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Bank of Canada
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Dear Sir/Madam:

**CBA Comments on Bank of Canada consultation on Standard 24 for Designated FMIs (Recovery Plans) and corresponding proposed amendments to the Companion Policy to CSA National Instrument 24-102**

The Canadian Bankers Association[1] (CBA) is pleased to provide its comments on the Bank of Canada's (BoC) consultation on risk management Standard 24 (Recovery Plans) for designated financial market infrastructures (FMIs) and corresponding proposed amendments to the Companion Policy to CSA National Instrument 24-102. Notwithstanding the detailed comments on recovery we are providing below, we would note that some of the foundational requirements have yet to be explicitly addressed. Firstly, appropriate recovery and resolution planning for FMIs must rest on a proper foundation that includes an appropriate capital structure and access to liquidity. This needs to be determined by stress tests using severe, but appropriate, assumptions that are consistent across FMIs. Secondly, the continuous functioning and stability of the financial system cannot be certain without a customized and robust resolution regime, and such a regime is still required in Canada. Such resolution regime should not only cover the take-over of the FMI by the resolution authorities, but also provide a clear plan for funding the FMI in, and potentially prior to, a state of resolution (e.g., Emergency Lending Assistance or direct capital injection from the resolution authorities). Without those cornerstones in place, our comments on the recovery tools lack context and may require revision.

We are encouraged to see that the BoC has incorporated in this draft standard some of the key points made by the CBA in its submission to the CSA and BoC in February 2015 regarding requirements for clearing agencies operating in the Canadian market. These points included recommendations that FMIs adopt recovery tools that are measureable, manageable, controllable, and subject to caps, as well as recommendations that FMIs not adopt destabilizing recovery tools such as involuntary contract tear-up, involuntary contract allocation, and initial margin haircutting.

[1] The Canadian Bankers Association works on behalf of 60 domestic banks, foreign bank subsidiaries and foreign bank branches operating in Canada and their 280,000 employees. The CBA advocates for effective public policies that contribute to a sound, successful banking system that benefits Canadians and Canada's economy. The Association also promotes financial literacy to help Canadians make informed financial decisions and works with banks and law enforcement to help protect customers against financial crime and promote fraud awareness. www.cba.ca.

We have set out our views, concerns, and specific comments on this draft standard below. We have also highlighted other concerns specific to the CSA's amended NI 24-102 at the end of this letter.

**Links Between Standard 24, Canadian FMI Resolution, and Potential Forthcoming International Guidance**

Most jurisdictions are still in the process of developing a recovery and resolution regime for their domestic market infrastructures. As a result, there is no clear global model for the types of actions that could be taken in recovery or resolution of an FMI in crisis. We see a high potential for overlap in the types of actions or tools that could be employed in either FMI recovery or by a resolution authority.

As the issues of FMI recovery and resolution are heavily intertwined, we believe the CBA would be better placed to comment on this draft Standard 24 if the FMI *resolution* framework in Canada were further advanced. While the CBA is supportive of ongoing work by Canadian authorities towards FMI recovery planning, we believe that the proposed Standard 24 may need to be revisited if further CPMI/IOSCO guidance for FMI recovery plans is released, or in light of comments received as the corresponding FMI resolution framework in Canada is developed. As such, we would be pleased to provide additional comments on this standard as more detail on these key aspects of FMI recovery and resolution become available. We would also encourage Canadian authorities to periodically review this standard and make the necessary and appropriate changes to ensure that the standard continually acts in concert with the FMI resolution framework in Canada and international best practices.

**Recovery Plans for Designated FMIs that are Payment or Settlement Infrastructures**

While general recovery principles laid out by Canadian authorities in this draft standard apply to all types of designated FMIs, we find it difficult to envision what recommended recovery tools would apply to non-CCP infrastructures (e.g., payment and securities settlement systems) subject to Bank of Canada oversight. We believe that further description of recovery tools applying to these types of infrastructures is essential, as a recovery situation in such infrastructures (e.g., LVTS) would generate downstream impacts on other designated FMIs such as CCPs. We elaborate on these concerns in the 'Recovery Tools' section of this letter.

**Transparency**

The CBA believes that transparency is essential to the FMI recovery planning process. To this end, FMIs should be required to make their full recovery plans, including triggers for recovery and stress scenario analysis and results, available to members so that members can better measure and manage their exposures and prepare for a potential recovery event. Indeed, we believe that members' ability to predict an FMI's recovery steps and act accordingly in a stress event would contribute to the overall stability of the market.

Should FMIs wish to keep certain parts of their recovery plans confidential, we believe that FMIs should be required to explain and justify to Canadian authorities why such information is not disclosed. In other words, we believe that FMIs should strive to operate on the basis of full transparency to members being the rule rather than the exception.

## The Relevance of the No Creditor Worse Off Safeguard for FMI Recovery

FMI recovery has a number of special considerations – as compared to bank recovery – that arise due to differences in business models, legal structures, and balance sheets.[2] We believe an important difference lies in the relevance of the No Creditor Worse Off (NCWO) safeguard to FMI recovery.

First, whereas NCWO is typically seen as relevant for bank *resolution*, we believe NCWO is fundamental not just to FMI *resolution* but also at the *recovery* stage. We believe this is true because of the substantial ability for an FMI to allocate losses from its failure in recovery; whereas a bank's losses could be allocated outside its ownership if resolution tools were applied by a resolution authority. Such loss allocation must be accompanied by appropriate NCWO protections – similar to those found in bank resolution – to promote a fair allocation of losses and ensure that members are not worse off after being subjected to recovery tools than they would be in FMI liquidation.

Second, FMIs do not typically have "creditors" whose interests must be protected. FMIs are thinly capitalized by their owners, can contribute relatively little to loss allocation, and have little to no debt, relying instead on their membership for financial support. Therefore, it is an FMI's participants who must be the focus of NCWO protections.

Third, unlike NCWO provisions for banks, where the impacts of recovery and resolution actions are weighed against an alternative of resolution, we do not believe liquidation is necessarily the appropriate alternative against which to weigh an FMI's recovery actions. We would suggest, rather, service closure as the appropriate counterfactual in the NCWO calculation for FMIs.

Finally, we see a much broader potential for violating NCWO in FMI recovery and resolution than in bank recovery and resolution. The FMI will have significant discretion in its use of loss allocation tools, many of which have the potential to concentrate losses within a handful of larger participants.

With the above in mind, we believe two conclusions can be drawn:

1. FMIs face an imperative that recovery tools be made inclusive of all types and tiers of participants. Without inclusiveness, those participants who face concentrated loss allocation may be left worse-off in recovery than had contracts been torn-up and replaced outside the FMI.

2. Where inclusiveness cannot be attained, compensation to members who participate in recovery loss allocation is essential. We believe that such compensation could be provided through a residual claim on the estate of a defaulting member, a corresponding reduction in participant fees, and/or an ownership stake in the FMI.

## Objective Criteria to Measure Success of FMI Recovery

Following on the section above, an FMI's use of recovery tools should have a high likelihood of success if their use is to respect the NCWO standard. Furthermore, there may be circumstances under which an FMI cannot justify carrying out certain recovery tools given the corresponding

[2] A recent speech by Andrew Gracie at the Bank of England cogently identifies many of these issues: http://www.bankofengland.co.uk/publications/Documents/speeches/2015/speech871.pdf .

market impact of loss allocation and their low likelihood of success. For example, where a CCP has no reasonable expectation of returning to a matched book or where, more generally, an FMI has lost the confidence of its participants – who in turn seek to exit the FMI, the FMI should not continue to utilize loss allocation tools to their prescribed limits.

The CBA would therefore suggest that FMI recovery plans include criteria that measure the effectiveness of each recovery tool so that both the FMI and Canadian authorities are able to determine whether the recovery process is effective and should continue or whether the FMI should be deemed non-viable and, as a result, move to resolution. We believe the existence of such criteria is particularly important as some FMI members may choose not to participate in, or may be unable to meet their obligations under, any given recovery action. We note that similar criteria for the determination of bank non-viability exist in OSFI's capital adequacy requirements guideline, which may be helpful for developing comparable criteria for FMIs.

**Stress Testing**

While not part of recovery (rather, as part of the FMI's risk management procedures that reduce the likelihood of entering into recovery), we would encourage the BoC to work with global regulators to determine if it would be appropriate to establish minimum stress testing standards and scenarios across CCPs, especially in light of the interconnectedness in membership. And to reiterate, we believe that such stress testing analysis and results should be shared with members as part of the FMI's recovery plan or ongoing disclosure requirements.

**Mandatory Clearing Suspension**

Globally, there is a need to consider the links between mandatory central clearing requirements and the recovery and resolution of CCPs. Notably, authorities should have the ability to suspend clearing mandates for a product in the event of a crisis involving an important CCP that clears that product. As the CSA moves toward mandatory clearing for over-the-counter derivatives in Canada, they should consider events that may lead them to suspend clearing requirements, and ensure that they have the corresponding authority to do so.

Further, Canadian authorities may face the need to implement other temporary measures in support of an FMI that has entered recovery. For example, bank members may require regulatory guidance that allows for the continued treatment of a CCP in recovery as a QCCP, thereby avoiding sudden spikes in bank capital requirements that could frustrate a CCP's efforts to return to a matched book through voluntary contract allocation.

**Recovery Tools**

The CBA supports Canadian authorities' guidance on the characteristics of effective recovery tools including that recovery tools are transparent to participants and that there is fairness in the allocation of uncovered losses and shortfalls. We continue to believe that recovery tools should be applied across all member types/tiers, as noted in the CBA's February 2015 submission, in a manner that is both tailored to each participants' specific membership tier and consistent amongst FMIs. We also agree with the view that "FMIs should avoid uncapped, unpredictable or ill-defined participant exposures…". Further, FMIs should work to develop specific limits/caps for participant exposures in consultation with regulators and follow the rule book in recovery, as acting predictably will improve the chances of market stabilization.

The BoC may also wish to describe further the recommended recovery tools that would apply to non-CCP infrastructures (e.g., payment and settlement systems). Other than cash calls or the provision of liquidity, we find it difficult to interpret how recovery tools would be applied to other types of infrastructures. We believe it is all the more important to develop robust and specific recovery tools for these infrastructures because a recovery event at such infrastructures (e.g., LVTS) is likely to lead to disruption across other FMIs. We believe that proposed tools for payment and settlement infrastructures should be robust enough to mitigate this type of risk.

Lastly, we would also suggest that the draft standard elaborate on how non-critical services should be accounted for in the recovery plan and how these services would be treated during the recovery process.

Cash calls

The CBA suggests that the maximum cumulative value of rounds for mandatory cash calls be limited per default event, and per successive defaults within a period of time (e.g., limited to a number of rounds regardless of number of member defaults within six months). These limits would help members prepare for cash calls in advance and increase the likelihood that activities unfold in a predictable manner throughout a major default event. A longer window before the reset of cash calls (e.g., six months vs. 30 days) would give surviving members more time to stabilize. In addition, we believe that any additional cash calls beyond prescribed limits should be voluntary on the part of the membership.

Variation Margin Gains Haircutting (VMGH)

The CBA believes that VMGH should apply to all tiers of participants (and corresponding customer accounts) if applied by an FMI. Without the ability to fully haircut VM owing, the FMI may find itself with an ineffective tool that impairs its ability to continue operations despite an unmatched book. In addition, similar to cash calls, we believe that a dollar limit (as opposed to a time limit) should be established for the application of VMGH, again to allow members to better prepare for a major default event.

Voluntary contract tear-up

The draft standard recommends that FMIs build incentives for members to participate in voluntary recovery tools; we would suggest that FMIs be required to ensure that such incentives are appropriate and do not lead members to take actions that may be contrary to their own stability. As an example of appropriate incentives, we believe there may be circumstances where it is more desirable for the FMI to break a given portfolio into smaller parts in an auction (i.e. voluntary contract allocation) in order to increase the likelihood for participation.

The CBA notes that it would be difficult or impossible to apply voluntary contract allocation or tear-ups to indirect participants. Indirect participants may not have a direct relationship with the FMI and a direct participant would not be in a position to consent to voluntary loss allocation on behalf of an indirect participant.

Lastly, while we support voluntary contract tear-up as a recovery tool, we would like to ensure that the corresponding accounting/netting and capital criteria are consistent with the Canadian bank capital framework and not inappropriately impacted.

Tools not recommended for recovery plans

The draft standard cites five tools not recommended for recovery plans (unlimited or uncapped cash calls, unlimited rounds of VMGH, involuntary (forced) contract allocation, involuntary (forced) contract tear-up, and the use of non-defaulting participants' initial margin in FMI recovery plans), but also notes that such tools could potentially be used by a resolution authority. Where a tool is not recommended for use in an FMI's recovery plan, we believe it is also inappropriate for use in FMI resolution as the potentially negative impacts of non-recommended tools will only be amplified in a resolution event. In particular, because process and limits for the application of such non recommended tools in resolution would not be described to FMI participants ex-ante (i.e., through the FMI's rules or procedures), the potential for unexpected and potentially unbounded losses to destabilize surviving FMI participants is high.

However, the CBA recognizes that while involuntary (forced) contract tear-up is not recommended as a recovery tool, it may be required as a resolution tool. As such, we would suggest that guidance be provided that the FMI should have rules on how contracts may be torn up, such as by asset class and currency (and avoid cherry-picking by specific counterparty).

The CBA would like to stress again its support for the view in the draft standard that use of non-defaulting participants' initial margin is not a tool recommended for recovery plans. We also support the requirement for any FMIs that include this tool in their recovery plans to provide a strong rationale for doing so and suggest that this point could be further reinforced in the guidance. Should an FMI wish to use this tool as part of the recovery process – regardless of whether the FMI identifies IM haircutting as a potential tool in its recovery plan – we believe the burden of proof should be on the FMI to demonstrate to regulators that its use of IM haircutting is essential, cannot be substituted with another recovery tool, and would not have a negative impact on the broader financial system.

Recovery from non-default-related losses and structural weaknesses

The CBA would encourage Canadian authorities to strengthen the language surrounding the principle that an FMI should rely on FMI-funded resources to address recovery from non-default-related losses. We suggest that the standard explicitly state that shareholders, and not members, should bear all of the non-default-related losses unless members voluntarily contribute (e.g., in exchange for creditor/shareholder rights).

Defining full allocation of uncovered losses and liquidity shortfalls

We would like to understand what planning is contemplated in this section for an FMI's full allocation of both uncovered losses and liquidity shortfalls caused by stress events and question whether this is distinct from the stress testing typically associated with the calibration of an FMI's default fund or contingent liquidity facilities. If so, we fail to see why it would be necessary to account for these scenarios in recovery and/or resolution rather than in the FMI's ongoing risk management.

Legal consideration for full allocation

To the extent that an FMI has conducted a legal analysis of the recovery tools that form part of its recovery plan (including the basis for their inclusion as a recommended/not recommended tool), we believe the associated analysis should be made available to members up to and including naming the external counsel used.

The draft standard suggests that FMIs should consider whether it is appropriate to involve indirect participants *that do not benefit from a customer-protection regime* in the allocation of losses and shortfalls during recovery. We request that this point be further elaborated as we do not see how customer protection considerations come into play in an FMI's choice of loss allocation actions. Customer protection regimes typically provide customers with insulation against the default of a client's clearing member or fellow customers, but not against CCP actions or non-performance.

**Orderly Wind-Down Plan as Part of a Recovery Plan**

We would suggest that FMIs exempted from the requirement to develop an orderly wind-down plan be required to disclose this information to members. In addition, we believe that the principles of defined and limited losses to surviving participants should continue to be observed even if such an exemption is provided.

We also suggest that the standard provide more detail on the role of the orderly wind-down plan as part of a recovery plan and how this plan would differ from the FMI's resolution plan.

**Other Issues (not related to Standard 24)**

We continue to be concerned that the process for recognition or exemption from recognition in CSA jurisdictions requires foreign clearing agencies to interface with multiple Canadian authorities, thereby raising compliance burdens and making it less attractive to serve the Canadian market. However, we appreciate efforts being made to establish a memorandum of understanding among participating CSA jurisdictions that regulate clearing agencies and trade repositories to formalize a modified lead regulator model. Our hope is that a CSA lead regulator model could extend through to the recognition process, allowing foreign infrastructures to establish one ongoing touch point in Canada without loss of regulatory rigour because of CSA cooperation.

We would also like to reiterate our previous comments that CSA members should more explicitly establish an appropriate, and stress-tested, level of clearing agency capital to be dedicated to default loss allocation and suggest that the quantification of an FMI's own capital ("skin in the game") be sized relative to the FMI's risk (e.g., default fund) and not regulatory capital. Stress tests used for sizing of the capital should be appropriate and consistent across the FMIs. Although the establishment of such a requirement would require significant analysis and calibration, we believe it is essential to perform this work. Capital dedicated to loss allocation is an important source of incentives for appropriate clearing agency risk management and we do not believe the existing requirement that "such equity should be significant enough to attract senior management's attention" is sufficient.

We would be pleased to discuss these comments with you at your convenience.

Sincerely,