

Comments on

ESMA - Consultation Paper ESMA/2016/732 Guidelines on participant default rules and procedures under CSDR

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The **German Banking Industry Committee** is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks, the Bundesverband deutscher Banken (BdB), for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public banks, the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks finance group, and the Verband deutscher Pfandbriefbanken (vdp), for the Pfandbrief banks. Collectively, they represent approximately 1,700 banks.

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The German Banking Industry Committee (**GBIC**) is the joint committee operated by the central associations of the German banking industry. These associations are the Association of German Banks (Bundesverband deutscher Banken, BdB), for the private commercial banks, the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public banks, the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks finance group, and the Verband deutscher Pfandbriefbanken (vdp), for the Pfandbrief banks. Collectively, they represent approximately 1,700 banks.

Q1: Do you consider other stakeholders should be involved in the definition of the default rules and procedures of a CSD? If so, which ones, and what should be the level of their involvement?

GBIC believes that it is essential to involve CSD participants (participants) in the preparation of such procedures. Although the CSD should first develop and propose its participant default rules and procedures, taking into account relevance and efficiency, and should determine which type of stakeholders are to be involved, the involvement of the user committee according to **Art. 28 CSDR** is indispensable. CSD participants can include banks, other CSDs and CCPs.

Furthermore, the resolution authorities of the respective participants should be involved in the definition of the default rules and procedures. Any plan for a default procedure will have to be approved by the supervisory authorities of the CSD, the participants, as well as the respective resolution authorities. It should be borne in mind that, in the event of a participant's default, the responsible authority will take over the administration of that participant and could decide to keep that participant's business running.

We suggest clarification in the final guidelines to the effect that the default procedures also apply to CSDs or CCPs as defaulting participants. Specific procedures may be required in such a case.

Additionally, we would like to emphasize that uniform default rules and procedures should exist for a commonly used settlement platform in a cross-border context in order to ensure harmonized application of the rules in case of an insolvency affecting participants and CSDs in different countries. We would therefore like to point to the discussions among the T2S CSDs in connection with the so-called T2S collective agreement. The collective agreement takes into account operational and legal requirements for the insolvency of participants in a domestic and in a cross-border context. Particularly the default rules and procedures of a CSD which has signed the collective agreement should reflect its provisions.

Finally, we would like to make ESMA aware of the fact that a default of a T2S payment bank may also impact a CSD and its participants although such a payment bank does not have a securities account and is thus not a CSD participant. A default of a T2S payment bank could cause difficulties, since a participant using such payment bank would be left with no funding in T2S, which would impact the participant's ability to settle purchase instructions. Consideration should therefore be given to the CSD default rules and procedures taking into account the potential default of a T2S payment bank and the consequences thereof.

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Q2: Do you think that such acknowledgement process is appropriate? In particular, do you consider it necessary for the CSD to verify the information regarding the default with the designated authority under the SFD before the CSD can take any action, or should the CSD be able to start taking actions based on its reasonable assessment of the participant's situation and on the reliability of the source that informed the CSD in the first place?

GBIC agrees with ESMA's proposal that the participant itself or its designated authority under Directive 98/26/EC (Settlement Finality Directive [SFD]) (i.e. its resolution authority or other designated authority according to Art. 6 (2) SFD) should notify the CSD about the default. Such notification should take place in a timely manner in order to minimize any risks for the CSD and its other participants.

We are, however, sceptical about the proposal that default procedures can be triggered on the basis of information about a (potential) default from sources other than the above-mentioned. Any mistake could result in **fatal consequences** for the participant concerned and harbours the risk of systemic contagion. We therefore believe that notification of default should be sent **only** by the defaulting participant or the designated authority according to Art. 6 (2) SFD. This would go hand in hand with the fact that the CSD could trust the notification received and would thus not be required to verify the information on default. Consequently, the process described in paragraph 17 of the consultation paper could also be omitted.

GBIC believes that the acknowledgement process should be closely aligned to the rules on the recovery and resolution of banks and/or FMIs, since the management of a participant's default will also follow these requirements. Particularly the opening of default proceedings is not dependent on a participant's decision but on the ruling of its resolution authority or a court. As a result, it seems appropriate to base the notification process on the respective authority proceedings.

In a real-time settlement engine, the exact time of receipt of notification of default should be recorded. There may be a time-gap between the time of the court/resolution authority declaration of the default and the receipt of such notification by the CSD. However, such a situation is addressed in the SFD and based on the settlement finality rules of the respective CSD – transactions still settle between the time the default is declared and the CSD receives that information according to the process set out in Art. 6 SFD.

It should, however, be taken into account that different results might occur if the resolution decision is taken by an authority outside the EU or concerns participants which are not within the scope of the SFD or Directive 2014/59/EU (BRRD). In this case, it might be prudent to include other sources, though this could mean lengthened settlement processes that could move assets out of the reach of an administrator. Taking stock of the risks and consequences when relying on incorrect information, we would like to suggest to ESMA that best practices with other (non-EU) regulators should be developed in order to ensure swift and reliable communication of information for notification of a participant's default.

With regard to the types of information listed in paragraph 18 of the consultation paper, we would like to comment as follows:

a. Para. 18, indent 4:

"The number of clients concerned" – it is unclear if the requirement means the defaulting participant's clients or the CSD's clients. We assume that this means the CSD's clients, which would be the other non-defaulting CSD participants that are directly affected by the defaulting participant's default. Clarification

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would be beneficial to avoid any misunderstandings. In order to estimate the risk from a supervisory perspective, it seems, moreover, prudent to indicate not only the number of non-defaulting, directly affected participants but also all open transactions.

b. Para. 18, indent 5:

"Information on any risks such default might entail" – further clarification is required, as the current requirement is vague and open to interpretation.

c. Timeframe and communication channels

GBIC believes it is important to include a timeframe in paragraph 18 within which the CSD should transmit the information to its competent authority through whatever communication channels.

Q3: Do you consider that the actions listed are appropriate or that other actions should be listed? Should certain actions be mandatory, depending for instance on the type or size of default, the characteristics of the participant or the CSD or any other criteria?

We partly disagree with the proposed guidelines: we are in disagreement regarding the actions described in paragraph 19 (a) and (b). Under certain circumstances, it might be prudent to **suspend** a defaulting participant (para. 19 (a)) for a short period of time in order to assess and understand the consequences of that participant's default. However, we believe that such decision can only be made in cooperation with the designated resolution authority handling the respective default.

We believe that a suspension could negatively affect an orderly recovery or resolution process if assets based on existing trading contracts could no longer be settled or moved (especially if under the supervision of an administrator). This is particularly true when the assets are used for risk-divesting purposes. At a transaction level, the guidelines should take into consideration the different steps in settlement finality that any transaction goes through from the moment it is entered into the settlement system (settlement finality 1 (SF1)), via the binding matching of the transaction (settlement finality 2 (SF2)), to the final and irrevocable settlement of the transaction (settlement finality 3 (SF3)). While transactions in SF1 could still be cancelled unilaterally, transactions with SF2 status could only be cancelled bilaterally and would hence require the agreement of the trading party.

With regard to client business conducted by the defaulting participant (custody business), this should under no circumstances suffer from termination or suspension of that participant's access to the CSD. Taking into account the safeguards in place under MiFID/ CSDR, it is ensured that only client assets would be delivered. Therefore, there is no need to suspend or terminate the defaulting participant's access. Otherwise the defaulting participant would be prevented from earning additional income in order to pay potential claims and, even worse, it would significantly hurt client business conducted by the defaulting participant, which would no longer be able to deliver/receive traded securities and would thus be subject to buy-in and penalty procedures under the CSDR. We therefore believe it is of the utmost importance that transactions resulting from a participant's client portfolio can continue to move to non-defaulting participants.

Furthermore, we disagree with the possible action of **termination** of a defaulting participant's access to the CSD (para. 19 (b)), which should only be possible **after full resolution** of the defaulting participant due to the above-mentioned negative effects and consequences. Consideration may, however, be given

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to putting all or some of the defaulting participant's transactions temporarily "on hold" in order to allow the designated authority or respective administrator to take over immediate control of the pending transactions.

Immediate "termination" of access by the defaulting participant could also ignore a situation where the default of that participant can be 'waived' by the court or designated authority, i.e. such participant would be considered to be no longer in default. GBIC believes that the CSD default procedures should take such a situation into consideration. In addition, 'cherry picking' should be avoided by, for instance, blocking liquid securities or cash which could frustrate the proper performance of the participant's existing obligations towards other counterparties.

Finally, the guidelines should take into consideration that in some countries CSDs may also need to have specific procedures in place for so-called "indirect participants" i.e. clients of a participant acting as a custodian for such client which is itself expressly identified by the CSD¹. GBIC believes that rules and procedures on the potential default of indirect participants could help the direct participants to safeguard their business without impacting other clients of the direct participant.

The other actions listed are considered appropriate, bearing in mind that the CSD should adapt its measures listed on a case-by-case basis in accordance with the respective resolution plans of the defaulting participant. None of the actions, however, should be mandatory; they should be subject to the decision of the CSD's executive board and depend on the specific circumstances of the participant's default.

GBIC has, however, concerns regarding the proposed actions in para. 19 (c) to (f) in relation to specific transactions to which the defaulting participant is a party and for which the parties to the transaction have agreed on the consequences of the participant's default. Typically, this would be the case for repurchase agreements (repos), for example. The potential actions taken by the CSD should not interfere with the contractually agreed remedies of the parties to the affected transaction.

GBIC believes that it will not be possible to foresee and pre-define all possible consequences of the measures applied (as required by paragraph 20).

Q4: Do you think other items should be included in the internal plans?

We believe that the proposed items are reasonable and that they should be part of the licensing process. Moreover, we believe that such plans should be reviewed periodically, as the legal framework may change over time.

In our opinion, there is no need to include any additional items. However, we believe that the criteria for actions to be applied should rather have a general framework in order to enable the CSD to be flexible where appropriate.

Furthermore, it should be clarified that all non-defaulting participants which are **not directly affected** by the default are not within the scope of paragraph 23. Non-defaulting participants are not liable for other

¹ Cf. also Article 2, point (g) SFD.

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defaulting participants and have therefore no role to play in the default procedures unless they are directly affected by the defaulting participant's default (e.g. through pending transactions).

Q5: Do you think that information on the implementation of the default rules and procedures should be transmitted to other stakeholders? If so, which other stakeholders?

GBIC generally considers the list appropriate.

Additionally, it might be worth taking into account "an infrastructure to which the CSD has outsourced the processing of its business" (cf. Art. 30 and 31 CSDR). As this would obviously be applicable to the T2S settlement platform, an alignment process between participating CSDs would be desirable. Transmission of information to the T2S operator could also be worth considering. Furthermore, as CSDs may be operating on the central bank accounts of their participants, we believe that central banks should also be part of the discussion.

We question whether information on the implementation of the default measures should be directly transmitted to stakeholders which are not directly affected by the default (e.g. non-defaulting participants without any pending transactions with the defaulting participant). The CSD should instead be required to develop appropriate information tools like, for instance, bulletins or other publicly accessible messages to notify other stakeholders.

Should the competent authorities wish to be systematically informed of the implemented measures, the scope of actions has to be determined as well as the reporting frequency.

We have reservations about paragraph 26, as a CSD should be able to implement default actions in accordance with the applicable recovery and resolution plans without informing (or even obtaining approval from) its competent authority **beforehand**.

Q6: Do you think that such testing and reviewing processes are appropriate?

GBIC believes that testing makes sense in principle but should definitely also involve the relevant authorities managing the default.

We believe that the testing and reviewing processes as described are appropriate. It should, however, be clarified that no stakeholders other than those mentioned above and in paragraph 31 of the consultation paper are to be involved. The CSD should have the flexibility to define the participants in the tests in accordance with the stakeholders assigned to the default rules and procedures.