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DRAFT REPORT

on recovery and resolution framework for non-bank institutions
(2013/2047(INI))

Committee on Economic and Monetary Affairs

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MOTION FOR A EUROPEAN PARLIAMENT RESOLUTION

on recovery and resolution framework for non-bank institutions

(2013/2047(INI))

The European Parliament,

- having regard to the CPSS-IOSCO consultative report of July 2012 on ‘Recovery and Resolution of financial Market Infrastructures’,
 - having regard to the Commission services’ consultation on a possible recovery and resolution framework for financial institutions other than banks,
 - having regard to Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories (EMIR);¹
 - having regard to the Commission’s proposal for a directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms (COM(2012)0280) (BRRD), and the report of the Economic and Monetary Affairs Committee thereon (A7-0196/2013),
 - having regard to Rule 48 of its Rules of Procedure,
 - having regard to the report of the Committee on Economic and Monetary Affairs (A7-0000/2013),
- A. whereas assessments of financial market infrastructure are now included in the IMF’s and World Bank’s financial sector assessment programmes;
- B. whereas while EMIR and CSDR aim to reduce systemic risk through well-regulated market infrastructure, there is a strong possibility of unintended consequences;
- C. whereas mandatory central clearing has increased the concentration of systemic risk in CCPs and all CCPs are systemically important in their own markets;
- D. whereas the largest clearing members typically participate in more than one CCP, so that if one CCP fails others are also likely to face difficulties;
- E. whereas the rationale for using a CCP is to reduce counterparty risk by correctly margining products before offering to centrally clear them so that the default of any counterparty does not affect the rest of the market;
- F. whereas EMIR does not fully address the risks arising from a CCP wrongly assessing the margin requirements for a whole product class;

¹ OJ L 201 27.7.2012, p. 1-59.

- G. whereas CCPs have incentives to apply lower margins, particularly when entering new products or asset classes, in order to attract custom; whereas the effectiveness of default funds segregated by product or asset class is yet to be assessed;
 - H. whereas the risks of cross-margining of products (portfolio margining) within a CCP are untested and so while reducing collateral demands in the short term may reduce costs, the use of cross-margining should not jeopardise the ability of a CCP to correctly manage risk and should recognise the limitations of VaR analytics;
 - I. whereas the value clients derive from the clearing member lies in their provision of a firewall against counterparty risk in relation to both the CCP and other clearing members;
 - J. whereas the EU's ICSDs are globally systemically important institutions as facilitators of the Eurobond market and currently operate with banking licences;
 - K. whereas central clearing has increased the need for collateral management and related services which are now being performed by CSDs as well as custodian banks;
 - L. whereas the impending introduction of Target2Securities has caused CSDs to explore new services;
 - M. whereas standard insolvency regimes will not provide a complete framework for treatment of client assets should a CSD fail without implementation of the Securities Law Legislation;
 - N. whereas the IAIS is due to report later this year on recovery and resolution of insurance undertakings;
 - O. whereas while the systemic risk of an asset manager failing is not as pronounced as for critical market infrastructure, as asset managers' business models evolve they could become more systemically important, a factor which has been addressed in FSB work on shadow banking;
1. Calls on the Commission to prioritise recovery and resolution of CCPs and those CSDs which are exposed to credit risk, and when considering other financial institutions to differentiate appropriately between each type;
 2. Emphasises the importance of EU legislation following internationally agreed principles, as agreed in CPSS-IOSCO, FSB and IAIS;

CCPs

3. Calls upon the Commission to ensure that CCPs have a default management strategy for all products that are mandated for central clearing as part of a wider recovery plan approved by the supervisor;
4. Underlines the importance of monitoring risks to CCPs arising from a concentration of clearing members, and calls on supervisors to inform EBA of the largest 10 clearing members of each CCP so that such risk can be centrally monitored;

5. Calls on the Commission to develop tools for measuring CCPs' intraday risk, to ensure that intraday balances held by CCPs with commercial banks for account management and payment services do not exceed predefined limits that could otherwise threaten the functioning of the CCP;
6. Believes that in order to maintain incentives for good governance of CCPs the default waterfall established in EMIR needs to be respected such that the CCP's pre-funded own financial resources are used before any non-defaulting members' default fund contributions;
7. Calls on the Commission to recognise that while the aim of ring-fencing asset classes within a default fund of a CCP is to limit contagion, it is unclear whether this will be sufficient to prevent such contagion in practice;
8. Calls on the Commission to ensure that sound principles are established governing contractual arrangements between a CCP and its clearing members and how clearing members pass on losses to their clients, in such a way that the clearing member's default fund contribution will have to be exhausted before any losses from a defaulting clearing member can be passed on to the client;
9. Asserts that the dividing-line between recovery and resolution in the case of CCPs is when the default waterfall is exhausted, necessitating the option for the supervisor to remove the CCP's management board;
10. Underlines that any voluntary participation of clearing members in loss allocation before removal of the CCP's management should not involve client money, while the resolution authority, once responsible, may employ loss allocation tools such as variation margin cutting or refilling of the default fund by the non-defaulting clearing members;
11. Believes that if the resolution authority had the ability to impose a stay on early termination rights, alongside the lifting of the clearing obligation which would pause the CCP for a maximum period of two days, this could allow the market to correctly re-price the contracts, thus allowing for a more orderly diffusion of risk;

CSDs

12. Establishes that it is the responsibility of a CSD to ensure that its recovery plan clearly provides for operational continuity in reasonable crisis scenarios so that, even if other parts of its business can be disposed of, its primary settlement function can continue;
13. Calls, if no separate legislative proposal is imminent, for inclusion in the CSDR of references to the articles of the BRRD that should apply to those CSDs operating under a banking licence;
14. Calls on the Member States, in the absence of Securities Law Legislation, to coordinate their existing special administration regimes for CSDs in order to improve certainty as to how operational continuity will be maintained in a crisis, in particular by ensuring access to registries for the resolution authority so as to identify the owners of assets;

Insurance undertakings

15. Calls on the Member States to implement Solvency II within a reasonable time-frame, and calls for the completion of negotiations on Omnibus II so that EIOPA can effectively regulate insurance undertakings;
16. Calls on the Commission to take into account the IAIS's work on recovery and resolution of insurers, and to consider what action is needed to implement it;

Asset management

17. Calls on the Commission to assess whether any asset managers should be designated as systemically important due to their size or business model and would therefore require a recovery plan;
18. Believes that an effective securities law regime could mitigate many of the issues involved in case of failure of a large crossborder asset manager;

Payment systems

19. Calls on the Commission to engage with the relevant international financial supervisors and authorities in order to identify any weaknesses in globally systemically important payment systems and the arrangements in place to ensure continuity of service in the event of failure;
20. Instructs its President to forward this resolution to the Council and the Commission.

EXPLANATORY STATEMENT

The financial crisis has shown the interconnectedness of the global financial system where the failure in risk management processes within any large player in the market has the potential to spread via a contagion effect. As part of global efforts to make the financial system more resilient it is necessary for all market participants to have a better understanding of how their business will function, or be wound down in an orderly fashion under stressed circumstances.

Throughout the turmoil of the recent financial crisis, it is noteworthy that no piece of non-banking critical market infrastructure (CMI) failed or needed to be resolved. However new global commitments shifting bilaterally traded products into multilateral market infrastructure especially concentrating positions and risk through central clearing of trades means more stress is being put on these institutions. CMI operators therefore need to demonstrate proper governance and strong risk management for the benefit of the system as a whole.

The CPSS IOSCO consultation concerning recovery and resolution of financial market infrastructure recognises this need and will be followed by a new set of principles to complement the FSB's "Key Attributes of Effective Resolution Regimes for Financial Institutions" and complement and expand upon previous IOSCO work on "Principles for Financial Market Infrastructure."

Whilst within the EU it is hoped that EMIR, MiFID and CSDR will increase the safety and stability of the financial system it is important to recognise the limitations of legislation and the likelihood of unintended consequences as significant risk is transferred from individual market participants to mutualised central hubs.

This report will focus specifically on CCPs and CSDs as key critical market infrastructure that needs strong recovery and resolution rules as a priority. The report also acknowledges that there are many other entities that are non-bank financial institutions, including insurance undertakings, asset managers and payment systems. However, international work on these sectors is either yet to be completed or is awaiting further discussion and evaluation.

Central Counterparties - CCPs

A CCP stands between two counterparties so as to provide a way to manage the risk of default of a counterparty. EMIR already requires CCPs to be sufficiently resilient to survive the default of its two largest clearing members and the use of recovery tools such as a mandated default waterfall to predetermine the hierarchy of losses within the CCP should a clearing member default.

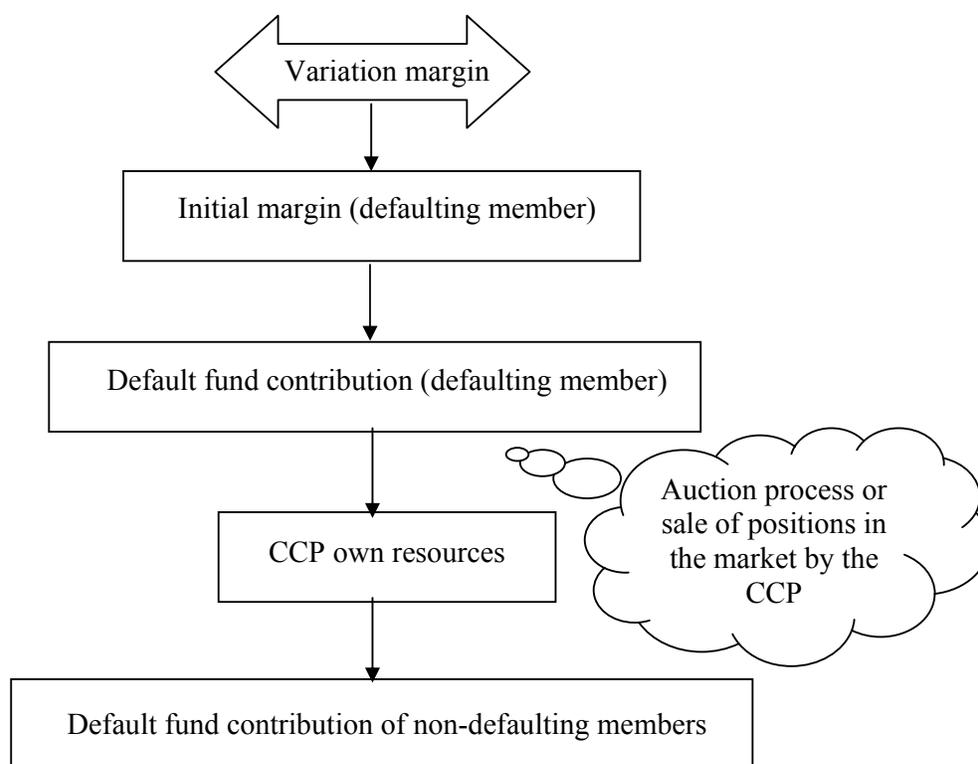
If a CCP is to mutualise the risk in the financial system, good governance is paramount and a recovery framework must ensure it provides the correct incentives for both clearing members who contribute to the default fund and to the CCP itself via its own contribution. The use of recovery tools beyond those mandated in EMIR are likely to indicate a severe governance failure within the CCP and should not be considered part of normal operations.

Where a clearing member of a CCP defaults, EMIR outlines a default waterfall for how losses

are managed by firstly utilising the margin of the defaulting member. The next stage requires using the default fund contributions of the defaulting member to cover further losses. If this is exhausted, the CCP has dedicated own financial resources that it must call upon, before the non-defaulting members default fund contributions can be used.

Although EMIR does not mandate it as part of the default waterfall, the CCP may liquidate the positions of a defaulting member in the open market. Alternatively in extreme market conditions the CCP can organise an auction process whereby other clearing members buy the positions of the defaulting member. A failed auction occurs when no clearing member is willing or able to buy the positions of the defaulting clearing member at a price the CCP can afford to pay.

EMIR default waterfall - article 45



Notably even during recent extreme market stress no EU CCP utilised their general default fund and therefore available recovery tools performed satisfactorily.

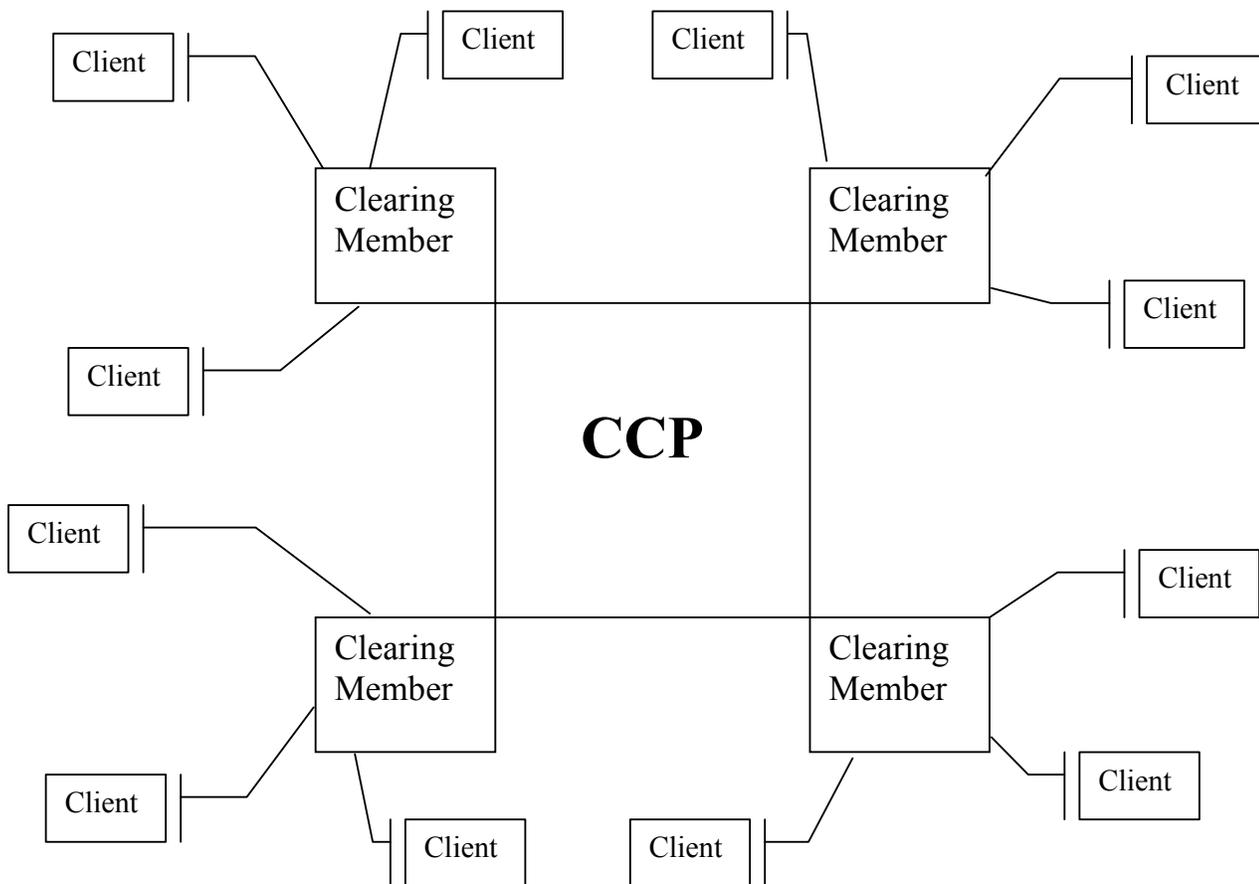
However, mandating central clearing of derivative products through CCPs may see increased competition between CCPs, encouraging them to centrally clear more products. While increased use of central clearing is the desired G20 regulatory outcome, it increases the requirement for strong governance and risk management. A recovery and resolution programme for a CCP should include the possibility of the failure of the CCP to correctly calculate the inherent risk of a product, and therefore the margin, as an additional risk for a

resolution authority to deal with, as well as the default of multiple systemically important clearing members.

Resolution Authorities should be provided with the necessary tools to deal with the wide variety of potential threats to the continued operation of a CCP in order to protect client assets.

Recovery and resolution frameworks for CCPs are further complicated by the relationship between CCPs and their clearing members and additionally the clearing members and their clients. The CCP has very little contact with the end clients of the clearing members although they are the intended beneficiaries of central clearing. Therefore the end clients have little say over the risk management of a CCP and have no contractual obligations to them, suggesting that any allocation of losses from the failure of a CCP should first impact upon the clearing members who are paid by their clients to provide a layer of protection against the CCP. Further loss allocation methods which may benefit the financial system as a whole by diffusing losses, should follow principles set out and agreed with regulators, so as to avoid unfavourable terms for the clients of clearing members which may be a result of unequal power relationships.

Relationship between CCP, and Clearing Member, and Clearing Member and Client



Any recovery or resolution regime must have protection of client assets as a core objective and should provide legal certainty to all users of financial market infrastructure. Should a significant clearing member default or should there be a failure of governance or risk management by the CCP, then arrangements need to be in hand for a resolution authority to ensure orderly interim function and possible resolution.

Central Securities Depositories - CSDs

CSDs are integral to national securities markets, and are critical to the functioning of the financial markets. Therefore any recovery regime needs to be fully endorsed by the supervisor. The focus on operational continuity in any resolution scenario can not be over emphasised and resolution authorities need to be given appropriate powers to ensure operational continuity of the securities system. In particular in the case of the International CSDs (ICSDs), the need for regulatory cooperation internationally is paramount, both between regulators within and beyond the EU.

CSD business models are evolving in anticipation of the introduction of Target2Securities by the ECB such that many CSDs are expanding into new services and offerings and other market participants are considering providing securities settlement services.

In addition, the regulatory drive towards central clearing has fuelled a demand for access to high quality collateral. Therefore CSDs are increasingly utilising their pools of collateral to provide collateral transformation services to market users.

These new services need supervisory oversight and detailed recovery plans to ensure that the CSDs primary settlement services are not put at risk.

Should a CSD be operating with a banking licence as referred to in CSDR then the recovery and resolution plan should be based closely upon the regulatory requirements of the Bank Recovery Resolution Directive (BRRD). This will ensure a level playing field between banks and CSDs as well as ensuring operational continuity of a CSD. National supervisors should be able to go beyond regulatory requirements of both the BRRD and CSDR should they believe that a particular business model necessitates additional steps to maintain the critical functions of the CSD in stressed market conditions.

Should a prolonged period of disruption occur at a CSD resulting from either a governance or operational failure, recovery plans need to ensure that decision making passes where appropriate to a resolution authority to ensure full legal certainty.

Insurance Undertakings

Although insurance companies operate very differently from banks, they are deeply integrated within the financial markets and, as proven in the recent crisis, have the potential to be systemically important. Recovery and resolution planning is therefore prudent.

However, international work by the International Association of Insurance Supervisors lags that of CPSS IOSCO in relation to critical market infrastructure. In addition the new regulatory measures such as Solvency II, which aim to increase the resilience of insurance

undertakings, have not yet been implemented across the EU.

Whilst encouraging insurance companies to work with national supervisors on individual plans it seems appropriate not to cover them in the EU legislation dealing with CMI recovery and resolution.

Asset Management

The size and business model of the asset management sector does not typically present systemic risk. However we are now seeing the growth of much larger asset management firms many of whom are exploring new business opportunities that could fundamentally change their business models and over time increase their systemic importance. More work needs to be done on an international basis in this area based upon improved data collection and analysis. Future recovery and resolution plans specifically for this sector may need to be addressed in subsequent legislation.

Payment Systems

While payment systems do not typically take on risk, their failure, particularly in the currency markets due to fraud or mismanagement could have resounding implications for the whole system of global trade. Accordingly, payment systems should be either subject to resolution regimes or to a bespoke insolvency regime that prioritises service continuity over the other objectives of the insolvency practitioner.