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Via E-mail

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RE: CLS Bank International Response to the CPSS-IOSCO Consultative Report: Recovery of financial market infrastructures

Ladies and Gentlemen:

CLS Bank International (“CLS”) welcomes the opportunity to share its views on the CPSS-IOSCO Consultative report: *Recovery of financial market infrastructures*, August 2013 (the “Consultative Report”).

CLS is a special purpose corporation, organized under the laws of the United States, established by the private sector as a payment versus payment system to mitigate settlement risk (loss of principal) associated with the settlement of payments relating to foreign exchange transactions (the “CLS System”). As an Edge corporation, CLS is regulated and supervised by the Federal Reserve. In addition, the central banks whose currencies are settled in the CLS System have established a cooperative oversight arrangement for the CLS System (the “CLS Oversight Committee”) as a mechanism for the fulfillment of their responsibilities to promote safety, efficiency, and stability in the local markets and payment systems in which CLS participates. The Federal Reserve organizes and administers the CLS Oversight Committee, which is the primary forum for the participating central banks to carry out their cooperative oversight of CLS, pursuant to a Protocol for the Cooperative Oversight Arrangement of CLS (the “CLS Protocol”).

General Comments

CLS would like to express its broad support for the Consultative Report and its appreciation for the CPSS-IOSCO's guidance for financial market infrastructures ("FMIs") on the development of their recovery plans. CLS recognizes that the failure of the CLS System could result in systemic disruptions in the financial markets and that recovery planning to prevent such an occurrence is an important aspect of its risk management framework. For this reason, CLS agrees with the Consultative Report's emphasis on ensuring the continuity of services provided by FMIs and confirms that the continuity of its settlement service is at the core of its risk management and recovery planning efforts. Consultative Report, 2.1.2.¹

Specific Comments

Guidance Should Respect the Differences among FMIs

The Consultative Report acknowledges that there are a range of FMIs that engage in diverse activities such as clearing, recording, and settling of financial transactions, and that the levels and types of risk accompanying each FMI differs substantially. Consultative Report, 1.2.1; 2.4.2 . Given these differences, it is evident that the guidance contains some statements that are not equally relevant to all FMIs.² However, CLS believes that it is critical that the final guidance adequately emphasizes key themes that are relevant to all FMIs, such as protection for their rules and participant agreements, which underpin the services they provide. The guidance should be clear for example, that an FMI's *ex ante* agreements, including provisions with regard to loss allocation, are enforceable at all times and in all circumstances, notwithstanding the application of any recovery tools.

In addition to respecting each FMI's *ex ante* agreements, the final guidance should clarify that the authorities and the FMI itself should not disturb existing corporate governance arrangements (which will be different for different types of FMIs because of national law, ownership structure, or organizational form), notwithstanding the application of recovery tools. The Consultative Report describes several tools related to corporate governance such as the replacement of management or escalation to an FMI's senior management or board of directors if certain trigger events occur. Consultative Report, 2.4.6; 2.4.11. An FMI may need to make changes, *ex ante*, to its corporate governance arrangements to incorporate these measures (Consultative Report, 2.3.3), but if a recovery plan were implemented, for the sake of stability and predictability, agreed corporate

¹ CLS also supports the International Institute of Finance's joint comment letter on the Consultative Report and the Financial Stability Board's ("FSB") Consultative Document: *Application of the Key Attributes of Effective Resolution Regimes to Non-Bank Financial Institutions* (August 2013) (the "FSB Consultative Document").

² For example, certain sections of the Consultative Report discuss types of default mechanisms and waterfalls that are not relevant to all FMIs (e.g., the Consultative Report discusses an FMI's "pre-funded" resources; however, CLS does not have pre-funded resources, and loss allocation is the first line of defense if in the remote event market fluctuations result in uncovered losses for CLS). Consultative Report, 2.2.1.

governance arrangements and applicable corporate law should be respected by the FMI and its regulators.

Only the FMI Should Implement Recovery Measures

The Consultative Report provides that “recovery is defined as the actions of an FMI,” Consultative Report, 1.1.1, and CLS agrees that the types of tools proposed by the Consultative Report are appropriate for deployment by the FMI (whereas resolution tools, such as a transfer of the FMI to a bridge institution, are appropriately deployed by resolution authorities). Consultative Report 1.1.1; 1.1.6; 2.1.2; 2.3.3; 2.4.7-2.4.14. This approach is consistent with other regulatory guidance on resolution and recovery regimes for FMIs.³

In order to ensure that FMIs have the appropriate independence to implement their recovery plans, and that the boundary between recovery and resolution is clearly drawn, CLS has several recommendations. First, in order to clarify that only the FMI itself has the power to implement recovery tools, section 2.5.7 of the Consultative Report should be amended so that it is consistent with section 1.1 and other regulatory guidance in this area, which puts regulators at the helm of an FMI in a *resolution* scenario, rather than a recovery scenario.⁴

Second, in order to maintain clear boundaries between recovery and resolution, authorities across jurisdictions should coordinate triggers for resolution so that they are consistent and so that an FMI can deploy its various recovery tools without triggering resolution proceedings in some jurisdictions and not others. Consultative Report, 1.1.1; 2.3.5; 2.5.6. Resolution should only be triggered if the FMI cannot operate and the protection of a resolution authority or regime is necessary to effect an orderly wind-down, or upon an insolvency or creditor action where a stay or other legal protection may be warranted to protect the FMI’s critical services.⁵

Finally, in order to ensure that the FMI can implement its recovery tools as necessary without inconsistent direction, authorities should facilitate coordination among supervisors and regulators. It is highly preferable for the FMI’s primary supervisor or regulator to function as its authority in recovery planning and its primary liaison if it were to implement its recovery plan. For internationally

³ See FSB, *Key Attributes of Effective Resolution Regimes for Financial Institutions* (October 2011), at section 1.6; CPSS-IOSCO’s Consultative Report: *Recovery and resolution of financial market infrastructures*, (July 2012) (the “CPSS-IOSCO 2012 Consultative Report”), section 2.3; see also European Commission’s Consultation: *a Possible Recovery and Resolution Framework for Financial Institutions Other than Banks* (October 2012) (the “EC Consultation”), at 5, FN 6; see also CPSS-IOSCO’s *Principles for financial market infrastructures* (April 2012) (“PFMIs”), Responsibility B (“primary responsibility for ensuring an FMI’s safety and efficiency lies with the system’s owners and operator.”).

⁴ See the FSB Consultative Document, at sections 3.3 and 3.4; CPSS-IOSCO 2012 Consultative Report, section 2.6; EC Consultation, at 5, FN 6.

⁵ CLS plans to comment further on resolution regimes for FMIs in a separate letter addressing the FSB’s Consultative Document.

active FMIs, the supervisor or regulator may also have protocols in place with other regulators already providing for cooperative oversight (e.g., the CLS Protocol). Communications regarding an FMI's recovery plan or the use of its recovery tools should be conducted in accordance with such protocols. In some cases, these protocols may require revision to reflect evolving recovery and resolution regimes for FMIs.

Risk Management and Recovery

The Consultative Report provides clear guidance on the types of scenarios that should be addressed in an FMI's recovery plan (i.e., those scenarios resulting in uncovered credit loss, liquidity shortfall, or capital inadequacy, as well as any business, operational or structural weakness that such stresses may reveal). Consultative Report, 2.2.1. CLS takes the view that certain scenarios that could lead to an FMI's failure to provide services may have already been mitigated by its business continuity plans ("BCP") or by its default management procedures and therefore should not be addressed in its recovery plan. Other scenarios, however, are addressed in the FMI's BCP and/or default management procedures, but still could result in uncovered losses under extreme circumstances and therefore may be included in the recovery plan along with descriptions of the corresponding existing BCP and/or default management procedures.

Wind-Down Planning

CLS agrees that in some cases the orderly wind-down of a systemically important FMI may be inappropriate, particularly where a viable alternative to using that particular FMI does not exist. Consultative Report, 2.2.2. However, there may be instances where disintermediation or substantial competition has affected such an FMI's business model and unique position in the market, and orderly wind-down of the FMI's business may become warranted, assuming a wind-down will not jeopardize the smooth functioning of the financial market ("feasible wind-down conditions"). CLS does not disagree that an FMI must take into account the viability of its business and accordingly should undertake comprehensive recovery planning. However, CLS contends that in certain cases, basic wind-down planning addressing primarily a wind-down in feasible wind-down conditions, is appropriate. A wind-down may also require the use of insolvency proceedings that prioritize the protection of creditors as opposed to continuity of the FMI's services. Outside of feasible wind-down conditions, a resolution which preserves the FMI's critical functions is likely to be preferable to a wind-down.

Determination of Critical Services

The Consultative Report provides that the FMI should "identify those services it provides that are critical," Consultative Report, 2.4.2, and that "critical" refers to the importance of the service to the FMI's participants and other FMIs, and to the smooth functioning of the markets and financial

stability.⁶ If an FMI provides services ancillary to its critical services, judgment will be required as to whether those ancillary services are critical. These determinations will need to be described in the FMI's recovery plan, but in light of the fact that continuation of a non-critical service may have little or no impact on the FMI's costs or its ability to recover, CLS assumes that the FMI will maintain the right to exercise judgment as to whether or not it will continue such ancillary service. CLS also assumes that the bases and tools for making such judgments need not be set forth in the FMI's recovery plan or encompassed in the recovery planning process.

Use of Third-Party Vendors

The Consultative Report recognizes that there may be scenarios where the FMI has made a determination to rely upon an independent service provider and where the FMI may or may not have a long-term strategy for mitigating that reliance. Consultative Report, 2.4.3. The Consultative Report does not provide recovery tools to be deployed if a critical third party service provider is unwilling or unable to provide its services. CLS proposes that such dependencies be addressed in a recovery plan that describes the controls around the service provider relationship and any initiative in place to reduce reliance on such provider over time.

Comments on Recovery Tools

Unless a recovery plan is actually implemented, neither an FMI nor its regulators can be certain that it would be effective due to unknown factors that may exist in the future. For this reason, CLS suggests changing the requirement that a recovery plan or individual recovery tools be "effective" to "credible." Consultative Report, 2.3.2; 3.3.2.

The Consultative Report also poses questions as to the balance between the automatic application of recovery tools and discretion by the FMI as to whether and when to use such tools. Consultative Report, 2.3.6; 2.3.7. FMIs should have discretion as to when recovery tools are implemented but for the sake of clarity should not have the right (and neither should the authorities) to disturb *ex ante* agreements as to how losses will be divided among participants. By making this clear, participants can properly assess the risks they take in participating in the FMI and rely upon those assessments.

Role of the FMI's Assets in Loss Allocation

Unlike CCPs, payment systems do not maintain pools of assets and do not guarantee the settlement of, or become parties to, transactions among participants. Payment systems' principal assets comprise (i) the tools and infrastructure to operate the system and maintain the business, (ii) a capital cushion that is required by PFMI 15 and is intended for use only in the event of an orderly wind-down, and (iii) a limited amount of credit and liquidity risk capital. Accordingly, a payment system's assets are likely to have a limited impact upon residual losses resulting from a participant default. Therefore, these assets should instead be used to preserve the payment system's critical services and should

⁶ CLS also agrees with the Consultative Report that its payment and settlement functions are critical. Consultative Report, 2.4.2.

not form a part of the system's "default waterfall."

Tools to Allocate Uncovered Losses Caused by Participant Default

The Consultative Report emphasizes the ability of an FMI to allocate "losses in full." Consultative Report, 2.3.5.⁷ It further clarifies that "[r]ecovery plans should be formulated on the *presumption* that *any* stress can be met by the FMI's, its owners', and its participants' own resources and allocation of exposures." Consultative Report, 2.3.1 (emphasis added). CLS appreciates that it must not only *allocate* losses "in full," but it must allocate losses so that that cash calls (or assessments) on participants are likely to be met. Consultative Report, 3.5.4. When participants are called upon to provide cash for losses (as opposed, for example, to having claims reduced), they may default due to a misalignment of interests or a lack of ability/liquidity. The FMI will need to exercise judgment as to when it can presume that its tools are reliable and that stakeholders that are contractually subject to allocations will meet them. Consultative Report, 3.3.12; 3.3.13; 3.3.14. In this regard, it may also be beneficial for regulators to encourage direct participation in FMIs whenever such participation is practical and permissible in accordance with the FMI's rules, so that losses can be mutualized among a larger group, thus reducing the systemic impact of a defaulting participant and the size of cash calls generally (assuming losses are shared *pro rata*), should they occur. Consultative Report, 3.3.12.

The Consultative Report also highlights that "[i]t may be less feasible to establish binding tools *ex ante* in the case . . . where the recovery plans involve third parties that are not subject to the FMI's rules or arrangements."⁸ Consultative Report, 2.3.4. If this issue cannot be fully addressed in all cases by encouraging direct participation, direct participants (under the supervision of their regulators) should consider either allocating losses to indirect participants in accordance with the risks faced by the direct participant and attributable to that indirect participant, or at least pricing this risk appropriately. This approach is consistent with PFMI 19, which encourages each FMI to understand and address risks introduced to its systems by indirect participants but which requests direct participants to consider and manage these risks.⁹

⁷ CLS supports the position that potential losses to participants should not be unlimited, but adds that losses may be unquantifiable or uncontrollable. Consultative Report, 3.5.3.

⁸ The Consultative Report states, "there may be benefits to allocating losses to those who have chosen roles that are consistent with absorbing such losses." Consultative Report, 3.3.6. CLS assumes that the reference to "those who have chosen roles consistent with absorbing such losses" refers to direct participants and any other stakeholder that has agreed contractually to absorb losses.

⁹ PFMI, Explanatory Note 3.19.8 ("[t]iered participation arrangements typically create credit and liquidity exposures between direct and indirect participants. The management of these exposures is the responsibility of the participants and, where appropriate, subject to supervision by their regulators.").

Uncovered Liquidity Shortfalls

In times of market stress when market prices fluctuate and can drop considerably, uncovered liquidity shortfalls can rapidly become uncovered credit losses. An FMI's recovery tools should take into account that liquidity shortfalls may accompany reductions in asset prices. Consultative Report, 3.2.1; 3.2.3. Additionally, there is value in having arrangements in place with third-party institutions to address uncovered liquidity shortfalls (and CLS maintains such commitments), although these arrangements may be less reliable in highly stressed environments, as they depend upon performance by the third party. Consultative Report, 3.6.2. Rather than solely relying on third parties, uncovered liquidity shortfalls may require participants to accept settlement in a different form (such as a payment in a different currency) if other tools applicable to uncovered liquidity shortfalls are unavailable.

Recapitalization

If an FMI depletes its loss absorption and allocation capacity, it will require tools to replenish its financial resources. Consultative Report, 3.3.3; 3.3.4; 3.8.3. However, if an FMI or the market as a whole has experienced distress or sudden losses, the FMI may face considerable challenges in its efforts to raise additional capital. Even *ex ante* agreements to provide capital (either debt or equity) typically provide, as a prerequisite, that the business of the recipient is stable. While *ex ante* agreements for optional contributions are certainly possible (Consultative Report, 3.8.5), because of their non-binding nature they cannot be considered a reliable recovery tool and do not alleviate the concern that parties with no obligation to do so will refuse to provide funding to a distressed FMI.

Additionally, although recapitalization may in theory address a one-off business-related loss such as an adverse judgment, in practice a one-off loss that exceeds the capital held by the FMI may be better addressed in a reorganization proceeding, where a stay will protect the FMI while it reaches an agreement with its creditors. This is particularly true for an FMI such as a payment system that has few assets but has value as a going concern.

Another approach to the recapitalization question would be to rely on participants to cover losses on the basis that they are incentivized to maintain the FMI's core services because of their reliance upon them. Consultative Report 3.3.3; 3.8.3. CLS agrees that loss allocation is an effective way to manage and neutralize losses from a participant default, and would add that the allocation of losses among participants may be appropriate for losses other than those arising from a participant default (e.g., losses from an adverse legal judgment). Consultative Report, 2.4.9. CLS's rules, for example, already require loss allocation in limited circumstances unrelated to participant defaults.

Explicit Insurance or Indemnities Agreements

The value of insurance and indemnity agreements as tools for an FMI's recovery is very limited. While insurance agreements can provide protection against narrow types of losses, it is unlikely that an FMI will be able to obtain insurance to cover losses from participant defaults or a general slowdown of its business — two key scenarios that could trigger recovery measures. Successfully



asserting claims on insurance policies can also be a litigious and slow process, and therefore even if the FMI were covered by insurance, insurance payments may not be available to satisfy real-time capital deficiencies. Consultative Report, 3.8.7.

The use of indemnities as a recovery tool presents many of the same challenges; collection may take time and considerable effort. Additionally, if CLS were to seek indemnities from stakeholders, it would face the challenges already described in this letter with respect to convincing stakeholders to agree *ex ante* to absorb the FMI's losses should they occur. Consultative Report, 3.8.9.

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We would welcome the opportunity to discuss any of these comments in further detail.

Sincerely,

A handwritten signature in blue ink that reads 'David W. Puth'. The signature is fluid and cursive.

David W. Puth

CC: Alan Marquard, Chief Legal Officer, CLS Group
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