

Position Paper
on
CESR/ESCB Standards for Securities Clearing and Settlement Systems
in the European Union
(related to the text version as of 5 May 2004)

In addition to the comments provided in the last consultation round, we would like to submit the following specific comments on the most recent text version:

I. General Remarks

1. Consistency of definitions throughout the standards

With respect to the impact of the CESR/ESCB standards for the future regulation of EU post-trade markets, we recommend to ensure the consistency of definitions used throughout the paper. Certain terms seem to duplicate each other (for example sub-custodian and local agent). For others more precise definitions might be found. We would like to refer in this respect to the ECSDA work made in this field.

2. Taking into account the particularities of CCPs

CCPs should be taken out of the scope of CESR/ESCB standards since their services are more trade-related and require a specific treatment. In particular, a distinction should be made between CCP clearing on the one hand and CSD / post-trade clearing in general on the other hand. CCP clearing concentrates on trade management, position management, collateral management, risk management and delivery management prior to the clearing performed by CSDs. CSD and post-trade clearing concentrates on validating and matching the delivery instructions; the result of which is forwarded to settlement. Whereas CCP clearing bundles clearing functions among multiple members, CSD clearing is generally applied to bilateral relationships. As a consequence, CCP clearing naturally involves more risks and also a different kind of risk, i. e. the counterparty risk where the CCP acts as a principal and not as an agent. The need for a specific treatment of CCPs is reflected by the most recent consultation document published by CPSS/IOSCO about recommendations for CCPs. Similarly, CESR/ESCB should treat the issue of CCP standards in a specific initiative. This would help

to avoid that certain standards in the current version do not fit for CCPs. This is in particular true for the following standards (core issues were in italics):

- Settlement cycles and operating times (standard 3): It is beyond the influence of CCPs to determine settlement cycles. The processes within a CCP operate on an intraday-basis. Therefore, it makes no sense to make CCPs reliable for the settlement cycles.
- *Central counterparties (standard 4)*: We do not understand the emphasis on cost-benefit aspects in the latest text when priority should be given to competition. Any other requirements regarding costs require a careful assessment on a case-by-case basis. As a consequence, CPSS/IOSCO recommendations for CCPs are more cautious in this respect.
- Securities lending (standard 5): CCPs themselves do not offer securities lending. The application of the standard to CCPs is not justified.
- Timing of finality (standard 8): Since CCPs do not ensure the finality of settlement between the seller and buyer of securities transactions, it does not make sense to extend the standard to CCPs.
- Operation reliability (standard 11): Specific aspects for CCPs were not taken into account. CPSS/IOSCO recommendations for CCPs are more accurate.
- Protection of customer's securities (standard 12): CCPs never offer custody services themselves.
- *Governance (standard 13)*: See general remarks.
- *Access (standard 14)*: From a risk perspective. A distinction is required between the participation on the one hand and the links between CCPs on the other hand. The different degrees of relationships between systems and/or participants are not reflected in the most recent text version.

3. Implications of the nature of standards

We strongly support that competent authorities in EU Member States align the supervision on market participants involved in post-trade business. We also support the binding nature of the standards as addressed to supervisory authorities. Nevertheless, we are deeply concerned about the fact that in the context of the elaboration of the future EU regulation on post-trade markets the standards might become directly binding for market participants (and are not only addressed to authorities) what could have misleading effects. In the case of the integration of the standards on Level 2 of a future EC Directive (see the Commission's Communication on "Clearing and Settlement in the European Union – The way forward") a new assessment of certain aspects is required. This is true in particular for the topics governance and efficiency control (see below).

II. Detailed Comments on specific standards

1. Central securities depositories (standards 6) and credit and liquidity risks controls (standard 9)

We welcome the fact that the report does not prescribe a certain CSD model and accepts that the regulation of some CSDs in Europe is based on banking regulation. It is therefore especially important to focus on the relevant functions when defining the scope of regulation. This is an issue mainly for standard 6 and standard 9:

- Regarding standard 6, we welcome the fact that the description of CSDs' role improved in comparison to previous versions. This is visible by the fact that CSDs' role for the markets is mainly described by their degree of centralisation. Nevertheless, the fact that not only CSDs, but also other entities performing CSD functions are included in the scope of the standard (see Key Element No. 1), should be clarified by amending the wording of the standard itself – also by amending the header of the standard - and in the Explanatory Memorandum. In this respect, the term “ultimate settlement” used for the definition of CSD services should be replaced (see Explanatory Memorandum No. 79) in order to not confuse this with the transfer of ownership of securities in general that can be provided by both CSDs in an institutional sense and other market participants in the same fashion. We recommend replacing “ultimate settlement” by the term “notary function” or “register function”. It is important to notice that the provision of the notary function is – at least according to German law – not restricted to CSDs in the institutional sense, but is open to other institutions.
- Regarding standard 9, the Basel II framework should be uniformly applied to (I)CSDs and custodians; the reference to Basel II in Fn. 1 on page 46 is not clear on this. We think banking regulation is the most prudent way to control risks for both (I)CSDs and custodians and recommend the inclusion of this as a principle within the standard. Where an (I)CSD is subject to banking regulation and exercises prudent risk management, we do not think full collateralisation of customer credit is necessary. We recommend that (I)CSDs are allowed a certain degree of flexibility to extend unsecured credit where these risk mitigants in the form of banking regulation and internal risk controls exist. We also do not think it is necessary from a risk perspective to establish minimum standards for the acceptance of collateral where an (I)CSD practices prudent risk management and is under banking regulation. (Explanatory Memorandum No. 106). The establishment of specific collateral standards for collateral could lead to the effect that business is shifted to less stable providers outside the scope of regulation.

2. Operational reliability (standard 11)

We support the overall ambition of the standard and the initiative to strive for lower recovery times for critical institutions. However, we find the mandation of a single unqualified and specific recovery time objective overly prescriptive and impractical to achieve with a high level of confidence under all circumstances, for instance in the area of software failures, people contingency or “total failure of telecommunication networks”. In addition, the unconditional requirement to set up a second active site with skilled and experienced staff, which we agree would enhance overall resilience, entails a fundamental and costly change in approach

to Business Continuity and daily operations for the concerned institutions and the third parties upon which they have critical dependencies, but which are not necessarily under their control.

Consequently we request a rewording of those aspects under Key Element 4 and the Explanatory Memorandum No. 134, 135 and 136 in order to qualify the requirements and leave more discretion for implementation to the institutions. We recommend amendments upon the lines of the US Interagency paper which rather sets an intra-business day recovery objective and recognizes that institutions need to "retain flexibility in their approach to establishing backup-arrangements". Further it states that "recovery time objectives provide concrete goals to plan for and test against. They should not be regarded as hard and fast deadlines that must be met in every emergency situation".

3. Governance (standard 13)

Setting general Corporate Governance standards at the level of listed companies is an adequate solution to potential governance issues in the area of post-trade services. We accept a standardisation of requirements regarding the management that are in line with banking regulation. Same is true for the consultation of users. However, anything beyond these issues requires a careful assessment of the competitive situation of post-trade markets on a case-by-case basis. In principle, competition as protected by competition law should have priority and ex ante governance regulation of competitive markets is not justified. This is of particular relevance against the background that the standards might leave their soft law status (see general remark I.3).

4. Efficiency (standard 15)

In competitive markets efficiency is a self-evident necessity. In case of dominant market positions of certain players we trust that the standards about access and the application of existing competition law will ensure the prevention of abuse and that competition will take place on a level playing field. Taking this into account, it does not make sense that potential additional regulatory requirements were stipulated now in standard 15 (see also general remark I.3). We believe it is superfluous and beyond the competence of CESR/ESCB to require that competent authorities review, when looking at the overall costs of clearing and settlement systems, the costs of certain users including the direct costs of operating any central facility and other indirect costs (see Explanatory Memorandum No. 170/171). In any case, an equal treatment of functions independently from who provides the function is required. The terms "CSD" and "CCP" do not provide sufficient clarity.

5. Risks in cross-system links (standard 19)

Addressing the issue of cross-system risks to (I)CSD links only does not reflect the reality of markets. Today, cross-system risks mainly occur within the systems of agent banks and custodians among each other or with (I)CSDs across Europe. Therefore, these systems should be covered as well. At the end, it is necessary to stipulate which systems are central for the European settlement processes (see also II.1).