7th June 2004

CESR-ESCB outcome from the Hearing
Complementary input and definitions

This hearing demonstrated some kind of consensus in the audience about a certain level of uncertainty which gives to the report a flavour of « work on process » and not yet a final version. It means that a final version needs major updates to cover major gaps of understanding how our industry really works. It is impossible to build robust standards on unclear definitions or concepts. Then after this robust conceptual base will come the "political" debate on borders and responsibilities. We are still at the first phase. For the second "chapter" the hearing shows a second time strong unanimity against measures that would complicate and fragilise our European value chain.

Here is a list of issues organised on two chapters:
- Process and methodology
- Definitions around standards

1. Process and methodology

- Revision of the report

The task force accepts the idea that this work confronted with reality may be imperfect and then will need some maintenance… in 4 to 5 years.

In reality in those 4 to 5 years major structural decisions and investments will be done. Strategical choices and consolidation initiatives at infrastructures or intermediaries level will be taken based on the actual understanding of those standards.

The idea of accepting a certain level of approximation by pragmatism and taking the chance to adjust the vision ex-post is in the fact a dangerous challenge.

We all know how complex is and will be the European construction. If we want to progress efficiently the necessity is to simplify this complexity. Those standards are key in this perspective. The need is then to have:

- robust and clear standards, no ambiguity, no uncertainty in interpretation at the national level, no uncertainty on the enforcement process

- a clear and voluntarist choice between models as it is the case in every countries in the world. CSDs in the world (as it is the case for RTGS) never emerged through a competitive process. Strategies of intermediaries and consolidation of CSD need to build up on a clear secured environment driven by a clear cut systemic model.

- a clear segmentation of functions between intermediaries and infrastructures

- a model deeply addressing systemic risk issues based on a risk-breaking/fencing principle where all chains of actors pass through a central facility reinitialising from zero the financial risk level, as it is the case in the payment world with the central bank functions (central bank money, accounts & RTGS)

- at the core of this secured system a special status and obligation is given for inscription of securities directly in CSD's book (notary function) cf. standard 6, the cash pillar is central bank money principle through the use of TARGET 2 and a clear definition of status, obligations and bridges for auxiliary systems.

- standards clearly anchored in a domestic context for Europe and not in between domestic vision and cross-border pragmatism. Those standards cannot promote obsolete schema for Europe. Cross-border should be identified as transactions between Europe and the rest of the world. Intra European transactions should be qualified as domestic. In the interim phase those standards should define the major principles to manage the gap.

- relation with the European Commission, Lamfalussy process and binding level. It is clear that pragmatism is a necessity and that the speed of any framework decision from the EC creates also a gap vs today reality and need. In this context those standards should not innovate and focus on extreme priorities to solve existing systemic risk and/or consolidation initiatives and consequences. Eventhough standard 18 reinforce regulatory co-ordination, using domestic arbitrages or decisions for sensitive issues is probably a significant risk for incoherence.

- Report's publication. This report will be difficult to adjust. The assessment methodology phase will in fact be a very important phase helping the task force to confront principles to operational reality. By consequence it will help to give more precision in definitions and diminish uncertainty. In this case it should be suggested to link the publication of the standards and of the assessment methodology.

2. Definitions and standards

- § 14 "Custodian functions". The definition given is not totally relevant and needs to be align with the reality. All the report is probably built on this patent misunderstanding.

  - This definition seems to address the global custody and the sub-custody functions, it mentions "settlement infrastructures" as if 2 categories of custodians could be identified with or without "infrastructures" which is not the case. All custodians small and big use settlement application to exercise their Customer-Settlement Function (CSF). This CSF is "proprietary" and is part of the overall custody service (transaction processing). The other side of the chain is made of the Inter-Bank Settlement Functions (IBSF). This function is common to all the members of the same infrastructures (CSD) and this function per construction and per nature is different from the first one. At the custodian level this function is materialised in an application or interface, not in a system.

  - It mentions "in-house settlement" defined as "internal settlement". This is probably a confusion of terms. As a global custodian the concept of "in-house settlement" is not the core structural function. On the contrary at this stage the custodian is an intermediary between an investor (in its books) and an other intermediary elsewhere in the world the sub-custodian that itself process one leg of the instruction, an other local

custodian processing the other leg. In between local CSD settles the 2 local agents based on massive (per construction) internal settlement.

- The definition uses the term "rather" as if dominant practice of sub-custodian (implicitly) was not to use a CSD. Here the definition seems to confuse the role of the global vs the sub-custodian and jump to a conclusion that by pass the CSD at this level. This part of the text should stick to the best practice definition of roles and functions of custodians as it is published in many reports. This introduction, misunderstanding of the business, leads to some confusion in the model definition, the scope and interpretation of standards.

- "Clearing and settlement activities comparable…". Again comparing those customers oriented vs inter-banking oriented functions based on volume and traffic is misleading about the functional definition. Functions and volumes are different criteria. Two different functions may generate equivalent systemic risk. As systemic risk are generated differently it should be addressed differently and anyway it cannot induce that functions are equivalent.

- "Systems", Big actors by their size may create systemic risk, but it is not a question of operating "important systems" for payments or securities. The term "system" seems to be used to align infrastructures and banks, by-passing the functional approach. For each nature of function (well defined) some clear systemic risk criteria should be identified and then proper risk management recommendations should be proposed and discussed by type of institutions to guaranty that the standard regulatory framework addresses correctly this risk.

- <u>Standard 1</u>

- KE2 § 33 / § 35

CBOSIS (Custodian bank operating systematically important system) may present certain risk but that is not a reason to assimilate those custodians to infrastructures specially in the obligation to disclose publicly procedures, contractual provisions. The correlation between this obligation and the systemic risk mitigation is unclear. The practicality of this measure and its impact on competition may be questioned.

- § 34 good list of issues but at this stage this memorandum should go one step further and identify few convergence principle on securities accounts, failures processing, transfer of securities. Those principles are needed in 19 (cross system links).

- At this stage some definitions should be needed to differentiate customers from members of an infrastructures and within those members the status of direct vs indirect members in relation with standard 6.

- <u>Standard 3: "Cycles"</u>

- This standard in its principle is aligned with Target 2 reflection on ancillary systems. This standard should define a kind of principle about the nature of settlement operations

accepted by infrastructures after the closing time of Target. By simplification it should be stated that a CSD is closed for new transactions when Target is closed.

- Failures processing: this standard should address clearer principles about recycling responsibility, penalties. This should not be a competitive factor between CSDs but a normative rule clarifying risk management all over Europe and being a convergent factor between CSDs.

- Standard 5: "Securities Lending": This standard is one of the major confusing one. It shows profound misunderstanding on SL process and usage. It defines as equivalent functionally bilateral SL and central SL and promote central SL as technically more efficient.
  In a well organised environment SL is to prevent failures. Intermediaries are best placed to evaluate this risk, as the custodian processes a transaction applicable to a specific position. From a regulatory point of view it should be obvious to fix a set of regulations reinforcing the responsibility of custodians to manage properly this risk (related to Standard 12) and find the best SL service provider to cover the risk if necessary.
  If the mutualisation of this service through an infrastructure seems a good alternative, then very specific rules should be set because this mutualisation creates other type of risk in the SL process itself. It should cover:

  - The mobilisation and the management of the pool of "lendable" securities.

  - The end to end legal principle between this "omnibus pool" and the investor in the custodian book. The standard identifying that no usage of custodian securities without authorisation is at this stage not sufficient.

  - What is triggering the SL lending process. Explicit instructions accompanying a specific transaction or a chaining process discovering a lack of position in an omnibus account?

  - At the CSD level it should be defined specific technical reasons in the chaining process to use a SL function.

  - The financial risk side obviously is still a problem. Why opening the door for CSD to be in principal ? Why an agent position is not sufficient ? Why competition at this level in reality will counterbalance the negative risk consequences ?

- Standard 6: "CSD"

- A question of model. It has been said that 2 models exist and that no demonstration exist to define why one is functionally equivalent. The reality is different:
  - 99% of domestic CSDs in Europe (41 CSDs) are based on the same risk-free model and it is the same in the world. Limited cases (3 in Europe) do exist to cover non domestic functions (including Clearstream Frankfurt). In the functional approach it is important to address 2 different functions:
    - domestic settlement
    - non-domestic settlement

Those two functions generate 2 different and non equivalent models. If the mid-term context of those standards is the convergence towards a domestic area they should build up on the actual domestic reality and experience and define core principles and rules based on this existing common practices in Europe and in the world.

- Those actual standards are opening the CSD function to intermediary function, but they are not addressing clearly the case of ICSD operating CSDs. This case should be explicitly covered in 2 ways:
  - How to deal with the mix of infrastructural and banking functions inside the ICSD bank itself?
  - How to deal with the plurality of heterogeneous bodies inside the ICSD group meaning what should legally and prudentially differentiate services at the banking level vs services at the CSD level and consequently what are the principles to regulate bridges between those entities in day to day operation and if a systemic crisis occurs at the banking level.

- Based on IOSCO principle "Securities should be immobilised by book entry in CSDs" this standard should specify how to materialise this obligation and how to arbitrage commercial competition inside an ICSD between the banking services and the CSD services. Are they prudentially equivalent ? Based on a clear definition of the legal prudential definition of the notary account, this standard should define a common understanding in Europe for direct or indirect members and define a kind of obligation for significant actors to be members and have their customers assets registered at the CSD level in an omnibus account. In the same idea the necessity of segregating accounts at the CSD level for prudential reasons should be stated and commonly defined in relation with crisis management principles at the custodial level..

- As consolidation will happen it is important to minimise new risk due to this process. To do that, those standards should help simplifying the actual diversity by defining common core functions for all European CSD asking domestic regulatory to monitor this convergence in a reasonable time frame. Those principles should help also the practicable implementation of standard 19 about cross system link.

- The end to end audit chain responsibility for CSD should be operationally precised. As this concept is key to reduce risk in the context of customer protection (standard 12). Some common operational principle in Europe should be stated again to bring this feature as a non competitive one but a convergent factor.

- <u>Standard 7: "DVP"</u>

In relation with Finality, this standard should define how to differentiate DVP at a CSD level vs DVP at a custodian level. The fact that some custodians are CBOSIS cannot trigger any kind equivalence in a DVP concept at those 2 levels. The fact that the standard introduces this possibility means that the industry is not clear. As this is a key concept this should be urgently clarified.

DVP is to reinforce the status of CSD in its role of risk breaking and to guaranty the synchronisation between cash and securities leg at this inter-banking level. As custodians are not infrastructures, contractually they may offer some services of DVP of a commercial nature. In banks the accounting process covers usually all the bank and not just one business

line and even if some intraday information system do exist the banking "finality" is given by the central accounting process usually at the end of the day. DVP is then structurally of a different nature and if regulators needs to identify a new concept at the banking level further investigation should be done among the industry. Some confusion between DVP and "contractual settlement" must be clarified.

- Standard 8: "Finality"

As for DVP no confusion should be introduced between Finality at CSD and at custodian levels for CBOSIS. Finality should be based on the finality directive. If some new kind of finality is needed at the custodian level that should be specifically identified and defined, which is not the case in this actual version of the standards.

Finality is in fact probably the major differentiation between a CSD and a bank. Systemically the securities eco-system is built on this characteristic as it is the case in the payment area using central banks infrastructures. Finality is interrelated with the CSD'' institutional status. Finality, legally is defined by its opposability to other parties and by the fact that a transaction cannot be overcome for any reason. The reinforcement of finality is given through the cash leg based on central bank money, the securities leg being as robust as the previous one.

This standard should elaborate more on how regulators give importance to this function and contribute to a common and clear definition of its operational content and consequences. This obviously would contribute significantly to the strategical objective of mitigating systemic risks as it is one of the fundamental pillars of any securities eco-system. .

This standard should cover more precisely core principles for finality in cross system environment in relation with standard 19. At this stage the need exists and this actual contribution is too vague and may lead to misuse of "creative" practices.

§ 99: This explanatory note is important because it fixes a real rule which is more than a comment. It is a good example of what we need: "Finality in a received S.S. must only take place once it is achieved in the system of origin". As a rule it should take place at last at the key element level. As a methodological suggestion it should be important from the report to identify more explicitly rules from simple comments, as those standards imply common decisions and actions. Coming back to this fundamental rule it should be elaborated in greater details within the regulator's visions about how to operate (in principle) cross system links (standard 19) in a domestic and secured environment in relation with comment §160 on interoperability.

- Standard 9: "Risk"

This standard is clearly the result of some compromises. The result is unclear vision and rules about the level of risk at the core of the securities value chain and how it is clearly segregated among actors.

- This time the Ex-memorandum looks stricter than the standard itself § 105 states: "In principle CSD should not run credit risk,…". But the wording of the standards and KE generates strong ambiguities about the application of this principle. What are the principles defining "credit activities exclusively necessary for the smooth functioning…".

Then the standard implies full collateralisation of credit but opens the door to uncollateralised credit based on classic robust risk mitigation procedures as for any banks.

This standard should stick to its principle (§105) and to the fact that in a well designed domestic environment central credit is not needed for a smooth functioning of securities systems. If the standard wants to address cross-border services for a CSD's holding it should identify its functional perimeter and define clear rules to stop the risk propagation from the cross-border function (subsidiary) to the domestic function among the infrastructure's holding.

- KE 3, this standard addresses net settlement unwinding procedures in case of the default of a major participant. Obviously this is important, but many models or processes are possible and create in Europe risk and competitive gaps. This standard based on recent experiments of those solutions should define more detailed operational principles to harmonised in Europe the implementation of such a standard.

- Standard 10: "Cash"

Implicitly this standard identifies a risk line between two classes of actors: CSDs based on central bank money with no cash risk and the other aligned on the cash agent risk. For pragmatical reasons, this recognition of those two classes is a necessity but for systemical reasons it would be clearer to edict as a principle to converge to an unique class of CSDs without cash risk and based on a TARGET 2 bridge. For a non-euro European countries in the domestic function some specific principles should be defined based on agent banks.

- Standard 12: "Customers' protection"

This standard addresses operational and legal risks among different nature of actors.

1) Protection against creditors' claims is important, the standard should precise in principle the major gaps in the ownership chain ; the entitlement effect and its consequences in Europe for the segregation principle or the accidental usage of customers' securities.
2) For operational reason segregation may be useful but for prudential reasons and in the objective to protect assets from claims it is not sufficient. It would be more appropriate to identify convergent high-level business practices to manage efficiently such type of crisis.

- KE 3, 5 and 8 are more or less of the same nature. They should clarify obligations vs CSD and vs other intermediaries (including at this stage Transfer agents and Sub-custodians). It is not obvious that the obligation of reconciliation of records (and positions) once a day is in practice possible all over the world.

- KE 6 an 7 ; those KE should define condition for contractual settlement services that guaranty the gap between the right to use securities and the time when those securities really are posted to the account.

- Standard 14: “Access”

This standard should also address the issue related to the equality of access for custodians to CSD vs the internal access of an ICSD bank to its CSD function. This dilemma is not just a question of communication interfaces and cost but also of the uses of common functions at the banking and at the CSD level. Some “cloning” principles duplicating the common layers of functions could be an idea for a clear cut solution.

- Standard 19: “Cross system links”

This standard is key in an European domestic environment based on an efficient linkage between few remaining groups of CSDs. Lessons from so called ICSDs’ bridge should be leverage to identify basic prudential principles on cross system finality, DVP, cash settlement…

KE 4 stated an important rule that should be highlighted: no re-transfer of securities until the first transfer is final. Except this last rule, this standard is of a too high level and will need more detailed recommendations from regulators to trigger the needed consolidation on robust and secured bases.