FEDERATION BANCAIRE DE L'UNION EUROPEENNE

Le Secrétaire Général

BI/AB
C1232

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Email

Friday, 31 October 2003

Dear Mr Kazarian,
Dear Mr Moeliker,

I would like to thank you for the opportunity to comment on the ESCB/CESR consultation on clearing and settlement. Please find attached the European Banking Federation's response to this consultation.

As you will see in our response we are supportive of the general approach taken by the ESCB/CESR joint working group. We do believe however that there are good reasons to reconsider the application of many of these standards to custodian banks. We provide more information on the reasons for excluding banks from the scope of these standards in our paper.

We would be delighted to provide further information. Should you have any enquiries please do not hesitate to contact me or, alternatively, Mr Patrick Poncelet (p.poncelet@fbe.be) or Ms Burçak Inel (b.inel@fbe.be).

Yours faithfully,

Nikolaus Bömcke

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Enclosure to Letter C1232

FEDERATION BANCAIRE DE L'UNION EUROPEENNE

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RESPONSE TO THE ESCB/CESR CONSULTATION

ON CLEARING AND SETTLEMENT

A. Introduction

The European Banking Federation (FBE) is grateful for the opportunity to respond to the ESCB/CESR consultation. The FBE is the united voice of the banks of the European Union (EU) and the European Free Trade Association (EFTA) countries. The FBE represents, through 18 national banking associations, over 4,000 banks, large and small, accounting for close to 20,000 billion euros in assets. The FBE is actively engaged in all CESR consultations in securities matters, and has supported the ESCB/CESR process of reviewing the regulatory framework for clearing and settlement since the beginning.

B. General remarks

⇒ **We welcome the fact that the document is based on CPSS/IOSCO recommendations.** We also explicitly welcome the format used in the document which facilitates the comparison between the two sets of documents.

⇒ **The form of a "standard" is not appropriate for all of the issues covered.** Consideration should be given to adopting certain items – such as those related to efficiency – as *recommendations*, rather than standards.

⇒ **In principle, we agree with the functional approach, but believe that it must be based on a different definition of functions: infrastructure versus intermediary.** Instead of using book-entry settlement as the basis of the functional approach, we would recommend using infrastructure and intermediary functions as the basis of differentiation for public policy and risk management purposes. One should subject intermediaries to only those standards that are justified by their role in the overall system. At times the paper subjects the banks to standards related to the systems of which the intermediaries are only participants. In these cases the standards should not apply to them. For example, the standards endorse credit extension by infrastructures and require such credit to be fully collateralized (whenever practicable). It is inappropriate to subject custodian banks to the same requirement, because banks are in the business of providing liquidity to the market and are duly regulated. Forced collateralization will impose unnecessary cost to all market participants.

⇒ **It is necessary to ensure that there is no over-regulation (regulation that is disproportionate with its benefits and stifles market activity) or overlapping regulation (regulation that is superfluous).** Even if the objective of a requirement may seem justified by the role played by a custodian, it should be adopted only if the means proposed are necessary in the global context of other rules applicable to banks, likely to be effective, and proportionate to the expected net gains. Custodian banks are regulated with respect to credit risk, cash risk, custody risk, operational risk, governance, transparency and customer conduct on the basis of a range of legislation, including not only Basel I (in the process of being revised) but also the ISD (its revision expected to be completed by next year). This is not the case with CSDs and CCPs (the latter being entirely new), which should be the main focus of the current standards. The application should extend to custodian banks only in so far as there is a clear regulatory gap for banks.

Below we provide further detail on the key policy questions affecting custodian banks, including our views on the functional approach, systematically important custodian, collateralization, and the level playing field. In the next section (C), we will provide detailed remarks on the proposed standards. Section D will conclude.

(i) Functional Approach

There is considerable merit in a consistent definition and measurement of risks associated with settlement for all institutions who deliver the same function. Above all we recognize that the Group is concerned with the possibility that major custodians could paralyze the entire system, just as much as Central Securities Depositories (CSDs) could. Consequently, both kinds of institutions need regulation targeted at the same level of protection of the system. However, the differences between the functions of CSDs and banks in the overall system translate into differences in terms of their impact on the viability of the system and, consequently, on the way these risks should be addressed.

Crudely put, as CSDs (and CCPs) are basically single-purpose providers of infrastructure, risks related to their activities may be best dealt with by a combination of relatively low capitalization and full collateralization of their (potential) claims. By contrast, custodian banks are usually multi-purpose general banks, fulfilling, inter alia, a socially and economically vital task by assuming higher risks through uncollateralized loans and other forms of credit, counterbalanced by a considerably higher capitalization (as demanded currently under Basle I and soon under Basle II). In their case, it is clear that a regulation of a different nature is needed to achieve the same level of protection for the entire system. This makes it critical to define the functions correctly.

The key functional difference between CSDs and custodian banks is that a CSD is created to serve as an infrastructure for the entire market, whereas custodians (and broker-dealers) serve as intermediaries providing investors access to that infrastructure and competing fiercely with each other. The relevant functions from regulatory policy and public interest perspectives should be (1) infrastructure and (2) intermediary. CSDs should be regulated with reference to risks inherent in an infrastructure's business, and banks acting as intermediaries for their clients to access the CSDs' services should be regulated with reference to risks inherent in a custodian bank's business.

Custodian banks compete with each other to provide intermediary services to access CSDs and are already regulated by banking regulations designed to ensure that they adequately manage their risks and have sufficient capital. Hence, regulation of infrastructures should be the focus of the standards, as it was intended by CPSS/IOSCO.

For example, custodians may, as a matter of their business plan, choose to take the risk of settlement, but they cannot settle until the system has. Hence it makes no sense to apply system-related standards on them.

Naturally, the effectiveness of the functional approach depends on the accuracy of the definition of the functions. A common misperception we encounter relates to book-entry settlement, which in fact establishes the ownership of securities at CSD-level and not the function usually provided by intermediaries.

In certain jurisdictions, a CSD is the ultimate record of ownership in a market; customer holdings in custodians' books are claims against the custodian bank, and these customers have to enforce their right of ownership through the custodian bank as intermediary which is a direct member and account holder at the CSD. Book-entry settlement is the primary function of a central securities depository, but only incidental for custodians: it happens when two customers need to transfer securities between their accounts, and only if the service provider maintains an "omnibus account" at the CSD (i.e. one account holding the positions of both clients). In this sense, book-entry settlement of securities is not any different in nature from book-entry transfers of cash between two customer accounts in a bank, the risks of which are already taken into account in the regulatory capital regime applicable to an intermediary. In this context, the size of a custodian bank's business is only relevant if it results in an increased risk profile and if it cannot meet any increased regulatory capital requirements, which brings us to the next important issue of distinguishing between custodians.

(ii) Systemically Important Custodian

The concept of a systemically important custodian, which is used in the ESCB/CESR paper for various standards, is not in itself new. However, these concepts developed in the US and by G-30 have a different scope. The “Interagency White Paper on Structural Change in the Settlement of Government Securities” of the US is focused exclusively on the operations and technology arrangements of institutions’ continuity of business arrangements. By contrast, the currently proposed standards encompass a range of other issues, such as credit extension, governance, access and transparency, which are not in the Interagency White Paper. The Federal Reserve Bank actually encouraged other banks to enter the government securities settlement business to improve competition, rather than imposing additional regulations on the existing, systemically important service providers.

Similarly, the Group of Thirty’s (G-30) Recommendation 13 (“Address the Possibility of Failure of a Systemically Important Institution”) only targets the adequacy of business continuity and disaster recovery arrangements with the objective of enhancing operational integrity. It does not utilize the concept to cover other risks such as financial failure. Furthermore, the G-30 report clearly recognizes that many recommendations must be adapted to an institution’s business model, and that prudential regulations are already in place for institutions such as banks.

As for whether it is justified to impose additional rules on larger intermediaries, it should be noted that the ability to cause havoc in the financial markets - through reasons such as insufficient contingency planning, insufficient financial resources or liquidity arrangements - does not necessarily reside solely in large institutions with a big market share in the custody business.

Taking this perspective, it would be useful for the ESCB/CESR Working Group to consider how and why existing prudential banking regulations and participant rules in securities settlement systems are deemed not to provide sufficient safeguards for the financial or operational failure of large custodian banks, or why the set-up of special-purpose vehicles to provide securities settlement services would be a cost-effective way to increase the safety of the financial system.

Not the least of the problems related to the definition of a systemically important custodian is the difficulty of capturing what is systemically important. Any such definition would have to take into account the client base (e.g. whether one derives volume from a small number of institutional clients or a large number of retail clients), other business lines of the

provider (e.g. ICSDs vs. commercial banks), and size of the national market (e.g. the relative sizes of the EU markets of which the institution has 25 percent of market volume).

On the other hand there is a case to be made that those not deemed to be systemically important providers would also have to be regulated in a way that does not give them an advantage or disadvantage vis-à-vis the systemically important providers. It should be considered that a differential approach towards banks dependent on size would have an impact on the existing competitive market structure, which is clearly not the intention of the Group.

(iii) Level playing field

Although creating a level playing field for all actors involved is a desirable goal, applying the same standards in the same way to all actors is not necessarily the right way to achieve that objective. As discussed above, applying the same standards in the same way to all actors may well result in overregulation of some actors, for example by making custody business more expensive without adding extra security to the business function, which would distort the level playing field. This will put such banks at a disadvantage against pure custodians that only have one set of rules to respect.

As actors are also of different sizes, the costs for implementing new standards may be reasonable for bigger players while they might force smaller players out of the market.

The same argument can be applied to entry barriers, as excessively high standards will hinder new players to enter the business given the costs of sticking to all standards. These costs can only be covered once they have reached a critical mass, which they might not be able to for several years. This will prevent new comers from entering the business and is therefore not helpful for creating an efficient and competitive environment.

To ensure a true level playing field, therefore, the functional approach needs to be implemented with great care, taking into account the precise areas where new regulation is justified and aiming to encourage the existence of smaller players or the emergence of new entrants.

(v) Collateralization

The Giovannini Report states that *“entities performing core functions…like netting, clearing and settlement…do not involve the provision of credit facilities. In contrast, it can be argued that value-added banking functions are not essential to the basic clearing and*

settlement process, and concentration risk is reduced if these functions are provided by multiple banks in a competitive environment".

The ESCB/CESR Standard 9 proposes requiring full collateralization "whenever practicable" and, while allowing incomplete collateralization, introduces additional requirements for this (e.g. minimum credit quality, exposure limits, and, for operators, minimum capital and internal risk control measures).

As a first comment, we would like to point out that the extent to which collateralization is actually required is not well defined in this standard and the accompanying Explanatory Memorandum.

Secondly, while it may be reasonable for the CESR/ESCB to aim at preserving the business model of infrastructures, which already extend credit, by requiring them to fully collateralize credit to decrease the risks involved, we do not think it is appropriate to extend this requirement to custodian banks, even with the exemptions offered in the text. This is because banks:

- Have a higher capital base for credit extension incidental to the value of settlement of their customers;
- Are not considered eligible institutions to participate in ESCB credit operations, and are therefore not required to meet the ESCB requirements of a securities settlement system; and
- Are experienced in credit assessment and monitoring, know how to manage risk, and have a wider relationship with most customers to keep close to their financial health.

Moreover, custodian banks already protect themselves against customer default by commercial contract. Most custodians have rights over securities they paid for on behalf of a customer until the customer provides funds to the bank. While collateralization is a valid and effective technique for reducing credit risk, there are other, equally effective, techniques. Custodians should be allowed to deploy the full range of risk management techniques in managing their exposures.

There is no reason why custodian banks' extension of credit for securities settlement should be differently regulated than credit extension for any other purpose that may have systemic implications, such as clean payments, repos, etc. Many market participants provide liquidity as part of their business model; the forced provision of collateral to a custodian bank will require such entities to borrow, probably from the banking system. The standard will therefore unnecessarily increase the costs of doing business for market participants.

C. Remarks on Proposed Standards

Standard 1: Legal Framework

Custodian banks are already comprehensively regulated, and have in place established policies and procedures to control risk. To promote efficiency, double regulation should be avoided wherever possible and, to this end, the proposed standards should not be applied to custodian banks where adequate regulation of the perceived risks is already in place elsewhere. Accordingly, for the reasons highlighted earlier in the paper, we believe that although the principles of this standard are valid, this specific standard should not be extended to custodian banks.

The ISD, as well as the Consolidated Credit Institutions Directive ("CCID"), relating to the taking up and pursuit of the business of credit institutions, already provides the necessary legal framework for all custodian banks, irrespective of their size.

This clarification is also in keeping with the fact that the Finality Directive referred to in Key Element 6 of Standard 1 cannot apply to any entity other than systems.

Additionally, we would recommend amending Key Element 2 as follows: "As a general matter ….public and accessible ***to the market."***

While we agree with the general principle of providing information to market participants, we find that the reporting requirements in Para 29 could be scaled down without reducing the transparency of the system. We believe that an explanation of the concept of PRIMA, as modified by the Hague Convention, would suffice. Any additional information could be produced by the customers.

Finally, it would be useful for Para 35 to explicitly mention the action plan proposed by the Giovannini Report.

Standard 2: Trade Confirmation and Settlement Matching

We support the general need for timely matching of trade confirmations. This happens invariably on trade date (T+0) between direct participants. However, requiring settlement instructions to be matched the day before settlement (Key Element 4) will pose an unnecessary burden. Furthermore, trade confirmation and settlement matching are distinct steps. Pre-matching is not necessary in all cases. We believe this is an area that should

not be governed by a standard but should evolve with market forces. Hence, we would propose deleting Key Element 4.

Secondly, given the different trading hours in the various international markets, we think that the proposed cycle of T+0 for indirect participants (Key Element 3) is too restrictive. We would support a cycle of T+1.

Standard 3: Settlement Cycles

First of all, in keeping with the principle stated up front that custodians should not be regulated on subjects beyond their control; we believe that custodians, as system users, should not be held responsible for adherence to settlement cycles. Hence the scope should be amended to delete custodians.

Secondly, we generally support harmonization of settlement cycles, but believe that this will be best induced through market forces rather than regulatory intervention. As the standard also states, there are benefits and costs associated with harmonized settlement cycles which need to be analyzed before taking further action. It is not exactly clear to us, however, how the wish to see such a study is to be viewed as part of a standard. Having said that, we support the ultimate goal of shortening the cycle beyond T+3.

On the other hand, we think that the final settlement cycle should not be extended to OTC markets, which should continue to benefit from freely negotiable settlement cycles.

Standard 4: Central Counterparties (CCPs)

First of all, this section states many principles about CCPs which are generally accepted, although this raises the question as to how this section fits in with the rest of the document, since it does not constitute a standard.

We fully support the principle of a thorough study of the costs of a CCP in Key Element 2, accompanied with an identification of the distinct benefits emanating from CCPs (linked with the process risk management of trades that have been concluded but not yet settled).

We also welcome the statement that, in the light of the upcoming CPSS/IOSCO work on CCP risk management, ESCB/CESR does not wish to lead to duplication and will re-visit its standard once the other work is finished.

More specifically, we believe that the recommendation regarding risk mitigation (Para 63) should explicitly state that the CCP should always be able to offer money settlement in central bank money.

Standard 5: Securities Lending

Not all lending is relevant to the objectives of this standard; only that which is linked with a settlement system. We support this standard in so far as it is imposed on providers of centralized lending systems where the potential counterparties do not know each other. We do not think that it should be extended to banks securities lending to customers on a bilateral basis, which is already regulated.

Centralized lending by CSDs should be allowed only on some occasions but not as a principle. It is in the public interest, and consistent with the recommendations of the second Giovannini Report, that CSDs do not take on risks not essential to their core function of settlement. Any centralized lending system run by CSDs should be operated on a purely administrative basis, and should not involve the CSD running credit risk in the transaction. CSDs should not be allowed to do commercial lending.

For clarity, the term “securities creation” should be replaced with creation of securities”.

We particularly welcome the removal of tax impediments (Key Element 3).

Standard 6: Central Securities Depositories (CSDs)

We endorse the standard in full.

Standard 7: Delivery versus Payment (DVP)

DVP is a mechanism to protect an investor from principal risk to the counterparty of the trade (the original counterparty, or, if applicable, the central counterparty). Thus the instrument is not designed for, or useful to, the protection of the investor against a failure of the custodian bank. Banks should be kept outside the scope of this standard not only because of this fact, but also because they are already subject to risk mitigation rules under Basel I.

Given the key role played by CSDs as central infrastructure provider in this area, we believe that the standard should be imposed on CSDs only. It is for this reason that the IOSCO standard explicitly mentions CSDs but not securities settlement systems.

Accordingly, Key Elements 1 and 3 should not be addressed at custodian banks.

We would also like to point out that it is inappropriate for Para 91 to cover the relationship between a direct participant and its clients. This should be left up to the market.

Standard 8: Timing of Settlement Finality

For the same reasons as above, we believe that this standard should be addressed at CSDs only, and not at custodian banks.

Furthermore, in the interest of efficiency, the operating days in the TARGET system should be used as a benchmark only and should not lead to special mandatory arrangements (Para 96 and 103, where compatibility with TARGET is mentioned).

Standard 9: Risk Controls in Systemically Important Systems

Banks already have strict risk mitigation procedures in place some of which would be in line with what is proposed in this standard. Such procedures are dictated by risk mitigation rules imposed on banks. However, while the specific requirements set out in this standard can be seen as a necessity for CSDs (especially in their critical infrastructural role in the ESCB credit operations), they are not necessary for the whole market. More specifically, the full collateralization of credit exposure called for here would lead to an over-regulation of banks, which are – unlike CSDs - already subject to banking adequacy rules and should be allowed to decide on the risk management techniques most appropriate to their individual business models. A bank should be allowed to make the commercial decision as to whether collateralization is necessary or desirable, as long as it complies with capital adequacy requirements.

Hence we would restrict the scope of the standard to CSDs.

Standard 10: Cash Settlement Assets

As stated in our response to Standard 4 with respect to CCPs, we believe that CSDs should always offer the option to settle in central bank money in order to reduce risks.

Considering the special function of CSDs as infrastructure, we believe that the standard should be restricted to CSDs and, furthermore, that they should be required to use central bank money. Hence we welcome Key Element 2 and Para 115 in this section.

Standard 11: Operational Reliability

We agree that operational risk should be identified, monitored and regularly assessed. However, banks are already subject to very clear guidelines in the ISD which require them to set up the organizational arrangements that will ensure robust and reliable functioning.

(The rules proposed for the revised ISD bolster these requirements.) In addition, operational risk is covered from a capital perspective in the Basel framework under revision. We therefore do not see any similarity in terms of the respective regulatory framework faced by CSDs, which are not regulated in this aspect, and banks, which already are. Accordingly, we believe that the standard should be restricted to CSDs and CCPs only.

Furthermore, we recommend an additional item for the list of requirements listed in the first paragraph of this standard: "(vi) frequent audit of the procedures."

Standard 12: Protection of Customers' Securities

We support this standard as proposed, especially the overarching principle of harmonization of national regimes in the EU. Among others, this will yield the benefit of creating legal certainty with respect to financial instruments held abroad for clients. The lack of such a framework currently hampers the business of custodians vis-à-vis a foreign depository.

With respect to the specific rules, we explicitly support the principle that customers' securities must be segregated (Key Element 2) and regularly reconciled with outside entities such as a CSD (Key Element 3).

However, we believe that no particular accounting method should be prescribed, since double-entry accounting and single-entry memorandum accounting may both be appropriate for the given system. We therefore propose that the wording of Key Element 2 be changed to reflect that double-entry accounting is only one of the methods that yield a robust accounting standard.

Finally, we believe that it should be clarified that the standard applies only to pure safekeeping, but not to any other service provided by the banks.

Standard 13: Governance

We agree that governance is an important feature of any regulatory framework. However, once again, banks are already subject to clear rules that are designed to ensure good governance (for example, conflicts of interest rules in the ISD). Furthermore, banks constantly develop and apply best practice in governance that goes beyond these requirements to ensure quality and reliability of service. We would therefore prefer this standard not to be applied to custodian banks.

As a point of principle, we also wish to state that governance standards should not shift the regulatory burden to the market players. Hence, the wording of Key Element 5 and of Para 148 should be changed to reflect that the management boards are not required “to take into account all relevant interests” and that the defence of “public policy interests” is not the responsibility of the market participants, but of the regulators/supervisors.

More specifically, the disclosure of objectives and major decisions to owners, users and public authorities (Key Element 3) should only be required when this is not already required under other EU or national laws.

Standard 14: Access

We find that this standard, if applied to banks, would totally contradict the basic principle of a bank as a free enterprise functioning in a competitive environment. It would mean establishing a de facto requirement for banks to accept clients, irrespective of the bank’s commercial criteria and business plan. Banks should not be forced to justify or disclose the basis on which they make commercial decisions, regardless of their size or market share. The wording in Key Element 2 that refers to “grounds other than risks” is not sufficient to ensure this basic principle. Banks should be allowed to decide on their clients for any commercial consideration, which may be much wider than a consideration of risks. In any event, as banking business is fully competitive, if a custodian rejects a client, the client is always free to look for another service provider, which may not be the same case for an infrastructure.

Hence, we would propose not imposing this criterion on banks. This is a clear example of the pitfalls of a misconceived functional approach.

As far as CSDs and CCPs are concerned, we believe that Para 153 could allow arbitrary decisions limiting access to a given system. We would therefore propose deleting the paragraph.

If retained, Para 153 could be amended to clarify the nature of the basis of decisions, by specifying that CSDs and CCPs are allowed denial of access to applicants on the basis of “non-discriminatory minimum requirements.”

Standard 15: Efficiency

As noted previously for some other standards, we find that this section represents more a description of a policy ideal than a standard to be heeded by market participants. Furthermore, we do not believe that inter-operability between national systems (Key

Elements 3 and 5) should be elevated to the level of an objective in itself. We see efficiency as the objective and inter-operability as one among various possible solutions for creating an efficient system (integration being another). Like other possible solutions, interoperability also involves costs and benefits to be weighed against others. It goes without saying that we believe that no specific solution aimed at efficiency should be forced upon the banks at the exclusion of others. These two paragraphs should be amended to reflect this.

Furthermore, the scope of the standard should be restricted to CSDs and CCPs. Given the significance of standardization to the cash side, one should also consider extending the scope to the European System of Central Banks.

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

We support the general principle of harmonization of market practices, which is the focus of Barrier I in the Giovannini report.

We also explicitly welcome the way the standard distinguishes between providers of systems and participants in these systems, a distinction we believe should permeate through the whole report.

We also support the statement that a timetable and deadlines should be established to develop common practices (such as ISO standards). However, this should be done in close cooperation and consultation with all market participants involved; Key Element 2 should be amended to reflect this approach. Additionally, Para 175 should also refer to all market participants.

Standard 17: Transparency

In principle, we fully support the objective of transparency. However, we believe that this standard should not be extended to custodian banks since they are already subject to sufficient transparency rules. If the standard were to apply to banks, Key Element 4, Para 184 and Para 195, for example, would be damaging to banks' basic business by forcing them to expose their commercial risk policy to their rivals. Hence Key Element 1 should be amended to exclude banks from the scope.

More specifically, Key Element 2 requires excessive detail of information (e.g. balance sheets) which should be deleted for streamlining.

Standard 18: Regulation, supervision and oversight

By and large we endorse the standard. However, the very critical question of jurisdiction – which is intended to be based on the approach of the ISD, or the “European model” – can be made clearer (Para 194). The mutual recognition system works best when the country of origin principle is laid out clearly, with no room for loopholes and exceptions. Hence phrases such as “as much as possible” should be replaced with “in all cases” and “primary responsibility” with “sole responsibility”.

The paragraph should be amended to state clearly that entities active in several EU Member States shall be subject to supervision by only one authority (that of the competent authority of origin).

Standard 19: Risks in cross-system links

We believe that the standard should not apply to custodian banks because they are merely users of infrastructures (“systems”) but do not *operate* systems; the reference to them in the context of “cross-system links” is not appropriate or justified. When a custodian accesses an infrastructure, it is a member user of that infrastructure, and is not operating a “cross-system link”. Once again, banks, as intermediaries, should not be subject to requirements that are appropriate for entities that provide infrastructure.

D. Conclusion

Clearing and settlement of securities is an important aspect of creating a single market in securities. The FBE would like to reiterate its appreciation for the current consultation, which forms a very good basis of discussion on the subject, and commit itself to providing any further support needed by CESR and ESCB as the Working Group revises its document.