



Banc Ceannais na hÉireann  
Central Bank of Ireland

Eurosystem

T +353 1 224 6000 F +353 1 671 6561

Cúirt Uíbh Eachach, Bloc D, Bóthar Fhearchair,  
Baile Átha Cliath 2, Éire.

*Iveagh Court, Block D, Harcourt Road, Dublin 2, Ireland.*

[www.centralbank.ie](http://www.centralbank.ie)

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**The European Commission consultation paper on a possible recovery and  
resolution framework for financial institutions other than banks – Response from the  
Central Bank of Ireland**

Dear Sir/Madam,

The Central Bank of Ireland ("Central Bank") welcomes the opportunity to respond to the European Commission's Consultation Paper on a possible recovery and resolution framework for financial institutions other than banks. We believe that this consultation presents an important opportunity to explore some substantial differences between the failure of a bank and a non-bank and should prompt a fundamental review of issues affecting parties to a failed non-bank financial institution.

Our response to the consultation is set out in the attached document. We would be happy to assist in any follow-up questions which the European Commission may have in relation to the responses which we have provided to the consultation.

Yours faithfully,



Gareth Murphy

**Director of Markets Supervision  
Central Bank of Ireland**



**The European Commission consultation paper on a possible recovery and resolution framework for financial institutions other than banks – Response from the Central Bank of Ireland (“the Central Bank”)**

The Central Bank shares the view that financial markets infrastructure firms (FMIs) provide essential services to market participants and that it is in the public interest that these services are continuously provided even under stressed market conditions. We welcome proposals for a recovery and resolution framework for financial institutions other than banks, and specifically for central clearing counterparties (CCPs) and central securities depositories (CSDs). This response has been framed with the failure of a CCP or CSD in mind. It is structured as follows:

1. What are the objectives of a resolution and recovery regime for FMIs?
2. Why are FMIs different?
3. What parts of European legislation may need to be revisited in order to deliver an appropriate recovery and resolution framework?
4. What tools should be part of the resolution and recovery framework?
5. The importance of sound governance and trigger procedures to operate the recovery and resolution regime.

**What are the objectives of a resolution and recovery regime for FMIs?**

We share the view, agreed by the G20 and the Financial Stability Board, that any effective recovery and resolution framework for non-bank financial institutions should be designed to meet the following objectives:

1. To safeguard financial stability;
2. Ensure the continuity of any critical financial services;
3. Avoid unnecessary destruction of value; and
4. Minimise costs to taxpayers.

We wish to draw the attention of the Commission to the scenario where systemic instability is the trigger of the FMI default, and not vice versa and the necessity that this situation should be adequately provided for in a recovery and resolution framework.



One such scenario, which is entirely plausible in the current economic environment, is the downgrade of a widely used type of collateral, which prompts CCPs to increase haircuts and trigger margin calls to all clearing members (and clients) on all or many outstanding contracts. It is likely that a second round effect would emerge as the downgraded collateral may be heavily sold on the market (to be replaced with more acceptable collateral), further fuelling the margin calls and escalating further fire sale of assets to the detriment of the entire market.

CCPs and CSDs face the risk of a systemic crisis irrespective of how well they manage their risks because they play such a large role in the financial ecosystem. We therefore believe that, regardless of the best efforts of current regulation and supervision, specific FMIs such as CCPs and CSDs can still fail even when they are well administered and well regulated because certain systemic risks are too expensive to mitigate at the level of the FMI.

#### **Why are FMIs different?**

In drafting a robust recovery and resolution framework, the Central Bank suggests that the following characteristics of FMIs should be taken into account:

**A. Inherent vulnerability to systemic risk.** This is due to the extremely high level of risk concentration that FMIs carry for the markets they serve. The example of a collateral downgrade highlights certain risks can have systemic impact on a CCP and yet be very difficult hedge at the level of the CCP;

**B. Difficulty to replace without significant set-up costs and lead-time preparation.** While competition undoubtedly delivers dividends in terms of lower prices to the final users and higher efficiency, it can have unintended implications<sup>1</sup>. In particular we believe that competitive pressures between CCPs will push them to differentiate service offerings in order to attract clients, or at least to segment the market. One of the inevitable consequences is the loss of perfect substitutability/interoperability between competing CCPs which in turn will make the option of porting clients out of a failing CCP less viable. Furthermore, in the event of a systemic shock to all CCPs, porting of clients may not be a viable option. We would therefore suggest limiting the reliance on portability as a recovery and resolution tool and providing a mechanism for the effectiveness of substitutability to be kept under review.

**C. Vulnerability to 'fast-burn' liquidity risk.** The inability to settle in cash may be interpreted by most counterparties as a signal of insolvency and is used as a trigger for

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<sup>1</sup> Duffie and Zhu (2008) show that having more than one CCP servicing a trading venue can (i) lead to collateral inefficiencies and (ii) increase systemic risk. In this instance, the benefits to consumers of competition between reduced fees from competing CCPs may be offset by (i) the increased systemic risk and (ii) the costs incurred in mitigating this risk by the CCPs and regulators. This results in a lack of substitutability between CCPs.





initiating default procedures. Such an event would be a 'fast-burn' default event where the initiation of default procedures by one counterparty could lead to the rapid cancellation of positions and the seizure of collateral.

**D. Inherent differences between FMIs and banks**, in terms of function, business models, and users. It is important to understand that a recovery and resolution framework for banks may not be effective for an FMI. Bank customers have the benefit of deposit protection and there are usually a number of substitute banks to transfer business to. Counterparties to a CCP benefit from other protections, such as certain segregation and portability provisions of EMIR<sup>2</sup>, which lead to a different dynamic in a default scenario.

#### **What parts of European legislation may need to be revisited in order to deliver an appropriate recovery and resolution framework?**

We wish to highlight that the goal of designing a robust resolution regime may not be achievable without material changes to other European legislation and to some well-established legal principles. These include:

1. **Rights of participants to exit from positions** – It is expected that market participants will act in their own best interests to maximise profit and reduce losses. However, during a systemic event, it is precisely this instinct of financial self-preservation that will precipitate the crisis of the FMI and further the losses. We therefore see that the protection of individual property rights might be in contradiction with objective 1 and 3 stated above and that unless managed this could result in a suboptimal outcome for the system. In our opinion, consideration should be given to a resolution framework which may, in certain circumstances, restrict actions of stakeholders during a systemic crisis from enacting behaviours which may undermine the integrity of the financial system.

2. **Forced mutualisation of losses** – The timely settlement of transactions and variation margins is the cornerstone of the process flow of CCPs and CSDs. Failure to pay in full will trigger the counterparties' risk management procedures which will isolate the defaulting agent or counterparty. It may be necessary to force clients to take a loss in order to ensure that the CCP (or CSD) can continue to function and to avoid a systemic collapse. We therefore see

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<sup>2</sup> EMIR Art 39 on segregation and portability specifies that client assets should never be commingled with the clearing member assets and that clients should have the option of full individual segregation; Art 45.4 specifies that "a CCP shall not use the margins posted by non-defaulting clearing members to cover the losses resulting from the default of another clearing member". The combination of these two articles provides clients with a full protection of their assets, in effect placing all resources of the CCP and of other clearing members (through the default fund) behind what amounts to a guarantee for each client.



that objective 2 and objective 4 might not be reflected in EMIR and in the proposed CSDR in terms of risk management in a systemic crisis.

**3. Early intervention and ‘no creditor worse off’ principle** – We support the view that early intervention is an effective tool to achieve Objective 3 and to limit the damages from contagion. However, we are conscious that the damage we are trying to prevent is to the wider system and not necessarily to the creditors and clients of the stressed FMI. We can see inconsistencies between the application of the no creditor worse off principle (which is local in nature and contemplates only the benefit to the creditors and clients of the specific corporate entity, in this case an FMI) and the aforementioned objectives of a resolution and recovery framework for an FMI. Given the systemic nature of the failure of an FMI, it is not clear the optimal outcome for society will coincide with the no FMI-creditors worse off outcome.

#### **What tools should be part of the resolution and recovery framework?**

In addressing both the risk posed by a failing CCP (or a CSD) to the system and the risk posed by systemic shocks to FMIs, we believe that a comprehensive recovery and resolution should comprise of the following tools:

- Stay of creditors’ rights
- Mutualisation of losses
- Public intervention in the form of lender of last resort

In a systemic event scenario, the focus shifts to maintaining continuity of critical services and prevention of contagion. The measure of success is the survival of the FMI since that preserves the system. When all other resources are exhausted, and the effects of a default are not limited to the clients of the distressed firm, resources to fund continuity of services should be collected from the widest relevant stakeholder base possible, to prevent default. Where not viable, the State should intervene, to inject the required liquidity, but these temporary measures should be supported and backed by stakeholders’ assets, in order to avoid long-term liability to the taxpayer. (In the case, the definition of ‘stakeholder’ may be wider than the direct counterparties to the CCP or CSD).

#### **The importances of sound trigger definition and governance procedures to operate the recovery and resolution regime**

The success or failure of a resolution and recovery regime may hinge on when it is triggered. The purpose of the regime is to prevent contagious firesales and liquidations prompted by counterparties’ fear of loss. In this regard the definition of the trigger and governance around the resolution and recovery regime matters.



The Central Bank favours a trigger definition and governance framework that is sufficiently robust and remote from challenge so as to avoid delayed intervention and to protect against legal challenge. We believe that the governance and triggering procedure is one of the biggest challenges faced by the European Commission in drafting an effective recovery and resolution framework and when assessing cost-benefit analysis due consideration should be given to the risk of potential legal claims and legal costs of the proposed framework to FMI stakeholders, the resolution authority and ultimately to the taxpayer.