may be a source of strength, or alternatively may impede raising additional capital at a time of crisis, and should be fully understood. There is a strong notion around interconnectedness of FMIs as well as the wider connection with participants which should at all times be considered. It should also take into account when an FMI is part of a wider financial group.

[3] See http://www.iosco.org/library/pubdocs/pdf/IOSCOPD388.pdf Page 3, paragraph 2.3

12) 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?

Certain recovery actions may be referenced in FMI's contractual documentation and/or rulebook. Resolution actions, however, would be within the domain of resolution authorities. An FMI's contractual documentation and rulebook would not speak to/govern resolution actions.

AFME members also support that in the continued effort to provide more transparency for users within the market, the FMIs should consult with their users/members/participants in all stages of possible recovery or resolution, including before the unforeseeable situation of either recovery or resolution should occur. Transparency with users is important to retain user confidence. Additionally assuring users that all possible plans are being put in place, that in the event of a recovery or resolution scenario, the FMIs have in place (and planned where appropriate with the help of independent experts) measures to ensure that substitutability and business continuity will be invoked.

Resolution Triggers Q 13-15

Questions considered here:

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

It is important that any triggers incorporated in the framework are very clear and easily assessed. AFME's members generally agree with the resolution trigger expressed by the Commission although further consideration must be given to what constitutes 'distress' or, in other words, 'failure or likely failure' for CCPs and CSDs. In addition, when determining whether winding up the institution would risk causing financial instability a resolution authority must consider the size, activities, instruments and jurisdictional impact of the FMI. In addition, when performing the analysis as to whether the resolution trigger has been met, a resolution authority must consider critical factors like: the FMI's prospects for raising additional capital and for obtaining adequate liquidity to make continued operation feasible, the FMI's insolvency or the likelihood of insolvency, and the lack of a private market sector solution Such considerations apply whether or not the FMI is of a type that takes on credit risk of its participants. There should be an onus on FMIs to ensure that they have efficient plans and have fully considered how they could orchestrate their own recovery of capital.

As with bank resolution, although regulators need a degree of discretion in determining resolution triggers, an EU level framework should ensure a consistent approach is taken that results in triggers as close as possible to the point of insolvency, to avoid the case that viable businesses with a chance of recovery enter into resolution procedures.

There should be a clear distinction between when an FMI is:

- Functioning of its day to day workings
- In recovery stage
- In resolution stage

14) 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?

The conditions work generally for FMIs but there may need to be differentiation as to what would constitute 'distress' or 'failure or likely to fail' for specific types of FMIs and the factors that may affect financial stability in a standard insolvency context. Resolution authorities should be afforded a reasonable amount of discretion to determine whether the resolution trigger has been met for a specific FMI.

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

Prior to the point that resolution actions are triggered, the implementation of business as usual actions followed by recovery actions by the FMI's management should be respected. In addition, an FMI's supervisory authorities would continue to be able to utilise their existing supervisory powers to ensure that an FMI continues to operate within its conditions of recognition. We would recommend that the Commission use caution when considering incorporating statutory early intervention measures as such measures may create uncertainty with respect to the settled expectations of clearing members and customers (e.g. forced allocation). Some early intervention actions might be appropriate in urgent situations (e.g. requirements to activate portions of a recovery plan) where other would not (e.g. forced triggering of contractual loss sharing arrangements).

AFME members would also like to ask the Commission to explore further the notion of intervention and what this would mean in relation to third country institutions, for example, should a Euro based CCP be affected by the actions of a third country CCP that it is has exposure to, and vice versa, and what this would mean for any contracts and how these would be settled. As with the bank recovery and resolution regime, any EU level framework should provide for recognition of third country resolution proceedings.

Resolution Powers Q 16-19 and Q24

Questions considered here:

16) 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?

AFME agree with the majority of the powers proposed, however we:

- object to the notion of initial margin haircutting;
- suggest that powers to 'temporarily stay the exercise of early termination rights' and 'impose a moratorium on payment-flows' need to be examined (see our responses to questions 18 and 19 below); and
- suggest that the power to "recapitalise an entity by amending or converting the terms of specified parts if the balance sheet of the entity" requires further analysis and clarity is required on what is proposed here particularly for CCPs.

Following clarification a full impact assessment on CCPs and CSDs, their members or their participants would be required. The impact assessment should also consider the cost implications of such measures on CCPs and CSDs and the potential for such costs to be passed on to the market.

17) Should they be further adapted or specified to the needs of FMI resolution?

Please see questions 16, 18 and 19.

18) Do you consider that temporary stay on the exercise of early termination rights could be a relevant tool for FMIs? Under what conditions? How should it apply between interoperated FMIs? How should it be articulated with similar powers to impose temporary stays in the bank resolution framework?

As a general rule, a participant should not be stayed or prohibited from exercising early termination rights arising under relevant agreements and CCP rules with respect to financial contracts with a CCP in insolvency. However, for a systemically

important CCP that is resolved pursuant to the resolution regime we describe herein, the resolution authority must have the power to transfer such contracts to a bridge entity or another CCP or retain such contracts in the CCP, subject to the usual anti-cherry-picking limitations (all contracts of the participant must be transferred or all retained or rejected) and non-discrimination against cross-border participants.

The resolution authority's determination with respect to transferring or retaining contracts should be communicated to participants within 1 business day of its appointment. A participant should be stayed from terminating by reason of the resolution authority's appointment (or the insolvency of the CCP) until the resolution authority notifies the participant of its contracts' transfer or retention. Thereafter, if its contracts have not been transferred to another CCP or transferred to or retained in an entity that will be recapitalized (which could be either the bridge or the CCP, depending upon how the resolution authority structures the resolution), the participant should be permitted to exercise its termination rights. If its contracts are transferred to another CCP or transferred to or retained in an entity that will be recapitalized, neither the appointment of the resolution authority nor the insolvency of the CCP should be considered a default of the other CCP or the recapitalized entity that would give either party the right to terminate its transferred contracts. This limitation would not affect any subsequent default by the other CCP or recapitalized entity, such as a payment or delivery default, or an insolvency event.

Any rules with respect to stays must take into account the principles of the *Key Attributes* and also their effects on the treatment of assets under international standards, such as the Basel treatment of netting.

19) 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?

In a resolution context, there should be no moratorium on payments that are necessary for the continuity of the critical operations of FMIs. Up until the point where resolution is triggered, the existing rules and procedures of the FMI should be followed closely. This is vital to providing market confidence and should not be varied under any foreseeable circumstances (except perhaps a catastrophic shut-down of the entire market). If an FMI entered into liquidation, then the usual liquidation procedures and priorities should apply. It would be advisable that a moratorium would only be applied, if required, to non-business related items for payment systems (on bills like auditors, dividends, for a limited period of time, to ensure that FMI redresses their liquidity. For CSDs that have a banking function, moratorium payments not linked to the core FMI functions could be appropriate.)

Resolution Tools Q 20-23

Questions considered here:

20) Which reorganisation tools could be appropriate for resolving different types and CSDs and CCPs? What would be their advantages and disadvantages?

AFME's members agree with the Commission's assessment that the tools facilitating the transfer of an FMI's business to a commercial purchaser or to a bridge institution are useful tools (with the latter being particularly useful where there are limited appropriate commercial purchasers). The extent to which any resolution tool (including insolvency procedures where relevant) would be used for a specific FMI would be anticipated by the resolution authority with input from the FMI in the resolution planning process and ultimately determined upon the occurrence of a resolution event.

21) Which loss allocation and recapitalisation tools can 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?

AFME members are of the opinion that it is important to articulate clearly mechanisms of loss allocation ***prior*** to a resolution event to ensure that a clear line is established between business as usual mechanisms, recovery mechanisms and, finally, resolution mechanisms. For the purpose of this portion of our response we will focus primarily on CCPs as more analysis has been done recently on CCP loss allocation or 'absorption'.

CCPs will have internal rules and procedures to address significant issues like member default which establish the order in which various resources are called upon to absorb losses. This is commonly referred to as the financial 'waterfall'. Note that a CCP may incorporate options near the end of their waterfall that are effectively 'recovery' actions (e.g. additional guarantee fund assessments, variation margin haircuts, etc.). It is essential for systemic stability to cap liability of clearing members to a pre-determinable amount, otherwise a CCP be left standing but the financial system around it will be compromised.It is imperative that the waterfall is exhausted first prior to resolution actions being taken. With the exception of bail-in (we would assume in the context of equity), initial margin haircuts and tear-ups, the loss absorption tools referenced in the paper might be considered as appropriate recovery (i.e., pre-resolution) measures. However, it is imperative that any liquidity calls are subject to caps so that clearing members are not exposed to uncapped liability.

Ultimately, with respect to any FMI, loss allocation should be governed by principles emphasizing predictability and parity. In other words, participants should not be exposed to losses, or be required to provide new support, in ways that are not consistent with the rules and procedures of the FMI (particularly with respect to the waterfall).

Loss allocation or absorption, whether prior to resolution or in the context of resolution, should never operate in a manner that creates uncapped liability for members. We would suggest that considerably more work needs to be done to assess the best methods to allocate losses in the context of resolution. We do see some merit in a form of 'bail-in' but would argue against forced tear ups and any proposal for ex ante funding by market participants. Importantly, loss allocation should not be structured to provide advantages to first movers who withdraw liquidity from the FMI at a critical time

Losses resulting from operational failures, including fraud, rather than from participant defaults, should be borne first by the holders of the FMI's equity. Where an FMI is owned on a mutual (or *quasi*-mutual) basis, the same principles should apply. The members, like shareholders, would stand to lose their initial investment on a pro rata basis. We believe that losses should be allocated based, in large part, on the nature of the loss. For example, losses arising from an operational, financial, or business failure of the FMI, or its owner, should accrue through the ownership and control structure, without reference to default procedures Such situations are much closer to a typical insolvency of a public utility. In that circumstance, the owners of the FMI should stand to lose control of the FMI through the resolution procedure, with the resolution authority able to sell, merge, or otherwise change the ownership structure of the FMI while simultaneously preserving the positions of the participants.

In all cases AFME members believe that the concept of 'uncapped liabilities' for members of a CCP should not form part of any recovery and resolution framework. Uncapped liabilities are impossible to risk manage for firms as they cannot confirm the actual size of their exposure to the CCP. In a stressed market environment they also have the potential to cause liquidity strains on member firms who have to remain members of a CCP if they are to continue clearing client trades. This situation is exacerbated where there are no alternative providers of clearing services for a particular market. Whilst members can choose to leave a CCP should the amounts that they are being called for be deemed unreasonable this may lead to these businesses becoming unprofitable and / or lead to further market instability as investors have to seek alternative arrangements as members exit the CCP.

22) What other tools would be effective in a CCP/CSD resolution?

At this stage, AFME members do not feel that there are specific other tools which would be effective in a CCP/CSD resolution. We refer you to our concerns about certain of the proposed loss allocation/recapitalisation measures in Question 21.

23) Can resolution tools based on contractual arrangements be effective and compatible with existing national insolvency laws?

True resolution (end of the waterfall, FMI failing, no private sector solution, normal insolvency won't work) would involve statutory mechanisms giving powers to the authorities. True resolution would not be affected via contractual arrangements. We would seek further information from the Commission about what is being contemplated here.

Group resolution Q24

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

AFME members believe that this depends upon the nature of the group (i.e. location, activities, etc.). In some circumstances it may not be appropriate to resolve at the group level (e.g. Deutsche Boerse Group). Resolution authorities should have the discretion to decide.

While there may certainly be legal and operational impediments to transfer to a solvent third party, there should also be no presumption against such a transfer, and the legal impediments (including impediments to cross-border transfer), ought to be removed if at all possible.

Operational impediments may indeed be serious (including such matters as the depth and extent of participation in another FMI, the operational or capital capacity of another operator, or the like). However, if a given FMI can be transferred on a stand-alone basis into the ownership of another group that runs FMIs and is capable of operating it, that may often be an attractive solution, and there should be no prejudice against it. There should be no risk of contagion with other FMIs in the event of one FMI undergoing resolution and the onus of ensuring this should be on the FMIs themselves.

It may be that there is a group that runs an FMI for similar products in the same jurisdiction, or that an operator of the same kind of FMI in another jurisdiction would be an appropriate operator for an orphaned FMI (e.g. in the case of CSDs). Outright merger of one FMI into another would be more complex, and is not likely to be feasible overnight, given the credit and risk-management issues if there is

mutualisation of risk, but, again, should not be precluded. Clear parameters should be set out that would enable the absorption of one FMI by another.

Cross border resolution Q25-29

Questions considered here:

25) 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?

One difficulty which the industry must address is that of third country involvement (as mentioned above). It is in the interest of participants and end users to ensure that the regulators involved on a global scale work together to avoid any instances in which third country involvement could prove detrimental to the end investor. The workings of CPSS-IOSCO provide a basic framework for such an international regime and can be used to provide some base principles in the individual member states. The authorities should endeavour to minimise jurisdictional disputes on both a European as well as an international level where challenges of ensuring that this framework for the recovery and resolution of FMIs is efficient, safe and harmonised and where multiple jurisdictions are involved. Affected parties should not be penalised dependent on the jurisdiction in which they reside or in which they have completed the transaction of either clearing or settlement in.

An orderly resolution or recovery process for an FMI with operations in multiple jurisdictions will require binding cooperation arrangements among the resolution authorities in those jurisdictions. To the extent key functions of the FMI are performed through an affiliated group of entities, some of which may be formed in jurisdictions other than the home jurisdiction of the FMI, it is essential that the resolution process encompass all such entities in a single process, and that all applicable jurisdictions agree to respect the determinations of the primary jurisdiction. During the financial crisis, there were circumstances in which courts in two jurisdictions claimed jurisdiction over a dispute, rendered conflicting judgments, and refused to enforce each other's judgments—leaving market participants with no clear form of redress. Where multiple resolution authorities may claim jurisdiction over a single FMI, including as a result of different jurisdictions of formation of its affiliates, these authorities should agree in advance as to which authority has primary jurisdiction and how to ensure that its determinations have finality in other jurisdictions. Jurisdictional disputes will magnify the effects of a failure by delaying recoveries for other affected parties and creating uncertainty that may overhang the market for an extended period. It

should also be noted that the regulatory jurisdiction of the FMI will often differ from that of its members and this should be considered when developing effective recovery and resolution plans.

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

Resolution colleges definitely should be involved in resolution issues of cross border firms. They will need to be streamlined and efficient, however, in order to act effectively in a cross border situation.

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

We do not have specific views at this time but do believe that work would need to be done within resolution colleges to ensure that a resolution event can be dealt with swiftly. For the most systemic FMIs that operate in a number of jurisdictions it is possible that EU-centralisation could work. This would have to be examined further.

28) Do you agree that a recognition regime should be defined to enable mutual enforceability of resolution measures?

Where an FMI operates across borders via a group of entities, mutual recognition measures and resolution facilitation tools (e.g. ability to transfer assets to a foreign entity) would be useful to ensure the maintenance of critical functions and efficient and effective resolution of an FMI. It is important that there be a legal basis for such measures such that market participants have full confidence that an FMI's default rules and the applicable national resolution provisions will be fully respected. These would be particularly important where an FMI operates in a third country. Within the EU, it might be possible to establish a framework in a manner such that cooperation mechanisms are built into the framework and, as such, no separate measures or tools would be required.

29) Do you agree that bilateral cooperation agreements should be signed by third countries?

We agree that bilateral cooperation agreements with third countries could be an important step in the effective resolution of a multijurisdictional FMI. A network of such agreements can be cumbersome, however, and, accordingly we recommend the Commission work with the FSB and other key policymakers to determine whether a single multilateral agreement could be possible among key countries/regions. Arguably even more important than bilateral cooperation agreements are institution specific agreements among the relevant authorities.

Safeguards Q30

Questions considered here:

30) Do you agree that the resolution of FMIs should observe the hierarchy of claims in insolvency to the extent possible and respect the principles that creditors should not be worse off than insolvency?

We agree that the resolution of FMIs should respect the hierarchy of claims in insolvency to the extent possible. Counterparties have contracted with FMIs on this basis and it is an important principle to respect priorities in the event of insolvency. However, we also appreciate that in some circumstances it might be necessary to depart from a strict application of this principle in order to achieve the objectives of resolution. In order to protect creditors in these circumstances we agree that there should be a principle that creditors should be no worse off than they would have been had the FMI been wound up instead of the resolution action being taken.

Questions remain as to how resolution of an FMI would interact with existing insolvency law. This will ultimately depend upon what the new legislation provides.