BNY MELLON

The Bank of New York Mellon – London Branch
One Canada Square
London E14 5AL
United Kingdom

T +44 (0)20 7570 1784

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European Banking Authority
Floor 46
One Canada Square
London E14 5AA

(submitted via EBA website)

Re: CONSULTATION PAPER (EBA/CP/2014/27)
Draft Guidelines on payment commitments under Directive 2014/49/EU on deposit guarantee schemes

Introduction

BNY Mellon is a global investments company dedicated to helping its clients manage and service their financial assets throughout the investment lifecycle. As one of the world's largest investment services and investment management firms, BNY Mellon welcomes the opportunity to respond to the EBA Consultation Paper (*EBA/CP/2014/27*) in respect of Draft Guidelines on payment commitments under Directive 2014/49/EU on deposit guarantee schemes.

BNY Mellon operates in Europe through: (i) branches of The Bank of New York Mellon (a New York incorporated financial institution) and (ii) directly established and duly authorised subsidiaries established in several EU jurisdictions and branches of those entities operating in most of the core EU member states. It provides services to clients and end-users of financial services globally. It is accordingly keenly interested to ensure financial markets operate fairly and consistently globally and that common standards ensure playing fields are kept level.

Our interest in this consultation paper is in our role as a custodian and collateral manager, for which we can provide some useful insights, whilst the EBA finalises its guidance.

Executive Summary

BNY Mellon is broadly supportive of the EBA's proposals in this Consultation Paper. In particular, the proposals envisage a significant role for custodians (or to be more precise, collateral managers) in the context of Financial Collateral Arrangements. It is this aspect that BNY Mellon is most interested in, as BNY Mellon provides collateral management services, that may enable credit institutions and DGSs to meet the requirements associated with the utilisation of payment commitments as envisaged under this Consultation Paper.

The key points that BNY Mellon makes are:

- We agree that the Low Risk Assets should be segregated from the assets of the custodian/collateral manager.

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- The expression “full segregation” requires clarification:
  - If “full segregation” is intended to mean that the interest of the particular credit institution or DGS must be noted at each sub-custodian or CSD (ie, throughout the custody chain), then we do not support this interpretation.
  - We believe such interpretation is operationally unworkable for triparty collateral management; nor is it necessary from a legal perspective.
  - We believe that such an approach is unworkable from an operational perspective in the context of collateral management (especially triparty collateral management), because beneficial ownership of collateral may change frequently (including intra-day) and it is not feasible for records to be constantly updated and synchronised at every level in the chain of custody.
  - Nor is this required from a legal perspective, as an omnibus account structure higher up the custody chain is fully effective from a legal perspective and safeguards the interests of the ultimate beneficial owner of the asset.
  - The ability to use omnibus account structures higher up the custody chain should be preserved.
  - If “full segregation” is intended to mean that in the books of the custodian/collateral manager, the Low Risk Assets are segregated from the assets of the custodian/collateral manager and from the assets of other clients of the custodian/collateral manager, and that higher up the custody chain there is segregation in the books of any securities account provider between the client and the proprietary assets of the securities account provider including through the use of omnibus account structures, then we support this interpretation.

- The usual (limited) security interests and rights of collateral managers should be maintained:
  - We agree that there should be no right of disposal of the assets in favour of the custodian. We understand that the Low Risk Assets are the property of the credit institution, but are to be held in favour of the DGSs as collateral to support the Payment Commitment Amount, in the event of a failure of a credit institution and the DGS needs to pay out.
  - A custodian/collateral manager would typically retain a security interest in the unallocated assets held by the custodian/collateral manager, on behalf of the credit institution (in this case), to cover unpaid fees, expenses and any extensions of credit by the custodian/collateral manager to the credit institution. Please note that credit extensions are generally restricted to “operational/settlement” credit purposes.
  - Such an interest would not be applied over the assets allocated in favour of the DGS, but would only be applied over the excess inventory that a credit institution leaves with the collateral manager (triparty agent) to cover collateral substitutions and margin calls.
  - In summary, the custodian/collateral manager would agree to taking no security interest in the assets of the credit institution which were allocated to the DGS to cover the Payment Commitment Amount

- Therefore the usual security interests and rights of collateral managers (over securities that have not been allocated to the DGS) should not be considered to be a "third party right" in the context of the DGSD or the Guidelines.

Responses to Specific Questions

BNY Mellon is responding to the EBA using the electronic response form on the EBA website. However, for convenience, our responses are also contained in this document in Annex 1 below.

We suggest some drafting amendments to the Guidelines in Annex 2 below.

BNY Mellon looks forward to further engagement with the EBA in regard to this Consultation Paper and other consultation papers relating to BRRD and DGSD. In particular, should the EBA be interested in having BNY Mellon provide a presentation on collateral management services and how these can support the objectives of this Consultation Paper, please contact the writer and we would be pleased to arrange such a presentation.

Veronica Iommi
EMEA Head of Public Policy
Office of Public Policy and Regulatory Affairs
Legal Department
BNY Mellon

ANNEX 1 – Responses to Specific Questions

Q2: Do you agree with these provisions to be included in Payment Commitment Arrangements? Do you think other provisions should be provided?

BNY Mellon is generally supportive of the requirements set out in Part 2 of the draft Guidelines. We have the following additional observations and recommendations.

Given the complexity of collateral management and the need to ensure that collateral is controlled by an independent third party to protect the interests of the credit institution and the DGSs, our strong view is that it is essential for the security of the DGSs that the collateral manager and custodian be able to hold the collateral in a sound and secure legal and operational environment. See our answer to Question 5 for more details on this point.

We recommend that paragraph 11(e) of the Draft Guidelines is amended to reflect that:

- one or more Financial Collateral Arrangements may support a Payment Commitment Arrangement;
- a custodian/collateral manager may be a party to a Financial Collateral Arrangement as defined (for example, the custodian will be a party to a triparty collateral management agreement, in addition to the credit institution and the DGS); and
- for the purposes of the Guidelines, the usual rights and security interests of a custodian or intermediary should not be considered to be a "third-party right" (for the reasons described in our Executive Summary).

We suggest some drafting in Annex 2.

Q4: Do you agree with the option left to the DGS to enter into a Security Financial Collateral Arrangement (full ownership remains with the credit institution) or a Title Transfer Financial Collateral Arrangement (full transfer of ownership)?

BNY Mellon is supportive of the option left to the DGS to enter into a Security Financial Collateral Arrangement or a Title Transfer Financial Collateral Arrangement, ie, both options should be available.

However, our view is that Title Transfer is a far preferable means for the management of collateral where there is an effective interposition of a triparty collateral manager. This is a specialist activity that involves collateral eligibility monitoring within agreed guidelines, intraday and daily marketing to market, margin calls, concentration limit management, processing of collateral substitutions requested by the credit institution (within collateral guidelines agreed between the DGSs and credit institutions) and substitutions necessary to process and protect corporate events such as dividends and rights issues.

The triparty collateral manager model is a specialised business which facilitates groups such as "credit institutions" delivering eligible collateral to the collateral manager, in excess of the Payment Commitment Amount. The excess is held in what we term the "Dealer Box" (which is a custody account established for the collateral provider and from which allocations of collateral are allocated), and would only be allocated to the DGSs or the secured party under precise terms such as eligibility requirements, margin calls and substitutions. Otherwise the excess collateral remained held for the collateral provider by the collateral manager in the Dealer Box, and because of its ready availability, margin calls and substitutions can be processed immediately without the standard “bilateral” market settlement timeframes which may involve days of delays, with all of the attendant risks of such an arrangement. In particular, the triparty collateral manager model enables continuous intra-day movements of collateral, thus optimising the allocation of collateral.

We refer to our answer for Question 2, where we state that one or more Financial Collateral Arrangements may support a Payment Commitment Arrangement, so there should be flexibility in this regard.

In regard to Part 3 of the draft Guidelines, we would recommend that paragraph 12(b) is amended to enable the credit institution to dispose of the collateral with the prior consent of the DGS. We have suggested some drafting in Annex 2.

Q5: Do you think other requirements about the choice of the custodians should be provided under these guidelines?

As addressed in our response to Question 4, we believe that for something as significantly important to the stability of the financial markets in times of market or credit institution failure, it is essential that an organisation is appointed which is capable of adequately protecting collateral and correctly administering the process of release of the collateral to the DGSs, for example. We believe that the criteria for the choice of a custodian/collateral manager should be primarily based on considerations of legal protection and service.

In regard to Part 4 of the draft Guidelines, BNY Mellon recommends a number of changes to paragraphs 14 and 15. We have suggested some drafting in Annex 2.

We recommend that the draft Guidelines are amended to clarify that the collateral manager/custodian should not be a related entity to the credit institution providing the collateral. This is in order to reduce correlation between the circumstances of the credit institution and the custodian. We think this is an appropriate additional requirement.

We recommend that paragraph 15 is amended so that the expression “full segregation” is not used. Instead, we propose some alternative drafting in Annex 2.

We do not support any interpretation that requires “full segregation” throughout the chain of custody, if this means that the interest of the particular credit institution or DGS must be noted at higher levels in the custody chain, such as each sub-custodian or CSD. We believe that such an approach is unworkable from an operational perspective in the context of collateral management (especially triparty collateral management), because beneficial ownership of collateral may change frequently (including intra-day) and it is not feasible for records to be constantly updated and synchronised at every level in the chain of custody. Nor is this required from a legal perspective, as the omnibus account structure is fully effective from a legal perspective and safeguards the interests of the ultimate beneficial owner of the asset. The ability to use omnibus account structures should be preserved. BNY Mellon can provide the EBA with more detailed information on the “full segregation” issues, should the EBA think this will be helpful.

We recommend that paragraph 14(a) is amended to refer to “record” rather than “information”, as it is not the role of the custodian to provide “information” which could have a broader interpretation than “records”.

As stated elsewhere in this response, the collateral manager’s/custodian’s usual rights and securities interests should be maintained, and therefore we recommend some amendments to paragraphs 14(a) and 14(b) of the draft Guidance.

Q6: Do you agree on the requirements suggested for the eligibility of collateral? Would you suggest other limits on concentration in exposures?

The point raised in (19) is critically important, in that any failure on the part of the DGS to develop a robust and risk protective collateral schedule, will have implications for the DGS and its beneficiaries. In that respect, the definition of the Low-Risk Assets will need to be cognisant of asset type, currency, concentration, liquidity and correlation risk.

In respect of point (20) and (21), we would suggest that if smaller institutions are unable to support the collateral diversity and exposure limits anticipated by the DGSs, that the haircut applied to their collateral contribution be higher than that for the larger institutions, who are able to support the diversity and exposure requirements.

In regard to Part 5 of the draft Guidelines, BNY Mellon recommends that the drafting is amended in order to maintain the collateral manager’s/custodian’s usual rights and security interests in unallocated collateral when providing custody and collateral management services. We have suggested some drafting in Annex 2.

We believe the policy intent is for the Low-Risk Assets to be unencumbered at the point in time they are placed into custody, and for such Low-Risk Assets that are allocated to the DGS to be made available to the DGS upon request; but not to override the usual rights and security interests that a collateral manager/custodian has in regard to unallocated (excess) collateral, when performing custody and collateral management services.

Q9: Do you agree with the criteria on the eligibility of the collateral provided in this Part 6? Do you think other requirements should be provided in these guidelines on this issue?

Our responses above address this question, in particular Question 6. Also, we would emphasise that it is important to distinguish between Low-Risk Assets that are allocated to the DGS, versus the unallocated (excess) collateral which are not allocated to the DGS at that time, but can be allocated to it in future. The collateral manager should have a security interest in the unallocated collateral, but not in the collateral allocated to the DGS.

Q10: Do you agree with the criteria on the haircut provided in this Part 7? Do you think there are other requirements which should be provided under these guidelines about this issue?

We agree with the direction of the comments in this section. However, we would strongly advocate that policy in terms of marking to market be established in order to provide the highest standards of care for the DGSs. In times of crisis, collateral values may move significantly and the need for additional collateral based on intraday marking may be a valuable protection for the DGSs.

ANNEX 2 – Suggested Drafting

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5. For the purpose of these Guidelines the following definitions apply:

i. “Payment Commitments” has the same meaning as set out in point (13) of Article 2(1), of the DGSD, i.e. payment commitments of a credit institution towards a DGS which are fully collateralised providing that the collateral: (i) consists of Low-Risk Assets; (ii) is unencumbered by any third-party rights and is at the disposal of the DGS**. For the purposes of these Guidelines, the security interests of a collateral manager, custodian or intermediary in unallocated (excess) assets, in order to secure the obligations of the credit institution to the collateral manager, custodian or intermediary in regard to unpaid fees, expenses or credit extensions, are not considered to be “third-party rights”**;

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vii. “Financial Collateral Arrangement” means a **T**itle **T**ransfer **F**inancial **C**ollateral **A**rrangement or a **S**ecurity **F**inancial **C**ollateral **A**rrangement;

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Part 2 – The Payment Commitment Arrangement

10. The admissibility of Payment Commitments should be conditional upon the conclusion of individual written Payment Commitment Arrangements between the DGSs and their member institutions. The Payment Commitment Arrangement may be concluded each year, or included into a master arrangement that is amended or supplemented each year to take into account new calls for ex ante contributions.

11. The Payment Commitment Arrangement should at least include the following elements:

a) The Payment Commitment Amount;

b) The irrevocable obligation for the credit institution to make the promised cash payment of the Payment Commitment Amount at any time, upon simple and unconditional request of the DGS, without undue delay and at any rate no later than 2 working days from the receipt of the notice pursuant to letter (c) below. Such payment period is reduced to 1 working day in case early intervention or crisis management measures are applied on the credit institution by the competent or resolution authority. The arrangement should preclude any reduction in the Payment Commitment Amount, or any termination of the Payment Commitment Arrangement, without the consent of the DGS.

c) The provision of a notice by the DGS to the credit institution by any effective means of communication ensuring receipt, whenever the DGS claims the cash payment of the Payment Commitment Amount;

d) The obligation for the credit institution to immediately communicate to the DGS any event affecting the institution’s ability to honour its obligations, or the DGS’s ability to enforce its rights, under the Payment Commitment Arrangement or the Financial Collateral Arrangement, including the institution’s downgrades by external credit rating agencies and any material prudential or business changes or any deterioration in the value of the Low-Risk Assets provided as collateral;

e) The conclusion of **one or more Financial Collateral Arrangements** between the DGS**,** the credit institution**, and if applicable any collateral manager or custodian,** securing the obligations undertaken by the credit institution in the Payment Commitment Arrangement, by way of provision by the credit institution to the DGS of Low-Risk Assets collateral, that are unencumbered by any third-party rights and are put at the disposal of the DGS. **For the purposes of these Guidelines, the security interests of a collateral manager, custodian or intermediary in unallocated (excess) assets, in order to secure the obligations of the credit institution to the collateral manager, custodian or intermediary in regard to unpaid fees, expenses or credit extensions, are not considered to be "third-party rights".**

Part 3 – The Financial Collateral Arrangement

12. In order to safeguard the DGS's creditor position, a Financial Collateral Arrangement should explicitly include the following contractual terms:

a) The credit institution undertakes to substitute the Low-Risk Assets provided as collateral when they fall due, when they no longer comply with the requirements laid down in Part 6 and 7 of these Guidelines or in other specific cases agreed upon with the DGS, so that the Payment Commitment is permanently secured by appropriate collateral;

b) In case of Security Financial Collateral Arrangement, the credit institution is not allowed to dispose of the collateral (e.g. sale, encumbrance) **without the prior consent of the DGS**;

c) The credit institution is required to top up the Low-Risk Assets provided as collateral upon request of the DGS, in the event the value of the underlying collateral asset, after the haircut provided for in Part 7 of these Guidelines, or in consideration of the applicable exchange rate in case of cash collateral, falls below **the** Payment Commitment Amount;

d) The provision of Enforcement Events as defined in Title I, para. 5, point (viii) of these Guidelines. Pursuant to point (ii) of such definition, the obligation of the credit institution to pay the Payment Commitment Amount is accelerated so as to be immediately due, at least when:

> (i) The credit institution fails to replace the Low-Risk Assets provided as collateral when they fall due, when they no longer comply with the requirements laid down in Part 6 or Part 7 of these Guidelines, or in the other specific cases agreed upon with the DGS;
>
> (ii) The credit institution fails to top up its collateral when required to do so by the DGS, in the event of a breach of the coverage level, as laid down in Part 7 of these Guidelines;
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> (iii) The authorisation of the credit institution is withdrawn;
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> (iv) The credit institution is no longer a member of DGS;
>
> (v) The credit institution is subject to reorganisation measures other than early intervention or crisis management measures, or is being wound up.

e) At the occurrence of an Enforcement Event, the DGS should realise or appropriate the Low-Risk Assets provided as collateral in accordance with the terms of the Financial Collateral Arrangement;

f) The DGS should release and return the Low-Risk Asset collateral upon cash payment by the credit institution of the Payment Commitment Amount.

Part 4 - Delivery of the collateral by the collateral provider to the DGS

13. Under the Financial Collateral Arrangement, the DGS should ensure that the credit institution delivers the Low-Risk Assets to the DGS in accordance with one of the modalities provided in the Financial Collateral Directive as applicable, so that the Low Risk Assets are in the possession or under the control of the DGS.

14. Such delivery by the credit institution to the DGS should be fulfilled by means of crediting the collateral as follows:

a. In the case of a Security Financial Collateral Arrangement, the Low Risk Assets provided as collateral should be credited on a securities account (i) maintained with custodians or intermediaries, identified by the designated authority or by the DGS, that are able to provide complete, accurate and up to date **records** regarding both the credit institution and the Low-Risk Assets and (ii) held by the DGS [[*BNY Mellon comment: query whether in a Security Financial Collateral Arrangement, the assets are "held by the DGS"*]] specifically and destined to the registration of Low-Risk Assets provided by credit institutions in fulfilment of the Payment Commitments. The designated authority or DGS should ensure that **collateral managers and** custodians are not allowed to dispose of the Low-Risk Assets provided as collateral **which are allocated to the DGS** and that they have contractually waived any retention right or right of pledge they may otherwise have over **such** Low-Risk Assets. **For the avoidance of doubt, the collateral manager/custodian may retain a security interest in unallocated (excess) assets held by the collateral manager/custodian on behalf of the credit institution, to cover unpaid fees, expenses and any extensions of credit provided by the collateral manager/custodian to the credit institution.**

b. In the case of a title transfer financial collateral arrangement, a transfer to the DGS on a securities or cash account held by the DGS specifically destined to the registration of Low-Risk Assets provided by credit institution in fulfilment of the Payment Commitments. If a DGS is entitled to receive cash deposits from members, the cash collateral may be provided directly to the DGS by the credit institution. The designated authority or DGS should ensure that **collateral managers and** custodians are not allowed to dispose of the Low-Risk Assets provided as collateral **which are allocated to the DGS** and that they have contractually waived any retention right or right of pledge they may otherwise have over **such** Low-Risk Assets. **For the avoidance of doubt, the collateral manager/custodian may retain a security interest in unallocated (excess) assets held by the collateral manager/custodian on behalf of the credit institution, to cover unpaid fees, expenses and any extensions of credit provided by the collateral manager/custodian to the credit institution.**

15. For the purpose of a Security Financial Collateral Arrangement, DGSs or designated authorities should only accept **a custodian that segregates the Low-Risk Assets provided as collateral from the custodian's own assets in such a way that the Low-Risk Assets can at any time be clearly identified in the books of the custodian as belonging to clients of the custodian (ie, the credit institution or the DGS),** and enable the DGSs' prompt access to the **Low-Risk Assets** upon request. This in order to prevent any losses to the credit institution or to the DGS due to the default or insolvency of the custodian. **Furthermore, DGSs or designated authorities should only accept a custodian that is not a related entity to the credit institution providing the collateral, to reduce correlation between the circumstances of the credit institution and the custodian.**

Part 5 – Criteria to assess the inexistence of third party rights to the collateral

16. Point (13) of Article 2(1) of the DGSD provides that the collateral must be unencumbered by any third party right. Accordingly the DGSs and the designated authorities should not accept any Low-Risk Assets which are already encumbered or collateralised by means of pledge or other security arrangements. **For the avoidance of doubt, the collateral manager/custodian may retain a security interest in unallocated (excess) assets held by the collateral manager/custodian on behalf of the credit institution, to cover unpaid fees, expenses and any extensions of credit provided by the collateral manager/custodian to the credit institution.**

17. The assets provided under a Financial Collateral Arrangement must be legally realisable without prior claim over the assets concerned. It should not be possible for third parties **(with the exception of the collateral manager, custodian or intermediary, in respect of unallocated (excess) collateral, and pursuant to the Financial Collateral Arrangement)** to intervene and successfully claim the assets pledged or any rights attached to them.

18. For that purpose the DGS should require under the Financial Collateral Arrangement that credit institutions warrant that no Low-Risk Asset provided as collateral is being simultaneously encumbered or used as collateral to the benefit of any third party **(with the exception of the collateral manager, custodian or intermediary, in respect of unallocated (excess) collateral, and pursuant to the Financial Collateral Arrangement)** or to secure another already existing obligation towards the DGS, and undertake that no asset used under the Security Financial Collateral Arrangement is given as collateral to any third party.

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