

Joint Work of the European System of Central Banks and the Committee of European Securities Regulators in the Field of Clearing and Settlement

Contribution from the Fédération Bancaire Européenne - FBE

Point 2.1 : Nature of the Recommendations

- 1. We think that standards and business practices applicable across all individual European market places in the form of comparable rules, should be the subject of recommendations only, and not of legislation.
Good standards are best developed through market initiatives.
Codes of conduct which really improve the effective custody and settlement processes are often sufficient to minimise operational risk and preferable to legislation.
Once there is broad market consensus on their usefulness, certain basic standards could be subject to legislation in order to ensure mandatory compliance.
- 2. Having said this, legal certainty and a level playing field for all players in the European Union are important issues for the banks. The legal framework governing clearing and settlement of securities should be harmonized at EU level. The diversity of the relevant legal frameworks and the inherent uncertainty for cross-border transactions should be removed. The same rules and standards for all issues related to the clearing & settlement and to the safe-keeping of securities as well as corporate actions (where appropriate) should apply across the EU. At a later stage, the tax treatment of securities (withholding tax) should be harmonized at EU level.

It is of paramount importance for the market that the legal framework applying to clearing and settlement of securities be sorted out, as soon as possible.

Point 2.2: Addressee

- 3. The principal addressees for the standards and the recommendations will depend upon each topic dealt with. They will be, according to the case, the systems and their operators, market participants, then of course the regulators and legislators.
- 4. At global market level, the organisations responsible for developing global business standards (such as ISMA, the International Securities Market Association) should be one of the addressees of any recommendation coming from this work.
- 5. Third party providers to the market infrastructures, such as Swift for communication purposes must be kept informed.

- 6. Service providers (e.g. CSDs/ICSDs) as well as users, will have to adopt the standards. The best incentive for implementation and compliance will simply be competitiveness.

Point 2.3: Scope

- 7. Before defining the scope of the Group's work, it seems necessary:
 - a) to agree on clear definitions of the roles, tasks and responsibilities of the different players and service providers.
In this respect, a clear distinction between the terms "users" and "infrastructures" would be welcome to clarify the debate.
 - b) to agree on a clear segregation of duties amongst the different parties
- 8. We agree that the Group's work has a wide scope and should not be limited to any particular type of service provider.
It is important that providers of like services, duties or functions are regulated alike.
CSDs, ICSDs, CCPs, SSSs, Central banks, custodians and registrars are all key players in the system and should therefore be included. However, the main scope should be on the infrastructure, i.e. CSDs, ICSD and CCPs because users cannot expose these infrastructures to competition.
- 9. Besides European and national legislation, standards and general rules are the framework within which all actors in the market operate. In order to truly achieve efficient processes that support cross-border investments, custody services/safekeeping needs to be part of the scope.
- 10. However, certain provisions of the framework are meant for a specific category of players. Each participant in designing his system and procedures has to adhere to all rules and accommodate the standards which affect him directly and should understand the rest. Investors/ Fund managers also play a key role in the smooth functioning of the system. They have to adhere to the rules and respect deadlines and limitations (as for example issuing timely instructions to custodians, ensuring availability of the traded asset: funds or securities etc.). The implications of a default, if not yet protected otherwise as is mostly the case, should be enforceable and should affect the responsible party.
- 11. An investor or intermediary should be free to choose for the respective functions between a) using a custodian for his clearing and settlement requirements as well as for custody services and b) different service providers for the respective functions (agent of choice). The trade off between improved efficiency on one hand and increased associated risk on the other hand should be assessed by each participant individually and by participants collectively on behalf of the market.
As a general principle, where a market function does not work because of the existence of a monopoly situation in the centre of the process, there is space for additional legislation.

- 12. Credit institutions must comply with strict capital requirements and safeguard the assets of the investors.
- 13. The different nature of the various securities require differentiation. Derivatives are a good example.
- 14. Cross-border transactions should receive the main attention as they are one of the core issues and at the centre of the debate. Direct membership to an exchange, a depository or a CCP (assuming the fulfillment of certain criteria), harmonization of withholding tax treatment, operating hours, deadline for trade confirmations, communication channels, conflict resolution, investor's protection are just a few examples of issues relating to cross-border transactions. Considering the fact that domestic markets are generally very efficient, the objective is to create a single European market without reducing the efficiency of local markets, although they will need to be harmonized where appropriate.

Point 2.4: Objectives

- 15. We firmly support the objectives that are to be pursued by the group in its work. The 4 objectives stated are all very important to the European banks. We wish to stress that, once these objectives are defined and agreed, a roadmap including the different phases to reach the objectives, and involving both the private and the public sectors, must be established. We would like to complement the stated objectives with the following:
- 16. Facilitating capital raising in the EU market is a primary objective, not explicitly stated though.
- 17. It could be useful to look separately at the process for retail and professional/institutional investors. Their requirements for cross-border investments are different.
- 18. Within the risk mitigation objective, the possibility to settle against central bank money must be further examined. Central bank-money functionality is amongst others related to the central collateral management for cross-border trades. Generally speaking, the role of the central banks within the desired infrastructure should be defined.
- 19. Although one of the stated objectives is, quite rightly, the promotion of integration of the EU securities markets infrastructure, one must not lose sight of the need for true globalisation of the markets, beyond the borders of the EU. Some transactions may generate or end outside the EU. Concertation with the major non-European markets is important.

Point 2.5 : Access conditions.

- 20. Although remote access is in general possible, it implies some constraints, if not fundamental restrictions. For example, remote access often requires to use the CSD's proprietary systems. Not all CSDs yet fully apply common standards and communication, such as SWIFT/SWIFT net or even Internet access.
The inherent complexity of systems should not bring discrimination to access. This, besides other factors can lead to the situation that access to some markets requires, in reality, the physical presence of the clearing and/or the settlement agent.
- 21. If access must be controlled, this should be exclusively on the basis of objective criteria with respect to operational and financial competence of participants. All other restrictions (such as physical presence) should be removed.
Infrastructures such as CSDs or CCPs should publish their schedule of conditions with clear requirements for membership in accordance with agreed standards. Adherence to these standards should be monitored by the regulators.

Point 2.6: Risks and Weaknesses.

- 22. The most relevant weakness and risk factor in cross-border clearing and settlement is that no true real-time DVP mechanisms exist. Efficient DVP methods must be in place in order to facilitate cross-border transactions. The main question to be resolved is what is the most efficient DVP mechanism. Particular attention should be paid to the delivery side of both stocks and cash.
- 23. Since the legal framework governing securities transactions is not harmonized across EU, contradictions amongst local legal provisions on the same issues represent an additional source of risk. The several actors involved usually in a cross-border transaction are bound by bilateral agreements with different provisions regarding applicable law and jurisdiction. A harmonized legal framework governing settlement across the EU is the solution. We agree with the comment on the settlement risk.
- 24. Segregation and reconciliation of assets under custody and special laws for the protection of these assets as well as, in the case of insolvency, provisions for the immediate transfer of those assets to another custodian are the main issues to be addressed under custody risk.
The overriding objective of a custodian from a legal point of view is to ensure legal protection of client assets under custody.
The need for harmonization of European legislation exists also in the case of insolvency protection and for corporate action claims
- 25. We agree with the most crucial issues to be addressed with regard to settlement risk.
STP and central counterparties can reduce the pre-settlement and settlement risks. Central Banks represent the optimum solution for the settlement of the cash leg of all securities transactions. Their role is essential for the safety and

efficiency of the clearing and settlement process and to mitigate systemic risk.

- 26. As for operational risk, the main factors to be considered are the broad divergences in the way corporate actions are handled and system/volume capabilities. Common operational standards and minimum technical requirements (including contingency procedures and back-up facilities) applying throughout the EU will improve the security of the systems.
- 27. Securities lending and borrowing should be facilitated as it can effectively mitigate settlement risk and should be considered as a complement to stringent buying-in rules.
- 28. Book-entry settlement should become the norm. This can be greatly facilitated through generalized dematerialization of stocks. Dematerialisation should be promoted by the law and regulations, throughout the EU. Standards should be adopted for more frequent reconciliation of balances. Standard frequency for reconciliation of balances in turn would drive down both operational and settlement risk and make corporate actions safer. Where registration for entitlement of stocks in CSDs is required, this should be harmonized across Europe and registration should take place within a specific timeframe.

Point 2.7 : Settlement cycles

- 29. Harmonized settlement cycles across the EU are desirable in order to reduce costly funding arrangements.
- 30. In order not to increase operational risk, the infrastructure and STP needs to improve before settlement cycles can be shortened. Harmonization of the different time cycles and different public holidays for EMU and non-EMU systems should be sought. A shorter settlement cycle will increase risks for indirect market participants located overseas. The settlement of back-to-back transactions will become riskier. A corresponding improvement in the forex market is also a consideration for a shorter cycle.
A thorough examination of the business case is an essential pre-requisite to the shortening of settlement cycles.
Shortening the settlement cycles without first establishing general benchmarking for system improvements could end up in increasing the operational risk.
- 31. Different settlement cycles may apply for different financial instruments. A typology of transactions (instruments/regulated markets/OTC) should be established and it should be made clear when the compliance with the standard is mandatory or simply advisory.

For certain securities such as derivatives there is a need, in order to minimize associated risks, to have a very short settlement cycle. For sovereign debt a shorter cycle may be possible.

Point 2.8: Structural issues.

- 32. Harmonization of the infrastructure across the EU is the goal. The existence of many providers of trading, depository and custodian services in the EU and the ever increasing number of cross-border transactions have created *de facto* a competitive environment between the different players based on their specific roles.
Competition laws against abuse of dominant positions are important but they should not lead to a further fragmentation of the market.
Any monopoly legislation should be abolished.
- 33. However, in view of the importance to the system of the functions of these firms, a clear distinction should be made between the different market player roles and a comprehensive regulatory environment should exist. Monitoring by the competent supervisory authorities, as already in place in the national markets, is the key for a safe competitive environment. The various rules and requirements to secure the financial stability of the markets should have the same impact on all service providers which carry out the same function and belong to the same category (i.e. the same rules apply for all CSDs). Exchanges, CSDs, CCPs and ICSDs may have additional recommendations or rules regarding their special role and be subject to competition law. Market participants i.e. financial institutions, institutional investors brokerage firms and/or their associations should be represented in their capital, if they wish so, and in their governing bodies.
- 34. The Governance principles applying to market infrastructures will be the subject of a specific paper from the FBE, to be issued in the near future.

General Observation

- 35. The terms used in this report, and in other documents published by the authorities and regulators, should be clearly and consistently defined.