European Association of Co-operative Banks
Groupement Européen des Banques Coopératives
Europäische Vereinigung der Genossenschaftsbanken

COMMENTS ON

THE CESR-ESCB STANDARDS FOR SECURITIES CLEARING AND SETTLEMENT SYSTEMS IN THE EU

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PREFACE

The European Association of Co-operative Banks (EACB) is one of the main associations of the European credit industry. Its core objective lies in defending the professional interests of its members.

The association represents one of the leading banking groups in Europe. Its membership base of more than 30 organizations comprises co-operative banking groups from the 15 European Union Member States, but also from Central and Eastern European countries. These represent 37 million Members, 101 million customers, 505,000 employees in more than 50,000 business points and deposits of about EUR 1,209,000 million.

The activities of the EACB's members are mainly focused on their respective national or regional markets. Even where they are identified as having an international dimension, they are nonetheless groups of that are composed of medium-sized or small-scale institutions. Co-operative banks are among the leading providers of capital to small businesses and private customers in Europe.

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GENERAL REMARKS

The members of the EACB support the idea to provide regulators, supervisors and overseers with a European-wide framework for clearing and settlement systems in order to enhance the safety, soundness and efficiency of securities clearing and settlement, to avoid systemic risks and to build confidence in the markets by providing strong and reliable rules.

However, it is not clear how the CESR-ESCB standards could fit into the existing system of mandatory EU law that lays down binding rules for market participants. The standards address regulators, supervisory authorities and overseers, but it is left open whether or not they are to create immediate obligations or rights for undertakings.

We therefore see a strong need for clarification as regards the character of these standards.

There is already European legislation in place that deals with some clearing and settlement aspects, such as the Investment Services Directive (93/22/EC), the Directive on settlement finality in payment and securities settlement systems (98/26/EC) and the EU Banking Directive (2000/12/EC).

A duplication of rules has to be avoided in order to provide legal certainty. The CESR-ESCB standards should not aim at complementing existing European legislation, but be integrated into the EU's legal system. Undertakings should not be obliged to follow different sets of rules from different European regulators.

Therefore, the CESR-ESCB standards should have no legal force, but be implemented by the relevant legislator, preferably at the European level, through appropriate arrangements. Only these implementing arrangements should create binding obligations for undertakings.

PAPER 1: THE SCOPE OF APPLICATION OF THE CESR-ESCB STANDARDS

Question 1:

The members of the EACB think that the essentials of clearing and settlement operations require a binding legislative framework. Such framework should include all entities involved in the settlement process.

However, the applicable standards must be carefully differentiated depending on the character of the entity in question (CSDs, ICSDs, CCPs and custodians). The differences in legal status, structure, risk potential and competitive situation would need to be reflected clearly: whereas CSDs, ICSDs and CCPs are market utilities and often in a (de facto or de jure) monopoly position, custodian banks are selected by their customers and therefore acting in a very competitive environment. The word "central" in the abbreviations of CSD, ICSD and CCPs already emphasizes this specific role. And while custodian banks are designed to deal with counterparty risk, CSDs should not be exposed to such risk at all.

As regards ICSDs, who take counterparty risk in their banking business and at the same time act as "notaries", who should avoid any risk (see standard 6), we suggest that the specific regulatory framework for each business should apply and that a clear separation between the two different activities be made.

Custodians, as well as "custodians operating systematically important systems" are already subject to a clear European-wide legal basis for their activities under the directive 93/22/EC (Investment Services Directive (ISD)), which will certainly be updated by the new ISD. Exposures linked to settlement activities are covered by the EU Banking Directive (2000/12/EC) and will be regulated even more detailed in the future, according to the European Commission's draft document on "Capital Requirements for Banks and Investment Firms" (see article 102). Furthermore, the upcoming CAD 3 will also tackle the issues of operational risk related to custodianship from different angles (see annexes H-2, H-3, I).

Accordingly, local custodian banks are already supervised by different authorities and by external auditors.

Custodians will nevertheless be affected by the standards through their direct links with CSDs and ICSDs because custodian banks have no other choice than to use a CSD or ICSD for settlement/custody of securities.

The inclusion of custodians under the CESR-ESCB standards should not lead to a duplication of rules. The proposed standards should therefore mainly focus on CCPs, CSDs, ICSDs and not on custodians.

Questions 2/3

Systemically important providers of securities could be regarded as such if they have a monopoly in the market for custody services, meaning there is no choice between different custody service providers (e.g. global custodians).

We recommend that clearing and settlement infrastructures should be regulated in a European Directive soon. Therein, CCPs and CSDs (and ICSDs) should be regulated tightly to protect their core mission as market utilities.

Question 8

As we think that the standards should not focus on custodians, we do not want to make any of the standards applicable to them.

PAPER 2: STANDARDS FOR SECURITIES CLEARING AND SETTLEMENT SYSTEMS IN THE EUROPEAN UNION

Standard 1: Legal Framework

The members of the EACB think that the essentials of clearing and settlement operations should be regulated through a legislative framework.

Where obligations for any undertakings are intended, the CESR-ESCB standards should have no legal force but require implementation through the relevant legislation, preferably at European level.

We therefore suggest adding the following wording to the key elements:

"The CESR-ESCB standards have no legal force. The authorities, preferably at the European level, will take steps to implement them through statutory arrangements, which are best suited to the relevant systems, European or national."

A duplication of rules has to be avoided and the CESR-ESCB standards should not lead to a fragmentation of European legislation.

It might be appropriate to lay down, in a specific piece of legislation, as a minimum, some very fundamental principles that apply to all parties involved in post-trade-activities. Such piece of legislation should clearly differentiate between CSDs, ICSDs, CCPs and custodians and reflect their particularities regarding legal status, structure, risk potential and competitive situation.

But there is already European legislation in place that deals with some clearing and settlement aspects: Custodians, as well as "custodians operating systematically important systems" are already subject to a clear European-wide legal basis for their activities under the directives 93/22/EC (Investment Services Directive (ISD)) and 2000/12/EC (Banking Directive). Under the new ISD and the upcoming CAD 3 these rules will be extended. Where the progress and the developments of the financial markets so require, these rules can be updated quite easily.

On the other hand, there certainly is a lack of harmonized legislation regarding the supervision and prudential management of CSDs, ICSDs and CCPs. Binding European legislation should be put in place, e.g. by a revision of the Directive 98/26/EC on securities settlement systems.

As regards ICSDs, who take counterparty risk in their banking business and at the same time act as "notaries", who should avoid any risk (see standard 6), we suggest that the specific regulatory framework for each business should apply and that a clear separation between the two different activities be made.

Moreover, key element 2 needs to be clarified as follows: *„as a general matter... public and accessible to the market."*.

The obligation under key element 5 will require a closer definition because it seems too far-reaching that the system operator should identify any conflicts of law "for each aspect of the clearing and settlement process" prior to cross-border transactions.

Standard 2: Trade confirmation and settlement matching

There are two different ways of interpreting "trade confirmation": it could be understood in the context of securities settlement systems, in which case the time period could be different in every given system (which needs to be clarified). But it could also be understood as confirmation to market parties.

Instead of determining "trade confirmation" by standards that have to be surveyed by supervisory authorities and which may be inflexible, such terms should rather be laid down in a self-regulating convention by the relevant industry bodies (which would have to cover markets European-wide). This would allow setting up confirmation deadlines that fully meet the needs of the relevant market. On the other hand, general rules imposed by law may not achieve this due to their general character.

We therefore suggest introducing the following wording in the key elements 5/6: *"This issue should be regulated through conventions of market counter parties (self-regulation)".*

Standard 3: Settlement cycles

As already mentioned with regard to standard 2, processing of settlement cycles should be tackled according to the needs of the market and therefore regulated through conventions of the concerned market counter parties.

Furthermore, the market in question needs to be clarified: does the standard only apply to regulated markets or also to internalisation and MTFs? If the aim of this standard is to avoid operation risks, the standard has to look at the needs and characteristics of the market and not only at the systems.

We also think that a distinction needs to be made between harmonisation by way of standardisation in the field of stock exchange dealings, and harmonisation in the OTC business. In the latter definitely no harmonisation should occur. Here, freely negotiable settlement cycles are appropriate and are fit for purpose. We also suggest covering only certain product groups (shares, bonds, derivatives) by the harmonisation efforts.

Regarding this standard, again, we see no need to include custodians as addressees. The responsibility for compliance with the settlement cycles primarily lies with the operators of trading systems, the clearing agencies (CCP) and with the central settlement agency assigned by the market. The system users, regardless of their relevance for the overall market, need to comply with the market rules laid down by the system operators and therefore do not need to be subjected to such a standard.

Standard 4: Central Counterparties (CCPs)

-Cost-benefit-analysis

We welcome that the implementation of central counterparties is accompanied by an evaluation of the cost-benefit ratio.

The benefit of a CCP also needs to be viewed against the background of the general goal of shorter settlement cycles. The shorter the settlement cycle is, the lower will be the benefit that the involvement of a central counter party may add in terms of risk management.

It is only in this context that standard 4 should address market participants.

-Appropriate risk-control management

Standard 4 sets forth a general clause for supervision. This general clause should apply to all CCPs in a uniform way and therefore should be regulated by a specific directive. The key elements 3-6 will have to be further developed in such a “Clearing & Settlement Directive”.

The setting up of “corporate governance” rules within entities that mix activities is not sufficient.

We suggest clarifying that, as regards the supervisory aspects, only CCPs should fall into the scope of standard 4.

Concerning the explanations and possibilities listed for CCP risk mitigation, we would welcome if the last sentence in paragraph 63 on page 31 would not only refer to the possibility of using central bank money but even promote such use of central bank money as a specific requirement. Hence, the last sentence should be drafted as follows: "*However the CCP should avoid these counterparty and concentration risks ~~do not materialise if the CCP uses~~ by using the central bank for money settlement... "*

In this context, it is of crucial importance to grant free access to central bank money at equal conditions both for domestic and foreign system participants alike in order to create a level playing field in the area of securities settlement. From the point of view of the market participants, the goal is to keep only one central bank account as cash account for the settlement of securities transactions within the EU.

Standard 5: Securities lending

In contrast to the IOSCO-Recommendations, the CESR-ESCB standard emphasizes in no. 75 "the benefit of establishing centralized securities lending facilities", although no. 70 leaves the choice of whether to introduce a centralized lending facility or not to each market. The standard should have a neutral position with regard to this question of structural importance for the market. We prefer the IOSCO-Recommendations in this respect.

Especially regarding securities lending, the role of the different types of entities should be carved out clearly. For custodians, securities lending is a tool both to ensure the delivery of securities and to provide an important risk mitigator to reduce the supervisory charges for exposures to customers. The CSDs are providing the back-up services for these activities and should not take any counterparty risk.

Item 8 should be clarified as follows: "*In no case ~~should~~ can debit balances nor the creation of securities ~~securities creation~~ be allowed. Client's asset ~~should~~ may be used only with an explicit consent. "*

In the further deliberations of this standard, the uncommon term *securities creation* should be explained the way that securities lending may only be performed by means of existing securities and not be carried out by artificial creation of securities.

Furthermore, we propose amending the 'Key Elements' under item 1 on page 32 as follows:

"....including CSD's, CCP's and principals to centralised securities lending arrangements ~~custodians operating systemically important systems~~. "

Concerning the standard's scope of application, it is essential that all entities providing central lending systems be covered hereunder whenever the potential counterparties do not know each other. This is the only instance where it is justified to impose specific requirements in order to offset potential risk resulting from such a scenario. We do not consider necessary such provisions for securities lending transactions of the credit institutions in bilateral relations with the customer.

Furthermore it has to be underlined that there is no need that a bank has to "fully collateralise its lending exposure" (para. 74) since it is subjected to the EU Banking Directive and therefore is designed to deal with counterparty risk.

Standard 6: Central securities depositories (CSDs)

A clear legal framework is needed to regulate CSD's activities. This should be done through a European directive, which will foresee legally binding rules for all CSDs in a uniform way. But this regulatory framework will have to clearly distinguish between activities of CSDs, which are market utilities with a user's governance and the banking activities, which are competition driven. The CSDs have to be governed with the aim to share investments in order to reduce transaction costs.

With regard to the important tasks of CSDs, there is a need for high standards, i.e. any systemic risk and any instability of the market have to be avoided. CSDs should not take any liquidity, market or counterparty risk, but be obliged to exclude systemic risk an reduce operational risk to a minimum. Therefore we suggest amending standard 6 as follows:

"In order to ~~minimise~~ <u>exclude</u> systemic risks, CSDs should avoid taking risks to the greatest practicable extent".

It is crucial to clearly define and separate the activities of CSDs, which are central market utilities from the customer related activities of investment firms. The setting up of "corporate governance" rules within entities that mix activities is not sufficient.

Thus, as regards ICSDs, who take counterparty risk in their banking business and at the same time act as "notaries", who should avoid any risk (see standard 6), we suggest that the specific regulatory framework for each business should apply and that a clear separation between the two different activities be made.

Standard 7: Delivery versus payment (DVP)

There are numerous forms of DVPs and it seems advisable to seek harmonisation, in particular achieve a interoperability regarding trans-border activities. The harmonisation of DVPs would significantly contribute to the progress of market integration.

This standard should only address CSDs.

We therefore suggest the following amendments on page 40, 'Key Elements':

"1. This standard is addressed to CSDs ~~and custodians that operate systemically important systems~~. (...)

3. All securities transactions against cash at the level of CSDs ~~and~~ ~~systemically important systems~~ should actually be settled on a DVP basis only."

Standard 8: Timing of settlement finality

The wording under item 2 should be strengthened, i.e. by changing '*has to*' into '*should*'.

This standard is meant to make reference to the necessary compatibility with the opening days of TARGET. Like in the foregoing text, we feel it is necessary to declare these opening days as a 'benchmark' only because we explicitly advocate against any national special regimes presently existing under the TARGET system. A harmonisation to the benefit of all market participants can only be achieved in the absence of special regimes. A corresponding amendment is recommended for paragraphs 96 (page 44) and 103 (page 46).

From our point of view, the original intention behind standard 7 and 8 apparently was only to address CSDs in their specific function for the respective market. Accordingly on page 43, 'Key Elements' item 1 should be amended as follows: *"This standard is addressed to CSDs ~~and custodians that operate systemically important systems~~."*

Standard 9: Risk controls in systemically important systems

Standard 9 would cause an unnecessary overlap of rules. It would also impact negatively on the shortage and cost of collateral as well as the reduction of cash liquidity for the market.

Standard 9 requires full collateralisation when an operator of a systemically important system grants credit to one of its customers. However, when this client is granted a credit for financing the acquisition of securities, the risk exposure of the bank is regulated by strict solvency controls under current prudential regulation.

If all "systematically important" clearing and settlement systems have to fulfil full collateralisation, this could result in pooling the entire liquidity in securities and cash in the ICSDs systems due to the fact that they are acting as national CSDs and ICSDs. Every clearing and settlement system, for instance a global custodian, a settlement bank or a transaction bank would have to require collateral from its customers. Moreover, they also have to provide collateral to ICSDs/CSDs systems. As a result, clearing and settlement through systems other than ICSDs/CSD would be much more expensive. This fact could be viewed as a competitive disadvantage for global custodians, settlement and transaction banks.

We again suggest limiting the standard's ambit to central depositors. We therefore suggest replacing the term 'systemically important systems' designating the addressees (both in the standard itself and also in the further description pp. 47- 50) by 'CSDs'.

The system users described as 'systemically important systems' are - as investment firms - already subject to sufficient risk control mechanisms under the ISD. Pursuant to Annex I, Section B (1) of the draft ISD, depositing is listed under the category 'ancillary services'. According to the draft, depositing should entirely subject to the rules of conduct and organisation applicable to investment firms.

Standard 10: Cash settlement assets

Since this is presently not yet a standard for all clearing and settlement systems, we are very much in favor to point out the access to money of the central bank as it is done in point 2. We also agree that for central banks, it is necessary to improve access conditions to central bank money pointed out on page 52 under paragraph 115 (cf. also our comments on standard 4).

We are opposed to the possibility that CSDs could settle in funds other than central bank money (see para. 116). The CSDs should operate core infrastructure services and settle in central bank money in order to keep risks to a minimum. Any other approach would lead to an increase of systemic risk. This should be stipulated under standard 6.

Furthermore, given the existing prudential supervision rules in force for investment firms, we do not think that it will be necessary to extent this standard to custodians. As a result, page 51, 'Key Elements', item 1, should be modified as follows: *"This standard is addressed to CSDs and ~~custodians that operate systemically important~~ ~~systems~~, more specifically, to the cash payment arrangements...."*

Standard 11: Operational reliability

In order to minimise operational risks, we suggest adding to the standard "(vi) frequent audit of the procedures".

In the course of fine-tuning of the standard, we also see the need for greater specification of 'outsourcing' mentioned on page 57 in paragraph 133. There should be a precise definition of functions to be outsourced and the competent supervisory authority.

Furthermore, we advocate clarifying item 3 by replacing *'should be*' with '*is*' in the second sentence. By way of further clarification, the second sentence ('should seriously consider') paragraph 130 on page 57 should be replaced by '*must*'.

As regards the personal scope, the 'Key Elements' under item 1 on page 54 may be reframed as follows: *"This standard is addressed to CSDs ~~and custodians that operate systemically important systems~~."* Investment companies are again sufficiently covered by the existing rules for investment firms[1]. In addition, it may be useful to include infrastructure providers in the personal scope, specified in item 1, such as, for instance, SWIFT or other Telcos.

Standard 12: Protection of customers' securities

In principle, we support the aim of the standard and we see the need for a uniform harmonisation of the national regimes within the EU, thus creating legal certainty within the

[1] Cf. article 12 paragraph 4 and 5 of the Commission proposal for a Directive of the European Parliament and of the Council on Investment Services and Regulated Markets and amending Council Directives 85/611 EEC and European Parliament and Council Directive 2000/12/EC from 2002.

EU concerning financial instruments deposited abroad on behalf the customer. However – but we think that the requirement of these standards are met already - Article 12 of the ISD (93/22/EC) requires from all entities holding customer's securities accounts to employ practices and safekeeping procedures that fully protect customer's securities. Article 12.8 of the proposed ISD already obliges Investment Firms to make "adequate arrangements so as to safeguard clients' ownership rights". Banks that operate as custodian banks (qualifying as an investment firm) should not need to respect two safeguard clauses from two different sets of law. As it is not clear how far these rules lead to duplication or to conflicts, we recommend deleting this standard.

Standard 13: Governance

Here, we suggest keeping the wording chosen by CPSS/IOSCO relating to the addressees of this standard, i.e. CSDs and CCPs. This is owed to the fact, that also in this field, the regulations for investment companies are clear due to the ISD. As a result, the addressees specified on page 63, 'Key Elements', item 1, should read as follows: *"This standard is addressed to CSDs~~,~~ and CCPs ~~and custodians with a dominant position in a particular market~~."* Should the standard be deleted, its content should be integrated into standard 4-6 which lays down a regulatory framework for CSDs and CCPs.

In order to take account of e.g. the Stock Corporation Act, we feel necessary to amend the disclosure obligations under item 3 as follows: *"Objectives and major decisions should be disclosed to owners – if not already regulated in another specific law (e.g. Germany: Stock Corporation Act) - , users...."*

These disclosure obligations may, if applicable, be limited to system users and to the competent prudential supervision authorities.

Standard 14: Access

We remind that this issue is partly regulated in article 32.1 ISD as regards CCPs. But it should also be regulated for CSDs, ICSDs.

We suggest adding a "Key element" as following: "Priority should be given to legislation on the EU level".

Standard 15: Efficiency

We think it would be sufficient to limit the personal scope to CSDs and CCPs - in line with standard 14 -. Paragraph 168 explicitly mentions the possibility of efficiency gains through standardisation. In our view, this aspect should not only relate to the securities side - and therefore to CSDs as depositories of the items – but also to the cash side. Hence, it may be worth considering expanding the personal scope to the European System of Central Banks (ESCB).

Standard 16: Communication procedures, messaging standards and straight-through processing

Approval.

Standard 17: Transparency

We think that, in general, this standard is too far-reaching and we therefore advocate keeping the wording of CPSS/IOSCO. As a result, on page 73, 'Key Elements', item 1, item 2 and item 4 should be reworded as follows:

"1. This standard is addressed to CSDs, and CCPs ~~and custodians with a dominant position in a particular market. For this standard to be effective it also needs to be applied by other providers of securities services, such as trade confirmation services, messaging services and network providers.~~

2.... ; the information should include the main statistics ~~and the balance sheet~~ of the system's operator. (...)

4. CSDs~~,~~ and CCPs ~~and custodians with a dominant position in a particular market~~ should publicly..."

To the extent that 'main statistics' refer to general ratios in relation to the services offered (e.g. number of transactions), we agree to the disclosure obligation, which is probably already a standard market practice nowadays.

Standard 18: Regulation, supervision and oversight

We agree with the proposed standard, including the homeland principle laid down in paragraph 194 on page 77, which is modelled on the ISD.

Standard 19: Risks in cross-system links

We think that the establishment of an obligation for certain system users as laid down in standard 19 is too far-reaching. We therefore propose amending the 'Key Elements' under item 1 on page 79 as follows: *"This standard is addressed to CSDs ~~and custodians operating systemically important systems~~ that establish cross-system links".*