# Department of Finance Reveals Resolution Regime for Financial Market Infrastructures

**April 30, 2019**

The Department of Finance Canada has recently released its proposed regulations to the *Payment Clearing and Settlement Act* (PCSA) (the Proposed Regulations) that, together with the amendments to the PCSA pursuant to the *Budget Implementation Act, 2018, No. 1* (the PCSA Amendments), will establish a resolution regime in the event of failure of designated financial market infrastructures (FMIs) that are deemed systemically important.[1] FMIs are also referred to in the PCSA as "clearing and settlement systems" or "clearing houses".

Significant adverse effects on the functioning of the financial system and economic activity in Canada could result from the failure of an FMI. As the backbone of the financial system, the failure of an FMI could put a stop to payments and securities and derivatives transactions. The resolution regime would ensure that, in the unlikely event of a failure of a designated FMI, the critical services of the FMI are maintained, financial stability is promoted and the potential exposure of public funds to loss is minimized.

## The PCSA Amendments

FMIs are systems that facilitate the clearing, settling or recording of virtually all payments, securities, derivatives or other financial transactions among participating entities.

The PCSA Amendments give the Bank of Canada (the Bank) the power to declare an FMI as non-viable, take control of and resolve an FMI in a manner that achieves the objectives of the regime and recover the costs associated with operationalizing the resolution process. The Bank would have various powers and tools to take timely actions to achieve the following outcomes:

- continue to provide the FMI's critical payment clearing and settlement services to its participants;
- facilitate the timely settlement of obligations of the FMI;
- allocate any losses that have not yet been covered; and
- replenish the FMI's resources to meet its regulatory requirements.

# The Proposed Regulations

The Proposed Regulations provide further details of the resolution regime implemented in the PCSA Amendments, including the Bank's ability to recover costs associated with the resolution process and the compensation accessible to participants in the event of the resolution of an FMI.

### Limited Clearing Members

Limited Clearing Members (LCMs) are participants in certain designated clearing and settlement systems that, under the rules of the system, are: (i) not required to contribute to a default fund; (ii) not required to absorb losses arising from the default of another participant (other than a certain type of reduction in an LCM's variation margin gains); and (iii) subject to additional initial margin requirements. LCMs are subject to modified risk controls for default management and recovery, which are designed to ensure that LCMs do not participate in arrangements that mutualize any losses that arise from the default of another participant in the clearing and settlement system.

### Cost Recovery of the Resolution Process

The Proposed Regulations provide the Bank with the ability to recover costs associated with operationalizing the resolution process from clearing houses and participants. A special rule in the resolution regime applies to LCMs, which limits the costs the Bank can recover from LCMs based on certain factors.

### Compensation for Participants

The Proposed Regulations prescribe the persons or entities eligible to access compensation in the event of the resolution of an FMI: creditors, shareholders or participants of the FMI.

# Rationale of the Resolution Regime

Implementation of the resolution regime is an important component of the package of financial sector regulatory reforms endorsed by G20 leaders to address the underlying causes of the 2008 global financial crisis. The resolution regime achieves these goals by:

- *Enhancing financial stability* — The resolution regime allows the FMI undergoing the resolution process to continue to provide critical services and minimize disruptions for participants and the public in the event of a crisis.
- *Reducing government exposure* — In the absence of a resolution regime, if an FMI becomes non-viable, it would either be wound down through existing corporate bankruptcy procedures or rescued through a public bailout. This could in effect reduce the incentives for FMIs and their participants to appropriately manage their risks, which could potentially create significant cost to taxpayers.
- *Lowering costs for businesses* — Because the Bank will absorb any costs associated with the preparation of an FMI resolution within its existing resources, there are no anticipated compliance or administrative costs for businesses.

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[1] The FMIs designated as systemically important are the Large Value Transfer System, the CDSX, the Canadian Derivatives Clearing Services, CLS Bank and SwapClear.

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