European Banking Federation

Ref: EBF_022039

30 June 2016

Subject: EBF response to the ESMA Consultation Paper on guidelines on participant default rules and procedures under CSDR

Introductory Comments

The EBF notes that this consultation is very tightly focused on CSD rules and procedures in the event of a default/insolvency of a direct participant in the CSD. This is clearly an important and relevant focus.

However, it is also important to note that a CSD, as a central safe-keeper, and as operator of a settlement system, is impacted by an insolvency of any trading party in the issuance and custody chains (i.e. by the insolvency of issuers, and of trading parties/investors that use an intermediary to access the CSD).

It is also important that CSD rules and procedures (with relation to insolvency procedures, but also broadly, such as with relation to settlement discipline) take into account the possibility that an issuer or investor, or indeed another intermediary in the issuance and custody chains, may enter into insolvency, and that intermediaries (issuer agents, custodians) may have to manage the insolvency of their clients.

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?

The EBF believes that it is essential to involve **CSD-participants** (participants) in the preparation of such procedures which can include CCPs and other CSDs. Although the CSD should first develop and suggest its participant default rules and procedures, taking into account relevance and efficiency, and should determine which type of stakeholders are to be involved, the involvement of the user committee according to Art. 28 CSDR is indispensable.

Furthermore, the **resolution authorities of the respective participants** should be involved in the definition of the default rules and procedures. Any plan for a default procedure will have to be approved by the supervisory authorities of the CSD, the user committee as well as the respective resolution authorities. It should be borne in mind that, in the event of a participant's default, the responsible authority will take over the administration of that participant and could decide to keep that participant's business running.

We also suggest a clarification in the final guidelines that the default procedures also apply to **CSDs or CCPs as defaulting participants**. Specific procedures may be required in these cases.

Additionally, we would like to emphasize that uniform default rules and procedures should exist for a commonly used settlement platform in a cross-border context in order to ensure a harmonized application of the rules in case of an insolvency affecting participants and CSDs in different countries. We would therefore like to point to the discussions among the T2S-CSDs and national Central Banks in connection with the so called "T2S collective agreement". The

collective agreement takes into account operational and legal requirements for the insolvency of participants in a domestic and in a cross-border context. Particularly the default rules and procedures of a CSD which has signed the collective agreement should reflect the provisions of the collective agreement.

Furthermore the default rules should account for the interconnections between CSDs, CCPs and payment systems, as well as for the default of CSDs clients' participants.

Finally, we would like to make ESMA aware of the fact that a default of a T2S payment bank may also impact a CSD and its participants even though such a payment bank does not have a securities account and is thus not a participant of the CSD. A default of a T2S payment bank would cause difficulties since a participant using such payment bank would be left with no funding in T2S which would impact the participant's ability to settle purchase instructions. It should therefore be considered that the CSD default rules and procedures take into account the potential default of a T2S payment bank and the consequences of this.

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?

The EBF believes the process is generally appropriate, although where a CSD acquires knowledge from other reliable and authoritative sources that a participant is in default, the CSD should be authorised to immediately suspend that participant from settlement.

The EBF agrees with ESMA's proposal that the participant itself or its designated authority under the Directive 98/26/EC (Settlement Finality Directive, SFD) should notify the CSD about the default. Such notification should take place in a timely manner in order to minimize any risks for the CSD and its other participants.

For the safe and efficient management of default events, the convergence and coordination of insolvency management procedures and applicable legal framework on a cross border level is of crucial importance.

We are however, skeptical towards the proposal that default procedures can be triggered on the basis of information about a (potential) default from other sources than the above-mentioned. Any mistake could result in fatal consequences for the participant concerned and bears the risk of systemic contagion. We therefore believe that the default notification should be sent only by the defaulting participant or the designated authority according to Art. 6 (2) SFD. This would go hand in hand with the fact that the CSD could trust the notification received from other CSDs using a common settlement platform (T2S) and would thus not be required to verify the default information. Consequently, also the process described in paragraph 17 of the consultation paper could be omitted.

The EBF believes that the acknowledgement process should be closely aligned to the rules on the recovery and resolution of banks and/or FMIs, since the management of a participant's default will also follow these requirements. Particularly the opening of default proceedings is not dependent on a participant's decision but on the ruling of its resolution authority or a court.

As a result, it seems appropriate to base the notification process on the respective authority proceedings.

As it regards par. 18 on page 11, where it is stated that "…the CSD should identify and transmit to its competent authority at least the following information: (…) the number of clients concerned (…)", it is not clear "who" the clients are. If par. 18, 4th bullet, refers to "clients of the CSD", then such bullets should be replaced with a reference to "Participants" rather than to "clients". In fact, a CSD may not know who are the clients of the Participant that defaults.

In a real-time settlement engine the exact time of the receipt of the default notification should be recorded. There may be a time-gap between the time of the court/resolution authority declaration of the default and the receipt of such notification by the CSD. However, such a situation is addressed in the SFD and based on the settlement finality rules of the respective CSD, transactions still settle between the time the default is declared and the CSD receives that information according to the process set out in Art. 6 SFD.

It should, however, be taken into account that different results might occur, if the resolution decision is taken by an authority outside the EU or concerns participants which are not in the scope of the SFD or the Directive 2014/59/EU (BRRD). In this case it might be prudent to include other sources but this could mean lengthened settlement processes, which could move assets out of the reach of an administrator. The CSD should identify in its Rules the "sources" considered a priori reliable, in accordance with the local legal framework governing bankruptcy and insolvency.Taking stock of the risks and consequences when relying on incorrect information, we would like to suggest to ESMA that best practices with other (non-EU) regulators should be developed in order to ensure a swift and reliable information communication for the notification of a participant's default.

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?

The EBF partly disagrees with the suggested guideline: we are in disagreement regarding the actions described in paragraph 19 (a) and (b). Under certain circumstances, it should be allowed might be prudent to suspend a defaulting participant (para. 19 (a)) for a short period of time in order to assess and understand the consequences of that participant's default. However, we believe that such decision can only be made in cooperation with the designated resolution authority handling the respective default.

We believe that a suspension could negatively affect an orderly recovery or resolution process, if assets based on existing trading contracts could no longer be settled or moved (especially if under the supervision of an administrator). This is particularly true when the assets are used for risk divesting purposes. At a transaction level, the guidelines should take into consideration the different steps in the settlement finality that any transaction goes through from the moment it is entered into the settlement system (settlement finality 1, SF1) over the binding matching of the transaction (settlement finality 2, SF2) to the final and irrevocable settlement of the transaction (settlement finality, SF3). While transactions in SF1 could still be cancelled unilaterally, transaction with SF2-status could only be cancelled bilaterally and would hence require the agreement of the trading party.

Furthermore, it should be noted that there is currently no harmonisation of rules within EU markets about the processes of holding, recycling or cancellation of pending instructions (transfer orders) for the account of the defaulting participant (also noted by the T2S Ad-Hoc Task Force on Insolvency Procedures, established under the T2S CSD in 2014). At a minimum within the context of the T2S common settlement platform, it would be important to implement one single harmonised process for the identification and management of pending transfer orders.

With regards to client business executed by the defaulting participant (custody business, non "proprietary account"), it is important that the impact of a termination or suspension of that participant's access to the CSD be minimised. From a systemic perspective, and to minimise market disruption, and taking into account the safeguards in place under MiFID/ CSDR which ensure that client assets are clearly differentiated from proprietary assets, efforts should be made in collaboration with the resolution authority to maximise the possibility for continued settlement of client activity. A suspension or terminating of client activity would prevent the defaulting participant from earning additional income in order to pay potential claims and, even worse, it would significantly hurt the defaulting participant's client business which would no longer be able to deliver/receive traded securities and would thus be subject to buy-in and penalty procedures under the CSDR. We therefore believe it is of utmost importance that transactions resulting from a participant's client portfolio can continue to be settled against other non-defaulting participants.

Furthermore, we disagree with the possible action of a termination of a defaulting participant's access to the CSD (para. 19 (b)) which should only be possible after a complete resolution of the defaulting participant due to the above mentioned negative effects and consequences. It may be considered, however, to put all or some of the defaulting participant's transactions temporarily "on hold" in order to allow the designated authority or respective administrator to take over immediate control over the pending transactions.

An immediate "termination" of access by the defaulting participant could also ignore a situation where the default of that participant can be 'waived' by the court or designated authority, i.e. such participant would be considered to be in default no longer. The EBF believes that the CSD default procedures should take such a situation into consideration. In addition, 'cherry picking' should be avoided, for instance, by blocking liquid securities or cash which could frustrate the proper performance of the participant's existing obligations towards other counterparties.

In addition to the above, point (d) and (e) seem to be unclear. We would like to ask clarifications as regard:

- What does 'changes to the treatment' mean: Cancellation? Holding of instructions?
- Who is the owner of the mentioned 'financial resources' as per point (e)

Finally, the guidelines should take into consideration that in some countries CSDs may also need to have specific procedures for the so called "indirect participants" i.e. a client of a custodian which is expressively identified by the CSD (in general, a segregated client). In this scenario, the CSD participant cannot and should not be called upon to guarantee settlement of trades on behalf of a defaulting "indirect CSD participant". This implies that, in case of default of an "indirect CSD participants", all transactions of the "indirect CSD participants" should be suspended similarly as would occur in case of default of a direct CSD participant.

We think that such 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.

We believe that procedures relating around "indirect participants" are in line with the CSDR approach which gives clients of a CSD participant the possibility to have its assets in a segregated account at the CSD. However, we believe that procedures, and solutions to operational problems in the case of an insolvency event, should be in place that deal not simply with the activity of clients of a CSD participant that have the status of "indirect participant", but also with the activity of all trading parties, no matter their account structure and their place in the issuance and custody chains.

The other actions listed are considered appropriate bearing in mind that the CSD should adapt its measures listed on a case-by-case basis in accordance with the respective resolution plans of the defaulting participant. None of the actions, however, should be mandatory; they should be subject to the decision of the CSD's executive board and depending on the specific situation of the participant's default.

The EBF has, however, concerns regarding the proposed actions in para. 19 (c) to (f) in relation to specific transactions to which the defaulting participant is a party and for which the parties to the transaction have agreed on the consequences of the participant's default. Typically, this would be the case for e.g. repurchase agreements (repo). The potential actions taken by the CSD should not interfere with the contractually agreed remedies of the parties to the affected transaction

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

The EBF believes that the suggested items are reasonable and that they should be part of the licensing process. Moreover, we believe 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 the T2S perimeter, for example as a CSD participant in one market and simultaneously as a client of a CSD participant in another market.

CSD's participants should communicate to the CSD the updated contact list for any communication concerning the insolvency procedures. The CSD is due to ensure the collection and storage of its participants' data and contacts for this purpose. It should be noted that appropriate contacts for insolvency management do not necessarily coincide with those for system contingency.

Consequently, we regard that agreed procedure(s) with other market infrastructure(s) and / or other CSDs when involved should be taken into account.

In our opinion it is not required to include any additional items. However, we believe that the criteria for actions to be applied should rather have a general framework in order to enable the CSD to be flexible where appropriate.

Furthermore, it should be clarified that all non-defaulting participants which are not directly affected by the default are not in the scope of paragraph 23. Non-defaulting participants are not liable for other defaulting participants and have therefore no role to play in the default procedures unless they are directly affected by the defaulting participant's default (e.g. through pending transactions).

Q.5 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?

The EBF generally considers the list appropriate.

The implementation of the default rules will be a matter of public notice, as the participant has entered insolvency proceedings (which are on public record), and those proceedings automatically trigger the CSD's default procedures.

Additionally, it might be worth taking into account "an infrastructure to which the CSD has outsourced the processing of its business" – (cf. Art. 30 and 31 CSDR). As this would obviously be applicable to the T2S platform, an alignment process between participating CSDs would be desirable (see recommendations of the T2S Ad-Hoc Task Force. An information to the T2S operator could also be worth considering. Furthermore, CSDs may be operating on the central bank accounts of their participants, we thus believe that central banks should also be part of the discussion.

A coordinated involvement of T2S governance groups (e.g. "settlement managers call") should be implemented for the timely and efficient dissemination of the information about a default procedure and for cross-CSD coordination in the deployment of the pre-agreed insolvency management procedures.

However in addition to the list presented in the consultation paper, information on the implementation of the default rules and procedures should also be transmitted to connected payment systems' managers because there are cases where the owner of a DCA in T2S is not a participant to that relevant CSD. This information should also be transmitted to the relevant CCP and Trading venues.

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

The processes appear appropriate. However 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.

We 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"

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), we would argue that all the discussions around insolvency procedures should be extended to also include these “indirect” participants. It should also be permissible that the identity of key ‘indirect participant’ clients would be disclosed by the CSD participant on a voluntary basis 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 should be harmonised across all participating CSDs and NCBs.

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