



RESPONSE TO THE DRAFT

**CESR-ESCB STANDARDS FOR SECURITIES CLEARING AND
SETTLEMENT SYSTEMS IN THE EUROPEAN UNION**

JUNE 2004

A. INTRODUCTION

1. European banks are committed to the goal of establishing a regulatory framework that ultimately contributes to a competitive, efficient, safe, and robust market. The European Banking Federation¹ (FBE) attended the open hearing on May 25, 2004 and submitted a preliminary response to the Revised Draft of CESR-ESCB Standards for Clearing and Settlement of Securities ('Revised Standards') at that time. The current document is a response to the call for written comments by June 21st. While we fully appreciate the opportunity of providing written comments after the hearing, due to the limited time available, we have not been able to go into all of the issues raised by the revised Standards in depth. Our comments will therefore only address a limited number of issues. We would be happy to continue working with CESR and ESCB further on all aspects of the Standards to continue improving their quality.
2. We appreciate that the Joint Working Group has been reflecting on these shortcomings. During the hearing on May 25th, it was evident to us that the Joint Working Group also shared the belief that the Standards were not perfect and would almost certainly need to be revised in a few years' time. While we fully support the Joint Working Group's efforts to bring this two-year long work to a conclusion, we do not share the underlying assumption that the Standards cannot be improved further, or that the areas of remaining controversy are resolved in a way that achieves at least a short-term solution.

¹ Set up in 1960, the European Banking Federation (FBE) is the voice of the European banks. It represents the interests of over 4,000 European banks from the EU as well as Norway, Switzerland and Iceland, with over 2 million employees and total assets of 20,000 billion euros. As of 1st of July 2004, the FBE will gather a total of 26 national banking associations as members, the remaining two joining at a later stage. This document, given on the 25th of May, does not constitute a formal position of the FBE, which will be prepared in due time by the deadline for written contributions.

3. Even if one accepts the premise that the Standards are being adopted as a temporary solution for a limited period of time before a future Level 1 initiative takes place, one would need to tackle this in a way that minimizes the costs to the EU market in terms of wasted market and regulatory investments as well as loss of efficiency and competitiveness. A temporary mechanism that will have to be revised should be based on a very strict standard of cost/benefit analysis. In our view, many parts of the document would not be justifiable on this basis.
4. Even more importantly, a Level 3 initiative should stay away from subjects that require a Level 1 decision. We appreciate the frank exchange in the hearing, which made it clear to us that the Joint Working has sought to reach a true middle ground on one of the most contentious issues, i.e. how to regulate the risks assumed by ICSDs. However, we do not believe that the current formulation of Standards 5, 6, 9 and 10 can be seen as a useful solution yet. In fact, we believe that adopting these as they are would not only fail to impose any effective controls over the risks carried by the ICSDs, but would extend them to areas where such risks are not currently assumed (domestic CSDs). We do not find the principle of leaving these decisions to the digression of national regulators satisfactory. If this area will be regulated by the CESR-ESCB Standards at all, this should happen in a way that provides for a reduced degree of risks, a level playing field, and legal certainty. The proposed solution suggests to us that CESR and ESCB may have been unable to decide on a mechanism for dealing with these risks. If that is the case, then this subject should not be a part of this paper. Non-action now would be better than an action with a negative impact on the safety of the systems which at the same time lacks a common EU framework.
5. Finally, the issue of the unclear scope is only made more difficult by the lack of an assessment methodology. Without this, we are unable to fully evaluate the impact of the Standards on our business. It would be very useful to be able to review these two issues – the content of the rules and the assessment methodology – together.
6. Based on all these concerns, **we propose that CESR-ESCB Joint Working Group continue working on the Standards in collaboration with the market and in conjunction with the work to be started on the assessment methodology.** This work should be carried out in **a well-defined timeframe** – e.g. starting immediately, and ending with the completion of the assessment methodology – so that there is no risk of it being delayed indefinitely. The FBE would be committed to full collaboration with CESR and ESCB in this work.
7. Below we provide an overview of the four key subjects that would be tackled in the continuing revision of the Standards, followed by a list of other issues that are also important.

B. MOST URGENT ISSUES

I. Eliminating misunderstandings concerning activities carried out by banks

8. The majority of the proposed standards should not apply to banks,² because (i) banks do not carry out infrastructure functions, whereas the Standards are designed for infrastructure functions, and (ii) the risks borne by banks vis-à-vis the clients, which are covered by the banking regulations, should not be confused with the risks they are exposed to vis-à-vis the CSDs, which are risks emerging from the systems, which are not subject to control by the banks. A consequence of the inaccurate depiction of banking activities is a significant mismatch between the objectives of some of the Standards and the activities of banks.
9. Whereas the risks carried by banks vis-à-vis their clients are subjected to risk limitation and control by means of banking regulation, CSDs are not subjected to any regulatory measure specified to CSDs that could mitigate the system risk when dealing with intermediaries (banks). It is unjustifiable to subject banks to further requirements in order to cover risks which are emanated by CSD activities.
10. These misunderstandings are evident in Paragraph 14, which would have to be revised to reflect market reality, taking into account the following points:
 - Banks do not carry out “clearing and settlement” activities comparable to those of CSDs. Banks provide services that are part of the settlement process; they do not provide infrastructure for clearing and settlement.
 - Banks do not carry out clearing as they have no market overview and therefore cannot calculate mutual obligations.
 - Banks are very active in the field of clearing and settlement as users and intermediaries. They serve the retail and wholesale market segment as intermediaries for the investors, with regional and global custodian banks acting in some cases as nominees for large foreign investors. Some have their own IT devices for settlement for their clients and networks of sub-custodians which are necessary for them to fulfil their functions as intermediaries in the clearing and settlement of transactions.
 - Banks are not subject to the Finality Directive.
 - Banks do not serve markets, they serve their customers.

² Throughout this paper, the terms “banks” and “custodian banks” are used interchangeably and they both refer to banks carrying out custodian activity in the strict sense. It is unclear whether they include ICSDs which may have a banking license.

- Banks are not members of the Eurosystem.
- Banks may not always act as nominees but they always act as intermediaries.
- As a result of all of these factors, banks' interposition between the client and the CSD does not give rise to any risks for the global system.

11. For example, the internal settlement activity that is referred to in Paragraph 14 constitutes a random and negligible activity for banks that takes place in some jurisdictions. There is no cost-benefit analysis provided in the revised standards that would justify applying any of the standards to banks carrying out this activity. If the Working Group is concerned about this activity, it should identify why it is of concern, pointing out which aspects, in their view, create risks that are not already covered by regulation, and then analyse them separately.

12. In some cases, the application of the Standard to banks is both impractical and even undermines the safety of the system. An illustration of this problem is the application of Standard 7 ("Delivery Versus Payment" - DVP) to banks. Although the application of DVP to CSDs is essential for reducing risk, its application to banks is not only impractical, but would in fact undermine banks' risk management. If banks were obliged to ensure DVP, this would prevent them from extending credit. Furthermore, it would require "real time book entry", which would mean a dramatic change in all IT systems. The Standard does not acknowledge at all the consequences of this rule for banks and does not justify it in terms of benefits. In the least, such a change would have to be discussed in full. Our view is that such a drastic change would be fully disproportionate in terms of costs compared with any potential benefits. Hence, Standard 7 should be amended by stating that it is addressed to CSDs.

II. Ensuring appropriate inter-action with banking supervision and avoiding double regulation.

13. There is a clear risk of double regulation if banks are subjected to a second set of rules and this fact is not well recognized. Therefore, we welcome in principle the recognition in Para 15 and in numerous other parts of the document that banks are subject to banking supervision and that this should be the main channel for regulating the banks' use of clearing and settlement systems. However, the Standards do not provide for a clear framework for banks to be regulated under the Basel framework.

14. First of all, in many cases, the Standards seem to be fully applicable to banks even if the risks in question are already addressed by the Basel framework and general banking supervision. For example, intra-day credit risk (which was presented in the hearing of May 25th as a justification for applying the Standards to banks) is indeed the

result of normal banking activity and is therefore fully covered by banking supervision rules.

15. Furthermore, Paragraph 15 is not sufficiently clear in establishing that banking supervisors will be in charge of this supervision. Paragraph 15 should make it clear that the Basel framework “*will*” (as opposed to saying “*is likely to*”) address these issues.
16. It is not clear whether it is the securities regulator or the banking supervisor who will have the responsibility of oversight. We obviously believe that it should be the latter.
17. Last but not least is the unclear scope with respect to banks. The effect of Paragraph 14 is to leave to national discretion the scope of banks that might be caught by the definition of systemically important systems. This means that we do not know if the standards will apply to banks, and if so, to which banks. This uncertainty not only makes it difficult for banks to evaluate the appropriateness of the standards for their own activities, but it also undermines the whole rationale of creating an EU level framework which is based on the premise of a level playing field. In fact, we believe that no bank would fall under the definition of a “systemically important system” since they would be “sufficiently protected” under the Basel framework.
18. The above lack of clarity leads to a situation of double-regulation and disproportionate regulation. An example is Standard 9, which deals with risks that are already regulated by international and EU banking regulation. Applying this Standard to banks would mean double regulation, and even constrain the ability of banks to deal with their risks. Collateralization, which seems to be assumed in the Standard and Key Element 4, is only one of a range of risk management techniques used by banks, which fulfil stringent capital adequacy requirements. Similarly, applying Key Element 5 of Standard 9 to banks would contradict the Pillar III of the Basel accord, which deals with disclosure of risks to the market and to the supervisors.
19. Hence, we strongly believe that banking supervisors, working under the umbrella of CEBS, should have the primary responsibility for addressing the risk management of banks with respect to lending or securities lending, and Standard 9 should only apply to other entities (CSDs and CCPs).
20. Similarly, applying Standard 17 (transparency) to banks would ignore the fact that Pillar III already establishes the appropriate transparency measures for all activities of banks.
21. Another example is Standard 11, which requires banks to operate a second processing site which undertakes immediate processing and is located at an appropriate

geographical distance. This Standard ignores the fact that banks are already under a banking supervision requirement to measure and minimize operational risks. Even if banks were kept in the scope of this requirement, the extent of obligations (for example the time) would have to be tailored to banks (e.g. in other jurisdictions such as the US, this period applies only to core clearing and settlement organizations, while other market participants are explicitly allowed longer periods.) There is a contradiction between the 2-hour requirement and the obligation to maintain the second site at a considerable geographical distance. Whether back-up staff is also required is not addressed. In fact, we believe that the Standard may effectively require a complete replication of the bank's activities in two locations. Furthermore, the effect of Para 136 would be making banks responsible for the settlement of CSDs.

22. Hence, we believe that either the Standard 11 should not apply to banks, or it should be revised in accordance with the activities and role of banks in the process, e.g. clarifying Para 136 and replacing the 2-hour requirement with a statement such as “as required in the Service Level Agreement”.
23. Last but not least, the lack of a proper coordination with the banking supervision framework creates a problem for the competitive environment for EU banks. The proposal of leaving the definition of a “systemically important bank” to national discretion will make it impossible to generate coherence among the application by authorities, which may differ in terms of their strictness. The fact that Basel is effectively by passed will also lead to discrepancies with global banking supervision at the cost of EU banks.
24. For all these reasons, we believe that the great majority of the Standards should not apply to banks. Banks should be supervised by the banking supervisors. This would make the distinction of banks operating “systematically important systems” unnecessary and place the participation in the clearing and settlement process of all banks in the hands of the supervisors. These supervisors are not only best equipped to deal with these activities, but the resulting supervision would also have the advantage of creating a level playing field both within the EU and on a global scale, since it would be firmly based on Basel II.

III. Preventing CSD activities from generating unnecessary risks to the system

25. As users of clearing and settlement systems, banks are very concerned about the global degree of risk in the systems. CSDs are the place where ultimate settlement occurs. As entities responsible for safeguarding the integrity of immobilised/dematerialised securities issues, CSDs should not carry credit and liquidity risk. We therefore find it unacceptable that CSDs are allowed to take on credit and

liquidity risk (Standards 6 and 9), even if this is left to national governments and is supposed to be limited. Standard 9 is particularly important since it is used as the reference for risk management for several other activities of CSDs, such as securities lending in Standard 5.

26. The Chairmen of the Joint Working Group explained in the hearing that they believed two different models with regard to CSDs existed in Europe, a 'risk-taking' model allowing CSDs to take credit risk, and a 'risk-free' model. In our view, this is not reflecting market reality, as no CSD takes credit risk on a national level. The only entities that take risk by extending credit are the ICSDs.
27. As a result, Standards 6 and 9 have the consequence of artificially introducing systemic risk which cannot be reconciled with the overall obligation of CESR/ESCB to mitigate the risks of CSD activities. As users of infrastructure systems, European banks are weary of the danger to the safety of the systems. This approach does not seem to offer any direct counter-balancing benefit, and is even aggravated by the fact that the activity is allowed to take place without full collateralization in certain instances. The proposed conditions in Paragraph 107 and 108 are insufficient in limiting the risks of such activities.
28. In the interest of the main objective of keeping the system safe, we believe that ideally CSDs should continue not to assume any credit risk. In any case, ICSDs should have adequate risk mitigation procedures and also an adequate segregation of functions in place insofar as they are justified from a risk point of view, such that spill overs of financial risks to the various players and users in the market can be avoided. Further requirements should be solely of concern to competition authorities.
29. We also ask for a re-consideration of the proposal in Standard 5 to allow CSDs to act as principal in securities lending. Securities lending should not be done on a principal basis by CSDs. Furthermore, lending products by CSDs should be limited only to those instances of avoiding settlement failures. Finally, participation should not be mandatory.
30. If CESR/ESCB feels that it would be impossible for its Standards to establish the above approach, we would take this as a clear sign that the subject indeed exceeds the boundaries of Level 3, and must be left to Level 1. In that case, Standards 5, 6, 9 and 10 (please see below) should be completely taken out of the scope of the Standards. This is because we believe that no action in this area would indeed be better than an action that will increase risks and go counter to the interests of the clearing and settlement system of Europe. Given that the Commission Communication is launching a debate on these structural issues, the EU will in any event have an

opportunity to reach a more long-lasting and balanced solution in the near future.

IV. Settling in Central Bank Money

31. A subject closely linked to the above discussion is Standard 10, which does not require CSDs to settle in central bank money (while TARGET2 specifications seem to recommend this). Such a loophole would increase the risks of clearing and settlement systems and clearly contradict the objectives of the CESR-ESCB work, which include further integration of the systems across Europe. As the cash leg of securities settlement is a very important part of the process, these transactions would not be going through TARGET2 if their specification deviated from the TARGET2 standard.
32. We are aware that not all CSDs currently settle in central bank money. However, the interests of the safety of the system and the compatibility with the Target2 system clearly outweigh the costs of a transition to a fully safe settlement procedure. Therefore, we would recommend a transition period during which the entities in question could adapt to settlement in central bank money.

C. OTHER IMPORTANT IMPROVEMENTS

I. Ensuring a clear EU regulatory framework

33. Since the work of CESR and ESCB is proceeding separately from that of the Commission, we are not sure how Standards 1 and 18, for example, are going to function in practice. In fact, the difficulty encountered by the Joint Working Group in resolving the policy conflicts demonstrates to us the need to settle these questions at a higher level of principle (Level 1) instead of attempting to introduce national rules (Level 3) that lack a political consensus and guiding principles. The planned “assessment methodology” will not suffice to bring clarity to the matter in the absence of a higher order of principles. The impossibility of creating a level playing field in the absence of an EU framework is evident in the high number of issues left to national discretion in the paper (e.g. whether CSDs should be able to grant credit is left to national rules in Standard 9.)

II. Legal ambiguity of the application of the standards

34. It is unclear which parts of the proposed document constitute the standards: the first lines, the key elements, or the entire text that follows under each standard. Furthermore, it should be clarified whether these separate elements all apply to all the addressees for each standard, and, if not, which parts apply to some of the addressees.
35. We also note the use of numerous notions in the proposal in relation to the type of

banks that would be brought under the scope. The revised standards fail to bring clarity and instead transfer the question of scope to the national level. Hence the confusing list of references to banks and other entities (e.g. “critically important service providers” in Paragraph 135) remains a problem.

III. Impractical Requirements

36. We find that Standard 12, which requires reconciliation to be made “at least once a day”, lacks any discussion as to whether the benefits of this requirement would be proportionate to the dramatically increased costs that it will involve. It is not even clear to us what is meant by reconciliation: between a bank and a CSD or a bank and a client. We assume that what is meant is reconciliation between a bank and a CSD. We would like to note that this is actually current market practice in Europe in most cases under normal market conditions. While striving towards this practice may be fine, the wording is unnecessarily strict (“at least once a day”), as it may not always be suitable or possible, depending on bank holidays, different cut-off times, and the market situation. Furthermore, it is clear that such high-frequency reconciliation is not at all suitable vis-à-vis non-EU markets, as some markets deliver information on a monthly basis rather than daily and the intensity of the market relationship may be far too small to justify reconciliation more frequently.

IV. The Glossary

37. The Glossary would have to be aligned with the original IOSCO-CPSS Standards; it is a pity that the format used in this section of the Revised Standards does not allow the reader to see the differences.

38. Secondly, the definitions used must be aligned with those definitions used elsewhere in EU legislation (e.g. the EU Settlement Finality Directive).

39. In the absence of sufficient time, we are not able to provide detailed suggestions for amendments to several definitions. However, we would be able to do this if CESR and ESCB decided to continue working on the Standards along with the work on the assessment methodology.

C. CONCLUSION

40. To conclude, we would like to reiterate our belief that the Standards can be improved significantly in a way that meets the goals set by CESR and ESCB, in particular the

promotion of systemic stability. This can be done in a limited timeframe that also meets the objective of delivering a short-term solution to the perceived risks in the European clearing and settlement systems ahead of any future regulatory development. By working with the industry on the assessment methodology and the Standards, CESR and ESCB would be ensuring that the resulting work commands coherence as a whole package and achieves appropriate coordination with the banking supervision framework.

41. This approach would ensure a better quality product and broader endorsement of the standards, as well as enhanced confidence in CESR's own-initiative work more generally and, ultimately, in the Lamfalussy process. The FBE is fully committed to working with CESR and ESCB in the continuation of this work.