EUROPEAN COMMISSION
Directorate General Internal Market and Services

FINANCIAL INSTITUTIONS
Financial stability

SUMMARY OF THE REPLIES TO THE CONSULTATION OF THE INTERNAL MARKET AND SERVICES DIRECTORATE GENERAL

ON

A POSSIBLE RECOVERY AND RESOLUTION FRAMEWORK FOR FINANCIAL INSTITUTIONS OTHER THAN BANKS

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The European Commission held a stakeholder consultation on a Possible Recovery and Resolution Framework for Financial Institutions other than Banks (hereafter – Consultation) between 5 October and 28 December 2012. The initiative follows the adoption, on 6 June 2012, of a Commission proposal for an EU framework in this area for banks and investment firms. Consistent with international-level work in this area, it examines whether and how the failure of different kinds of nonbank financial institutions, notably central counterparties, central securities depositories, and systemic insurance companies, should be managed by specific steps to ensure orderly recovery and resolution where necessary.

The Commission services received 67 responses to the Consultation. The consultation attracted a wide range of view from stakeholders (see figure 1). The business community was the most active stakeholder group, which made up two thirds of all responses (see figure 1). Besides the public institutions, which were relatively active participants in the Consultation, the Commission services also had an opportunity to hear the views of other important stakeholders, such as trade union or academics.

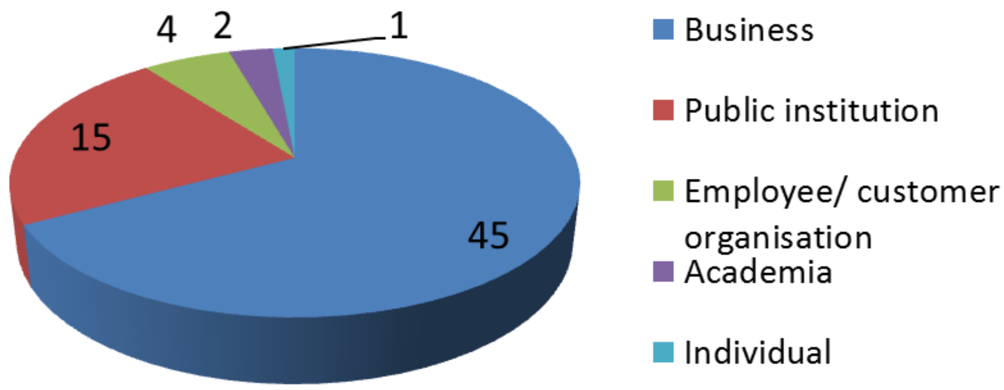

Figure 1. The distribution of respondents

A vast majority of businesses that replied to the Consultation were the providers of different financial services. Figure 2 depicts the participation of business community in the Consultation.

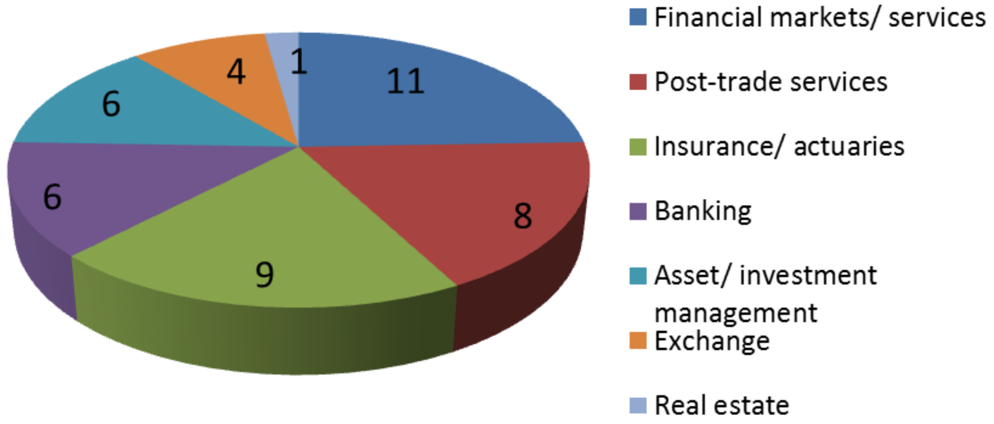

Figure 2. Responses from business community

As regards the geographical dimension, only four responses were not from the Union – all of them arrived from the United States of America (see Figure 4 below). Responses came from half Member States (14 out of 27). Two thirds of Union's responses (41 out of 63) came from the UK, DE and organisations representing Union-wide interests.

For the transparency purposes, it should also be mentioned that among respondents from business and employee/customer organisations, two thirds (33 out of 49) of respondents were organisations recognised in the Transparency Register, which was set up and is operated by the European Parliament and the European Commission.

This summary aims to provide different interest groups' views on the three categories of financial Institutions other than banks, as reflected in the Consultation: 1) financial market infrastructures; 2) insurance companies; 3) other non-bank entities and institutions.

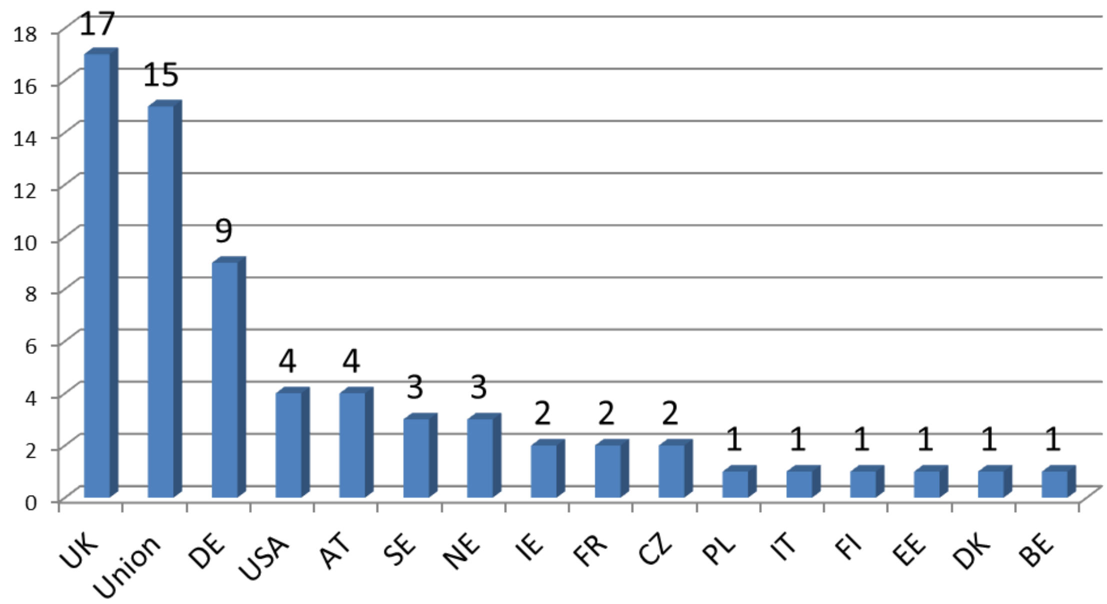

Figure 4. Geographical representation of the interests of respondents

1. FINANCIAL MARKET INFRASTRUCTURES

All identified stakeholders groups, except insurance, provided comments on the possible recovery and resolution framework for financial market infrastructures (FMIs), i.e. central counterparties (CCPs) and central securities depositories (CSDs).

There is a broad agreement that specific measures should be defined for the recovery and resolution of FMIs as they are central to the financial system and often non substitutable given their unique role. The vast majority of respondents agree that CCPs, carrying much more risk than CSDs, should be the first ones to be subject to a specific EU-framework for recovery and resolution. Stakeholders saw national insolvency rules as inadequate and were broadly supportive of Commission proposals to improve resolution process.

CCPs insist on the need to give careful considerations to the practical implications of such a regime on their operations. They also suggest that the Commission should not rush into the definition of a specific regime. The EMIR legislation has defined extremely stringent operating standards which should mitigate the increased risks linked to the broader range of derivatives contracts centrally cleared as a result of the clearing obligation. In their views, the Commission should instead play an active role in the development of appropriate policy responses at international level, before proposing legislation in that area.

There is a broad understanding that any recovery and resolution framework should be adapted to the specific characteristics of each type of FMI. In this respect the recovery and resolution framework for CSDs should be different from the recovery and resolution framework for CCPs, given the substantial differences between these two types of institutions, notably in terms of risk profile. CCPs underline that due to the strong interdependencies between FMIs, recovery and resolution regimes should be coordinated and effective for all of them to mitigate potential spill over effects.

Consequently, everyone is broadly in agreement that CCPs and CSDs with banking licenses should be subject to a framework specific to them rather than the one for banks, by way of a functional approach.

The vast majority consider that resolution measures should primarily aim to ensure the continuity of the essential services provided by FMIs which is key in order to safeguard financial stability, and that robust recovery planning under the oversight of supervisors is vital in order to preserve stability in the markets. Few business representatives however question if the objective of the resolution should not be the protection of creditors as it is the case under the insolvency procedure. Specifically, some asset managers believe that bail-in for CCPs would not be an appropriate as a resolution tool, which instead should aim to protect clients' assets. Trade unions underline that, regardless of the design of the framework and the powers invested in the administrator, there must be no worsening of employees' rights in any aspect due to a company being put under resolution.

As regards the management of a crisis situation, financial service providers recommend a clear distinction between the different phases (ordinary procedures in difficult situation, recovery, and resolution). Such a distinction in their view is of the utmost importance in order to avoid any uncertainty over who has the full responsibility. Specifically, CSDs believe that all CSDs should be covered by the future recovery and resolution framework and that such framework should emphasise recovery over resolution in view of the their systemic importance and lack of substitutability in their respective markets.

There has been a general support for reaching a common understanding in the point of resolution (trigger), but differences appeared on the conditions for the trigger. For instance, asset managers saw the trigger to be as close as possible to insolvency and as long as resolution authorities have sufficient discretion to determine whether the resolution trigger has been met. Contrary to this, one of the exchanges argued that *"the intervention out to be when a FMI shows early signs that it may be a viable business in the short to medium term, taking into account the nature of the business and the stage in its development (e.g. start-ups may need more leeway)"*.

Stakeholders also broadly agree that supervisors should be able to require changes to FMI operations as part of recovery and early intervention efforts, but there should be clarity and transparency on the criteria/circumstance justifying such intervention. Specifically, trade unions would not like to see recovery costs to be incurred by employees.

There is wide agreement on the necessary tools and powers to transfer operations to a competing FMI or a bridge entity, some notable operational constraints (portability of positions, common technical standards) notwithstanding. Banks underlined that non-systemic parts of FMIs should be liquidated and steps should be taken to avoid concentration in the FMI market. CCPs challenge the practicality of solutions based on the transfer of business to another, while CSDs agree that resolution authorities need to have a broad range of resolution tools available to them, but they insisted that such tools should be adapted to their business models and services provided.

On the temporary stay on the exercise of early termination rights, public authorities are broadly in favour, but banks and asset managers expressed concerns to have the temporary stay as a general rule. In their view, the temporary stay might exacerbate a crisis. If it were to be used, strict guidelines would have to apply. Specifically, CCPs highlight that, though useful under certain circumstances, the resolution authority's power to halt payments should not lead to an automatic suspension of all transfers.

Respondents listed predictability, clarity, preciseness, transparency and parity among principles governing loss allocation, but also clarity on the impact on the employees of an entity concerned. Many support effective and proportionate loss allocation tools among non-defaulting members or avoidance of moral hazard on the side of management and shareholders. Contrary to this, asset managers strongly defend to cap liability of clearing members to a pre-determinable amount, and to exclude allocation of losses to non-defaulting parties. Finally, trade unions would like to see employees' prioritized right to salaries and other means of remuneration in cases of failing financial institutions.

Everyone generally agrees on the need for effective cross-border cooperation between relevant authorities, but views diverge somewhat on the role and powers of possible resolution colleges. The role of colleges and cross-border recognition of resolution measures are considered as important. CCPs however emphasize that the coordination between authorities should not jeopardize the prompt implementation of recovery and resolution frameworks in emergency situations, whereas CSDs consider that there should be no more resolution specific cross-border arrangements between national authorities than those provided for normal supervisory tasks.

Banks highlighted that before any recovery and resolution framework is implemented, the rules and regulations for establishing FMIs as well as the rules ensuring the protection of participants assets, portability of assets, and segregation need to be established. In the same vein, banks invite the co-legislators to take into account the new legislation: EMIR[1] and also forthcoming CSD Regulation (CSDR) and Securities Law Legislation which addresses questions related to custody and the transfer of securities. Moreover, banks urge the European Commission to consider conclusions of the CPSS-IOSCO consultative report on recovery and resolution of FMIs, to which banks responded, in order to ensure international consistency.

[1] Regulation on OTC Derivatives, Central Counterparties and Trade Repositories

2. INSURANCE AND REINSURANCE FIRMS

While a wide range of stakeholders provided their views on FMIs, only public institutions and insurers commented in detail on the part of the Consultation dealing with the resolution of insurance and reinsurance firms.

Public institutions, trade unions and consumer bodies generally perceive insurers to give rise to less systemic risk than banks. Many public institutions consider that the traditional tools (run-off, portfolio transfer) work well for traditional insurance business, and observe little need to further harmonise them at EU-level. Still, there is considerable support for developing these and other powers further, notably for larger cross-border groups, especially when they are engaged in a range of non-traditional and non-insurance (NTNI) activities. Trade unions and consumer bodies view that some harmonisation of the resolution framework at the Union level would be beneficial, but should account a specific nature of the industry.

Most however note that Solvency II will considerably enhance supervisors' powers of intervention, and many note that the regulatory responses specific to NTNI activities on a systemic scale should wait for and be informed by the work currently undertaken by the International Association of Insurance Supervisors (IAIS) on policy measures for global systemically relevant insurance institutions (G-SIIs).

Reflecting this, there is general but not unequivocal support for further studying the scope for resolution tools which could protect policyholders as well as financial stability in the event of an insurer's failure. However, responses are not conclusive on whether or not detailed recovery and resolution plans should be prepared and resolution authorities and colleges set up.

Insurers and insurance associations were unanimous in voicing strong concerns on the proposal to develop recovery and resolution measures for the insurance sector and they do not see the rationale for additional measures on top of the current framework which does not appear to have failed. The main criticisms and reasons why the proposal is not needed are the following:

- need to first identify the sources of systemic risk in insurance. The international debate is still open on which activities (mainly non-traditional and non-insurance ones) have the potential for systemic risk in insurance. Hence no measures should be decided upon (including enhanced recovery and resolution) until the scope of application (definition of systemic relevance) is not clearly defined. Moreover, insurers do not provide critical functions essential for the smooth functioning of financial services infrastructure.

- consistency with international developments must be ensured. The result of any anticipation at EU level on the international outcomes could be a different interpretation (of both on systemic risk and on the applicability of the FSB key attributes of effective resolution regimes to insurance[2]) than the global regulators with the risk of creating competitive disadvantages for European insurance undertakings.

- current framework is sufficient: the existing and forthcoming supervisory tools and powers on recovery and resolution (including those envisaged in Solvency II)

[2] Key Attributes of Effective Resolution Regimes for Financial Institutions. October 2011. FSB

are seen by insurers as sufficient and adequate to address recovery and resolution in insurance. Potential gaps may be filled by Member States.

- measures that work for bank do not work for insurance. Insurers fear that the Commission may propose a framework that was originally thought having banks in mind and which would not work for insurance. It is paramount that the features of the insurance business (long-term perspective, funding model, limited interconnectedness, high substitutability) are taken into account when looking at systemic risk and at potential resolution scenarios for insurance. The tools suggested in the consultation paper were felt as already available for supervisors or not fit for insurance. Specifically on bail-in, all respondents failed to see the usefulness of this tool in insurance except one who mentioned that this could be relevant for mutual insurance companies in order to enhance their capital base. On powers, views were mixed, ranging from those who believe that they are already in place to those that think that not all of them are necessary for insurance.

In conclusion, according to insurers, there is no evidence that resolution measures are needed for insurance. Accelerated insolvency is not needed for insurance and the focus should rather be on recovery. Since the latter is already sufficiently covered in existing or forthcoming framework, no additional measures are needed. Some respondents also mentioned that the risk posed to financial stability by non-insurance activities can be effectively managed through enhanced supervision and enhanced risk management and governance requirements (e. g. own risk and solvency assessment in Solvency II).

Along these lines, no respondents favoured the appointment of a resolution authority at EU level and only a few respondents would welcome more harmonization at the Union level. However this should come together or possibly as a follow-up activity to the implementation of Solvency II.

Some respondents from the insurance industry recognised that in relation to cross border groups, due to their potential for increased systemic relevance, coordination may be improved. However, this is already ensured by Directive 2001/17/EC (the Insurance Winding-up Directive) and by the existing supervisory colleges and the increased powers (also on crisis management) that they would have under Solvency II.

Finally, a few respondents suggested that the Commission should start a full analysis of what powers are already available at EU and national level and would like to get more clarity on the next steps on the Commission work on Insurance Guarantee Schemes.

3. OTHER NON-BANK FINANCIAL INSTITUTIONS

Many **public institutions** are strongly in favour of looking further into appropriate recovery and resolution arrangements for payment systems which are not owned, operated or financially guaranteed by central banks. Various respondents also signal that trade repositories, trading venues, hedge funds and money market funds could assume systemic relevance, while noting that the latter (and other activities like repos) would be best looked at under relevant shadow banking work-streams, rather than steps in terms of recovery and resolution.

Investment funds and asset managers argued that they are less likely to have systemic implications. This view is largely based on the likelihood that such institutions may experience financial distress, and on the impact of such distress on financial markets, clients and taxpayers. Therefore, no specific resolution powers are necessary to transfer asset management contracts to a new asset manager, as this type of transition does not create any turbulence in financial markets.

Particularly, the following features would make a resolution regime for asset management industry unnecessary: (1) as an agency business, asset managers trade on behalf of their client and do not use their own on proprietary capital; (2) clients and investor trade bear the full burden of market risk and the associated losses; (3) clients assets are required to be held by a third party depository; (4) there is significant control of liquidity both on an ex ante and ex post level.

In the case of payment systems**,** investment funds and asset managers think that moratorium should only be applied to non-business related items – wider application, even if for a very short period of time, could have catastrophic effects.

Banking community share the view that payment systems, all of them having specific relationship with and being subject to oversight by central banks, currently do not require further consideration on their recovery and resolution. However, they fear that uncontrolled failure of Payment Institutions (PI) and Electronic Money Institutions (EMI) – irrespectively of their size – could trigger a much wider loss of confidence. The banks also emphasized the importance to apply a level playing field.

Trade unions and consumer bodies noted that the emergence of "shadow banks" which did not need to abide by the same rules as banks could create unsound competition between different parts of the sector and also be an incentive to move operations from banks to nonbank financial institution, thus threatening both transparency and financial stability. Therefore they generally support proposals to include nonbanks in order to ensure a level playing field.