ISDA Safe, Efficient Markets

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Dear Sirs,

Report of the Working Group on Resolution Regime for Financial Institutions

Introduction:
The International Swaps and Derivatives Association, Inc. ("**ISDA**")[1] welcomes the opportunity to provide comments on the *Report of the Working Group on Resolution Regime for Financial Institutions* ("the **Report**") that was submitted to the Governor, Reserve Bank of India ("**RBI**") and Chairman of the sub-committee of the Financial Stability and Development Council ("**FSDC**").

Scope of this response:
In this response, we will primarily address the issues of bail-in, the proposed temporary stay, the protection of netting sets and cross-border resolution as well as the need to consider the distinction between the recovery and resolution framework for financial institutions ("**FIs**") and financial market infrastructures ("**FMIs**"). As our focus is on the over-the-counter ("**OTC**") derivatives market, our response will only address certain aspects of the Report. Some of our members may have their own views on different aspects of the Report and may provide their comments to RBI independently.

We commend the proposed recommendations in the Report and its support of the Financial Stability Board ("**FSB**") *Key Attributes of Effective Resolution Regimes for Financial Institutions*[2] including the associated report *Application of the Key Attributes of Effective Resolution Regimes to Non-Bank Financial Institutions*[3]. In particular, we strongly support

[1] Since 1985, ISDA has worked to make the global over-the-counter (OTC) derivatives markets safer and more efficient. Today, ISDA has over 800 member institutions from 64 countries. These members include a broad range of OTC derivatives market participants including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure including exchanges, clearinghouses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's web site: www.isda.org

[2] http://www.financialstabilityboard.org/publications/r_111104cc.pdf, Financial Stability Board, *Key Attributes of Effective Resolution Regimes for Financial Institutions*, Oct 2011.
[3] http://www.financialstabilityboard.org/publications/r_130812a.pdf, *Application of the Key Attributes of Effective Resolution Regimes to Non-Bank Financial Institutions*, 12 Aug 2013

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the recommendation for a resolution framework that explicitly provides for rules, laws and practices governing enforceability of contractual set-off, close-out netting and collateral arrangements.

Comments on specific recommendations in the Report

1. **Recommendations 2, 3 and 4 – The financial resolution framework:**
   We support the proposal of a separate financial resolution framework as stated in Recommendation 2 of the Report that is applicable to all FIs. When setting up the financial resolution framework, it is extremely important that this financial resolution framework will override and/or work in conjunction with other existing legislation. If the financial resolution framework is to be effective and supersede relevant existing legislation, it is extremely important that it will interact in such a manner that will not give rise to possible conflicts between different pieces of legislation.

   The Report intentionally covers a wide variety of financial institutions however rightly acknowledges that particular sectors may require sector-specific consideration to recognize, for example, the different business models, balance sheet structures and/or methodologies for the assessment of risks. Consequently, the financial resolution framework should accommodate and provide flexibility for sector-specific provisions. For example, the commodities market will be different from the insurance sector and from the banking sector. These important considerations have been acknowledged in the Report and analyzed in further detail within the FSB's consultative document the *Application of the Key Attributes of Effective Resolution Regimes to Non-Bank Financial Institutions*.

   We support that the overall recovery and resolution framework for FMIs will require further analysis in response to their unique structure and function to the financial markets (as described in paragraphs 4.74 – 4.77[4] and 4.83[5] of the Report). As an example: while we acknowledge that rapid decision-making may be necessary, FMI participants must understand ex-ante all circumstances that may invite early intervention by a resolution authority so as to not disrupt market confidence and the expectations of participants. We believe that the FMI recovery and resolution framework should focus on the continuity of critical functions. The determination of critical functions will depend on the nature and financial market significance of services provided by the FMI.

   The Report sets out various objectives when considering financial resolution framework. In addition to those described, especially when applied to FMIs, it is important that the liabilities of participants to the FMI be predictable and limited as a financial entity would be unable to support or be authorized by its prudential regulator to participate in an activity where exposures are unlimited and unquantifiable. In addition, the resolution authority should respect the default management strategy of the FMI (including, for example, the default waterfall) as outlined in its rules and procedures. Any concerns that the supervisory and resolution authorities may have with the default management process or other arrangements of the FMI should be

[4] http://rbi.org.in/scripts/PublicationReportDetails.aspx?UrlPage=&ID=767, *Report of the Working Group on Resolution Regime for Financial Institutions*, Paragraph 4.74 - 4.77, Pages 99-100, 18 Jan 2014.
[5] http://rbi.org.in/scripts/PublicationReportDetails.aspx?UrlPage=&ID=767, *Report of the Working Group on Resolution Regime for Financial Institutions*, Paragraph 4.83, Page 102, 18 Jan 2014.

raised during the review and assessment of the FMI's recovery and resolution. Within our responses to the FSB's consultation paper on *Application of the Key Attributes of Effective Resolution Regimes to Non-Bank Financial Institutions* as well as the Committee on Payment and Settlement Systems ("**CPSS**") and International Organization of Securities Commission ("**IOSCO**") (together, "**CPSS-IOSCO**") consultation paper on the *Recovery of Financial Market Infrastructures*[6], we have outlined the industry's views on the overall recovery and resolution framework, including a set of Key Principles. These two responses are attached to our response to the Report for ease of reference.

Paragraph 4.39[7] of the Report recommends that the resolution authority, in coordination with the respective regulator, have the ability to designate any other financial institution to be covered by the financial resolution framework. While we understand the need to be flexible in the scope of FIs covered, we would like to suggest some lead time be provided to the FI that may be included in the financial resolution framework. It is important that the scope of FIs be clearly defined as this will avoid uncertainty and confusion amongst FIs as to which entity would be subject to the financial resolution framework.

Recommendation 3[8] of the Report provides objectives that guide the resolution framework in India. While we support the objectives stated in paragraph 4.32[9] of the Report, consideration should be given to the cross-border impact of a resolution framework. As the scope of the financial resolution framework in India will cover all FIs, including foreign banks with branches or subsidiaries in India, there will be an element of cross-border impact that should form part of the objectives of a resolution framework in India as these foreign banks will be governed by a resolution framework in their respective home jurisdictions. This is also supported by the FSB's *Key Attributes of Effective Resolution Regimes for Financial Institutions*, Key Attribute 7, which outlines the legal framework conditions for cross-border cooperation.

2. **Recommendations 6 and 8– Financial Resolution Authority:**
It should be noted that it is extremely important that the Financial Resolution Authority ("**FRA**") has the necessary expertise to apply the appropriate resolution regime, tools or plans and the timing of implementing such plans for a failing financial institution. Additionally, the FRA should cooperate/coordinate with the relevant regulators/supervisors of the financial sector as well as with its overseas counterparts to ensure a smooth and coordinated resolution process.

Recommendation 8[10] of the Report proposes that the FRA may be setup by transforming the present Deposit Insurance and Credit Guarantee Cooperation ("**DICGC**") into the FRA or by subsuming DICGC into the FRA. In either scenario,

[6] http://www.bis.org/publ/cpss109.pdf, Committee on Payment and Settlement Systems and the Board of the International Organization of Securities Commissions, *Recovery of Financial Market Infrastructures*, Aug 2013.

[7] http://rbi.org.in/scripts/PublicationReportDetails.aspx?UrlPage=&ID=767, *Report of the Working Group on Resolution Regime for Financial Institutions*, Paragraph 4.39, Page 85, 18 Jan 2014.

[8] http://rbi.org.in/scripts/PublicationReportDetails.aspx?UrlPage=&ID=767, *Report of the Working Group on Resolution Regime for Financial Institutions*, Recommendation 3, Page 82, 18 Jan 2014.

[9] http://rbi.org.in/scripts/PublicationReportDetails.aspx?UrlPage=&ID=767, *Report of the Working Group on Resolution Regime for Financial Institutions*, Paragraph 4.32, Page 82, 18 Jan 2014.

[10] http://rbi.org.in/scripts/PublicationReportDetails.aspx?UrlPage=&ID=767, *Report of the Working Group on Resolution Regime for Financial Institutions*, Recommendation 8, Page 90, 18 Jan 2014.

the roles and responsibilities should be clearly demarcated between its function as a resolution authority and its function of protecting depositors to avoid any potential conflict of interest that may arise.

3. **Recommendations 8, 9 and 10 - Triggers for Entry into Resolution**
While we acknowledge that a prompt corrective action ("**PCA**") framework may allow regulators/supervisors to intervene at a sufficiently early stage to prevent a FI from reaching non-viability, we caution against the use of fixed, pre-determined quantitative measures as a definitive and automatic indicator of a FI entering non-viability. For FMIs, in particular central counterparties ("**CCPs**"), we believe the triggers as proposed in the FSB's *Application of the Key Attributes of Effective Resolution Regimes to Non-Bank Financial Institutions* should be considered. Accordingly, the CCP's default management strategy should be respected and only when the default management strategy (including any loss allocation or voluntary mechanisms) is deemed ineffective should resolution measures be considered.

The four stages of the PCA framework that is proposed under Recommendation 9[11] should be clearly defined. In the event of a FI failing, each of the stages of the PCA should be evaluated according to that specific FI and its circumstances and should not be subject to an automatic early intervention trigger. As you are aware, too-early an intervention by the resolution authorities may disrupt market confidence, for example, by assessing a failing FI as stage 4 instead of a lower stage of the PCA framework.

Recommendation 10[12] of the Report proposes that the FRA may take a distressed institution into resolution even at an earlier stage. As noted above, we caution against a too-early intervention by the resolution authorities as this may disrupt market confidence pre-maturely.

4. **Recommendations 13, 14, 15 and 16– Resolution tools:**
Recommendation 13[13] proposes the use of a variety of resolution tools such as, liquidation; purchase and assumption ("**P&A**"); bridge institution; good-bank and bad-bank; bail-in and temporary public ownership to enable FRA with the flexibility to resolve a FI and preserve its critical functions. We support the need for the resolution authority to have the necessary tools that will enable it to fulfill its function of resolving a failing FI and to preserve its critical functions. For a bridge institution, it is important that the bridge institution has the necessary expertise to manage the portfolio that has been transferred to it from the failing FI. We only support the use of temporary public ownership if it is used as a last resort after exhausting all other available tools.

With regard to Recommendation 14[14], it is important that a more detailed framework for FMIs be considered, at a later stage, based on the policy documentations to be issued by the FSB and other international bodies.

[11] http://rbi.org.in/scripts/PublicationReportDetails.aspx?UrlPage=&ID=767, *Report of the Working Group on Resolution Regime for Financial Institutions*, Recommendation 9, Pages 93-94, 18 Jan 2014.
[12] http://rbi.org.in/scripts/PublicationReportDetails.aspx?UrlPage=&ID=767, *Report of the Working Group on Resolution Regime for Financial Institutions*, Recommendation 10, Page 94, 18 Jan 2014.
[13] http://rbi.org.in/scripts/PublicationReportDetails.aspx?UrlPage=&ID=767, *Report of the Working Group on Resolution Regime for Financial Institutions*, Recommendation 13, Pages 101-102, 18 Jan 2014.
[14] http://rbi.org.in/scripts/PublicationReportDetails.aspx?UrlPage=&ID=767, *Report of the Working Group on Resolution Regime for Financial Institutions*, Recommendation 14, Page 102, 18 Jan 2014.

We support the principle of statutory bail-in within the resolution regime as this will align India's resolution regime with other regimes such as the United States ("**US**"), United Kingdom ("**UK**") and the European Union ("**EU**"), provided that bail-in as a resolution tool is only applied after the relevant authorities have made the reasonable determination that all other feasible measures/ tools have been exhausted in preventing a failing financial institution from reaching a point of non-viability. However, we recommend that any local considerations for inclusion or exclusion of specific capital instruments should be aligned to international standards, being developed by the FSB as part of its current discussion on Gone-concern Loss Absorbing Capacity ("**GLAC**") proposal, which will be presented at the G20 Brisbane Summit in November 2014.

For a global systemically important bank ("**GSIFI**"), it is important for regulators/supervisors to coordinate and cooperate on a global level to facilitate the resolution of a GSIFI across jurisdictions. Paragraph 4.92[15] of the Report recognizes that the practical implications of bail-in across jurisdictions has yet to be tested, however, we would like to point to paragraph 7.5 of the FSB's *Key Attributes of Effective Resolution Regimes for Financial Institutions* which recommends a mutual recognition process or by taking measures under the domestic resolution regime that supports and is "consistent with the resolution measures taken by the foreign home resolution authority as this would enable the foreign home resolution authority to gain rapid control over the firm or its assets that are located in the host jurisdiction"[16]. As a general principle, bail-in should only be exercised by the authority with primary resolution of that FI, for example: the home authority in relation to a GSIFI.

The bail-in must respect, as far as possible, pari passu treatment of creditors and the statutory authority of priorities. In relation to the application of bail-in, recapitalization should be effected by starting at the bottom of the capital structure, that is, with the equity level and then moving up the structure in reverse order of priority. Senior debt should only be subject to statutory bail-in after exhaustion of subordinate levels of capital. And, of course, senior debt should only be bailed in to the extent necessary to recapitalize a FI or, as the case may be, the portions of its business transferred to a bridge institution, at a reasonable level.

It is extremely important that the bail-in framework is predictable and has legal certainty. It should be noted that numerous legal issues will need to be addressed in detail, including (but not limited to) company, securities, property, insolvency, commercial and private international law issues. It is also equally important to clearly define the scope of the instruments that may be subject to the bail-in requirement as Recommendation 16[17] proposes the bail-in framework to include capital instruments (additional Tier 1 and Tier 2 capital) and other unsecured creditors while excluding deposit liabilities, inter-bank liabilities, and all short-term debt.

[15] http://rbi.org.in/scripts/PublicationReportDetails.aspx?UrlPage=&ID=767, *Report of the Working Group on Resolution Regime for Financial Institutions*, Paragraph 4.92, Page 104, 18 Jan 2014.
[16] http://www.financialstabilityboard.org/publications/r_111104cc.pdf, Financial Stability Board, *Key Attributes of Effective Resolution Regimes for Financial Institutions*, Section 7.5, Pages 13, Oct 2011.
[17] http://rbi.org.in/scripts/PublicationReportDetails.aspx?UrlPage=&ID=767, *Report of the Working Group on Resolution Regime for Financial Institutions*, Recommendation 16, Page 104, 18 Jan 2014.

We believe derivatives transactions should be excluded from the scope of the bail-in framework. As you are aware, as a general rule, liabilities of a party to a derivative transaction are largely or wholly contingent while the transaction is outstanding. Derivative transactions contemplate both payment obligations and, where physical settlement is permitted or required, delivery obligations, that is, obligations to deliver an agreed form of asset. For payment obligations, any future payment obligation under a swap transaction will remain contingent in relation to future payment dates and only payments due and payable on a particular payment date would be considered as not contingent. The amount of any future payment obligation under the swap transaction will also potentially be subject to payment netting against any amount due on the same day by the same party and potentially also to netting against amounts due on the same day by the same party under other transactions under the same master agreement. Given that the value of a derivative transaction is determined by a range of underlying assets, it is likely there would be practical and operational difficulties in applying a statutory bail-in power to a "live" derivative transaction as it would still have outstanding obligations to be performed at the time a statutory bail-in may be exercised as well as the potential disruptive impact on related positions (which may be either hedges for or hedged by the transactions subject to the bail-in power). Consideration should also be given to the potential negative implications from a regulatory capital perspective if derivatives transactions were subject to a bail-in framework. Where derivatives transactions are exchange traded and cleared or traded over-the-counter and cleared, as is increasingly required by the G20 commitment, then additional operational and other difficulties are likely to arise in applying the bail-in power. It should be noted that cleared derivatives transactions have been exempted as a bail-in tool under the European Union ("**EU**") Framework for the Recovery and Resolution of Credit Institutions and Investment Firms[18].

It is possible to apply a statutory bail-in power to a net amount under the close-out netting provisions of an ISDA Master Agreement. Such an amount, once determined, would usually be an unconditional debt owed by the party that is "out of the money" on a net basis under the relevant master agreement, regardless of whether the party is the defaulting party or the non-defaulting party. This debt may then be written down or converted to equity without the need to apply bail-in to "live" derivatives transactions. It should be noted that (1) all transactions under a master agreement would need to be terminated and valued and this process can take some time; and (2) the FI may not be a debtor, in which case, the resulting net amount from the close-out may not be available to be bailed-in. Regarding the first point, the timing of the process of close-out is unlikely to be sufficiently rapid to accommodate the speed with which resolution authorities may want to recapitalize a failing FI in order to minimize market disruption and to ensure continued performance of the failing FI. Regarding the second point, although in the circumstances described the net amount, being owed to the failing FI, would represent an asset of the failing FI and therefore strengthen its balance sheet, the benefit of realizing that asset may be outweighed by the disadvantage of losing the on-going risk protection offered by the transactions under the master agreement. Additionally, there are cogent reasons for the principle why derivative transactions should be excluded from the scope of bail-in power. Bail-in is concerned with recapitalization. Liabilities under derivatives transactions do not form part of the capital of a FI, other than, perhaps, in the very limited case

[18] http://www.europarl.europa.eu/sides/getDoc.do?type=TA&language=EN&reference=P7-TA-2014-0354#BKMD-28, European Parliament, 15 Apr 2014.

where a specific derivative transaction is closely related to a capital transaction of the FI. The vast majority of derivative transactions constituting the normal derivatives trading of the FI would not fall into this category.

5. **Recommendations 20, 21 and 22 - Recovery and Resolution Plans ("RRP")**
For Recommendation 21[19], we seek further clarification on the scope of FIs that will be required to prepare a RRP. For example: if all financial groups/conglomerates are subject to the RRP requirement as well as systemically important FIs, how would this work with the requirement to prepare a recovery plan on a regular basis by institutions on a pre-approved format and approval from the respective regulator? If a RRP is prepared on a group level, would it still need to be prepared on an individual FI level, within the group structure? We recommend that only systemically important groups be required to prepare a RRP. As noted under our comments regarding the PCA framework, we caution against setting automatic triggers within a recovery plan.

We believe the RRP for FMIs should be addressed, at a later stage, based on the policy documentations to be issued by the FSB and other international bodies for non-bank FIs.

Recommendation 22 proposes that systemically important FMIs may prepare RRPs that may prescribe methodologies to "allocate uncovered losses and liquidity shortfalls to direct participants, indirect participants, third-party institutions and/or owners on the basis of and to the extent they are permitted by ex-ante arrangements"[20]. It is important to note that any recovery and continuity mechanisms must not challenge accounting or regulatory capital criteria to net cleared exposures. Any provision that undermines a FMI's participant from attaining netting or set-off in accordance with market practice and render participation in the FMI unviable should be guarded against. The allocation of "uncovered losses and liquidity shortfalls" of a FMI should not create potential liabilities that are unlimited and unquantifiable as this would undermine the risk management in the system and create incentives to "run" from a given system or the products it supports. As the aim of a resolution framework is to preserve a FMI's critical function, this would run counter to the spirit of a resolution regime. Additionally, we seek clarification if Recommendation 22 will be a requirement for systemically important FMIs or will FMIs be permitted to create RRPs on an optional basis.

6. **Recommendations 24 and 25 – Powers to Restructure Complex Financial Institutions**
We acknowledge there may be a need to remove barriers to resolvability, however, such decisions should be firm specific and not a matter of general policy requiring structural reform. We are concerned with the power granted to the regulator/supervisor as we believe this power should only be used for the critical functions of a systemically important FI. Coordination with other regulators/supervisors may be required if the systemically important FI is a foreign FI as a foreign FI will be subject to the requirements of both the home and host jurisdictions. As there will be associated costs and business impact from a restructure,

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[19] http://rbi.org.in/scripts/PublicationReportDetails.aspx?UrlPage=&ID=767, *Report of the Working Group on Resolution Regime for Financial Institutions*, Recommendation 21, Page 115-116, 18 Jan 2014.
[20] http://rbi.org.in/scripts/PublicationReportDetails.aspx?UrlPage=&ID=767, *Report of the Working Group on Resolution Regime for Financial Institutions*, Recommendation 22, Page 116, 18 Jan 2014.

FIs should be provided with sufficient lead time as well as an open dialogue with the relevant regulator/supervisor to discuss their concerns and requirements to reach a mutually agreeable solution.

7. **Recommendation 26 – Financial Holding Company Structure**
   With respect to Recommendation 26 which states that "to improve resolvability of financial conglomerates, the Group recommends that the financial holding company structure may be introduced for Indian financial system"[21]. While we understand the rationale to require local firms headquartered in India to have a holding company structure, we propose that for international banking groups this should not be a mandatory requirement, especially, if that group is headquartered in a jurisdiction with a comparable resolution framework and where the financial group, in discussion with its home regulatory authorities, has a SPE ("**Single Point of Entry**") approach as its preferred resolution strategy. The creation of local financial holding companies in any other jurisdiction would work counter to a SPE strategy.

8. **Recommendations 30, 31 and 32 – Enforceability of Contractual set-off, Close-out Netting and Collateral arrangements, and Segregation of Client Assets:**
   We strongly support recommendation 30[22] which states that the resolution framework should explicitly provide for rules, laws and practices that govern the enforceability of contractual set-off, close-out netting, collateral arrangements and segregation of client assets. When the resolution framework is being setup, the legal framework should be clear, transparent and provide safeguards/protection of netting to reduce systemic risk and costs.

   Recommendation 31[23] in the Report proposes a stay of two days (48 hours) with the possibility of an extension by a maximum of another three days (72 hours) after specifying the reasons in writing by the FRA. In our view, we believe the stay should not exceed two days as a longer stay would result in market uncertainty and therefore risk and instability. It would be extremely difficult for market participants to properly manage the market risks of their positions if they do not know if these positions will be transferred to a creditworthy new entity, such as a bridge bank, or left with an insolvent residual entity, such as the Good Bank-Bad Bank resolution tool. The proposal for a stay should also only be apply to the suspension of early termination rights for a limited time period only. We note that the US has successfully operated its resolution regime for US banks with a 24 hours stay period. We strongly support the FSB's *Key Attributes of Effective Resolution Regimes for Financial Institutions* Key Attribute 4[24] and the related guidance in Annex IV, which was developed after a careful and detailed consultation with all relevant stakeholders, including ISDA and its members.

   We believe that it is neither necessary nor desirable for resolution authorities to have the power to extend the stay period from two days to five days. Any extension of the

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[21] http://rbi.org.in/scripts/PublicationReportDetails.aspx?UrlPage=&ID=767, *Report of the Working Group on Resolution Regime for Financial Institutions*, Recommendation 26, Page 120, 18 Jan 2014.
[22] http://rbi.org.in/scripts/PublicationReportDetails.aspx?UrlPage=&ID=767, *Report of the Working Group on Resolution Regime for Financial Institutions*, Recommendation 30, Page 127, 18 Jan 2014.
[23] http://rbi.org.in/scripts/PublicationReportDetails.aspx?UrlPage=&ID=767, *Report of the Working Group on Resolution Regime for Financial Institutions*, Recommendation 31, Page 128, 18 Jan 2014.
[24] http://www.financialstabilityboard.org/publications/r_111104cc.pdf, Financial Stability Board, *Key Attributes of Effective Resolution Regimes for Financial Institutions*, Key Attribute 4 and Annex IV, Pages 10-11, 41-43, Oct 2011.

temporary stay beyond the two days, particularly if market participants are uncertain as to whether the resolution authorities would extend the stay period by another three days or not, would raise serious concerns as to whether a close-out netting or collateral arrangement with a firm in a jurisdiction with such a resolution regime would satisfy the high degree of legal certainty needed under the Basel Capital Accord for purposes of determining regulatory capital requirements. If a bank is unable to satisfy the legal certainty standard, it would result in an increased cost of capital. Further we seek clarity as to which period payment obligations should continue to be performed.

As noted above, a technical point in relation to the scope of the proposed suspension, is that the stay should only relate to the right of a counterparty under a derivatives master agreement, such as the ISDA Master Agreement, with a failing FI subject to the resolution regime to terminate its transactions early as a result of the triggering of the resolution regime against the FI. Early termination is the essential first step in the process of close-out netting. The other steps in the process of close-out netting are valuation of the terminated transactions, followed by the determination of the net balance owing by or to the defaulting party under the close-out provisions. Every master netting agreement operates on this basis, even if the details of the close-out mechanism may vary. During the period of the temporary stay, the non-defaulting counterparty's rights and the failing FI's obligations (and vice versa) under the master agreement should not otherwise be affected. Throughout this period, the non-defaulting party should (bearing in mind Recommendation 30 of the Report that proposes the resolution framework or existing statues should explicitly provide for rules, laws and practices governing enforceability of contractual set-off, close-out netting and collateral arrangements) be permitted to consider its exposure to the failing FI to be fully net. It is extremely important that this temporary stay period should not "suspend" close-out netting. At most, it should simply stay temporarily the initiation of the close-out netting process, namely, the early termination of transactions following an event of default. Where a master agreement is collateralized, it should be clear that the temporary stay should have no effect on the obligations of each party under the collateral arrangement. Collateral calls should be capable of being made and should be complied with in the agreed manner, including the operation of any relevant dispute resolution mechanism. Therefore, a failure of a FI to make payment that is due during the period of temporary stay should constitute an event of default (assuming the appropriate notice has been given and any relevant cure period has elapsed), and the other party should be free to exercise its early termination rights in relation to that event of default notwithstanding the temporary stay.

Further, as the FRA has the ability to use a number of resolution tools such as good bank-bad bank, in which the failed FI is split into two, it is important that in such cases, the legal certainty of enforcement of netting is not impaired as market participants will need to satisfy the legal certainty standard from a regulatory capital perspective. It should be noted that it is not necessarily the case that the entry into a resolution regime would, of itself, currently trigger early termination rights in most financial contracts. Only the aspect of the resolution regime that could be characterized as either a form of liquidation or reorganization proceeding for the benefit of all creditors or related or preparatory acts would normally be caught by the existing "bankruptcy" events of default, such as the Bankruptcy Event of Default in

Section 5(a)(vii) of the ISDA Master Agreement. Consequently, the exercise of a resolution power to transfer the shares of a troubled FI to temporary public ownership or to a private sector purchaser would not, of itself, trigger an Event of Default under either the 1992 or 2002 version of the ISDA Master Agreement, at least as far as the standard form as published by ISDA. As you may be aware, parties are free to amend the existing provisions of the ISDA Master Agreement and to supplement it as they see fit, and it is both possible and perhaps likely that as resolution regimes become more common and more extensive in the powers granted to public authorities parties will seek to develop additional early termination rights specifically to address the exercise of resolution powers beyond the commencement of special bank liquidation, administration or other reorganization procedures.

If such a power to suspend early termination rights is to be included in India's resolution regime for FIs, we believe that it must be made subject to certain conditions, namely that:

- The stay only applies to early termination rights that arise for reasons only of entry into resolution or in connection with the use of resolution powers;

- the ability of the resolution authority to suspend early termination rights is strictly limited in time (ideally for a period not exceeding 24 hours and should not exceed two business days in all circumstances);

- where the relevant contract permits a counterparty to the FI not to perform as a result of a default or potential event of default in relation to the other party (as is the case, for example, under Section 2(a)(iii) of the ISDA Master Agreement), that provision should be unaffected by the stay;

- the relevant master agreement and all transactions under it are transferred to an eligible transferee as a whole or not at all, together with any related collateral (there is no possibility of "cherry-picking" of transactions or parts of transactions or divorcing the collateral from the obligations secured or supported by it);

- the proposed transferee is a financially sound entity with whom the counterparty would prudently be able to contract in the normal course of its business (including a bridge institution backed by appropriate assurances from the resolution authority and its government) and the transferee should be subject to the same or a substantially similar legal and tax regime so that the economic (apart from the issue of credit quality) and tax position of the counterparty is not materially affected by the transfer;

- the early termination rights of the counterparty are preserved as against the FI entering resolution in the case of any default by the FI occurring during the period of the stay that is <u>not</u> related to the exercise of the relevant resolution power (for example, a failure to make a payment, as discussed above, or the failure to deliver or return collateral, in either case, on a due date occurring during the period of the stay);

- the early termination rights of the counterparty are preserved as against the transferee in the case of any subsequent independent default by the transferee; and

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- the counterparty retains the right to close out immediately against the failed financial institution should the authorities decide not to transfer the relevant master agreement during the specified transfer window

We note that some of these conditions are acknowledged in the Report.

We support Recommendation 32[25] of the Report.

9. **Recommendation 33[26] – Respect of Creditor Hierarchy:**
We believe it is important to clearly define the loss allocation amongst creditors under the financial resolution framework. We support the creditor hierarchy whereby the highest ranking creditors are repaid first and the lower priority creditors paid later only after the senior creditors have been paid. We seek further clarification and understanding on the need for the FRA to be provided the flexibility to depart from the general principle of equal treatment of creditors of the same class and under what circumstances this would this apply.

10. **Recommendation 34[27] – Preference given to Depositors, Insurance Policyholders and Investors**
While we agree with Recommendation 34 of protecting interest of certain groups of liability holders, such as depositors, under the resolution framework, we believe the inclusion of "investors" in such a preference may not be appropriate. This is because by definition, "investors" to a FI would typically include equity holders and debt holders. As such, under a bail-in, such "investors" would be expected to absorb losses in accordance to the creditor hierarchy. Consequently, we recommend that any references to protect the interest of the "investor" should be avoided.

11. **Recommendations 37, 38, 39 and 40– Need for Cooperation and Coordination:**
Paragraph 5.20 of the Report states that "in the absence of effective cross-border cooperation and information sharing or in the event of inaction or inappropriate action by the foreign home jurisdiction, the statutory framework should provide the right to the resolution authority for taking discretionary national action on its own initiative, if considered necessary, to achieve financial stability"[28]. We believe for a resolution framework to be effective, particularly in the context of a foreign FI with both home and host resolution requirements, cooperation and mutual recognition is required to avoid any potential conflicts that may arise between the resolution actions of a home or host resolution authority. We strongly support the principle set out in the FSB *Key Attributes of Effective Resolution Regimes to Financial Institutions* that the home jurisdiction of the parent company should have the primary responsibility for the resolution of the parent any subsidiary of the parent company located in the home country. Each host country's resolution authority should cooperate and coordinate with the home country resolution authority effectively to ensure that all creditors of

[25] http://rbi.org.in/scripts/PublicationReportDetails.aspx?UrlPage=&ID=767, *Report of the Working Group on Resolution Regime for Financial Institutions*, Recommendation 32, Page 128-129, 18 Jan 2014.
[26] http://rbi.org.in/scripts/PublicationReportDetails.aspx?UrlPage=&ID=767, *Report of the Working Group on Resolution Regime for Financial Institutions*, Recommendation 33, Page 129-130, 18 Jan 2014.
[27] http://rbi.org.in/scripts/PublicationReportDetails.aspx?UrlPage=&ID=767, *Report of the Working Group on Resolution Regime for Financial Institutions*, Recommendation 34, Page 132, 18 Jan 2014.
[28] http://rbi.org.in/scripts/PublicationReportDetails.aspx?UrlPage=&ID=767, *Report of the Working Group on Resolution Regime for Financial Institutions*, Paragraph 5.20, Page 141, 18 Jan 2014.

and counterparties of a particular class are, as far as possible, given equal treatment. We believe Recommendation 37[29] of the Report should aim to achieve a cooperative solution as a first step instead of a discretionary national action as a first step, particularly for FIs that are subject to both home and host resolution frameworks.

While we recognize the challenges in cross-border coordination and cooperation due the differing resolution frameworks, legal frameworks and national mandates in each jurisdiction, it is important that work on these issues continue through an international body such as the FSB. Cross-border cooperation is only possible if each jurisdiction is willing to recognize and mutually agree to support the resolution measures of the resolution authority in each jurisdiction.

We support Recommendation 38[30] which enables the FRA to share non-public information with foreign home/host resolution authorities on a reciprocal basis and subject to confidentiality requirements and protection, including agreements to resist Freedom of Information requests for FIs' confidential information to the fullest extent possible. We also support Recommendation 39[31]. However, we believe there may be a need for a specific supervisory college to be set-up that will deal specifically with the resolution of a FI. We also support Recommendation 40[32] of the Report which empowers the FRA to form Crisis Management Groups ("**CMGs**") and institution-specific Cross-border Cooperation Agreements ("**COAGs**") for systemically important institutions headquartered in India.

ISDA appreciates the opportunity to provide comments on the Report. If you have any questions on this submission or would like to further discuss any other topics, please contact Keith Noyes at (knoyes@isda.org, at +852 2200 5909) or Cindy Leiw at (cleiw@isda.org, at +65 6538 3879) or Erryan Abdul Samad (eabdulsamad@isda.org, at +65 6538 3879) at your convenience.

Yours sincerely,

For the International Swaps and Derivatives Association, Inc.

Keith Noyes
Regional Director, Asia Pacific

Cindy Leiw
Director of Policy

Erryan Abdul Samad
Counsel, Asia

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29 http://rbi.org.in/scripts/PublicationReportDetails.aspx?UrlPage=&ID=767, *Report of the Working Group on Resolution Regime for Financial Institutions*, Recommendation 37, Page 142-143, 18 Jan 2014.

30 http://rbi.org.in/scripts/PublicationReportDetails.aspx?UrlPage=&ID=767, *Report of the Working Group on Resolution Regime for Financial Institutions*, Recommendation 38, Page 146-147, 18 Jan 2014.

31 http://rbi.org.in/scripts/PublicationReportDetails.aspx?UrlPage=&ID=767, *Report of the Working Group on Resolution Regime for Financial Institutions*, Recommendation 39, Page 147, 18 Jan 2014.

32 http://rbi.org.in/scripts/PublicationReportDetails.aspx?UrlPage=&ID=767, *Report of the Working Group on Resolution Regime for Financial Institutions*, Recommendation 40, Page 149, 18 Jan 2014.

ANNEX 1

ISDA Safe, Efficient Markets | IIF Institute of International Finance | The Clearing House At the Center of Banking Since 1853

11 October 2013

CPSS Secretariat
Committee on Payment and Settlement Systems
Bank for International Settlements
Sent by email: cpss@bis.org

IOSCO Secretariat
Technical Committee
International Organization of Securities Commissions
Sent by email: fmirecovery@iosco.org

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

Dear Secretariat:

This letter contains the response of the International Swaps and Derivatives Association[1] ("ISDA"), the Institute of International Finance Inc. ("IIF") and The Clearing House ("TCH") (together, the "Associations") to the Committee on Payment and Settlement Systems (CPSS) and International Organization of Securities Commissions (IOSCO) (together, "CPSS-IOSCO") consultative report, *Recovery of financial market infrastructures* issued for comment on 12 August 2013.

Effective recovery, continuity and resolution mechanisms for financial market infrastructures (FMIs) are critical to the efficient operation and sustainability of the financial markets. We appreciate the guidance provided within the consultative report related to recovery of FMIs and desire to provide meaningful response to ensure a viable framework is adopted. Our response focuses on central counterparties (CCPs) which will arguably become the most systemically relevant infrastructure in the financial markets as a result of regulatory reform already enacted.

Systemic risk reduction and financial market resilience is reliant on the robustness of the CCP and the prevention of contagion risk due to a suboptimal recovery or resolution process that could instigate the default of additional clearing members (CMs) or CM clients. This requires a CCP recovery and resolution process that contains mutualisation and limited liability for clearing participants with respect to their CCP exposures.[2] Any loss allocation mechanism must be equitable and fair and apply equally to all clearing participants at the beneficial owner level and further ensure that any burden placed on remaining clearing participants does not increase systemic risk. Although the primary goal in a default situation should be recovery and continuity of the CCP, the need for resolution cannot be excluded and therefore resolution mechanisms must also be in place. The overall recovery and resolution framework should be designed to avoid creating moral hazard on the part of CCPs and ensure, in the event of CCP insolvency, following application of the recovery and resolution framework, an economic outcome no less fair than that which would apply in a general CCP insolvency liquidation proceeding (i.e. no creditor is worse off). We support that it is inappropriate for taxpayers to be exposed to any residual losses in the event of a CCP insolvency.

[1] A description of the Associations is included within the Appendix.

[2] Throughout this response, we use the term "clearing participant" to capture the full range of entities who may have direct or indirect exposures to CCPs by virtue of their cleared positions. CMs are a subset of clearing participants each of whom, in addition, unconditionally guarantees the performance of those participants it has as clearing clients, and provides a limited guarantee in the form of default fund contributions that are highly expected to assure, but not guarantee unconditionally, the performance of other CMs and their respective client guarantees.

We welcome the consultative report as an objective and thorough assessment of the various recovery mechanisms and tools that could be utilized at the end of the CCP default waterfall.[3] We support assessment powers and variation margin gains haircutting (VMGH) as the most effective mechanisms to allocate losses related to a participant default, and, in the sections that follow, detail why other mechanisms are less appropriate or should not be considered altogether. With regard to recovery tools for liquidity shortfalls and replenishment of financial resources, we are broadly supportive of the mechanisms proposed within the consultation; however, as described within, we acknowledge that CMs may face certain constraints in providing such services. We have significant reservations over the practicality of certain tools contemplated to re-establish a matched book, notably position-based allocation, which we've detailed in the sections that follow.

The overall recovery framework must consider a CCP's default management process, be clearly defined and well understood by all clearing participants, and contain sufficient flexibility to ensure voluntary mechanisms are employable prior to the application of potentially less effective and disruptive mandatory tools. For any mechanism or tool to be effective, it must demonstrate the ability to promote economic incentives, encourage participants to assist the CCP in its risk management and recognize the applicable legal, capital and accounting frameworks. Because CCPs operate in multiple jurisdictions and clear various types of products, the appropriateness and sequencing of certain mechanisms and tools may vary; therefore it is important that various mechanisms and tools be available. Resolution mechanisms should commence only after a CCP's default resources have been exhausted and its default management process is determined ineffective and the CCP is faced with potential insolvency.

We acknowledge that a disorderly default management or recovery process could instigate significant market disruption; therefore, it is critical to ensure that any measures to prevent a foreseeable default and ensure an effective recovery process are employed. It follows that the potential for such a scenario should be already considered when evaluating the appropriateness to mandate certain products for clearing. Where such assessment determines that a product is difficult or likely unmanageable, particularly in a default scenario, the product should not really be cleared to begin with, and certainly clearing participants should not be forced to clear such product.

It is accepted that scenarios may arise where loss allocation mechanisms are deemed ineffective, and absent any further voluntary mechanisms, CCP service termination, and, where the clearing service is full recourse to the CCP, resolution must ensue.

ISDA CCP Loss Allocation at the End of the Waterfall technical paper

In recognition of the significant complexity to achieve an optimal framework, we have engaged industry participants to outline key principles (described in Section I below) and practical mechanisms that respond to stated objectives, reflect risk management practices, and are sensitive to the legal and accounting frameworks of clearing participants and CCPs.

In August 2013, ISDA published a technical paper, *CCP Loss Allocation at the End of the Waterfall*, which analyzes the various recovery mechanisms and tools that can be utilized at the end of the CCP default waterfall.[4] For example, the technical paper advocates VMGH as the most effective credit loss allocation solution, in that it will effectively cover losses, preserve netting sets, does not create unquantifiable potential liabilities, corresponds to the principle of no party worse off than in liquidation, creates the right incentives among clearing participants to assist the CCP to risk manage the defaulted CM's positions, and is economically viable. The technical paper largely informs our comments throughout and is attached as part of our response to the consultation.

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[3] The default waterfall refers to the financial safeguards available to the CCP to cover losses arising from a CM default ("Default Losses") and the order in which they may be expended, while end of the waterfall refers to situations following the exhaustion of all such financial safeguards. There are also situations where a CCP's financial safeguards and any minimum CCP capital requirements may be exhausted that are unrelated to a CM default ("Non-default Losses" or "NDL"). Such situations including any recovery or resolution mechanisms should be viewed differently from those that would apply for Default Losses (See Section VI).

[4] CCP Loss Allocation at the End of the Waterfall, ISDA August 2013. Available at: http://www2.isda.org/attachment/NTc5Nw==/CCP_loss_allocation_waterfall_0807.pdf

I. Key Principles to ensure an effective and viable recovery framework

The consultative report outlines important considerations and numerous available solutions; however practical application of certain mechanisms and tools may render certain methods nonviable. We support the guidelines for appropriate recovery tools suggested in Section 3.3 which detail many of the requisite characteristics of an effective recovery framework; however we believe that each should be further measured against certain fundamental principles.

We suggest the following *Key Principles* be considered when evaluating each recovery mechanism:

1. Liabilities of clearing participants must be predictable and limited. No entity can support nor would be authorized by its regulator or management to participate in an activity where exposures are uncontrollable and either unlimited or unquantifiable.

2. Recovery and continuity mechanisms must be economically viable for all categories of clearing participants, that is, both direct and indirect participants as well as the CCP itself. Mechanisms should be at least consistent with the economic result that each type of clearing participant would experience in a general CCP insolvency proceeding (i.e. no creditor is worse off).

3. Recovery and continuity mechanisms must not challenge accounting criteria to net cleared exposures for financial statement and regulatory capital purposes. Where the specific requirements are not demonstrated, cleared exposures would need to be reported on a gross basis, thereby defeating the purpose of central clearing and consequently render clearing nonviable.

4. A recovery framework must encourage and create incentives for clearing participants to participate in CCP default management practices (e.g. providing risk-offsetting positions to the CCP, or participating in the auction process). Any circumstances of discretion or uncertainty would frustrate such incentives and the overall viability to the recovery framework.

5. Transparency and certainty must exist for clearing participants related to the (i) nature and operation of the default management process and default waterfall, (ii) nature of loss allocation in all circumstances including the exhaustion of the default waterfall, and (iii) relevant decision makers (i.e. Risk Committee, CCP management) at each step of the default management process and any recovery and resolution measures.

6. Recovery, continuity and resolution mechanisms should be designed to to avoid creating moral hazard that may compromise risk practices of the CCP itself. These mechanisms should not in any way insulate the board and senior management of the CCP (or its holding company) from the consequences of losses resulting from inappropriate risk-taking by the CCP.

7. Recovery plans should allow for the resolution of any non-critical functions if determined necessary for critical functions to continue. This would further help define clearing participants' liability, by placing a greater emphasis on continuity of critical functions and their restoration to viability.

II. Accounting Criteria to net cleared derivatives

To net cleared exposures for financial statement and capital reporting purposes, clearing participants must adhere to the relevant accounting guidance per their applicable generally accepted accounting principles (GAAP).[5] Primary accounting guidance requires that entities have transactions against an identifiable party with whom they have a legal right to offset (thereby, the "principal counterparty") and that exposures to a principal counterparty are determinable.[6] For the purposes

[5] For purposes of this response, the term "accounting guidance" refers to accounting criteria to net cleared derivatives per the GAAP applicable to the clearing participant (i.e. U.S. GAAP, IFRS etc.).

[6] FASB Interpretation No. 39 states that "it is a general principle of accounting that the offsetting of assets and liabilities in the balance sheet is improper except where a right to setoff exists." A right of setoff exists when all of the following conditions are met: (a) Each

of this letter, we have focused on netting of cleared derivatives, although note that the principles and considerations would apply equally to other cleared financial assets and financial liabilities (e.g. reverse repurchase and repurchase agreements).

We outline the following *Accounting Criteria* to be considered when evaluating each recovery mechanism and suggest that these criteria be further reviewed in collaboration with the audit firms.

1. Determination of the CCP as principal counterparty: Currently, for almost all CCPs, CMs consider the CCP to be their principal counterparty for their proprietary (i.e. house) positions when determining to which entity they have exposure. Such an assessment is of key relevance in the ability to net cleared derivative exposures for both financial statement and capital reporting purposes as netting is only applicable to transactions with a principal counterparty. The method of loss allocation is determinative in this assessment as it is indicative of whether the clearing process results in loss mutualisation and transformation of the reporting entity's credit risk as opposed to facing a bilateral counterparty prior to clearing. Recovery mechanisms that either allocate losses or close-out open trades on a basis that is dependent on which parties originally transacted with the defaulting CM prior to novation to the CCP or seek to identify participants which have offsetting risk positions against the defaulting CM, call into question, whether the CCP is the principal counterparty and consequently the loss mutualisation and credit risk transformation benefits of the clearing model.

2. Ability to define a netting set with the principal counterparty: Once the CCP has been determined the principal counterparty for CM proprietary positions consideration must be given to whether there is an identifiable and justified netting set for both accounting and regulatory capital purposes. As further detailed in the following section, we are concerned that some of the proposed recovery mechanisms could challenge the ability to define a netting set (e.g. partial or selective tear-up of a subset within a netting set) and thus assess "determinable amounts".

3. Consideration of CMs' role in clearing indirect participant trades: For GAAP purposes, some CMs have determined that they act as either legal agent or in substance agent for the indirect clearing participant with the result that the CM does not reflect back-to-back derivative trades (i.e. between themselves and the indirect clearing participant and themselves and CCP). Recovery mechanisms that effectively result in the CM absorbing losses on behalf of indirect clearing participants or otherwise shielding them from being exposed to such losses could challenge this assessment and result in the CMs regarding themselves, for accounting purposes, as principal to both sides of the trade.

III. Analysis of recovery tools to allocate uncovered losses caused by participant default

With consideration to the guidelines for appropriate recovery tools suggested in Section 3.3 of the consultative report as well as the *Key Principles* and *Accounting Criteria* described in the above sections, we analyze below each of the recovery tools to allocate uncovered losses caused by a participant default listed in Section 3.5 of the consultative report.

At the outset we advocate VMGH as the last stage of a CCP's default waterfall as the most effective recovery and continuity mechanism to achieve the objectives stated within the consultative report. Moreover, VMGH appropriately respects each of the *Key Principles* and *Accounting Criteria* described within this response and is consistent with insolvency measures that would otherwise be applied.

We believe that various recovery mechanisms should be accessible, however, for reasons supported within, certain mechanisms should be considered nonviable.

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of two parties owes the other determinable amounts, (b) The reporting party has the right to set off the amount owed with the amount owed by the other party, (c) The reporting party intends to set off, (d) The right of setoff is enforceable at law. IAS 32 paragraph 42 states 'A financial asset and a financial liability shall be offset and the net amount presented in the statement of financial position when, and only when, an entity (a) has a legally enforceable right to set off the recognized amounts; and (b) intends either to settle on a net basis, or to realize the asset and settle the liability simultaneously.'

Cash calls on participants ("assessment powers"): We agree that predefined, limited and quantifiable assessment powers are an important and effective component of the default waterfall. As a potential shortfall could be uncontrollable, unlimited and unquantifiable, an important issue that we believe must be addressed, it is appropriately required that assessment powers be predictable, measurable and transparent as supported in paragraphs 3.5.3 and 3.5.7 of the consultative report. When predictable and transparent, assessment powers are another effective recovery tool that create default management incentives and rightly take into account the above *Key Principles*.

To the extent that assessment powers are allocated on a pro-rata risk basis which ensures loss mutualisation across all CMs and is not with reference to the CMs which originally faced the defaulting member on their trades or to CMs with offsetting risk positions for the defaulting members trades, we consider that assessment powers are not in conflict with accounting guidance to net cleared derivatives for financial statement or regulatory capital purposes. For these reasons, predefined, limited and quantifiable assessment powers are already part of the default waterfall of many CCPs.

Variation margin gains haircutting by CCPs: We believe that VMGH is the most viable loss allocation measure and effectively responds to guidelines suggested in the consultative report (Section 3.3) as well as the *Key Principles* and *Accounting Criteria* outlined above. We further advocate the inclusion of VMGH as the last layer of a CCP's default waterfall to ensure the default management process is transparent and predictable, rather than subject to the discretion of a resolution authority.

Including VMGH as the last layer of the default waterfall incorporates a recovery mechanism into a CCP's default management process prior to the application of less effective and potentially disruptive mandatory tools. Further, VMGH is consistent with CCP insolvency measures that would otherwise be applied in a default scenario but can be utilized as a recovery, rather than resolution, mechanism. As a result, where it is understood that full contract tear-up or service closure will ensue (as would be dictated by requisite *Accounting Criteria*), VMGH would encourage all clearing participants to engage actively in the default management procedures and to bid aggressively in the auction process. Therefore, VMGH aligns well with stated guidelines that "… recovery tools should be designed to provide appropriate incentives for owners and participants. In particular, they should provide incentives for **surviving participants to assist the FMI in its default management process**" (paragraph 3.3.2; emphasis added). VMGH is also well aligned to a key reference within the consultative report:

> *In contrast to the use of mandatory tools, voluntary or auction-based sale or replacement of unmatched positions is likely to lead to a far more desirable outcome. Accordingly,* ***to maximize the chances of a successful voluntary or auction-based approach, the CCP should make use of the tools described in previous sections, such as variation margin haircutting and assessment rights****, so that it has significant additional resources over and above its pre-funded default resources before it is forced to employ mandatory tools such as tear-up of contracts or forced allocation. (paragraph 3.9.24; emphasis added)*

As the cumulative sum of clearing participants' VM gains since a CM default would always be sufficient to cover the defaulted CM's market-to-market losses in the same period, VMGH would allow a CCP to *distribute <u>all</u> losses pro-rata* to unpaid gains at the beneficial owner level.[7] Given that the proposal is to apply VMGH after the determination of the net portfolio of the CM, we consider that this should allow for an assertion of "determinable amounts" for purposes of US GAAP netting and an identifiable population of trades to which netting applies (subject to all other netting criteria being met) under IFRS. This process would appear to be consistent with the requisite *Accounting Criteria* outlined above and therefore should not undermine a CM's ability to net its proprietary positions for financial statement and regulatory capital purposes. Application to indirect participants, however, requires further consideration and should be determined separately from VMGH applied to transactions that the CM has cleared on behalf of indirect participants. Lack of distinction could lead to a CM absorbing losses on behalf of its indirect participants, effectively shielding them from losses and therefore challenge the assessment that some CMs have made that their role in clearing client trades is in substance that of an agent (See Section II).

[7] VMGH is applied at the beneficial owner level, on a portfolio basis, without cherry-picking the beneficial owner's in-the-money positions from their out-of-the-money positions. The description in paragraph 3.5.15 suggests otherwise, and is incorrect. Such potential for cherry-picking would break participant's ability to carry and reserve for positions on a net basis.

In the remote circumstance that the default waterfall, including VMGH, were insufficient to cover the mark-to-market losses and the transfer cost implied as a result of the portfolio auction process, or where the CCP were not able to determine a market clearing price for that portfolio, the CCP and its CMs must assess whether there exist any other mechanisms to manage or reduce the risk, otherwise full tear-up of the applicable CCP service line must ensue.

The ISDA technical paper *CCP Loss Allocation at the End of the Waterfall* describes in greater detail how VMGH works in practice, the scenarios in which VMGH may no longer be effective and when resolution authorities should step in.

Initial margin haircutting by CCPs (IMH): We believe that IMH is a less effective and predictable recovery mechanism that is incompatible, individually or collectively, with certain legal, regulatory, accounting and capital frameworks, thereby casting doubt on its viability. We consider IMH from two perspectives: a method to determine the proportional loss allocation to each clearing participant and secondly where initial margin (IM) is considered specifically as a resource for loss allocation.

We also consider IMH in relation to VMGH, and while we accept that IMH would more widely distribute the loss, we are concerned that IMH does not comprehensively achieve intended objectives and could introduce adverse risk incentives. VMGH, relative to IMH, maintains three key advantages: (1) it incentivises clearing participants to engage in behaviors that improve the availability of risk-reducing hedges to the CCP whereas IMH could promote behaviors that do not, (2) VMGH mirrors existing economics of what would happen if a CCP were to exhaust its waterfall, and (3) IMH could effectively instigate counter-productive market activity during a default management process as discussed in the following paragraph.

As suggested within paragraph 3.5.20 of the consultative report, there is doubt as to the ability to determine the amount of any IMH, further exacerbated by the potential immediate and unpredictable requirement for CMs to replenish IM requirements (paragraph 3.5.23), which may challenge *Accounting Criteria* to net cleared derivative exposures for financial reporting and regulatory capital purposes. We agree that "… participants, in particular indirect participants, may be unable or unwilling to participate in a CCP if their initial margin is subject to loss for reasons other than their own default" (paragraph 3.5.24). Further, any practice that could weaken the determination of IM as bankruptcy remote (as contemplated in paragraph 3.5.23) is inconsistent with the regulatory capital framework for bank exposures to CCPs and could create additional capital charges for clearing participants.[8]

Further, we believe IM is posted solely to support the performance of the non-defaulting clearing participants, and is specifically not intended for any risk mutualisation purposes. Consequently, we oppose any proposal in which a non-defaulting clearing participant's IM could be used as a loss recovery tool in any circumstance.

Consideration of moral hazard implications

We believe that it is critical CPSS-IOSCO carefully consider the moral hazard implications of the recovery measures it endorses. It would appear the consensus view that traditional bankruptcy liquidation proceedings are wholly ill-suited for CCPs (since they would fail to ensure uninterrupted continuity of systemically important clearing services) is driving the pursuit of making CCPs altogether bankruptcy-proof through the implementation of recovery measures. In pursuing this goal, CPSS-IOSCO should bear in mind that to the extent that recovery measures insulate the board and senior management of a CCP (or its holding company) from the consequences of inappropriate risk-taking, a resulting unintended consequence could be an increase in moral hazard risk. In seeking to avoid the failure of CCPs, CPSS-IOSCO could be unintentionally creating a new, and much more potent, version of too-big-to fail.

We encourage CPSS-IOSCO, in analyzing the appropriateness of any recovery measure, to actively consider mitigants to moral hazard risk. For example, CPSS-IOSCO could consider a requirement that in any case in which a clearing participant suffers losses as a result of a CCP's utilization of a recovery measure, the CCP (or its holding company) should issue the affected clearing participant a senior convertible debt note with a principal amount equal to the clearing participant's losses. The terms of the note would provide for amortization of the note with the CCP's net profits before they are dividended up to its holding company and out to shareholders and, subject to applicable regulatory constraints,

[8] Basel Committee on Banking Supervision Consultative Document: Capital treatment of bank exposures to central counterparties (BCBS253)

would allow the clearing participant to convert the note into equity of the CCP or its holding company so that the clearing participant would have the ability to influence the selection of board members. The amortization feature, in particular, could serve as a useful moral hazard mitigant since the potential for disruption of the distribution of net profits to shareholders could encourage shareholders to take an active interest in ensuring prudent risk management by the CCP's senior management.

IV. Analysis of tools to address uncovered liquidity shortfalls

Pre-arranged and highly reliable bilateral or syndicated liquidity arrangements with third-party institutions or CM bank affiliates could be a source of liquidity CCPs to rely upon for purposes of uncovered liquidity shortfalls. However we also acknowledge the potential constraints (e.g. banks' leverage ratio, liquidity coverage ratio, single counterparty credit limits, wrong-way risk) and potentially significant costs for CCPs to obtain sufficient liquidity for shortfalls beyond Cover 1 / Cover 2, in particular for less liquid forms of IM collateral (e.g. corporate bonds). We have suggested that IM collateral consist primarily of collateral in which a systemically important CCP could post to a central bank. In cases where a CCP does not have direct access to central bank facilities, we consider that indirect liquidity access through CMs via "… a collateralized loan, a repo or a swap transaction" (paragraph 3.63) be supported including the ability to post any received collateral to the CMs receiving central bank.

We believe that CCPs should adopt arrangements, agreed with CMs on an ex ante basis, for allocating uncovered liquidity requirements pro-rata across CMs therefore ensuring that the process is predictable and equitable. All such arrangements should be by way of collateralized loan or repo transaction, subject to an appropriate haircut that is not at the discretion of the CCP, such that the CM has the ability to onward pledge the securities to the central bank and obtain liquidity. However, in drafting such rules, CCPs should be cognizant of the challenges faced by non-bank CMs providing liquidity (e.g. they may not have direct access to a central bank and/or may face regulatory constraints in obtaining liquidity from banking affiliates) and should ensure that the burden of obtaining liquidity in a crisis is not transferred from CCPs to their underlying CMs.

V. Analysis of tools to replenish financial resources

We support the utilization of assessment powers as suggested within the consultative report. As described in Section II of this response, assessment powers that are predefined, limited and quantifiable can be an effective mechanism and as such, in many cases, are already member to a CCP default management process.

VI. Analysis of tools to allocate losses not related to participant default

It is difficult to anticipate the size and nature of losses not related to clearing participant default (i.e. non-default losses, or "NDL", paragraph 3.8.1) and further to which entities such losses should be allocated. As NDLs are losses that exceed a CCP's financial resources above the minimum regulatory capital requirements, and are not the result of any CM default (paragraph 3.8.1), any resulting liability should not be borne by clearing participants.

We consider that regulatory standards should be explicit that the losses resulting from NDL should accrue firstly through the CCP ownership and control structure. That is, NDL should be borne first by the holders of the CCP's equity and debt, and thus should only impact a clearing participant to the extent that the clearing participant has an equity or debt claim on the CCP's capital. We consider that any NDL exceeding the CCP's capital should be covered by a bail-in regime. The bail-in regime may be supplemented by insurance contracts that cover a limited quantum of losses in excess of a CCP's minimum regulatory capital requirements. However, an appropriate bail-in or insurance regime would take time to develop, agree and implement. Debt securities are common bail-in instruments for banks but are not commonly issued by CCPs. In the absence of bail-in, other statutory resolution such as business transfers to bridge institutions might be considered.

VII. Tools for CCPs to re-establish a matched book

If we are not to challenge requisite *Accounting Criteria* to net cleared transactions for financial reporting and regulatory capital purposes, certain tools to re-establish a matched book are not acceptable. Therefore, we caution against the utilization of position-based allocation tools like mandatory selective/partial tear-up or forced allocations and call attention to potential conflict with the *Key Principles* as well as negative effects on clearing participants' confidence in the FMI (paragraph 3.5.12).

Accounting guidance is particularly sensitive to position-based loss allocation tools, such as selective/partial tear-up and forced allocation which challenge the ability to demonstrate requisite *Accounting Criteria*, to net cleared derivative exposures for financial statement and regulatory capital purposes. We believe the inability to net, thus report all cleared derivative exposures gross for financial statement and regulatory capital purposes would render clearing uneconomical. Additionally, the ability to net cleared derivative exposures is particularly challenged in scenarios where position-based loss allocation tools are part of the general default management process or do not explicitly provide for *pro-rata allocation for all clearing participants*. In such scenarios, more specifically, the determination of a CCP as a principal party (i.e. acting as principal, not agent), the ability to assert "determinable amounts" is difficult, by definition, to achieve.

Therefore a CCP should depend on mechanisms such as predefined, limited and quantifiable assessment rights and VMGH and further that it maintain sufficient funds to rely on such mechanisms. Where a CCP and its CMs determine that the default management process, including rebalancing through auction and any voluntary mechanisms, fails to manage or reduce the risk, the CCP rulebook should prescribe full tear-up of contracts within the segregated clearing service. The rulebook should not, for reasons described within, contain any forced allocation, invoicing back, partial non-voluntary tear-up, or any other actions that threaten the ability of banks to hold cleared derivatives on a net basis.

VIII. Conclusion

We would welcome the opportunity to discuss any of these comments in further detail including components of the ISDA technical paper to ensure that we are engaged appropriately with the process of developing the recovery, continuity and resolution framework.

Yours Sincerely,

Ryan Ingram
Risk and Capital
ISDA

Alex Radetsky
Associate General Counsel
TCH

David Schraa
Regulatory Counsel
IIF

Appendix – Description of the Associations

International Swaps and Derivatives Association (ISDA)

Since 1985, ISDA has worked to make the global over-the-counter (OTC) derivatives markets safer and more efficient. Today, ISDA has over 800 member institutions from 60 countries. These members include a broad range of OTC derivatives market participants including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure including exchanges, clearinghouses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's web site: www.isda.org.

Institute of International Finance, Inc. (IIF)

The IIF is a global association created in 1983 in response to the international debt crisis. The IIF has evolved to meet the changing needs of the international financial community. The IIF's purpose is to support the financial industry in prudently managing risks, including sovereign risk; in disseminating sound practices and standards; and in advocating regulatory, financial, and economic policies in the broad interest of members and foster global financial stability. Members include the world's largest commercial banks and investment banks, as well as a growing number of insurance companies and investment management firms. Among the IIF's Associate members are multinational corporations, consultancies and law firms, trading companies, export credit agencies, and multilateral agencies. All of the major markets are represented and participation from the leading financial institutions in emerging market countries is also increasing steadily. Today the IIF has more than 450 members headquartered in more than 70 countries. For more information, please visit www.iif.com.

The Clearing House (TCH)

Established in 1853, The Clearing House is the oldest banking association and payments company in the United States. It is owned by the world's largest commercial banks, which collectively employ over 2 million people and hold more than half of all U.S. deposits. The Clearing House Association L.L.C. is a nonpartisan advocacy organization representing—through regulatory comment letters, amicus briefs and white papers—the interests of its owner banks on a variety of systemically important banking issues. Its affiliate, The Clearing House Payments Company L.L.C., provides payment, clearing, and settlement services to its member banks and other financial institutions, clearing almost $2 trillion daily and representing nearly half of the automated-clearing-house, funds-transfer, and check-image payments made in the U.S. *See* The Clearing House's web page at www.theclearinghouse.org.

October 15, 2013

FSB Secretariat
Financial Stability Board
Sent by email: fsb@bis.org

CPSS Secretariat
Committee on Payment and Settlement Systems
Bank for International Settlements
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IOSCO Secretariat
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International Organization of Securities Commissions
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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. <u>FMIs and G-SIFIs are closely linked</u>

[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

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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);

[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

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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

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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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