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GROUPEMENT EUROPEEN DES CAISSES D'EPARGNE
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Response by the European Savings Banks Group

to the

Consultation launched by the ESCB-CESR

on their

Standards for Securities Clearing and Settlement Systems in the European Union

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Profile European Savings Banks Group

The European Savings Banks Group (ESBG) represents 25 members from 25 countries (EU countries, Norway, Iceland, Bulgaria, Czech Republic, Hungary, Latvia, Malta, Poland, Romania, Slovak Republic) representing over 1000 individual savings banks with around 66,500 branches and nearly 770,000 employees. At the start of 2002, total assets reached almost EUR 4,160 billion, non-bank deposits were standing at over EUR 2,012 billion and non-bank loans at just under EUR 2,095 billion. Its members are retail banks that generally have a significant share in their national domestic banking markets and enjoy a common customer oriented savings banks tradition, acting in a socially responsible manner. Their market focus includes amongst others individuals, households, SMEs and local authorities.

Founded in 1963, the ESBG has established a reputation as the advocate of savings banks interests and an active promoter of business cooperation in Europe. Since 1994, the ESBG operates together with the World Savings Banks Institute (WSBI, with 109 member banks from 92 countries) under a common structure in Brussels.

1. General Observations

The European Savings Banks Group, ESBG, welcomes the opportunity to comment on the Consultation launched by the European System of Central Banks (ESCB) and the Committee of European Securities Regulators (CESR). It welcomes the fact that the ESCB CESR are proposing defined standards for securities clearing and settlement systems in the European Union (EU) with the aim of promoting and sustaining integration in the European markets. It also welcomes the fact that the proposed standards are based on the CPSS-IOSCO Recommendations for Securities Settlement Systems published in November 2001, and that, as such, they should facilitate greater mutual recognition and promote greater overall reliability in financial markets, which are becoming ever increasingly global.

The ESBG does however have some serious concerns about the functional approach, the proposed scope and the impact of some of the standards, as outlined below.

1.1. The Functional Approach – Discrepancy between "soft" and "hard" law

The ESBG is of the opinion that the CPSS–IOSCO risk–based functional approach taken by the ESCB-CESR to its proposed standards is not fully aligned with the current European legal framework. The reason for this is that no effort is made to equate or integrate this "soft" law functional approach under the already existing set of European "hard" law, which follows an institutional-related supervisory approach (banks-investment firms).

It is noted that the proposed ESCB-CESR standards are not mandatory. Nonetheless, the Consultative Report states that national regulators, supervisors and overseers will integrate the standards into their respective assessment frameworks in a best effort basis and assess compliance with them in this way. Furthermore, the ECB will incorporate those ESCB-CESR standards that are deemed relevant from a central bank user perspective into its "Standards for the use of EU securities settlement systems in ESCB credit operations" (Paragraph 7). This will effectively give these standards the status of **"**soft law".

Although, in principle, "soft law" constitutes an advantage of greater flexibility for day–to-day supervisory purposes, is should be noted that many of the standards proposed by the ESCB-CESR are of a highly **political nature** and, in some cases, impact on basic **competition issues**.

In this context, the ESBG would like to point out that it is not acceptable that ESCB-CESR simply states in the Consultative Report that issues relating to competition do not fall within its mandate. Although, strictly speaking, this may be true, the Group should not go ahead and make proposals for standards that will distort competitive conditions under current market and legislative circumstances and imply that it is up to the relevant national and European Authorities to sort matters out after the event.

An example of the highly political nature of certain standards mentioned above is the approach advocated by the ESCB–CESR to address selected standards to non–infrastructures, such as custodian banks that "operate systemically important systems." If, for example, these banks are expected to apply full collateralisation to their credit exposures under Standard 9, this is a policy decision that should not be imposed unilaterally by the ESCB–CESR but discussed and decided by the European Institutions (Commission, Council and Parliament) under the usual democratic decision–making process established at a European level.

In this context, it should be noted that the ESBG supports the position outlined in the Second Report of the Giovannini Group dated April 2003, that a clear drive towards the elimination of the identified barriers to cross–border clearing and settlement in Europe needs to be accompanied by a regulatory/supervisory structure that can function on a pan–European basis. This should take the form of European Legislation, which would define the various functions in the business and lay down the conditions for access to and exercise of the entire value chain in the clearing and settlement business. Such legislation is necessary so as to be able to make a distinction between core or public utility infrastructure services, on the one hand, and value-added banking or intermediary services, on the other. This is an essential prerequisite to create a level playing field and fair competition in the Single European Financial Market and to clarify the blurring of roles that has taken place as a result of the consolidation of clearing and settlement infrastructures in the EU further to the switchover to the Euro.

1.2. The Scope of the Standards

The proposed application of the scope of the standards to custodians operating systemically important systems in addition to CSDs, ICSDs and CCPs is new and goes far beyond the CPSS–IOSCO Recommendations on the topic. Accordingly, the ESBG would have expected that the approach taken by ESCB–CESR of including custodian banks under a functional-based supervisory approach would have been justified on the basis of a cost benefit analysis of the suggested advantages in terms of risk mitigation, safety and reliability against the disadvantages of double regulation and increased compliance costs.

A mere reference to the fact that custodian banks form part of the clearing and settlement value-chain is not sufficient justification, particularly because, in their capacity as credit institutions and investment firms, custodian banks are already subject to a strict prudential and conduct-of-business regulation under current and forthcoming EU Banking Legislation[1] as well as future Basel Rules.

Furthermore, custodian banks are members and users of infrastructures such as CSDs and are ultimately dependent on such infrastructures to settle their trades. Accordingly, the ESBG believes that the impact of the standards should be through the direct links of the custodians with the infrastructures in which they are members and that they should not be subject to the same standards or soft law provisions as infrastructures, which are not covered by existing European legislative rules. The application of the proposed standards to custodian banks would constitute double regulation without any additional proven benefit in terms of safety and reliability for the settlement system.

Unfortunately, there is very little in terms of a founded justification for the risk-based functional approach in the Consultative Report. Clearly, ESCB–CESR start from the premise that custodian banks, which operate systemically important systems, entail systemic risk that is not addressed sufficiently by existing banking supervisory rules (this is in any case the understanding of Paragraph 11 of the Consultation Paper). The functional supervisory approach is also justified on the premise of the principle of "same business-same regulation" (Paragraph 11 also).

In the opinion of the ESBG both these lines of argument remain theoretical. In effect, the Consultative Report does not contain any explanation as to why the liquidity and solvency rules under the aforementioned general banking supervisory framework are not sufficient to cover the systemic risks linked with the operation of "systemically important systems" under a number of the proposed standards, including Standard 9.

The principle of "same business–same regulation" is the justification for applying selected standards to custodian banks that carry out in-house settlement of amounts that are comparable to those of national CSDs in terms of volume and value. The Consultative Report does not however give any indication as to what such volumes or value may be.

[1] Examples include the Second Banking Coordination Directive (89/646/EEC), the Own Funds Directive (89/299/EEC), the Solvency Ratio Directive (89/647/EEC) and subsequent amendments, the Large Exposures Directive (92/121/EEC), the Capital Adequacy Directive (93/6/ EEC) and subsequent amendments as well as the EU Investment Services Directive, ISD, (93/22/EC), currently undergoing revision.

Such issues are the subject of a parallel Consultation on the Scope of Application of the ESCB-CESR Standards, which is very open–ended and provides latitude for diverging interpretations.

1.3. Impact of Standard 9-Collateralisation

In addition to the abovementioned conflict with banking prudential regulation, the ESBG would like to point out that the introduction of this standard would impact negatively on the volume and cost of collateral and reduce cash liquidity for the market.

It could have the effect that the entire liquidity in securities and cash is pooled in the ICSD systems due to the fact that they are acting as national CSDs and ICSDs. Clearing and settlement systems, for instance, a global custodian, a settlement bank or a transaction bank, would have to require collateral from their customers due to the forthcoming ESCB-CESR standards. Furthermore, they also have to provide collateral to ICSD/CSD systems as part of their normal business operations. As a result, clearing and settlement through systems other than ICSDs/CSD would be much more expensive. This would in effect create a competitive distortion for global custodians, settlement and transaction banks. It would also lead to an increase in cost levels when the overlying ambition is to make securities clearing and settlement transactions cheaper and achieve a reduction of costs for the end investor, particularly in the euro–domestic area.

In summary, the ESBG is against the proposed approach of ESCB–CESR of including custodians operating systemically important systems under the scope of the Standards for the following reasons.

- The indiscriminatory introduction of such “soft” law standards, that were originally designed for infrastructures such as CSDs, ICSDs and CCPs into an existing “hard” law framework governing intermediaries such as custodian banks creates a burden of double regulation and increased compliance costs without necessarily adding any additional benefits in terms of safety and reliability for the system.

- There is no evidence to demonstrate that the purported systemic risks are not already very adequately contained by the stringent prudential, capital adequacy and operational risk rules that such banks are subject to under current and forthcoming EU Legislation as well as Basel rules.

- Increased collateralisation would lead to additional costs as well as potential distortions of competition aand impact negatively on the volume and cost of collateral.

2. Comments on the Consultative Report on the ESCB–CESR Standards for Securities Clearing and settlement in the EU

Introduction

As a first general remark, the ESBG would like to point out that the three layers of detail or levels in the standards, i.e. Standard / Key Elements and Explanatory Memorandum lead to a certain amount of confusion as to which level(s) are supposed to be binding. At the Open Hearing in Paris on 2 October, it was clarified that the first two levels formed an integral part of the standards and that the explanatory memorandum was there to clarify the intentions of the Regulators, but was not binding as such. The ESBG believes that it would be useful to specify this in the final version of the standards for the sake of clarity. It would also be useful to incorporate some of the points made in the Explanatory Memorandum into the Key Elements to ensure that the meaning of the standard is clear as indicated in the comments on Standards 1 and 5 below.

Standard 1: Legal Framework

The purpose and scope of this Standard should be made clearer, as it is open to different interpretations. If the scope of the standard is to establish the legal framework for clearing and settlement systems, then it could be argued that the standards should be addressed to central banks, securities regulators and other relevant authorities as is the case of Standard 18. If, on the other hand, the main scope of the Standard is the disclosure of information on the legal framework to market participants as clarified in Paragraph 29 of the explanatory memorandum and stated at the Open Hearing on 2 October this point should be specified more clearly in the key elements as stated above.

In line with the arguments made in the introduction to this paper, the ESBG believes that the concept of “Custodians operating systemically important systems” should be deleted from the list of addressees of the standard which should be limited to CDSs and CCPs. Custodian banks are participants in the system and they already have a well founded legal basis and clear disclosure requirements under EU legislation and, in particular, the Investment Services Directive (ISD).

Standard 2: Trade confirmation and settlement matching

As a further recommendation it could be added that matching should occur via an electronic communication system and not via telephone, as is the procedure in Italy and Spain, for example.
Time differences in the European Union may also cause some difficulty for the T+0 standard for trade confirmations at the end of the day.

Standard 3: Settlement cycles

The ESBG believes that T+3 settlement is a minimum as stipulated in the proposed Standard. The ultimate aim must be T+1 and settlement systems should be able to support T + 0. These comments are made on the assumption that the scope of the standards are trades executed on regulated markets. The Standard should not apply to OTC transactions and it would be useful to specify this point in the text.

Custodians that operate systemically important systems should be deleted as an addressee of this Standard as they rely on infrastructures to provide their services. The impact of the standards for custodians should thus be through the direct links of custodians with CSDs and ICSDs.

Standard 5: Securities lending

There is an anomaly in this case between the concept that a CSD could be “the principal to centralised securities lending” (Point 6 of the key elements) and the statement in the Explanatory Memorandum (Paragraph 72) that this is not the practice in most member states but that CSDs should be able to provide a technical functionality for their participants and other users who are able to act as a principal. A reference to this effect in the key elements of the standard would clarify matters and eliminate potential risk for CSDs, which, in the opinion of the ESBG, should always settle in central bank money.

The ESBG maintains that this Standard should not be addressed to “custodians operating systemically important systems”, as any bank that is already regulated by the aforementioned EU and Basel regulatory and prudential framework should not need to “fully collateralise its lending exposure” (Paragraph 74).

Standard 7: Delivery versus payment (DVP)

It would be useful to specify that delivery versus payment should be processed *via a secure electronic system.*

This Standard should not be addressed to "custodians operating systemically important systems" on the grounds that there is competition in the market for custodian services and that such forces and, in particular, certain criteria like risk evaluation, price, standing in the market, should prevail to promote best practice and efficiency.

Standard 8: Timing of settlement finality

The ESBG believes that this standard should apply to both the cash and securities settlement systems.

This Standard should not be addressed to "custodians operating systemically important systems" for the reasons mentioned under Standard 7 above.

Standard 9: Risk controls in systematically important systems

This Standard is very relevant for CSDs and ICSDs in the light of their virtual monopoly position on the market and the ensuing systemic importance as well as their business model of high levels of collateralisation to offset the lack of individual credit risk assessments and their relatively low capital base.

As indicated in the General Observations contained under Section 1 of this paper, the ESBG maintains that this Standard should not be addressed to "custodians that operate systemically important systems" in the light of the business model of banks in which credit lending and risk assessment is one of their core activities as well as the aforementioned strict capital adequacy and solvency controls under existing and forthcoming EU Legislation as well as Basel Rules. The application of the Standard would lead to over–regulation for the banking sector without contributing any proven beneficial impact on the securities clearing and settlement business in the EU.

In an extreme case, we could imagine an example of a bank, that operated both as a custodian bank and a universal bank, having to collateralise an unsecured credit line that it had granted to a retail customer, because the latter had decided to use this credit line to carry out transactions in securities.

In addition to the abovementioned conflict with banking prudential regulation, the ESBG would like to point out that the introduction of this standard would impact negatively on the volume and cost of collateral and reduce cash liquidity for the market. The introduction of the proposed standards, as they stand today, could also lead to the reduction of players in the market and result in a new barrier for the free access to the market of new players, especially those of a small and medium size. It may also incite CSDs to become banks[2] thus complicating further an already blurred regulatory situation.

Standard 10: Cash settlement assets

The ESBG is against the possibility that CSDs could settle in funds other than central bank money (Paragraph 116). The reason is for the mitigation of risk to the largest extent possible to comply with the provisions of Standard 6. As mentioned in the General Observations, the ESBG believes that CSDs should operate core infrastructure services and settle in central bank money in order to keep risks to a minimum.

This Standard should not be addressed to custodians that operate systemically important systems. They do not have access to central bank money and their strict regulation under EU and Basel rules should guarantee their standing and creditworthiness as custodian banks.

Standard 11: Operational reliability

The ESBG agrees that sources of operational risk arising in the clearing and settlement process should be identified, monitored and regularly assessed.

It believes that the key elements could usefully specify that the addressees should use external audit firms to confirm -at least- the existence of a (functioning) business continuity and disaster recovery plan as recommended in Paragraph 128.

Nonetheless, it believes that the standard should only be addressed to CSDs, CCPs and other providers of services critical for clearing and settlement as stated in the document. It should not be addressed to custodian banks, as they are already obliged to set up organisational arrangements to ensure business continuity and regularity under the Investment Services Directive. Furthermore Basle II will also introduce stringent rules on operational risk.

[2] The concept of limited purpose- banks is introduced in paragraph 109.

Standard 12: Protection of customers' securities

This Standard has a very broad scope of application as it effectively applies to all banks that hold customer deposits. It also provides a good example of overlapping of the "soft law" regulation emanating from the proposed ESCB-CESR standards and the existing set of EU "hard law" regulation as illustrated below.

Standard 12 requires from all entities holding customer's securities accounts to employ accounting practices and safekeeping procedures that fully protect customer's securities. Art. 12 Para. 8 and 9 of the forthcoming new ISD deals with exactly the same issue requiring that investment firms "make adequate arrangements so as to safeguard the client's ownership rights" when they are holding financial instruments belonging to the client. Thus, effectively a custodian bank (qualifying as an investment firm) according to the ISD and fulfilling its obligation under Art. 12 Para 8 and 9 of the new ISD should automatically comply with Standard 12.

The ESBG does however support the introduction of the standard in the light of the importance of effective protection of customers' securities. Nonetheless it believes that some of the provisons of the standard could have very far–reaching compliance implications in practice. One example can be found in Point 8 of the Key Elements, where the ESBG would propose to delete the last part of the sentence which states "and should inform the customer accordingly". This provision is too onerous and unpractical and the deletion of this clause would not detract from the obligation for a custodian or entity providing a similar role of performing its duty and bearing any potential risk.

Standard 13: Governance

This Standard is suitable for infrastructures such as CSDs and CCPs, which, in many cases, benefit from a monopoly position on the market. It should not be addressed to custodians, which have to compete with other custodians on the market in terms of price, service offer, quality etc. Furthermore, custodian banks are already subject to clear rules that promote good governance under corporate legislation at a national and European level, such as conflict of interest rules in the ISD.

Furthermore, the ESBG has a problem with the term "dominant" position on the market, which has not been measured in any way. In the light of a response as to what was meant by "dominant" position and potential thresholds to measure this at the Open Hearing in Paris, the ESBG could envisage that this Standard be applied to custodians with a "monopoly" position in a particular market. This is however subject to the proviso that the existence of such custodians is ascertained through consultations with the relevant banking supervisory authorities.

In the interest of consistency, the reference to other providers of settlement services (for example, trade comparison or messaging services) made in paragraph 147 should also be included in the list of addressees, if they have a monopoly position.

Standard 14 Access

The ESBG proposes that custodians are excluded from the scope of this Standard unless it is established that they enjoy a "monopoly" position in certain markets, as mentioned above.

Standard 15 : Efficiency

The above remark concerning custodians with a "monopoly" position also applies to this Standard.
Consideration should also be given to addressing the standard to central banks as their services are critical for clearing and settlement transactions.

Standard 17: Transparency

The ESBG welcomes the proposal to improve transparency in the market. It does however believe that custodian banks are already subject to stringent rules concerning investor protection and conduct of business obligations under the scope of the ISD and therefore that it would be subjecting them to double regulation if they were to be subject to this standard also.

Standard 19: Risks in cross–border links

This standard should not be applied to custodians operating systemically important systems, given that custodians are participants in a system and do not create links between systems or with central banks.

3. Conclusion

As mentioned in the introduction to this paper, the ESBG welcomes the ESCB–CESR standards, as amended to reflect the arguments raised in the market consultation, as a useful tool to promote efficiency and reliability in the European securities clearing and settlement market. It does however believe that the scope of the standards should be limited to infrastructures such as CSDs, ICSDs and CCPs and not to intermediaires such as custodian banks, which would have the effect of over-regulating the banking industry. In particular, the implementation of the proposed collateral arrangements under Standard 9 would not only lead to competitive distortions as noted above, but will also entail unnecessary regulatory costs without providing additional safeguards.

There is also a danger of putting the cart before the horse, so to say, by introducing a risk based functional approach or a set of "soft laws" into a set of EU "hard laws", which have not yet been updated to reflect the realities of new market circumstances.

To this effect, close coordination needs to be maintained with the European Union to ensure that the proposed new EU legislative approach is not undermined or complicated by any national legislation that may be enacted to ensure the implementation of the proposed ESCB–CESR standards at a national level. Thus the legislative and standardisation approach should proceed hand in hand to avoid confusion in the market and redundancy of legislation and implementing measures at a European and national level.

The ESBG trusts that ESCB–CESR will note and accept these arguments in the constructive way that they are intended and is available for any clarification that may be required on their comments on the proposed Standards.

4. THE SCOPE OF APPLICATION OF THE ESCB–CESR STANDARDS

As argued above, the ESBG does not agree that the scope of some of the standards should be extended to "custodians operating systemically important systems" as foreseen in the Consultative Report. This applies in particular to the proposed ESCB-CESR Standards on the legal framework (S1), securities lending (S5), risk control measures (S9), cash settlement assets (S10) and operational reliability (S11) which should not be applied to any institution that is already subject to strict prudential and conduct-of-business regulation under current and forthcoming EU Banking Legislation as well as Basel Rules. This remark also applies to the standard on settlement cycles (S3), delivery versus payment (S7), settlement finality (S8), and risks in cross–border links (S19), where custodians rely on their membership of systems to effect their business. Consequently, the impact of the standards for custodians should be through their direct links with CSDs and ICSDs.

The ESBG believes that it is completely arbitrary to try and define concepts such as "systemically important "in terms of market share thresholds. It is not obvious that such information is broadly available and it could also lead to distortions or inefficiencies as market participants keep below certain thresholds to avoid the impact of higher compliance costs. Furthermore it will be very expensive and onerous to monitor fixed benchmarks periodically for systemically important providers of custodian services.

The ESBG also believes that standards 13, 14, 15 and 17 should not apply to custodians unless it is ascertained that one or other custodian has a "monopoly" position on a particular market. Such organisations could also be requested to make certain assurances to the national and/or EU Competition Authorities.