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Finance for Europe

Consultation response

ESMA's Consultation Paper relating to the Guidelines on participant default rules and procedures under CSDR

30th June 2016

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to comment on ESMA's Consultation Paper relating to the Guidelines on participant default rules and procedures under CSDR. AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.

AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia.

AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76.
AFME members would like to raise three introductory comments that should be kept in mind when considering the overall impact of such Guidelines and when reviewing the AFME response below.

First, AFME members believe it is important to note that whilst there is a distinction between "insolvency" and "resolution" (resolution being pre-insolvency) and we understand ESMA considers its remit under CSDR in relation to its Guidelines to be limited to the narrower sense of "default" (meaning insolvency), the reality is that in relation to financial institution participants that are subject to BRRD, how a participant subject to a resolution action would be dealt with (if at all) under the default rules is important and ESMA should factor this important regime into its considerations. This could be achieved in part, for example, by providing in the Guidelines that resolution authorities should be stakeholders in the formulation of the default rules.

Secondly, AFME members would like to point out that the 'default rules and procedures' need to be flexible to deal with different participant types. For example, when the defaulting participant is another CSD or a third country financial institution as well as when the participant is an EU participant subject to BRRD and other European legislation governing the insolvency/winding up of financial institutions. The Guidelines need to adequately reflect that participants may be both direct and indirect (but disclosed). These differences should be reflected in the Guidelines and translated into the relevant default rules.

Thirdly, in connection with the above, it is important that ESMA is mindful of, and the Guidelines take into consideration, not only how the default rules would apply in the insolvency (and preferably resolution) of EU participants but also how they would be applied to third country participants in insolvency (or resolution).

Q1: Do you consider other stakeholders should be involved in the definition of the default rules and procedures of a CSD? If so, which ones, and what should be the level of their involvement?

A1: It is important to involve all participants in the preparation of the default rules and procedures of a CSD. These include:

- CSDs
- CCPs and their Clearing Members
- CSD Participants
- Recovery and Resolution Authorities
- T2S Community
- Central Banks
- National Competent Authorities of CSDs

Furthermore, the relevant recovery & resolution authorities must be included in this discussion. Any plan for a default procedure will have to be implemented by the resolution authority responsible for the defaulting CSD participant, and the default rules and procedures for a CSD must take into account this change of responsibility. In the event of a default of a bank – which may be a direct or indirect CSD participant depending on local legislation, as outlined under Settlement Finality Directive ("SFD") – the respective authority will take over the administration of that entity, including decisions about how and whether to keep the entity running.

In this context the role of payment banks and their relationships to CSD participants is an important additional consideration. Where CSD participants use a payment bank to gain access to central bank money, the default of a payment bank could impact CSD participants' ability to settle their purchase instructions. In this situation a CSD participant would be required to switch to another payment bank to fulfil its obligations. Payment banks and CSD participants should be involved in the development of specific rules and procedures designed to manage such a scenario.

Moreover the procedures should make clear how the CSDs intend to cover potential losses stemming from the default of a participant and if it expects any contagion risks from such default.

The T2S community should also be involved in the development of these rules and procedures. CSDs and NCBs migrating to T2S have agreed to sign a Collective Agreement which addresses the legal requirements stemming from SFD and the operational requirements for insolvency scenarios involving CSD and National Central Bank participants. Agreement on these requirements is especially important in the context of cross-CSD settlement, as non-harmonised default rules and procedures on cross-CSD transactions could impede the recovery & resolution process. It would be important to ensure that the ESMA Guidelines for the consistent application of CSDR Article 41 and the operational approach established under the T2S Collective Agreement are consistent.

The default rules and procedures should be designed to take into consideration the Principles for Financial Market Infrastructures (PFMI), specifically, Principle 13 (Default Procedures) and Principle 11 (CSD's).

Finally, AFME asks that ESMA clarify in the final guideline that the default rules and procedures also apply to situations where the defaulting participant is another CSD or a CCP.

Q2: Do you think that such acknowledgement process is appropriate? In particular, do you consider it necessary for the CSD to verify the information regarding the default with the designated authority under the SFD before the CSD can take any action, or should the CSD be able to start taking actions based on its reasonable assessment of the participant's situation and on the reliability of the source that informed the CSD in the first place?

A2: It is important to take note of existing approaches to develop a suitable process.

The T2S Collective Agreement describes situations in which local legislation already requires CSDs to take certain steps in response to a default. In principle, CSDs can only take action if they have "reliable" information about the default of a CSD participant, directly or indirectly. However, the definition of "reliable information" is not harmonised across jurisdictions at present, and it would be useful to develop a harmonised approach.

The rules and process for the management of a participant's default should be closely aligned with existing recovery & resolution requirements and guidelines for banks and FMIs. The decision to put an institution into resolution rests with the resolution authority for that participant – or in some cases a court, if the institution is not a bank. As a result, it is appropriate for the resolution authority (or court) to notify the CSD at the point where this decision has been made. This notification, from the relevant resolution authority (or court), would constitute "reliable information" about a default. In the event that a default of a participant is published by reliable sources in advance of the court publishing the definitive default notice, CSDs should validate the reports and, if found to be correct, suspend the participant account pending official publication of the default notice.

These dynamics may be different where the resolution decision is made by an authority that is not subject to the EU Bank Recovery and Resolution Directive. However this should only be the case in situations where CSDs recognise indirect participants and authorities initiate insolvency proceedings for these indirect participant entities. Because the risks involved in any default management procedure are material, the CSD should only rely on information relating to a participant or indirect participant default to the extent that it comes from the regulatory authority that is responsible for managing the insolvency or recovery of its participants. To account for scenarios involving the default of non-EU participants, it would be good practice for regulators and CSDs to develop best practices including information-sharing Memoranda of Understanding for the purposes of communicating this information in a timely and reliable manner.

Finally, AFME wishes to raise awareness of a potential dynamic regarding settlement after a default. While in a real-time settlement system the exact time when a default notification is received should be recorded, there may nevertheless be a time-lag between when a resolution authority or court declares a default and when a CSD receives that information. Depending on the settlement finality in CSDs, certain transactions still may need settlement in the time between declaration of default and the moment the CSD receives that information. In order to avoid the potential uncertainty arising from possible misalignments in the time for default declarations across different CSDs, the T2S Ad-hoc Task Force on Insolvency Procedures (established under the T2S CSG in 2014) agreed on a common procedure to share information via the T2S structure (including both common technical and operational arrangements as well as a single governance/escalation process for all connected CSDs). This Task Force also recommended "to consider the notification received from a CSD/NCB through T2S as reliable notification", so that all participating CSDs could rely on the decision of one single court/resolution authority in one of the T2S participating markets, without the need to wait for additional decisions in each market, which would very likely become available at different successive times. Here, the work done by the T2S CSG Task Force on Insolvency could serve as baseline and be developed further (i.e. harmonised) where appropriate.

Q3: Do you consider that the actions listed are appropriate, or that other actions should be listed? Should certain actions be mandatory, depending for instance on the type or size of default, the characteristics of the participant or the CSD or any other criteria?

A3: AFME does not consider that the proposed actions are appropriate in all circumstances.

AFME has concerns with regards to the proposed power to suspend or terminate a defaulting participant's access, as per 19(a) and 19(b) of the consultation paper. In certain scenarios, it may be prudent to suspend a CSD participant for a short period in order to assess and understand the consequences of that participant's default; however, such a decision can only be made in conjunction with the resolution authority that is responsible for managing that particular default. Indeed, the suspension of a defaulting participant is likely to generate several challenges.

A suspension is likely to be an impediment to an orderly restructuring or wind-down process, particularly if it means that existing contracts cannot be moved while an entity is under the supervision of an administrator – this is often an important process for risk divesting purposes that would be complicated or impeded by a suspension that could have the effect of "blocking" the unwinding of risk.

Furthermore, the automatic termination or suspension of access to a CSD for a defaulting CSD participant could generate practical and legal issues where the default of the participant is subsequently 'waived' by a court (i.e. in scenarios where a defaulting participant is legally determined not to be in default going forward). It is important that the default rules and procedures allow for this contingency.

In addition to the challenges that arise from the automatic suspension of a defaulting participant, AFME has specific concerns regarding the proposed actions outlined in 19(c), 19(d), 19(e), and 19(f) of the consultation paper. In general, AFME does not consider it appropriate that a CSD, which is not a party to a transaction nor aware of the legal terms associated with a transaction, should have the ability to intervene to take action in relation to specific transactions. The actions that each counterparty to a transaction may take in a default scenario are among the most heavily negotiated clauses in counterparty agreements and it is important that counterparties abide by those agreements.

The default rules and procedures should not include the ability for the CSD to place arbitrary limits on the use of certain instruments in a default scenario, i.e. by blocking settlement of liquid securities or cash, a move that may impede a defaulting participant's fulfilment of its liabilities and obligations to its counterparties.

AFME also notes broader considerations that should inform the development of rules and procedures relating to the actions a CSD may take in a default.

At a transaction level, the actions included in the guidelines should account for the steps in the settlement finality process that any transaction goes through: the moment it is entered into the settlement system (SF1); the binding matching of the transaction (SF2); and the final and irrevocable settlement of the transaction (SF3). While transactions in the SF1 stage can still be cancelled unilaterally, transactions in SF2 can only be cancelled on a bilateral basis as the relevant trade instructions remain in the system until both counterparties agree to a change of status. The agreement of both parties to a trade in the SF2 stage about the appropriate course of action is something that must be included in the rules and procedures.

Furthermore, it would be appropriate for supervisors to implement a harmonised approach that takes account of the status of transactions in the settlement finality process, which is particularly important for scenarios involving cross-CSD settlement. In particular, the default rules and procedures should provide clarity on the insolvency regime applicable in cross-border, cross-CSD settlement scenarios, i.e. where French securities are to be settled between a German entity and an Italian entity through their respective CSD accounts in the CSD of their home-country (i.e. Germany and Italy). In such circumstances the insolvency law that is relevant to the defaulting entity should structure the process.

Finally, the guidelines should take into consideration that in some countries CSDs may also need to have specific procedures for the so called "indirect participant" i.e. a client of a custodian which is expressly

identified by the CSD (in general, a segregated client). AFME believes that such a topic should be explicitly covered by the ESMA Guidelines in order to provide certainty of operational procedures and to reduce systemic risks by safeguarding the business of custodians/settlement agents in case one of their clients goes in default, without impacting the other clients of the same custodian/settlement agent.

Q4: Do you think other items should be included in the internal plans?

A4: AFME believes that the suggested items are reasonable and that they should be part of the licensing/authorization process. Moreover AFME believes that such plans should be reviewed periodically, as the legal framework may change over time.

In particular, the aspect of adequate coordination amongst CSDs and NCBs should be particularly analysed and covered in the context of the T2S common platform, where the same insolvency may affect multiple market infrastructures and multiple participants in various markets and jurisdictions. Of particular concern seems to be the possible case of the insolvency of a legal entity which is active in different roles within T2S, for example as a CSD participant in one market and simultaneously as a client of a CSD participant in another market.

Q5: Do you think that information on the implementation of the default rules and procedures should be transmitted to other stakeholders? If so, which other stakeholders?

A5: AFME agrees that the existing list of stakeholders is appropriate, but encourage the additional involvement of central infrastructures to which CSDs may outsource implementation. In particular, this refers to T2S, under which an alignment process between participating CSDs is an important objective (see recommendations of the T2S Ad-Hoc Task Force), along with any other linked FMI's, such as payment systems which allow for the movement of funds to support the securities settlement process (e.g. the Target2 payment system for any securities settlement which takes place via the T2S platform of a European CSD).

Relevant central banks should also be included, as CSDs may be involved in the central bank accounts of participants.

Q6: Do you think that such testing and reviewing processes are appropriate?

A6: In principle the testing appears sensible, but it should also involve the custodians/settlement agents for what concerns the possible default scenario of a "client of a CSD participant"; in any case these testing activities should also involve the relevant authorities managing the default.

AFME would argue that such testing should also involve the custodians/settlement agents for the possible default scenario of a "client of a CSD participant" as this logically follows on as a consequence of requesting the inclusion of detailed procedures for the insolvency of "clients of CSD participants", which as mentioned in the last paragraph of our response to Q3, is "expressively identified by the CSD".

The concept of "indirect participant" is contained in the SFD: Art 2 (g):
'indirect participant' shall mean an institution, a central counterparty, a settlement agent, a clearing house or a system operator with a contractual relationship with a participant in a system executing transfer orders which enables the indirect participant to pass transfer orders through the system, provided that the indirect participant is known to the system operator;'

So, provided that the CSDs are informed of the identities of indirect participants (which is already the case in some markets, whenever these participants are also active as trading members), AFME would maintain that all the discussions about insolvency procedures should be extended to include these

“indirect” participants. It could be argued that the identity of key ‘indirect participant’ clients should be disclosed by the CSD participant to the CSD exactly for the purpose of ensuring that these key clients are included in the scope of such extended CSD insolvency procedures.

In the context of the T2S common settlement platform it would be appropriate to ensure that these testing activities are harmonised across all participating CSDs and NCBs.

In addition and with reference to paragraph 31: “The results of these tests should be shared with the CSD’s management body, risk committee, competent authority and relevant authorities”, AFME suggests that, in addition, these test results should be made available to CSD participants, as part of their own risk assessments of dealing with these market infrastructures. AFME believes such information would be of interest to their members’ internal risk management functions.