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Consultation paper on guidelines on participant default rules and procedures under CSDR

Dear Sir/ Madam,

Deutsche Bank welcomes the opportunity to comment on ESMA's consultation on guidelines on participants default rules and procedures under CSDR. The draft approach from ESMA is helpful and we agree with many of the proposed guidelines, including the approach to items included in default plans and the suggested testing and reviewing processes.

We also believe that additional work is needed to ensure that the guidelines appropriately take note of existing frameworks and legal requirements, and so that broader default management processes are orderly and unimpeded. This may require coordination with other authorities implementing default and recovery and resolution frameworks. In particular:

- We do not consider that the potential actions available to a central securities depository (CSD) are appropriate in all circumstances. In particular, the proposed CSD power to suspend or terminate a defaulting participant's access could impede an orderly wind-down and generate significant legal and commercial challenges.

- Default acknowledgment and notification processes should be driven by the responsible resolution authority. We encourage ESMA to consider principles and practices in existing frameworks, including the T2S Collective Agreement and Recovery and Resolution requirements for banks and market infrastructures.

- It is important that all relevant stakeholders are involved in the development of default rules and procedures, including all CSD participants as well as participant supervisors, resolution authorities, payment banks, and participants in the T2S

project. It is also important to consider the approach to cross-CSD transactions and scenarios involving the default of non-EU participants.

We would be happy to further discuss any of the points raised in the response.

Yours Sincerely,

Matt Holmes
Global Head of Regulatory Policy

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?

It is important to involve all CSD participants in the preparation of the default rules and procedures of a CSD. This includes other CSDs, CCPs and their clearing members.

The relevant supervisory and, most importantly, resolution authorities must also be part of 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 bank default – which may be a direct or indirect CSD participant depending on local legislation, as outlined under Settlement Finality Directive ("SFD") – its 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.

Participants in the T2S project should also be involved in the development of these rules and procedures. CSDs migrating to T2S have signed 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.

Finally, we ask 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?

It is important to take note of existing approaches to develop the right 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.

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 beneficial 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, we wish 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. 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?

We do not consider that the proposed actions are appropriate in all circumstances.

We have 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 divesting risk 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, we have specific concerns regarding the proposed actions outlined in 19(c), 19(d), 19(e), and 19(f) of the consultation paper. In general, we do 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 with liquid securities or cash, a move that may impede a defaulting participant's fulfilment of its liabilities and obligations to its counterparties.

We also make note of 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 status of the 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 & 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 CSDs in certain jurisdictions may also need to have specific procedures for indirect participants, namely a client of a custodian that is identified by the CSD (i.e., a segregated client). Such tailored procedures are needed to ensure that a custodian can continue to process its custody business even if one of its clients is in default.

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

The suggested items are reasonable and that they should be part of the planning process. Moreover, such plans should be reviewed periodically, as the legal framework may change over time.

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?

We agree that the existing list of stakeholders is appropriate, but the additional involvement of central infrastructures participating in the T2S project – and in some instances, implementing changes with and on behalf of CSDs – would be beneficial.

Certain 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?

The testing and reviewing processes are appropriate, and would be strengthened if the close cooperation of the relevant authorities (i.e. the authorities responsible for managing any default) was secured.