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European Commission
Directorate General Internal Market and Services
Sent by email to: cmarkt-nonbanks@ec.europa.eu

Response to ‘Consultation on a possible recovery and resolution framework for financial institutions other than banks’

This letter contains the response of the International Swaps and Derivatives Association, Inc. (“ISDA”) to the European Commission (EC) Consultation on a possible recovery and resolution framework for financial institutions other than banks. ISDA commends the EC for its consideration of the issues raised by a possible recovery and resolution framework.

Since 1985, ISDA¹ has worked to make the global over-the-counter (“OTC”) derivatives markets safer and more efficient. Given ISDA’s membership, areas of expertise, and focus on these markets, we have focused our comments on the recovery and resolution of OTC derivatives Central Clearing Counterparties (CCPs). In relation to the consultation’s application to non-bank financial institutions more broadly and in other financial markets, we endorse what we consider to be complimentary positions outlined in the Association for Financial Markets in Europe (“AFME”) response to the Consultation.

We welcome the opportunity to share these comments and would be pleased to have further discussions with the EC in implementing an appropriate non-bank recovery and resolution framework to enhance market liquidity, reduce risk and foster financial stability.

At the outset, we wish to emphasize seven overarching points and stress that matters raised throughout the rest of the paper are subsidiary to these key principles:

1. Certainty, transparency and limited liability

Clearing Members (CMs) of CCP’s require limited liability to prevent systemic risk. Recovery measures and any resolution regime must provide this in a way which has certainty and transparency. Measures such as recapitalisation, the closure of segments of a CCP and variation margin (“VM”) haircutting must be implemented in a way which does not contradict the principle of CM limited liability, and features such as forced tear-ups and uncapped default fund liability should be avoided altogether.

¹ ISDA is one of the world’s largest global financial trade associations, with over 800 member institutions from 56 countries on six continents. These members include a broad range of OTC derivatives market participants: global, international and regional banks, asset managers, energy and commodities firms, government and supranational entities, insurers and diversified financial institutions, corporations, law firms, exchanges, clearinghouses and other service providers. Information about ISDA and its activities is available on the association’s web site: www.isda.org.

- 2. Where a CCP has (approved) recovery rules in place to cover specific sources of loss, they must respected.**
- a. Under EMIR, CCPs, and other FMIs, must have rules approved by the regulator. Through a combination of market discipline and thorough supervision these rules contain extensive provisions on how losses must be allocated from a particular source (for example, the credit loss arising from CM(s) default) and procedures in place to handle loss allocation. As approved operating rules, these provisions have been agreed by market participants and supervisors who have factored these procedures into their contingency plans. These rules form a contract between FMI's and CMs and it is therefore important that the FMIs follow these loss allocation procedures prior to resolution. Put simply, the supervisors must respect the CCP rules. Where the rules may not effectively provide recovery in a given scenario, as with limited or capped VM gains haircutting, that limit or cap provides a trigger for supervisors to take over. Nevertheless, recovery rules should be effective in all conceivable circumstances. Resolution should be viewed as a last resort.
 - b. Loss allocation models on initial margin (IM) contradict Article 45 of EMIR. In addition, under the BCBS 227 interim framework for bank exposures to CCPs, if IM were subject to the mutualisation risk it would receive a much higher regulatory capital charge thus discouraging central clearing.
- 3. Consistency with CPSS-IOSCO**
- a. We believe that CPSS-IOSCO principles for recovery and resolution of financial market infrastructures, relating to which a consultative report was issued in June 2012, should be applied rigorously on a global basis. It is of crucial importance that the European framework for FMI recovery and resolution be consistent with this CPSS-IOSCO framework².
 - b. Accordingly we encourage the EC to adopt the definitions and delineations of recovery and resolution as set out in the CPSS-IOSCO consultative report. In particular, FMIs should be responsible for putting in place well-designed, comprehensive and substantive plans to recover from a range of extreme but plausible scenarios. Relevant regulatory authorities will need to ensure that such recovery plans are in place and will oversee the execution of these plans. In addition, the relevant regulatory authorities will need to put in place resolution arrangements which cover extreme and unforeseen events beyond those covered by recovery arrangements.

² ISDA acknowledges the assistance of the IIF Response to CPSS-IOSCO Consultative Report on "Recovery and resolution of financial market infrastructures" of September 2012 in the preparation of this letter. The IIF response is available at <http://www.iif.com/regulatory/article+1132.php> Also, liaison with individual CCP regulators is also a prerequisite for the construction of an effective harmonized international framework for the supervision of OTC derivatives markets, trading, risk and infrastructure.

4 Relationship between recovery and resolution of CCP's

- a. We believe that the EC should focus firstly on “recovery and continuity” versus resolution of CCPs. In particular, FMI recovery rules around credit losses should be robust enough so that supervisory intervention is unwarranted.
- b. Should resolution be unavoidable, it is imperative that resolution arrangements are transparent, predictable and consistent with recovery arrangements in place at FMIs. In particular the determination to initiate resolution should specifically take into account an FMI's recovery arrangements.
- c. An FMI should not be placed into resolution until its agreed and documented recovery arrangements have been implemented and given the opportunity to succeed. Unless this principle is adopted and stated clearly, the threat of resolution will jeopardise the recovery arrangements in place at FMIs and lead to their likely failure.
- d. Predictability is a critical objective. Given widespread market dependence on FMIs and substantial exposures to default fund, maximizing predictability of exposures and outcomes should be a high priority. Other objectives include facilitation of going-concern risk management of FMIs and their members, maintenance of market efficiency, enhancement of stability and reduction of moral hazard risk.

5 Transfer of membership agreements and positions

Reference is made in the consultation document to the possibility of transferring membership and positions in a failed CCP to a solvent third party which may be highly problematic in some cases. If the resolution of a failed FMI involves porting positions to a solvent FMI, then rules and procedures need to be put in place to cover all practical matters and these should be tested periodically. This may involve identifying back up CCPs. Further, as noted in paragraph 7 below, any transfer must be done in a way that does not interfere with members' existing rights to net exposures against a CCP.

6 Co-operation and co-ordination between authorities

We are supportive of an approach whereby an FMI's national resolution authority should take prime responsibility for resolution arrangements, co-ordinating and co-operating with other national regulatory and resolution authorities as appropriate. We would stress that such arrangements should be specified clearly in advance, and should allow for time-critical action to be taken without the need for lengthy discussion and negotiation. The situations in which resolution is invoked will likely be highly stressed and require actions to be taken in an extremely time-critical manner.

7 Recognition of netting and collateral arrangements

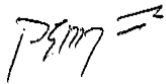
In circumstances where a CCP's recovery process has not been successful, any resolution tools need to contain protections for netting and collateral arrangements, and should contain restrictions on the transfer of part only of a CCP's business in a way that interferes with members' netting rights. As well as creating difficult to manage economic risks, any open ended resolution regime may also have an impact

on members' regulatory capital requirements. In order to report exposure to a counterparty (including a CCP) on a net, rather than gross, basis, accounting rules require institutions to obtain a legal opinion that there is a legally enforceable right to net transactions against that counterparty. Any resolution powers that do not contain appropriate safeguards for netting and collateral arrangements may impact members' ability to obtain such opinions, with potentially significant regulatory capital impacts.

This letter follows the structure of the EC Consultation and contains a number of comments in relation to the questions posed.

We appreciate the opportunity to provide these comments. Should you require further information, please do not hesitate to contact the undersigned.

Kind regards,

A handwritten signature in black ink, appearing to read 'PES' followed by a stylized flourish.

Peter E M Sime

Head of Risk and Research

International Swaps and Derivatives Association, Inc.

Response to ‘Consultation on a possible recovery and resolution framework for financial institutions other than banks’

General matters and responses to specific questions

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

Yes, in principle we are supportive of a bespoke regime for FMIs, however as noted a more final framework by the EC should draw clear distinctions between:

- a. the normal procedures for loss allocation that CCPs will turn to following a member default under the CCP’s approved operating rules. As noted, CCPs and other FMIs already have extensive rules and procedures in place to handle loss allocation; because market participants have factored these procedures into their contingency plans, it is important that the CCPs follow these procedures prior to resolution.
- b. the recovery phase i.e., time for a service evaluation phase when a CCP reaches a situation where its financial resources (CCP capital plus default waterfall) are insufficient to re-balance the CCP, during which either an orderly wind-down or a voluntary recapitalisation by a new group of owners can be organised³; and
- c. the resolution phase i.e., when there is a source of loss for which the CCP has no approved rules, or, in other words, where the market participants have not agreed to take the loss. The default system in such scenario is the wide loss allocation of ordinary insolvency law. As stated, CMs’ exposure to unforeseeable or unlimited losses will significantly increase systemic risk. A robust segregation regime should ensure that CMs are able to recover IM.

Credible CCP recovery plans and resolution regimes are vital for financial stability, particularly given that a CCP disruption might have significant impact on substantial financial markets and a large number of participants. In the absence of adequate crisis management planning, CCP stress might preclude the functioning of a product market and/or threaten the stability and functioning of the global financial system.

As is amply recognized in the Financial Stability Board’s *Key Attributes of Effective Resolution Regimes for Financial Institutions*, traditional recovery and resolution processes are not suited to the kind of immediate action that is required to preserve value in financial crises, and that is particularly true for systemic FMIs. In our view, the focus for FMI’s should be more on recovery and continuity versus resolution. Therefore, the powers and procedural requirements would be quite different from the classic insolvency administration as well as recovery and resolution procedures for financial institution.

³ During the recovery phase, the CCP is able to perform its services as normal so that market participants can continue to manage the risk of their portfolio with the CCP. Re-capitalisation cannot occur before the CCP has been rebalanced.

CCP resolution frameworks should be globally consistent, given the global nature of their business.

The concentration of a large amount of IM in a few global custodians and through the coming margin rules make it imperative to provide robust resolution frameworks for custodians.

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

Relevant scenarios for CCPs include losses from CM defaults, fraud or investment losses (where the investments presumably are made in breach, or error, of the regulated CCP investment policy). Both EMIR and CPSS-IOSCO Principles for FMIs set out specific requirements dealing with the manner in which a CCP handles investments. As noted, CCP rules typically specify extensive provisions on how losses must be allocated from the credit loss arising from CM default and procedures in place to handle loss allocation in cases where the default waterfall – including recourse to the CCP’s dedicated own resources – has been exhausted and the CCP is faced with potential insolvency or resolution.

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

Yes, resolution should not impact existing provisions retrospectively. Market participants need to know exactly what will happen in CCP recovery and resolution to make sure they can manage the resulting risks. For example, market participants do not want to roll back settlement cycles, but allocate losses in proportion to VM gains. It is also important that rules elsewhere do not result in market participants being unable to operate properly as part of CCP infrastructures, as such rules could cause financial contagion.

As noted above, to the extent that other provisions of EU law are amended to accommodate a recovery and resolution regime for FMIs, certain core rights of members will need to be safeguarded in order to provide for predictable outcomes. In particular, rights to net and apply collateral are core to members’ management of their exposures to CCPs and should not be capable of being violated.

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

No, given the different structural and risk issues between FMIs, we believe that there should be separate – and clearly distinctive – regimes for FMIs which take on credit risk (such as CCPs) and those which do not take on credit risk (such as CSDs). This is recognised both by CPSS-IOSCO and the recent HM Treasury consultation on recovery and resolution regimes for FMIs.

We agree that the level of credit risk that an FMI may be exposed to is a useful indicator on which to differentiate the various FMIs. There are, however, different forms of credit risk (e.g., credit risk that results from novating transactions and mutualising risk versus credit risk that arises directly from credit-based services), and the problems that these different forms of

credit risk may pose for resolution need to be recognised and addressed. In devising standards that are aimed at maximizing the resilience of FMIs, the EC will need to be careful not to create too many contingent liabilities; one of the unintended consequences of a system with too many contingent liabilities is that it will create an incentive for members to “rush to the exit” prior to resolution.

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

Yes, we consider that a common resolution framework should apply to all FMIs and not just to those which attain specific thresholds in terms of size, level of interconnectedness etc. First, it would be very difficult to reach agreement on what those thresholds should be and how they interrelate: the individual measures may be indicative though by themselves not independently determinative, importance may change over time depending on the structure of the financial system, conditions of individual markets and balance sheets, and external events. Categorical designations or certain quantitative triggers may overlook changes to the importance of particular entities in the financial system.

Second, it is inappropriate to create a moral hazard situation where a CCP may be more willing to take a risk, knowing that the potential costs and/or burdens of taking such risk will be borne, in whole or in part, by others. It is an inescapable fact that (absent perfect information) any finite liability of CMs may be exceeded by some extreme event under unpredictable circumstances⁴. These circumstances should be addressed by all FMIs. Also robust resolution frameworks can mitigate the potential effects on the rest of the financial system due to failures in markets and market infrastructures. The presence of such elements may act as potential mitigants (and their absence amplifiers) of the systemic importance of FMIs.

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

We consider an additional framework is appropriate for FMIs due to the systemically important services which they provide (as opposed to the particular ownership of an FMI). The recovery and resolution issues for FMIs are quite different from credit institutions, and any final framework should make sure that the differences between banks and FMIs and among FMIs are adequately accommodated.

⁴ For example, one can envisage a circumstance where a CM fails on several CCPs simultaneously. This will result in liabilities for remaining CMs that operate on the same several CCPs perhaps several times the liability to any individual CCP.

Objectives

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

Yes, we agree that the presumption should be in favour of recovery and continuity of systemically important FMI services as essential market infrastructure on a fair and transparent basis. However, this should not be at the expense of the overarching points set out in the first part of this letter. Resolution should allow for change of management and appropriate disposition in resolution of the corporate structure or other businesses of an FMI's owner or operator, and for exceptions that may be appropriate for smaller, product- or jurisdiction-specific FMIs that could be closed without systemic consequences, or for cases where replenishment is simply not possible.

Given the definition of "FMI" used in these comments, it is important to stress that this presumption applies to important FMI services as such and not to the corporate ownership structures of specific FMIs, which should be put into resolution in appropriate circumstances. It will be necessary to recognize that all these issues come up in different ways for different types of FMI services and with different ownership and control structures, and care must be taken to avoid straitjacketing solutions that may or may not be appropriate in different contexts.

A related, and highly important point, is that the more liability or potential losses for participants that an FMI, especially a CCP, presents in its operational models and rules, the more inherently unstable it will be, and the more instability there will be in the system. Where liabilities and losses at the end of the waterfall for participants in a system are in some sense unlimited or unquantifiable, the way firms manage such risks is by resignation from the system when the risk begins to appear too great. In the same way that depositors have an incentive to run if they are uncertain about their potential losses, participants in such systems may have an incentive to rush for the exit if they would be subject to unpredictable losses. Any such rush for the exits would, of course, exacerbate any deteriorating situation. Conversely, maximizing predictability of outcomes and losses will tend to act to reduce incentives to run. This fact should be kept in mind when devising standards on FMI resolution, to avoid unforeseen, unintended consequences.

Notwithstanding the valid objective of continuity of critical services, it is entirely appropriate for CCPs to include within their recovery provisions the possibility, as a last resort, of terminating a particular product set. This provision might be used in certain extreme circumstances as a necessary means of restarting the market and avoiding contagion to other product sets.

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

Yes, as set out above, predictability is a critical objective of the going concern default procedures (i.e., loss allocation) and subsequent recovery and resolution framework.

We also agree that resolution should, consistent with the FSB principles, ensure the continuity of critical services (for example via voluntary recapitalisation) or orderly wind-down (if, say, the service is provided by competitors), preserve financial stability, avoid

contagion and an unnecessary destruction of value, reduce moral hazard risk and guard against losses for taxpayers.

Resolution is necessarily undesirable so everything reasonable should be done to prevent it such as requiring:

- a. Strong risk management,
- b. Prudent decisions on products suitable for clearing,
- c. All options should be considered, but not everything is reasonable. In particular, it is important to closely scrutinize recovery measures and consider whether they could have unintended consequences. For example, recovery measures that could result in members' uncapped or unquantifiable liability may appear to be simple solutions to prevent the risk of CCP failure, but, as noted above, they increase rush-to-exit risk, which is inherently destabilizing. Similarly, very careful consideration should be given to the potential for recovery measures (and resolution regimes) to increase moral hazard, where a CCP under-protects the cleared positions with either insufficient margins or waterfall protections. This may arise particularly in the context of competition between CCPs to attract clients' business.
- d. To mitigate this troubling incentive, the adoption of one or more of following could be used:
 - The CCP should inject significant amounts of capital as required by EMIR both as "skin in the game" in the context of the default fund and as additional equity capital;
 - As required by EMIR, non-member clients should have representation on the Risk Committee, since CCP continuation is not a natural consequence and non-members should have at least a consultation right;
 - If the decision is made to persist with the clearing service, then the Resolution Authority should have the right to change management; and
 - The Resolution Authority should have the ability to organise a voluntary recapitalisation of the CCP.

9. Which ones are, according to you, the ones that should be prioritized?

Recovery and continuity should be the paramount focus of any EC regime. If resolution is to be initiated, predictability is essential to maintaining confidence in an FMI and avoiding any incentives to head for the exits in an adverse cycle

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

We set out the overarching principles in the first section of this letter. In addressing the issues of different types of systems, it will be necessary to address the sometimes thorny issues of allocation of losses to indirect participants and underlying customers, as well as to addressing ownership and control questions in either the recovery or the resolution. It is essential to point out that the issues and the dynamics of the appropriate exposures of indirect participants and underlying customers are changing as the markets move toward clearing more products,

concentrating more products in CCPs, and providing more segregation of customer assets, in line with G20 and FSB mandates. Furthermore, regulatory and market changes in many countries are radically changing the role of firms in such markets, with the effect that they will less often be acting as principals and the overall business in many products will be more customer-driven than was the case a few years ago. Among other things, clients will have more influence in choosing the way in which assets are held and the systems through which many products are cleared.

For these reasons, it is unrealistic to think that indirect participants and clients can be shielded from losses, although the specifics of down-streaming losses to indirect participants and clients can and should (for present purposes) be left to agreements of direct participants with them and to relevant conduct-of-business regulations applicable to such relationships. These are issues that require extensive debate and raise many questions that are not appropriate to be decided in the drafting of standards on recovery and resolution of FMIs.

Recovery and Resolution plans

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

As noted, predictability is essential to maintaining confidence in an FMI. Where there are rules, especially as to loss allocation, these should be respected above all other considerations. While it is understood that the details of official intervention, especially in the resolution phase, cannot be determined in advance, there is a strong case for making the “presumptive path” in recovery and resolution situations as clear as possible. This is why precision on what powers exist in each phase is key together with ex ante agreement on who can exercise those powers.

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

Efficient going concern loss allocation processes have been devised, agreed and approved at numerous CCPs. Rules for the allocation of losses form part of the contract between CCPs and their CMs, which will be approved by the competent authority.

Resolution triggers

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

Yes, intervention should only occur where losses come from a source for which there are no CCP rules. CCP rules should be followed until the trigger point is reached and then resolution should

take place. A consultation (however brief) should also take place with market participants ahead of resolution.

Great care must be taken on the intervention trigger and nature of the powers once the trigger is reached. In no circumstances must intervention powers be unfettered and apply retrospectively. This is a broadly based concern across ISDA members. In particular, resolution tools need to contain protections for netting and collateral arrangements, and should contain restrictions on the transfer of part only of a CCP's business in a way that interferes with members' netting rights.

Resolution should occur only where it is 'necessary' (rather than 'desirable') to address a serious threat exists to the stability of the financial system of the jurisdiction arising from central counterparty clearing services provided by the relevant clearing house; and in the opinion of the regulator, the specified action would ameliorate the serious threat, having regard to the public interest factors. There should also be consultation before this intervention occurs.

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

The conditions should relate specifically to the financial solvency of the CCP.

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

No, as for other financial institutions, the triggers of intervention in recovery (and resolution) situations should be as predictable as possible because of the need of the market for clarity. Although this issue comes up differently for FMIs, clarity and predictability of loss is if anything more important for the failure of an FMI, and care must be taken not to blur the recovery/resolution distinction. It needs to be made clearer that any early intervention should be limited to providing guidance or otherwise assuring the effective operation of the FMI's own procedures. Operation of powers beyond that is likely to cross the boundary between recovery and resolution.

FMI difficulties would probably come up suddenly, with little forewarning. It is most likely that the principal indicator for intervention for FMIs would be the FMI's own assessment that either it does not have or predictably will not have the resources to meet its obligations, or that it has suffered a catastrophic operational breakdown.

The systemic implications of an FMI problem are also likely to be greater. The UK Financial Services Act proposes a public-interest test for exercise of "stabilization powers" to prevent cessation of critical clearing services. But, even if so, as discussed at several points in these comments, it is important that intervention by the authorities, especially in the recovery phase, nevertheless not override the operation of the processes and the application of financial resources as provided by the FMI's rules. The stabilization powers set out in the UK Financial Services Act extend to intervention to stop the closure of a business line. Use of such powers would appear almost necessarily to move the process into the "resolution" realm

and it would be essential to focus on the issues arising from such extensive intervention (including resolution finance), as discussed further below.

Resolution powers

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

Yes, however, set out in the over-riding points in the first part of this letter, we believe that transferring membership and positions in a failed CCP to a solvent third party may be highly problematic in some cases. Further, any such transfer would likely need to be a transfer in whole, since partial transfers would impact members' netting rights.

Different FMIs will require different arrangements. However, if the resolution of a failed FMI involves porting positions to a solvent FMI, then rules and procedures need to be put in place to cover all practical matters and these should be tested periodically. This may involve identifying back up CCPs.

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

As set out in our response to question 6, it is imperative that resolution powers are specifically related to the nature of the failed institution.

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

This is not a necessary tool. In as much as CMs and CCPs have rules, then they have a contract. There is no reason not to respect that contract.

19. Do you consider that moratorium on payments could be a relevant tool for all FMIs or only some of them? If so, under what conditions?

No, this is not a necessary tool, and may even be dangerous. A moratorium on payments only speaks to FMIs who have failed to make adequate liquidity arrangements. In such a scenario, there should be a very limited 'grace' period and no longer. Put simply, a moratorium of payments should only be available on an exceptional basis when the CCP has collateral that is not cash and the CCP is unable to convert that collateral into cash as quickly as necessary.

CCPs should have arrangements in place to utilise repo lines with Central Banks or other liquidity providers covering all eligible collateral.

Resolution tools

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

Where possible, resolution should focus on continuity or orderly wind-down of service; this may include a change of management or ownership. As set out in the over-riding points in the

first part of this letter, we believe that transferring membership and positions in a failed CCP to a solvent third party is likely to be highly problematic in practice.

21. Which loss allocation and recapitalisation tools could be appropriate for resolving different types of CSDs and CCPs? Would this vary according to different types of possible failures (e.g. those caused by defaulting members, or those caused by operational risks)? What would be their advantages and disadvantages?

We strongly believe that a robust set of rules around credit losses should be encouraged such that supervisory intervention is unwarranted. The EC should ensure that CCPs enact such a framework as a first line of solvency defence.

The framework should avoid resolution when a CCP has rules and procedures for wide loss allocation whereby losses are allocated to all participants direct and indirect alike, i.e. at the trading account level. As noted, authorities should not intervene until this going concern system has run its course.

An important design criterion of a loss allocation system is that it provides participants with a strong incentive to provide hedges to the CCP to enable the CCP to de-risk a defaulter's portfolio. This is achieved with VM haircutting where, in the case of a large CM default, other CMs acting rationally try to flatten their exposure to the CCP, which in turn assists the CCP to rebalance. The precise mechanics of VM haircutting may vary at each CCP. IM haircutting may not offer the same incentive as IM could increase if a participant provides a hedge to the CCP – the possibility of such outcomes could harm the default management process. IM haircutting also distorts segregation and “bankruptcy remoteness”, which are embedded in many aspects of the new regulatory regimes and is inconsistent with the requirements of Article 45 (4) of EMIR. Please refer to the IIF submission to CPSS-IOSCO of November 17, 2011 and related Term Sheet for a full description (See Annex).

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

The organisation of a voluntary recapitalisation of a CCP might be effective in certain situations.

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

Yes, we encourage limited recourse and recovery via wide loss allocation rules, because of the complexity and uncertainty under existing national resolution laws.

Group resolution

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

No, CCPs should organise their affairs such that resolution only applies to the relevant legal entity in the group. Supervisors should consider how resolution might be effective in cases where one part of an FMIs services require intervention whereas other services are unaffected. Separate resolution per product is an option that may be appropriate in certain

circumstances. Where a group structure includes multiple FMIs, such solutions may make entire sense, and separate transfer of FMIs that are risk-managed separately may be entirely feasible.

Careful analysis will be required as part of the recovery and resolution planning process for each FMI to determine whether it is set up in a manner to allow it to be treated as such for recovery and resolution purposes as discussed in these comments; however, care should also be taken to minimize any inefficiencies or extra cost burdens on the market that might arise from the tradeoffs implied in that analysis.

Cross border resolution

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

Strong cross-border cooperation and coordination, both before and during resolution, are essential to the successful resolution of a failed FMI. The CPSS, IOSCO and FSB should reach beyond what it provided for in existing international standards and recommend the adoption of a substantive international mandate that would be relied upon in the wake of a crisis. ISDA's shares the IIF vision for a comprehensive cross border solution to recovery and resolution planning detailed in the recent report, *Making Resolution Robust – Completing the Legal and Institutional Frameworks for Effective Cross-border Resolution of Financial Institutions*.

In addition, there should be objective, non-discriminatory protections in place in each jurisdiction to ensure that all participants are treated fairly, regardless of "their nationality, the location of their claim or the jurisdiction where it is payable," as required by CPSS-IOSCO Key Attribute 7.4. These protections should apply not only in the resolution process but also to the loss allocation procedures that occur prior to resolution.

In addition, it will be important to include in the sphere of cooperation the relevant authorities for the principal currencies treated by the FMI. Including multiple currencies in FMI operations will be vital to market efficiency and also to achieving the risk-reducing potential of many FMIs, but, at the same time, it is clear that products in a given currency that are treated in an FMI outside of the home jurisdiction of the currency will raise concerns with the authorities governing that currency, and a strategy should be devised to assure due consideration of their issues. Not doing so may constrain their willingness to permit processing of products and currencies in a given FMI, with a danger of fragmentation of markets and supervision if such issues are not resolved.

The confidence-creating function of cooperation should therefore always take into account the currencies affected and the regulators of the most relevant products. Note, however, that this issue will not arise in the same way for all FMIs. The issues where an FMI provides novation and central-counterparty services would be quite different from an FMI providing settlement services, trade repository, or other, more limited services. Second, while it is clearly important that the prudential and regulatory authorities governing material

participants in a given FMI be informed of its default procedures and recovery and resolution planning, their interests are clearly different from the interests of the direct regulators of FMIs and of the relevant products in a given market; therefore, consultation and cooperation procedures need to be tailored, on the one hand, to assure full information of all concerned, and, on the other, to avoid decision-making groups from becoming too large and unwieldy. It would be most helpful if the EC, together with CPSS- IOSCO could establish clear procedures for such processes.

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

Yes. It is important, as set out in the over-riding points in the introduction of this response, that such co-ordination process be determined in advance. Furthermore such processes must facilitate rapid decision making and action, as this is likely to be of critical importance in a highly stressed resolution environment.

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

We consider that the authority who should lead this process would be the authority which is able to provide liquidity (if necessary). Having an authority lead these matters which has this option makes a lot of sense And agreement on the relevant authority must be made in advance.

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

Yes

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

Yes, though an international framework would be better.

Safeguards

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

It is essential that economic outcomes should be no less fair than insolvency. Supervisors should work toward a robust international regime which protects the sanctity of IM.

Annex

[IIF letter to CPSS-IOSCO Re: CCP Participant Default Contingency Plans and Term Sheet](#)

[Loss Allocation at the End of the Default Waterfall – Possible Term Sheet](#)