European Banking Authority

Opinion of the European Banking Authority on the European Commission's consultation on a possible framework for the recovery and resolution of financial institutions other than banks

Introduction and legal basis

1. The EBA competence to deliver an opinion is based on Article 34(1) of Regulation No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority) amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC1, as recovery and resolution issues relate to the EBA's area of competence, as per the explanations of the paragraph that follows.

2. In line with Article 25 of Regulation 1093/2010 (EBA regulation), the EBA contributes and participates actively in the development of an effective recovery and resolution regime for banks and investment firms. In this context, the EBA also takes a close interest in projects, which aim at setting out a similar framework for financial entities other than banks. This is particularly relevant as a number of key European financial infrastructure providers currently hold and operate under banking licences, including Central Counterparties (CCPs) such as Eurex Clearing AG and LCH.Clearnet SA, and Central Securities Depositories (CSDs) such as Clearstream Banking Luxembourg and EuroClear Bank[1]. In addition, the EBA's interests in resolution regimes for non-banking institutions also stems from the potential impact any such resolution might have on banks either because the latter are members of CCPs and/or CSDs, or because they are highly exposed to a failure of these non-banking institutions, which could in turn affect their own solvency.

3. In accordance with Article 14(5) of the Rules of procedure of the EBA, the Board of Supervisors has adopted this opinion.

Specific comments /proposals

4. In general, the EBA believes it important that any future regime should strengthen the legal framework and seek to harmonise the regimes for recovery and resolution across the European Union to avoid regulatory arbitrage and thus potential customer or taxpayer detriment. Regulatory arbitrage should also be avoided where financial market infrastructures (FMIs) operate under

[1] In the case of CCPs, such banking licences are however special purpose licenses under national regimes and not a feature of the forthcoming European framework for CCP regulation (EMIR).

multiple licences. As such, any proposed framework should ensure that an FMI that also holds a banking licence cannot determine at its own free will whether to abide by the banking resolution framework, which will not have addressed all FMI specificities, or the alternative non-banking framework. For this reason, a functional approach with clear rules determining which legal framework should apply to the various activities of infrastructures, ensuring a level playing field, and assigning responsibilities among the relevant authorities should be introduced. The EBA would also like to stress the importance of consistency between a European framework for resolution and recovery and the initiatives under way in CPSS-IOSCO[2] and the FSB[3]. Both documents provide an important basis for globally aligned crisis management approaches in respect of FMIs and financial institutions more broadly.

1.1 Scope

5. The EBA notes that the consultation does not, at this stage, include any proposal to extend recovery and resolution measures to other financial entities which are traditionally included in the so called 'shadow banking' sector, such as money market funds and hedge funds. This is particularly relevant as the use of hedge funds could increase once new prudential requirements for securitisations apply to banks and investment firms. Subject to a clear articulation of the wider social and economic benefits, in the EBA's view it should be considered to what extent these entities can be included in any non-bank recovery and resolution framework. To the extent possible, any proposed legislation should also be consistent with the FSB work-stream on shadow banking.

6. For other non-bank financial institutions, the consultation paper notes that the relationship between these and overall financial stability has not been fully articulated and that approaches and tools for the measurement of financial instability and financial distress are better developed for banks. Whilst the EBA agrees that work in this area is still relatively immature, the risks should not be underestimated and any legislative proposal should at least consider a future extension to capture these entities.

1.2. General Questions

7. Given the relevance to the EBA, the response focuses on the FMI section of the consultation paper. Whilst the EBA welcomes the thoughts on the insurance entities, this clearly lies outside the EBA's remit of expertise. The EBA would however like to note that, in the interest of harmonisation and level playing field, especially in the case of conglomerates which contain both banking and insurance entities, a common approach with the proposed legislation for banking and investment firms should be sought.

8. With regards to the general approach for recovery and resolution frameworks for FMIs, the EBA would like to note the following:

[2] http://www.bis.org/publ/cpss103.htm
[3] http://www.financialstabilityboard.org/publications/r_111104cc.pdf

- Given the systemic relevance of CCPs and CSDs, it is necessary to develop a harmonised framework for recovery and resolution of FMIs across the EU.

- The EBA notes that any amendments to the settlement finality directive should be carefully drafted. In the EBA's view this directive has worked well in providing certainty of finality with regards to settlement. Any amendments that alter the original objectives and applicability of this piece of legislation should be avoided. In the same context, the possibility of amendments to the Financial Collateral Arrangements Directive should also be considered carefully.

- In light of the specific nature of risks taken on by CCPs and CSDs, the EBA would favour a functional approach in determining recovery and resolution regimes to the infrastructure in question.

- It should be considered to what extent CSDs' banking activities, operated under a banking licence, should fall under the umbrella of the banking resolution proposal. In that context, it is paramount that any uncertainty over which authority is responsible for triggering a recovery and resolution framework and any conflicting decision-making should be avoided at all cost. Consistency between banking and non-banking framework is particularly relevant for ICSDs (operating with a banking licence) in order to avoid systemic risk and an uneven playing field with custodian banks and other non-bank CSDs competing for the same business. Other CSDs, including those that do not operate deferred net settlement systems (and whose main risks are thus of an operational nature) and those who are responsible purely for settling the securities leg of a financial transaction, could apply a more specific framework: they could be considered in conjunction with privately operated payment system infrastructures, such as CHAPS and BACS, which are responsible for settling payment instructions, and trade repositories, which are mere information providers. This would make sense given the functional similarity and the risks faced by these types of institutions (mainly legal and operational in nature). This is also in line with the CPSS-IOSCO report that differentiates between CCPs and CSDs operating deferred net settlement systems on the one hand, and FMI such as trade repositories and payment systems that are particularly vulnerable to legal, general business and operational risk.

- Even in cases where CCPs hold a banking licence, CCPs carry out activities that are not directly covered by the banking resolution framework and any legislative proposal should clearly identify these areas and how they can be treated if they were to fail or likely to fail. Any recovery and resolution framework for FMIs needs to clearly determine the legal framework applicable to such infrastructures and assign clear responsibilities to the relevant authorities.

- In line with existing infrastructure standards, ensuring business continuity and avoiding entering a recovery and resolution regime should remain a key focus. To the extent that further preventative steps are required to avoid triggering a resolution, these options should be fully explored. In that context, the EBA would like to reiterate the Opinion forwarded to the European Commission regarding capital requirements for CCPs, noting in particular the

absence of an adequate framework for managing risk arising from intra-day exposures and the unclear treatment of interoperable arrangements for non-cash products[4].

1.3. Objectives

9. In response to the paper's question in relation to the objectives of a resolution regime, resolution triggers and resolution powers by the respective regulatory authorities, the EBA notes that these should be aligned where possible to any proposal on the resolution of banks, where feasible. Key to any recovery and resolution framework should be the objective to maintain critical functions and operations whether in the existing or in a bridging institution and to maintain financial stability. With regard to triggering a resolution, a trade off needs to be struck between giving authorities sufficient flexibility in triggering the framework; in other words, any definition of trigger points should include both quantitative (to the extent possible) and qualitative indicators allowing relevant authorities to enact a recovery and resolution phase, where an FMI has not done so itself, whilst maintaining a degree of predictability and legal certainty. Regarding cross-border operations of infrastructures, strong cooperation between authorities, harmonisation and clarity around the steps to be taken by the relevant national and/or European authorities are most important. In a crisis, awareness in host jurisdictions about the likely actions to be taken by the relevant home jurisdiction in relation to a struggling FMI is imperative. This is in line with CPSS-IOSCO which note that 'coordination and information-sharing among and between all relevant parties are critical to the successful execution of the FMI's plans.'

10. The EBA also shares the objectives set out for a future framework ensuring, amongst other, preparation for failure, orderly resolvability, and coordination in crisis of FMIs. For this purpose, it is important that the framework establishes coordination channels in the form of Resolution Colleges which involve both national and European supervisors and overseers of the FMIs, in line with existing legislation where applicable, as well as relevant resolution authorities. Furthermore, any College arrangement and composition should also take due consideration of the participants of the FMIs and the likely impact of the proposed recovery and/or resolution mechanisms. It should also take due account of the FMI's third country operations where applicable.

11. These arrangements should resemble those of the crisis management groups (CMGs) envisaged by the FSB report on effective resolution regimes for financial institutions and Responsibility E of the CPSS-IOSCO Principles on Financial Market Infrastructures.

1.4 Tools

12. The EBA supports the proposal set out in the consultation paper that considers the transfer of FMI operations to a surviving market infrastructure as a viable resolution tool. This solution is only viable where another FMI operating in the same asset class is available or where there is a willing third party purchaser. In the case where such alternatives are available, and to facilitate such solution, any future recovery and resolution framework should seek to establish *ex ante*

[4] http://www.eba.europa.eu/cebs/media/Publications/Other%20Publications/Opinions/EBA-Op-2012-02--EBA-opinion-on-EMIR-and-CCPs-_1.pdf

operational arrangements between infrastructures to facilitate transfer of members and positions in a resolution scenario. The EBA acknowledges the view expressed in the consultation paper that such a process could nevertheless be time consuming and might require the setting up of a bridging institution but steps to facilitate the transfer before such event should be considered. In this respect, the FSB paper lists a number of actions that could facilitate such a transfer, including:

- Centralised repository for all FMI membership agreements;

- Standardised documentation for payment services, covering issues including notice periods, termination provisions and continuing obligations;

- Draft transition services agreement as part of resolution plans that, if needed, will allow the firm to continue to provide uninterrupted payment services on behalf of the new purchaser by using existing staff and infrastructures;

- A 'purchasers' pack' that includes key information on the payment operations and credit exposures, and lists of key staff, to facilitate transfers of payment operations to a surviving entity, bridge institution or purchaser.

  The EBA notes in this context that existing provisions in Regulation (EU) 648/2012, known as the European Markets Infrastructure Regulation (EMIR) and the upcoming Markets in Financial Instruments Regulation (MiFIR) already provide some requirements in this area.

13. With regards to other resolution tools, the EBA notes the strong interconnectedness between CCPs and their members, many of whom are banks. Given any recovery and resolution framework would in all likelihood be triggered in a financial crisis, some of the proposed loss allocation tools could spread the problems to previously non-defaulting members. This is particularly relevant in the case of initial margin haircutting, variation margin haircutting, or specific liquidity calls on members that are envisaged by the consultation paper. In a situation of stress, banks could be seriously hit if the margin in relation to an in-the-money transaction is haircut, whilst the margin for a corresponding hedging trade that is out-of-the-money is required in full. In our view, more consideration should be given to the specific circumstances of the clearing member and their ability to actually absorb losses. This could include contingency solutions with *ex post* redress for those members able to participate in the loss sharing arrangements. Whilst the CPSS-IOSCO paper describes in some detail the options available in setting up loss sharing arrangements, it also notes that 'choices about where losses will fall have consequences not only for FMI participants but potentially the wider financial system' as clearing members look to spread the increased costs further to indirect participants, i.e. clients.

14. It is therefore crucial that any recovery and resolution framework that envisages loss sharing arrangements beyond the pre-funded loss mutualisation (i.e. the guarantee fund) is closely coordinated with authorities responsible for the supervision and oversight of the clearing members.

1.5. Group resolution

15. Finally, on the issue of group resolution of financial market infrastructures, any recovery and resolution framework should aim to maintain the 'healthy' parts of the infrastructures. A resolution framework could consider winding up, or even tearing up clearing of specific instruments, in order to continue clearing for other services. Such scenario could contain the disruptive effects of a financial infrastructure failure and continue servicing the market with the remaining operations.

16. In addition, whilst CCPs should seek to operate on a stand-alone basis as required by the EMIR, a recovery framework could consider to what extent another FMI in the group could provide temporary support, for example through the provision of a liquidity line, to the infrastructure in difficulties. Any such support should be tightly controlled to avoid contagion among the infrastructures, should not put at risk the supporting infrastructure's own compliance with relevant rules and regulations, and should never result in an infrastructure lending support to an insolvent group entity.

This opinion will be published on the EBA's website.

Done at London, 21December 2012.

[signed]
Andrea Enria
Chairperson
For the Board of Supervisors