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For the attention of

Mr. Elias Kazarian
European System of Central Banks

Wim Moeliker
Committee of European Securities Regulators 26 November 2003

Gentlemen,

ESCB-CESR: Standards for Securities Clearing and Settlement Systems in the European Union

In response to the call for contributions to the ESCB-CESR Consultative Report on this subject, we are writing to set out the principal concerns of LIBA members. We have seen near-final drafts of the submissions made by the European Banking Federation and the British Bankers' Association and broadly endorse those positions.

A list of LIBA members is enclosed, from which you will see that LIBA members comprise the principal European and international investment banks. This contribution to the debate has been made from the perspective of LIBA members as users of securities settlement systems and as consumers of custody services. Other business lines within the membership are, we understand, preparing to submit their own views.

We first highlight the general areas of concern and then provide some specific comments at a more technical level on certain of the standards.

General areas of concern

- **CPSS-IOSCO standards broadly appropriate.** We believe that the underlying standards prepared by CPSS and IOSCO are very much on the right lines. Central counterparties (CCPs) and central securities depositories (CSDs), by their nature, almost never face significant competition in the markets they serve. Banks, on the other hand, whether offering cash payment services or securities services, are almost always and everywhere participants in competitive markets. In the public interest, competition between banks is moderated by regulation. The principal justifications for regulation are the special position occupied by banks and the difficulties faced by individual customers in assessing the creditworthiness of the bank. We do not believe that the case has been made for applying additional regulation to a sub-set of the banking community and we remain concerned that the 'systemically significant' criterion is poorly defined and capable of misinterpretation.

- **There should be no imposition of utility-type regulation on custodians.** We are concerned that the standards have been developed from the point of view of appropriate regulation of market utilities but broadened in their application so that they would impose utility-type regulation on systemically important or dominant custodians (SICs) operating in a competitive environment.

- **Custodians with "dominant position".** We are especially concerned that the standards reflecting public interest requirements in the governance of settlement systems (Standard 13), equal access to such systems (Standard 14) and transparency (Standard 17) should not apply to custodians. In general, these issues are addressed by the operation of a competitive market for custody services in which the individual competitors are regulated. Issues relating to abuse of competitive positions are adequately addressed by national and European competition law.

- **Custodians with 'systemic importance'.** We are equally concerned about the principal of applying uneven regulation to custodians, depending on whether or not they are of systemic importance.

We think that specific requirements for systemically important systems might be warranted when evaluating continuity of business arrangements. We believe that strong prudential controls need to be and generally are in place with regard to all custodians on issues such as securities lending (Standard 5), delivery versus payment (Standard 7), settlement finality (Standard 8), cash settlement access (Standard 10) and operational reliability (Standard 11). However, we do not see the merit of generally differentiating between systems with and without systemic importance.

- **Requirement for full collateralisation not appropriate for custodians.** We think that the suggested requirement that CSDs, CCPs and SICs should fully collateralise credit risks (see especially paragraph 109 of the Consultation Paper) is again formulated from the point of view of the classic role undertaken by CSDs and is not appropriate for custodians.

  In many situations European custodians advance credit that is not collateralised, either partly or fully. This is appropriately addressed in the context of prudential regulation by the combination of their systems and controls and the regulatory capital which they hold. Indeed, unsecured credit may be a valuable contribution to enhance settlement efficiency. One example would be where a custodian advances unsecured credit (on or before settlement day) to a client to facilitate settlement on settlement due date. Failure to settle a particular transaction on the due date can adversely affect multiple market participants.

  We think the possibility of such credit extension contributes significantly to the systemic stability of the financial system. A new requirement of full collateralisation for credit provision by parties acting as custodians would greatly increase the cost of investment in the EU. All participants in the investment chain would be adversely affected. This particular measure would damage progress towards two of the stated goals of the standards – cost reduction and increased efficiency.

- **Application to the settlement of ATS transactions.** In paragraph 13, reference is made to the relevance of the standards to providers of post-trade services. While we agree that the standards are relevant, we also believe that the standards are not applicable to such providers, since such providers (and providers of software and consulting services with which they co-operate and compete) are not regulated. It will be for the industry to work with its regulators to define the practical implications of the proposed standards and communicate this to the supplier community.

Specific comments on standards

Standard 2 – Trade confirmation and settlement matching

While LIBA members are working towards a single Virtual Matching Utility (VMU), this work will take some time to come to fruition. In the meantime, regulators should promote interoperability as the principal means of improving performance in this area.

Standard 3 – Settlement cycles

The principal source of forward movement on this issue is the implementation of the 'Giovannini 2' report in Europe. It is important to recognise that harmonised cycles for products are a first step. Each product has a 'standard' settlement cycle which applies in the absence of agreement between the parties and for some products 'supercycles' will be required to deliver securities or cash more rapidly than the standard settlement cycle.

Standard 4 – Central Counterparties (CCPs)

LIBA believes that having fewer CCPs would be beneficial and that markets should be encouraged to leverage existing CCPs, rather than develop their own.

Evaluating costs, risks, and benefits of CCPs should be done in conjunction with an analysis of the costs associated with a reduction of settlement cycles, as there is an argument that with the reduction of risk associated with CCPs the case for a reduction of settlement cycles weakens.

We have considered the proposition that market participants formally evaluate the costs and benefits of clearing through a CCP vs. clearing bilaterally. This is a rather far-reaching proposal that will place considerable additional responsibilities on market participants (the standard is directed at market participants & CCPs - not at trading platforms). Given the scope of the standards (bonds, equities & derivatives) this covers a number of markets currently not centrally cleared (e.g. eurobonds, credit derivatives, emerging market bonds, etc.).

In paragraph 63, we believe ESCB-CESR should specify that in all markets, CSDs and CCPs should ensure that arrangements are in place for the CCP to instruct cash and securities movements on the member's behalf. This will reduce mismatches and fails.

Standard 5 – Securities lending

We do not agree that the distinction between custodians with and without systemic importance is appropriate in this context.

The standard should encourage CSDs to play a role in facilitating automated borrowing and lending in appropriate product markets.

Standard 7 – Delivery versus Payment (DVP)

We do not agree that the distinction between custodians with and without systemic importance is appropriate in this context.

Any mechanisms to achieve true DVP should not introduce costly overnight funding requirements, where cash may need to be locked up on the day before settlement due date.

To achieve true cross-border DVP settlement, interoperability (or at least similar standards) will be required.

Standard 8 – Timing of settlement finality

We do not agree that the distinction between custodians with and without systemic importance is appropriate in this context.

An important element for this standard, in order to effect cross-system settlement, will be harmonisation of intra-day and end-of-day finality between CSDs.

We have also considered the proposal that incentives should be introduced to reduce late settlement (paragraph 98). The practical consequences of this proposal will require careful modelling so as to ensure that the effects of the incentives reach through the settlement chain to those whose behaviour it is intended to change. End investors often have limited influence on the intermediaries they use, to ensure settlement is earlier rather than later in the day.

Standard 9 – Risk control in systemically important systems

See above under "General areas of concern".

This standard as currently formulated does not give appropriate guidance for risk control as far as custodians that are subject to financial services regulation are concerned.

Also in this context, we do not think that the concept of differentiating between custodians with and without systemic importance is the appropriate distinction.

Standard 10 – Cash settlement assets

We do not agree that the distinction between custodians with and without systemic importance is appropriate in this context.

Standard 11 – Operational reliability

We do not agree that the distinction between custodians with and without systemic importance is appropriate in this context.

Standard 13 – Governance

We are concerned about the application of this standard to custodians. Concerns relating to the abuse of a dominant position are appropriately addressed by national and European competition law. Equally, governance arrangements for regulated entities and companies whose securities are dealt in on the public markets should be sufficient to meet the concerns articulated here. It may be appropriate for banking and securities regulators to identify the underlying concern and to consider how best to address it, perhaps through co-ordinated action at 'Lamfalussy level 4' (co-operation between regulators).

Standard 14 – Access

We are concerned about the application of this standard to custodians. Concerns relating to the abuse of a dominant position are appropriately addressed by national and European competition law. So long as ISD firms and banks have access to each regulated market through one or more custodians, the ISD can be given practical reality.

Standard 15 – Efficiency

Participants in markets should be encouraged to use processes and business practices that promote efficiency. A combination of market rules and regulatory and commercial pressure should be deployed in pursuit of this goal. These processes and business practices must be harmonised across markets at least to the extent required to achieve interoperability.

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

There is a difficult balance to strike in this area. On the one hand, too much regulatory prescription would be likely to hamper market development. On the other hand, too much ‘freedom’ to retain outdated methods (such as the fax machine) can add unnecessary operational burdens as deadlines tighten. On balance, we believe that market participants should be given more time to demonstrate what they can achieve before detailed regulatory prescriptions are developed and applied.

Standard 17 – Transparency

We are concerned about the application of this standard to custodians. Concerns relating to the abuse of a dominant position are appropriately addressed by national and European competition law.

Transparency should not be confused with unbundling. The proposal in paragraph 184 – unbundling of the costs of value-added services – may make these services become more expensive.

The CPSS-IOSCO disclosure framework could be developed so as to cover a description of the risks in the “processes” as well as the risk exposure policies of the operators.

Conclusion

In conclusion, we believe that the application of the CPSS-IOSCO standards to CSDs and CCPs will be a positive contribution to the development of European markets. We do not, however, believe that extending the scope of application o those standards to cover ‘systemically important’ custodians is appropriate. We would recommend further collaborative work by banking and securities supervisors at a European level to consider how best to address the concerns giving rise to the amended standards.

If you would like to discuss any aspect of this response with LIBA or its members, please contact me at the address above.

Yours sincerely,

John Serocold
Director

LIBA

MEMBERS OF THE ASSOCIATION

ABN AMRO Bank N.V.
Arbuthnot Latham & Co., Limited
Arbuthnot Securities Limited
BNP Paribas
Barclays Capital
Bear, Stearns International Limited
Cazenove & Co. Ltd
CIBC World Markets Plc
Citigroup Inc.
Close Brothers Corporate Finance Ltd
Collins Stewart Limited
Commerzbank AG
Credit Suisse First Boston (Europe) Ltd
Daiwa Securities SMBC Europe Limited
Dawnay, Day & Co., Limited
Deutsche Bank AG London
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Evolution Beeson Gregory Limited
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