BNP Paribas Securities Services contribution to the ESCB-CESR revised draft Standards on Clearing and Settlement

June 2004

Presentation of BNP Paribas Securities Services

BNP Paribas is a major international banking group and a market leader in Europe, where the Group has established a significant presence: excluding France, BNP Paribas employs 14.000 staff members and drives 20% of its activity in Europe.

BNP Paribas Securities Services, a wholly owned subsidiary of BNP Paribas, is a transaction bank, dedicated to providing securities services. Our strategy focuses on Europe, where we have established a presence in 12 countries: Belgium, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Switzerland, as well as the United Kingdom. We cover the whole range of financial instruments: securities (listed and unlisted, bonds, UCITS), derivatives and cash. This activity positions us as a major user of CSD infrastructures in the European Union. For instance in 2002, Euroclear France -the French CSD- settled 26.5 million transactions including 4.1 million for BNP Paribas Securities Services.

We serve international broker-dealers, global custodians, asset managers and issuers. The services covered include transmitting delivery and receipt instructions (domestic and cross-border), custody, back-office outsourcing, fund administration and asset servicing. We offer our clients efficient access to major markets across Europe: we combine our pan-European network with a personalised client approach, unmatched local market expertise, a consistently high quality product and service offerings, as well as fully integrated operations and systems technology. As a result, BNP Paribas Securities Services is consistently recognised in all major industry surveys as the premier pan-European bank providing securities services to financial institutions.

Introduction

BP2S welcomes the opportunity to comment on the ESCB-CESR revised draft Standards on Clearing and Settlement and welcomes the fact that at the Open Hearing of May 25 2004, a consultation period was extended until June 21 2004. We urge the working group to take sufficient time to analyze in details the various contributions before finalizing the proposed Clearing and Settlement standards.

BP2S contribution to this second consultation intends to illustrate the consequences for the market of some of the proposed standards, as well as the issue of coherence given other initiatives in this industry. It will not reiterate the principles stated in the first contribution by which we continue to stand.

We welcome some new elements of the revised version such as the recognition of EU existing banking regulation that will need to be taken into consideration and the recognition of the specific central role of infrastructures and in particular CSD. We share the objective of CESR-ESCB working group to avoid systemic risk, improve the safety and soundness of securities clearing and settlement, and harmonize the EU regulation, we believe however that some key aspects of the proposed standards are contradictory with those objectives and will lead to a potential increase of systemic risk.

We support the statements made by various industry associations, including the European Banking Federation, the French Banking Federation and AFTI: CESR-ESCB standards should not be drafted in isolation, but should be undertaken with caution and transparency within a process that enables an open debate based on facts and guarantees that the various regulatory initiatives in this field are coordinated and properly organized according to the EU hierarchy of norms.

It is all the more important that the standards reflect market reality and not theoretical concepts, since the proposed clearing & settlement standards will establish a precedent which may influence future related CESR work, for instance on CCPs, or the Commission initiatives. It is not acceptable for the industry that the current market misconception, based on the confusion between CSDs, ICSDs and custodian banks, is maintained. Although this aspect was largely commented in contributions submitted to the first consultation, it still forms the basis of CESR-ESCB standards, which are proposed for immediate implementation and review in five year time. We would therefore recommend that the working group launches a detailed fact finding project, which could be part of its assessment methodology analysis, prior to finalizing the standards.

A. Remarks on the proposed standards

1. Strict sophisticated risk mitigation measures, to limit the level of credit risk taken by CSDs, will not achieve CESR-ESCB objective to avoid systemic risk, given the central role of CSDs

Risk management in securities settlement systems is based today on 2 key principles:

- The concentration of securities settlements within one infrastructure (CSD) carrying no financial risk, managing operational risk only.
- The isolation and strict regulation of the financial risk related to cash and securities liquidity functions to prohibit any spill over to the infrastructure, by allowing only regulated financial intermediaries to provide such services, and by ensuring these risks are spread across different institutions, based on fair and effective competition.

Current situation

In the revised standards, CESR-ESCB recognizes the central role of CSDs, which by nature concentrate settlement flows: “CSDs have a central function in the overall settlement process”, “the role of ultimate settlement agent is unique to CSDs”.

By construction, CSDs are a concentration point for the industry and their risk sensitivity is maximum. This is testified by the value of securities deposited and the level of activity processed, which are indicated below for a sample of European CSDs.

CSD activity figures at end of 2002 (source: Bank for International Settlement – CPSS)

		Value of securities deposited with the CSD (billion euros)	Number of transactions (in thousand)	Value of the transactions (billion euros)	Use of central Bank Money
Germany	Clearstream Frankfurt	4 643	67 282	nav	✓
France	Euroclear France	1 753	29 004	52 996	✓
UK	Crest	1 292	75 700	51 499	✓
Italy	Monte Titoli	1 575	40 922	33 077	✓
Sweden	OM-HEX	nav	64 100	278	✓
Netherlands	Necigef	673	2 995	726	✓
Belgium	CIK	127	358	98	✓
	Total	**10 063**	**280 361**	**138 674**	

Today this central role is performed by CSDs in a risk-free environment, since CSDs remove credit and liquidity risk by requiring settlement on a DVP basis in central bank money. European CSDs, including the Nordic CSDs, the Euronext CSDs (Euroclear France, CIK, Necigef), Crest, Monte Titoli, Iberclear and Clearstream Frankfurt, for instance, currently do not take any credit or liquidity risk for their CSD activity.

The role of CSDs in the risk mitigation process is essential. The chain of intermediaries between the end investor and the issuer may be long. CSDs break the risk chain by introducing at interbank level a zero financial risk step. Should CSDs no longer be risk-free institutions (apart from the operational risk inherent to their core activity), they would not longer play the essential role of breaking the risk chain, and it would be more difficult for any member to the chain to identify and locate the risk it is taking.

The CSD activity should not be confused with the fact that,in some markets, a mutualised global custody solution was developed in the market alongside the CSD operations. In particular, the last Open Hearing indicated a level of confusion about the roles and practices of Clearstream Banking AG Frankfurt ("Clearstream Frankfurt"). As a direct user of the German CSD, BP2S would like to clarify the market situation:

- Clearstream Frankfurt does not take any financial risk for its CSD activity (settlement of German instruments in Clearstream Frankfurt's Collective-Safe-Custody Cascade system). The settlement is based exclusively, as for other European CSDs, on central

bank money. The DVP process was improved with the implementation of a night-time link with Deutsche Bundesbank in November 2003. Under this new German Settlement model, foreign banks can use their home NCB to directly obtain central bank liquidity (NCBs in Netherlands and Austria are part of the set-up today). Foreign banks can also pledge BuBa eligible securities with Clearstream Frankfurt, which in turn pledges them with BuBa in order to grant fully collateralised credit (risk-free) to foreign clients. Finally, Clearstream Frankfurt has developed a securities lending centralized facility, whereby the German CSD operates as a technical agent and does not take any financial risk. Hence, the German CSD follows the same risk-free model as other CSDs in Europe or in the world

- Clearstream Frankfurt also runs the former "Auslandskassenverein" activity, which is a mutualised global custody service, provided to German participants and covering non German instruments traded either on German stock exchanges or OTC. The Auslandskassenverein activity is segregated from and should not be assimilated to the domestic traditional CSD function: operated on different IT system platforms (Clearstream Frankfurt's Non-Collective-Safe-Custody business is operated on the Clearstream Luxembourg Creation system) and under banking commercial conditions and practices (settlement in commercial money, credit risk mitigation policies). In order to facilitate the visibility and more importantly to ensure that no financial risk could ever spill over to the CSD infrastructure, CESR-ESCB could suggest to reinstate the segregation of the global custody activity into a dedicated legal entity, as used to be the case until the mid 90's.

We may find a similar example in the Nordic market, where OMHEX (the owner and operator of the Swedish, Finnish and parts of the Baltic exchanges) owned the Finnish CSD and had developed (via the company HEX Back Office) a "global custody" activity for its participants, segregated from the CSD activity. In order to facilitate the consolidation of the Nordic CSDs and concentrate on its core risk-free domestic activity, OMHEX recently sold the Finnish global custody activity to another commercial bank, SEB. This recent strategic decision is a clear recognition of the core role of the CSD and the fact that this definition is shared within the European markets. Shortly after, the Finnish and Swedish CSDs announced their intention to merge, OMHEX retaining circa 20% ownership of the merged CSD.

ICSDs which mainly use the risk mitigation techniques proposed by CESR-ESCB still retain financial risks

ICSDs are instrumental in supporting the Eurobonds market and, by virtue of their status and offshore origin - eurobond settlement system combined with custodian bank activities for worldwide securities, under a risk management practice based on collaterisation- they engender several types of risk (see detailed analysis in Appendix 1). Firstly intermediation –lending cash and securities- exposes the ICSDs to counterparty risk. Secondly, the very wide range of securities accepted as collateral exposes the ICSDs to counterparty default, the risk of which is aggravated by possible legal disqualification of the guarantee (should the collateral be liquidated following the default). Thirdly, the ICSDs have liquidity needs which exceed the size of their balance sheet and create a gridlock effect. The consequences in terms of liquidity issue are developed in paragraph 2 below. Finally, the tippy nature of the ICSD eurobonds business, combined with the provision of custodian services, leads to significant concentration of financial risk within one hand.

Although we consider that the ICSDs are an appropriate market response to the Eurobonds segment, we do not see the justification to expand such practice to European CSDs, which deal with European equities, bonds and mutual funds.

Impacts

The mitigation measures proposed by CESR-ESCB in standard 9 would introduce but not eliminate financial risks at the level of CSDs. The CESR-ESCB standards 5, 6 and 9 would in effect contribute to expanding systemic risk, since they equate CSDs with ICSDs and entitle CSDs to perform custodian bank activities, act as principal on securities lending and extend credit. Although the credit activities are supposed to be limited exclusively to securities settlement and assets servicing, the definition of “asset servicing” is wide enough to allow CSDs to develop the full range of custodian services. In addition, CSDs will be entitled to develop uncollateralised credit (§107) in cases which are intended to be limited, but would be very large in practice. The limitations proposed in paragraph 108 also assume that CSDs can rely on a credit history, which is currently not the case.

In addition, given the complexity of the proposal and the high level of interpretation left to national regulator, it may become difficult for market participants to evaluate their exact exposure towards CSDs.

The standards introduce risk in a currently risk-free environment and put potentially in danger the safety of the post-market industry, contagion risk and concentration risk being increased.

The contagion risk – banking risks spilling over to the infrastructure - would be introduced, without any indication of the benefits for the whole system. The core principle of risk segregation between intermediaries and infrastructures, which today guarantees a risk-free infrastructure on domestic settlement, would be questioned.
This contagion risk is further increased by the various links that CSDs maintain with other CSDs, CCPs or other cash settlement systems within Europe: a CSD could spread systemic risk to or from other infrastructures – eventually located outside the Euro zone.

Beyond this systemic risk, the market and the authorities will also have to take into account a **concentration risk,** bearing in mind the natural monopoly position of CSDs. Indeed banking risks may no longer be spread among the settlement system participants but concentrated on the CSD, given their client range and the network effects they benefit from. The core principle of spreading financial risk would also be questioned.

The cost for the industry of the standards would be significant although we lack a justification of the benefit. The standards imply that all CSD participants would need to assess their risk exposure towards each CSD and allocate additional capital to cover this risk. In addition, should CSDs develop credit extension, they will need to develop credit risk assessment and monitoring system and also allocate capital to cover their uncollateralised credit risk (clean credit and outstanding risk related to collateralised credit). As an example, we estimate that **for the French market only**, where the settlement flows at the CSD represent around € 206 billion euros per day (daily average for 2003) **the additional cost of capital for the industry would amount to several billons of euros** (our first estimate indicates over 3 billion euros)**,** and deliver a less secure environment than today.

Furthermore, financial intermediaries will have no alternative than using the CSD, even if its creditworthiness deteriorates. It was confirmed at the Hearing that it was unacceptable for Central Banks to accept that CSD becomes insolvent, although this is explicitly envisaged in Standard 6 (§78). Those two elements may prompt moral hazard and develop “too big to fail“ entities, which seems to contradict banking regulation principles.

Proposal

One way to overcome this situation would be for **CESR-ESCB to require that:**

- **For existing CSD services, CSDs should always provided a risk free access to all securities,**
- **CSDs may develop a banking services offer, on the basis that it operates in a fully segregated environment** to prevent any contagion risk and anti-competitive behavior.
- **For financial groups which include both CSDs and banking entities, the standards should define guiding principles to regulate intra-group relations, in order to prevent any contagion risk and anti-competitive behavior.**

We propose therefore to confirm that CSDs should not be allowed to take credit or liquidity risk for their core CSD activity:

- in ***Standard 5***, CSDs should be limited to fail coverage and not act as principal
- in ***Standard 6***,
    - CSDs should not be allowed to take credit or liquidity risk (key element 4),
    - they should mitigate their operational risk according to standard 11 (key element 5),
    - should CSD develop banking activity, this activity should be fully segregated (legal entity, accounting, technology and operations, as well as segregated governance) in order to prevent contagion to the core infrastructure.(new key element 6).

This proposal would allow CESR-ESCB to remain neutral towards the post-market organization, while ensuring the maintenance of risk-free infrastructures and preserving a secure European post-market.

2. The proposed standards may increase liquidity issues and may limit Target 2 opportunities

Current situation

Today, CSDs do not take liquidity risk and settle in central bank money, which is seen as the most secure option. In the enlarged Europe, 47 securities settlement systems have been identified, out of which only 3 use commercial bank money: the Cyprus CSD and the two ICSDs. This confirms the use of central bank money as market practice in Europe, and it is the case in the United States and in Japan as well.

ICSDs have a large structural liquidity risk dependent on credit lines granted by commercial banks (cash settlement banks). The two ICSDs have little liquidity of their own ICSD and rely today entirely on their capacity to obtain unsecured credit lines. If a client wishes to transfer cash from its ICSD cash account (for example following a sale of securities) to another bank account, the ICSD uses its credit line and instruct the financial intermediary to effect the payment in Central Bank Money on its behalf. This creates a gridlock in the market, which may become even more problematic if banks cannot supply the required liquidity, or if the ICSD creditworthiness deteriorates.

To illustrate, we would like to share a recent example which took place on the German bunds market and demonstrates the ICSD failure to provide the adequate liquidity at the right time and place.
A member of the German market (Client A) purchases for € 5.5 billion German governments bonds on Eurex, to be settled on its Clearstream Frankfurt account, and sells the bonds back-to-back to various counterparties (Clients B). These counterparties require to be delivered on their Euroclear Bank accounts, for a value of € 5.1 billion. This involves that the counterparty to Client A for the settlement of the sales in Clearstream Frankfurt (Central Bank Money) becomes Euroclear Bank, who intermediates its clients (Clients B). As a market rule, Eurex compells its members to have the operations settled at the latest in Clearstream Frankfurt morning cycle and imposes penalties when the settlement takes place later during the day. Although Euroclear Bank clients (Clients B) have sufficient credit lines with Euroclear Bank and all transactions settle in commercial bank money during Euroclear Bank night cycle, Euroclear Bank fails to provide the necessary liquidity in central bank money to ensure the purchase settles in due course with Clearstream Frankfurt. Only €350 millions are provided, allowing the settlement of 7% of the transactions. In order to avoid Eurex penalties, Client A borrows the liquidity, faces added costs, and is exposed to liquidity and credit risks to Euroclear Bank, who is not the trading counterparty.

Impacts

Although it recommends the use of central bank money, Standard 10 allows CSDs to use commercial bank money. This implies that CSDs are entitled to take liquidity risk in the same manner as ICSDs. **This will increase the liquidity issue the market currently experiences, since the ICSD practice will expand to the transactions processed by CSDs**.

This liquidity issue will be even more accurate since cash settlement agents and custodian banks fuel liquidity to the market and, as requested by Standard 9 & 10, will be compelled to increase their risk mitigation measures. This implies that the cost of credit facilities will increase or worse that it would be more difficult for those banks to provide the same amount of credit facilities to the market.

The proposed standards, by both allowing CSDs to settle in commercial money without having appropriate liquidity on their own and by imposing additional collateral or capital constraint on custodian banks and cash settlement agents **will drain liquidity from Europe's financial market**.
We urge the working group to analyze the consequences for the industry in terms of costs, risk and efficiency, should CSD volumes be processed in commercial bank money.

Target 2 opportunities may not be leveraged
In addition, Securities Settlement Systems are very much inter related with payment systems. According to our estimates, cash payments linked to securities settlements account for half of the value of all interbank payment handled through the different European payment mechanisms. In

addition, securities underpin market liquidity and collateralise many of those systems. It is imperative to manage the risks related to securities settlement systems in coherence with the risk mitigation process implemented for payment systems and to guarantee that both the securities and cash environments are compatible. The Target 2 working document recognizes this interconnection with securities settlement systems and addresses the various issues in its chapter 5 dedicated to ancillary systems. **CESR-ESCB standard 10, by not imposing central bank money settlement is inconsistent with Target 2 specifications**. On page 85 of Target 2 document it stated that "from market and overseers perspective, there are strong requirements to settle the cash leg of securities transactions and other comparable transactions in central bank money". This means that on one side CESR-ESCB is allowing a securities environment to develop that will be incompatible with a cash environment that on the other side the industry and in particular the central banks are creating. The direct implication is that any banks will have to monitor two liquidity bubbles one for securities settlement systems and one in Target 2 for central bank money without being able easily to transfer the liquidity from one environment to the other one. Moreover given that cash leg of securities transactions represent half of the value of all interbank payment, and an even higher percentage for cross border payment, the volume of transactions within Target 2 would significantly be reduced. and the benefit for banks would be limited as one central liquidity management would be impossible

The ACI/ STEP working group, in its report dated December 2003, also drew similar conclusions, when focusing on the settlement aspects of euro denominated short term securities in the Euro-zone, in the context of promoting a Short Term European Paper. In particular, the group stated that "the efficiency of interaction with funds settlements systems is important because with a relatively small number of major international players active in this segment, availability to them of adequate liquidity at the right time and place may be a critical issue. Therefore, the models for interaction of SSSs and Payment systems deserve a special attention". "Preference should be given to central bank money settlement." In addition, "with the introduction of Target 2, it will be simpler to organize DVP cross-border settlement in central bank money".

As illustrated by this report, Target 2 is viewed as a strong vehicle to enhance the safety and efficiency of the European financial market. It would be regrettable that inconsistencies introduced by CESR-ESCB standards effectively hamper the benefits of the Target 2 project

Finally, for non euro activities, the use of central bank money could also be implemented using for example an equivalent to the mechanism introduced by CLS Bank in the foreign exchange market, whereby various Central Banks are impacted according to the currency of use.

Proposal

We recommend in ***Standard 10*** CESR-ESCB applies its objective to strengthen the safety of securities settlement systems, by making the use of central bank money mandatory for European currencies (Euro at the very least) and providing a convergence period for those CSDs who currently do not use central bank money. This temporary period should end with the implementation of Target 2, to ensure that the harmonization of securities settlement systems is consistent with the evolution of the cash payments systems.

3. Basel II is the adequate and sufficient vehicle to address CESR-ESCB concerns regarding custodian banks

The functional approach objective is to provide the same level of comfort in terms of risk mitigation for a given risk. This does not imply applying identical rules. Customising regulatory requirements to particular types of entities is not a source of risk as long as the level of risk mitigation is equivalent for identical risks. We believe therefore that the functional approach as proposed by CESR should be combined with an institutional approach in order to take into account existing regulation, avoid double regulation and unnecessary cost for the industry, while achieving the same objective in term of securing securities settlement process.
The recognition by CESR-ESCB in the revised proposed standards of the EU Banking regulation is acknowledging the necessity of that combined approach and we welcome this evolution.

We believe that the EU Banking regulation, with the future Basel II transposition, is fully adapted and sufficient to cover CESR-ESCB concerns towards custodians: it addresses them either directly or indirectly, and provides all the necessary tools for banking regulators to address remaining specific concerns. Furthermore, the consistency of financial regulation should be guaranteed by avoiding any regulatory traps, inconsistencies and overcharges.

Basel II structural changes

As confirmed by the Governor of the French Central Bank,[1] "**Basel II is a very innovative regulation** which covers the large scope of risk faced by banks and introduces requirements much more sensitive to risk. Basel II regulation is based on the most recent risk mitigation techniques and banks have a clear incentive to apply those advanced methods and manage their risks very precisely." This regulation also addresses both expected and unexpected losses, banks being led to booking direct provisions for expected losses, and capital requirement being aimed at covering unexpected losses.

In addition, by allowing banks under certain conditions to use internal models to calculate capital requirements under Pillar 1, **Basel II reform will already strengthen the internal control and risk management processes throughout the banks whole organisation**. "Banks will have to demonstrate high quality risk control management and comply with strict qualitative criteria in term of governance, audit, robustness of technology, risk management organisation…, that will also contribute to disseminate a true risk culture at all level of the organisation."

Regarding ***credit risk mitigation***, Basel II imposes strict capital requirement proportionate to the assessment of risk exposure. This can be based on internal model rating under certain conditions. Intraday credit exposures are covered in the way that they result from classical banking activities and are handled by banks in the same way as any other credit risk. Indeed, an intraday credit exposure can always become an overnight risk, and banks have an incentive to define and monitor intraday credit lines for each of their clients. As a result, we consider that standard 9, which implies the need for banks to increase their level of collateralisation, would create in fact double regulation. In addition, by focusing on collateralisation, which is considered by CESR-ESCB as the only risk mitigation technique and does not take balance sheet factors into account, this standard will restrict the ability for banks to manage their risk, according to the variety of risk management methods available today.

Concerning operational risk, Standard 11 imposes general requirements in terms of operational risk mitigation and internal control and specific requirements in terms of contingency planning and business continuity.
One important innovation of Basel II regulation is the request for additional capital to cover operational risk, that could be calculated using 3 different methods. The most sophisticated one, the Advanced Measurement Approach (AMA), addresses CESR-ESCB concerns both in terms of general and specific requirements. This approach is based on historical data of actual operational losses incurred by the custodian bank. Should the custodian have had poor internal control procedures or have been unable to restore its activity for a long period of time, its actual past operational losses would have been significant and hence the capital requirements as well. We believe that this approach should provide a satisfactory level of comfort, while preserving some flexibility to adapt risk mitigation measures and contingency planning to each bank organization. As currently drafted, Standard 11 provides for definite requirements in terms of business continuity planning (restore within 2 hours, second processing site at a considerable distance, commitment not to delay CCP and CSD operations…) where operational situations deserve flexibility and the set-up of crisis management teams, including the authorities. In addition, CESR-ESCB requirements could only possibly be fulfilled by maintaining two complete operational sites, running in parallel and replicating the full activity of the bank in real-time. The cost of such a set-up needs to be justified, given the requirements which banks are already subject to under Basel II.

Similarly, applying Standard 17 to banks will lead to double regulation and additional costs for the industry, since under Pillar 3 of Basel II, banks are subject to transparency requirements and disclosure to both banking regulators and the market of qualitative and quantitative information regarding their risk exposures, their evolution and their level of coverage.

[1] Speach of Mr Noyer on May 27 2004 at the conférence of the « Association d'économie financière »

Consistency of regulation

Furthermore, banking regulators under Pillar 2 of Basel II regulation will have the right to impose additional requirements to address specific risks they have identified for a specific activity or for a specific institution. This provision should avoid the need for CESR-ESCB to define a complementary set of regulation for custodian banks. Using the banking regulation as the only vehicle would ensure the consistency of the regulation and preserve the level playing field among banks.

Finally, we believe there is a confusion in the revised proposed standards between the risk carried by banks vis-a-vis their clients and the risk between banks and CSDs. The whole purpose of the banking regulation is to protect clients towards a default from their bank. The banking regulation therefore fully addresses the risks between banks and their clients, as we have illustrated before. Furthermore, since banks evolve in a very competitive environment, clients would always have the choice to change their banking provider, should the creditworthiness of the institution deteriorate.

Credit and liquidity risk between banks and CSDs have been addressed in different ways, in particularly by protecting banks against the risk of CSDs defaulting:

- first, through EU banking regulation that prevent banks default,
- second, through the limitation of the CSD activities to non risk taking activities and the use of central bank money and DVP processes,
- third, through the "securisation" of the systems themselves with self collaterisation processes for RTGS systems or guarantee funds for net systems.

The proposed standards by imposing additional requirements on banks while allowing CSD to take credit exposures would result in a double regulation for banks and the increase of the level of credit and liquidity risks between banks and CSDs, which is contradictory to CESR-ESCB objective.

Proposal

We recommend therefore:

- For ***standard 9 and in paragraph 15 of the introduction*** to confirm that
  - Banking regulators under pillar 2 of Basel 2 regulation will have the prime responsibility to address banks risk mitigation and assess whether those risk mitigation are sufficient for custodian banks given potential specific risk,
  - EU Banking regulation will be the only vehicle used to address potential risks related to custodians.
- For ***standard 11*** to exclude custodians banks from the standard as it stands, but to require that Banking regulators impose that significant custodians adopt the Advanced Measurement Approach for operational risk.
- For ***standard 17*** to exclude custodian banks from the scope of the standards, since they are already subject to information requirements under Pillar 3 of Basel 2 regulation.

4. Confusion between banks and infrastructures continues to lead to inadequate measures

Although some clarifications have been introduced in the revised draft standards, we believe there remains confusion between the activities performed by banks and the ones performed by CSDs, which leads to inappropriate regulation. Please refer to our contribution to the first consultation for the detailed description of the activities performed by those two categories of players.

Paragraph 14, a clear illustration of some misunderstandings

Banks do not perform infrastructure activities. Custodian banks are very active in the process of clearing and settlement but as participants only, given the definition of clearing and ultimate settlement provided in the glossary of CESR-ESCB. Indeed "clearing" requires to have the full picture of the market to be able to calculate mutual obligation of market participants. Only CCP can be in such a position. Furthermore CESR-ESCB has recognized that the "ultimate settlement" is unique to CSDs.

Banks in-house settlement is incidental and remains marginal, and they cannot substitute the CSDs

The statement that some banks have their own infrastructure is also misleading. Any custodian, and not only some, needs to implement technology and software to provide services to clients. However, the use of the word infrastructure to define those technological devices implies that custodian banks can substitute the CSDs, which is incorrect. Firstly, internal settlement takes is prohibited by legal or practical constraints in many countries such as the UK, Italy or Greece. Secondly, internal settlement is incidental for custodian banks, since it fully depends on the scope of clients and the activity of those clients. Internal settlement can only take place if one of the custodian's clients actually trades with a counterparty who happens to use the same custodian. Thirdly, given the market organization and especially the introduction in many European countries of CCPs, settlement related to on exchange trades is always settled at the CSD level. It is true that the number of settlements have significantly decreased, due to the introduction of CCPs which operate on a net basis. This is not related to an increase of internal settlement within banks. Finally, as an illustration of current market practice, BP2S processes at the most 1,3% of CSDs transaction volumes[2]. Such an estimate would further decrease if we excluded operations taking place within a group, such as transfers between entities of the same group or splits of block transactions performed by an asset manager on behalf of various funds.

Furthermore, the statement that **some custodians may have settlement activities comparable to national CSDs in terms of volume or value is incorrect**. By nature, CSDs concentrate the market flows and are a central point, a natural monopoly whose use is mandatory. Custodian banks on the other hand offer their services in a very competitive environment and their activity, whether domestic or cross-border, is reflected on the books of the CSD. No single bank is in a position to achieve the level of activity both in terms of volume or value of the local CSD. For example, in 2003 Euroclear France settled 25.4 million transactions representing € 67 500 billion in value, out of which 5.9 million transactions were settled for BNP Paribas, representing € 22 000 billion in value. Settlement processed in our books does not reach such a scale, as indicated by our internal settlement percentage. Therefore, in-house settlement cannot be a justification for equating CSDs and banks.

Standard 7 DVP, a concept not applicable to banks

The DVP concept of a CSD applied to banks would mean to link the securities and cash book-entries into the banks books and to align the timing of those entries with the process at the CSD. This would means for example that a banks could only process the book entries linked to the settlement of the transaction when the settlement has been irrevocably confirm by the CSD. In other words a bank can only credit the securities to its clients when it has irrevocably received the cash from its client. In order to have the cash leg irrevocable, the cash needs to be credited on the bank's central bank cash account, a debit of the client cash account in the bank's books would not be sufficient. This would imply that a bank can no longer extend credit to its clients, which is denying the core function of the bank. In addition, the bank would have to wait until the credit on its central bank cash account has taken place, which could take some time given the processing cycles of some net payment system, although the client would have actually provided the required cash to settle it securities transactions. All these delays could significantly damage the efficiency of the settlement system as the settlement of many transactions would be delayed in the day which would potentially increase the level of fails.

In addition to be compliant, banks would have to enable real time book entry for both cash and securities. The large majority of banks are running their accounting batch only once a day. Moving to real time accounting would be a significant structural change to the banks organization and IT and we do not see how potential additional benefits of that measure could justify such a large cost.

The DVP concept as processed by CSDs is impractical for banks and will have the opposite effect to CESR-ESCB intention, since it would probably lead to less efficient securities settlement systems.

Regarding standard 8 on finality, we believe here also there is a misconception between banks and CSD activities. The concept of finality, introduced with the finality directive, is related to the concept of irrevocability of the cash leg of the transaction. Irrevocability of cash payment is only

[2] The basis for the calculation is the total volume of the15 European CSDs (not including the two ICSDs) of settlement in both bonds and equities in 2002.

confirmed by the use of central bank money. Banks, as they use commercial money with their clients, can not offer such irrevocability.

Proposal

We recommend therefore:

- To amend ***paragraph 14 of the introduction*** to clarify the differences between the banks and CSD activities, and confirm that banks do not perform infrastructure activity

- In **Standard 7** to exclude banks from the scope of the standard

- In **Standard 8** to exclude banks from the scope of this standard.

5. The revised proposed standards create various sources of uncertainty which are damageable for the whole industry

CESR-ESCB stated objective is to increase the level of certainty by proposing a clear European regulatory framework and improving the consistency and harmonization across Europe through regulatory convergence. The revised proposed standards do not fully achieve this objective, due to remaining significant areas of uncertainty.

The joint working group acknowledged that the proposed standards need to be confronted with market reality and may have to be reviewed and adapted. CESR-ESCB proposes a process 5 years after the implementation of the standards. This proposal means that within those 5 years many structural and strategic decisions would have to be made on the basis of the current standards, which may lead to potentially inappropriate decisions and unnecessary costs for the industry. We would therefore recommend that the assessment of the probable impacts of the proposed standards on the European Financial market should be made prior to adopting the standards, as was done for the Basel II regulation, and not only ex –post.

Furthermore, the standards may have to be significantly modified following the announced European Commission future framework directive, which increases the level of uncertainty of the standards.

Another significant source of uncertainty is the absence of clarity to what actually constitutes the standards (the bold statement and/or the key element and /or the explanatory memorandum) and to whom exactly it applies. The revised version of the proposed standards does not allow banks to assess whether they are included or not in the scope of those standards. The clarification of the concept systemically important custodian is left to national regulators and would only be envisaged after the adoption of the standards, during the assessment methodology. Moreover the introduction of new concepts such as “cash settlement agent”, “critically important services providers” without any clear definition increases the level of confusion.

As mentioned at the Open Hearing on May 25, all the elements of a standard may not necessarily apply to all addressees. The proposed text does not at this stage reflect this statement and we would welcome the introduction of a matrix that would clearly outline for each individual standard which element applies to which addressee.

The uncertainty around the standards exact scope of application is damageable to the quality of the standards and does not allow the market to evaluate impacts in a precise manner, which means CESR-ESCB could be faced with unforeseen consequences while implementing them.

Proposal

We suggest to link the assessment methodology with the finalization of the standards, and to incorporate the findings of the various assessment (identification of institutions, assessment of risks, assessment of impacts of the proposed regulation..) in order to improve the clarity and quality of the proposed standards.

6. The standards raise various competition issues

Although competition is not directly in CESR or ESCB competency, as both CESR and the ECB are European institutions, they have to take into account the general competition rules of the EC treaties. We welcome in that respect the removal of the concept of custodian in a dominant position. Nonetheless, the standards continue to raise competition issues:

- By isolating custodians systemically important from other custodians banks and imposing on them specific rules, CESR-ESCB will remove the existing level playing field among European banks.
- By allowing CSDs to perform custodian commercial activities (as for example on standard 5 securities lending) although they benefit from a central market position and have a unique view on the whole market, CESR –ESCB will provide a significant advantage to CSDs which will be available to no other bank.
- By imposing significant additional constraints to European banks, the standards will create distortion with non European banks for example US banks, to which such requirements will not be imposed. They also introduce a distortion in the way CPSS-IOSCO standards are transposed in various regions of the world, which is of interest in the light of CESR EU-US dialogue.

Proposal

We urge the CESR-ESCB working group to consider the consequences of the proposed standards in terms of competition and to refrain from imposing any rule that could damage the existing level playing field. To facilitate this exercise, we would recommend CESR-ESCB to consider two distinct competitive arenas, that should not be confused, the one of the intermediaries and the one of market infrastructures.

B. Remarks on the process and methodology

1. CESR-ESCB pre-empts the debate that should and will take place at the Level 1

In its communication on clearing and settlement, the European Commission confirms that it intends to propose a framework directive under the Lamfalussy process requesting Level 2 implementation measures on the basis of a Commission mandate. It also confirms that the current CESR-ESCB proposed standards are not legally binding and do not replace a proper legislative framework. We fully agree with this statement.

Nevertheless the proposed standard will be binding in practice, as confirmed by the co-chairman at the hearing , given the commitment of regulators and central banks to implement those standards in their national legislation. In addition, despite CESR-ESCB intention to be neutral, the proposed text by opening "new doors" is setting guidelines that will influence the organization of the market.

We find that situation unacceptable as CESR ESCB is preempting a debate that should and will take at level 1 and furthermore we believe that CESR is going beyond its mandate by proposing level 3 measures while the Level 1 principles have not yet been defined.

Although CESR has proposed to extend its role at level 3, th**e mandate of CESR, as European committee, do not yet encompass the definition of binding rules without any mandate from the Commission**. In the Commission's decision of june 6, 2001, CESR is defined as a consultative committee that should advise the Commission. At no point the Commission decision provides CESR with power to establish binding rules and standards.
CESR "charte" defined (article 4.3) that the committee could propose guidelines, recommendations or standards that its members would introduce in their own national regulation on a voluntary basis. Although we could even questioned whether from a legal perspective, the CESR chart is line with the Commission decision, article 4.3 has to read in its entirety. Indeed the first sentence of this article provides that CESR will stimulate and control the implementation of EU legislation, and hence the proposal of any recommendations or standards as to linked to level 1 measures. This is not the case for the work performed by CESR on Clearing and Settlement.

Moreover CESR confirmed at the open hearing on the role of CESR at level 3, that CESR should always leave the priority to the Commission to establish level 1 measures before CESR defines level 3 rules and standards. He suggested however that if the Commission was not addressing a subject that should not prevent CESR from starting the work. On clearing and settlement this is not the case as the Commission clearly confirmed its intention to define level 1 measures. We hence do not understand CESR-ESCB position to finalize in the next month the proposed standards as it seems contradictory with the position CESR intends to have vis a vis the Commission.

The issue of the mandate and the legislation order is even more important that **both the industry and the Commission consider that a political debate is required at European Level** to define how the European post market should be organized. The joint working group has also acknowledged that some issues where highly political and contentious as demonstrated by the responses to the first consultation. The high number of issues left to national discretion in this revised paper is a clear illustration of the difficulty for the joint working group to achieve a consensus without any EU guidelines. The cooperation proposed in standard 18 will not be sufficient and could not substitute a clear EU legal framework.

Proposal

We would recommend to use the assessment methodology period to continue to improve the draft standards to achieve a high level of consensus , using the Basel II method : continuous dialogue with the industry and assessment of the impacts of the regulation …. The obtained consensus would then be an appropriate basis for level 1 measure.

Should the level of consensus remain insufficient, we urge CESR-ESCB to limit the adoption of the standards to the ones that have reached a high level of consensus and to leave open the other ones, until the Commission has clarified the level 1 measures.

2. CESR-ESCB proposed standards on Clearing and Settlements should be covered by the new CESR - SEC cooperation.

CESR and the US SEC have recently announced their intention to develop enhanced cooperation and collaboration between EU and US regulators. The objective of that collaboration is to identify emerging risks in the US and EU securities markets and to engage in early discussions to promote convergence in regulation[3].

Given CESR- ESCB interpretation of CPSS ISOCO recommendation, **we question whether those proposed standard will lead to further convergence with the US**. Indeed, US regulators never extended the concept of systemically important custodian to additional requirement on credit risk mitigation but limited the concept to operational risk management The interagency paper from the Federal Reserve, The Securities and Exchange Commission, and the Controller of the Currency published in December 2003 is explicit in that matter. In addition confusion between infrastructure activities and banking activities has been prohibited as well. Indeed the US market is clearly organized with a central CSD (DTC or the FED for government bonds) that is not taking any credit or liquidity risk. That organization has been even confirmed with the conclusion on the specific market of settlement of government bonds, whereas Regulators have concluded that the FED should not provided the banking facilities around those instrument but that credit extension should continue to be carried by banks in a competitive environment.

Proposal

We would strongly recommend that CESR engages early discussions with the SEC on this field before adopting the standards in order to ensure convergence between the US and the EU.

Conclusion

BNP Paribas Securities Services strongly believe that there is room to improve the proposed standards, in particular by continuing the dialogue with the industry, analyzing in details the current market practices, and identifying and quantifying the impacts of the proposed regulation.

We suggest the CESR-ESCB working group takes the opportunity of the assessment methodology to perform the proposed detailed analysis, in order to adapt the draft standards to market reality. This period would also help building industry consensus around the proposed standards which is vital to facilitate the implementation of the proposed regulation and maintain confidence in the Lamfalussy process.

We suggest therefore to link the standards to the assessment methodology and to adopt at the end of that process any standard that doesn't create double regulation or unjustified costs for the industry and for which a high level of consensus has been reached. Should the consensus not be achieved due to high political issues we would recommend CESR-ESCB to request the Commission to clarify EU legal framework before adopting any compromise.

We believe this proposal is feasible and a large number of standards if not all could be adopted at the end of the assessment methodology if the joint working group would endorse the pragmatic "Basel II" approach. BP2S is committed to continue to contribute constructively to that process and will remain at CESR-ESCB disposal for any further specific issues.

[3] CESR press release on May 26, 2004.

APPENDIX

The risk issue in securities settlement

1. The efficiency of securities settlement is fundamental for the broader efficiency of European financial markets and is key for financial stability.

Cash payments linked to securities settlement account for half of the value of all interbank payments handled through the different European payment mechanisms. But it is securities which underpin market liquidity and collateralise many of these systems. Following the introduction of the euro and ECB recommendations, European systems are already collateralised systems or are in the process of becoming so, either by the adoption of RTGS systems or – for net systems - a guarantee fund. In both cases securities represent the largest part of the collateral making up such guarantee funds and are used to obtain liquidity in RTGS systems.

Securities are thus at the heart of payment systems and in order to guarantee the financial stability of the European financial system, it is imperative to manage the risks related to securities settlement.

The stability of domestic systems traditionally rests on two keys principles:

- Specialisation of the function performed: functions related to investors and foreign institutions on the one hand (global custody or sub-custody) and on the other hand the function of central depositories consolidating interbank transactions and holding the issue position as 'notary'.
- Segregation of risks: financial and banking risks on one side, operational and systemic risk concentrated in the CSD on the other.

2. The CSD model currently in place at the domestic level has proven its efficiency in both cost and risk management:

The financial industry, along with national and European authorities, agrees that domestic securities settlement systems are highly efficient.

Risk management in securities settlement systems is based on the concentration of all asset transfers within one infrastructure carrying no financial risk and managing operational risk only (the CSD)

To manage the cash leg of securities transactions in total security, the central bank money model is optimal. There is no liquidity risk, nor any credit risk on a bank acting as cash agent for a CSD. In domestic markets, it was rarely considered necessary to include liquidity functions at the CSD to cover cash or securities needs. This function has always seemed more pertinent for the banks, and thus also reflecting the direct link between a client account and a short - or uncollateralised - transaction. The CSD stays away from banking risk, and thereby strengthens its core role. The CSD acts merely as a technical conduit, transmitting to the Central Bank the cash entries to be made on the accounts of its members. Once settled, these operations are therefore irrevocable.

The CSD takes no credit risk. It makes no loans as principal, nor does it extend credit (including intraday facilities) to its participants. For example, the CSD will not transmit payment orders for dividends or interest/coupon payments until it has received the required funds from the paying agent bank.

Concerning the settlement systems themselves, in most countries these are fully collateralised and the CSD is never at risk.

3. Financial intermediaries provide the cash and securities liquidity function that delivers flexibility to the securities settlement systems. The related risk, inherent in this function, is strictly regulated and isolated from the CSD infrastructure.

Regarding securities activity, financial intermediaries have developed, for their own account or for their clients, a range of services which deliver either flexibility to the securities settlement process via securities or cash "advances", or which supply credit or liquidity products via the use of securities as guarantee. In any case, these services create risks: a risk resulting from intraday facilities or overnight credit extensions; counterparty risk; liquidity risk.

All of these risks are 'classic' banking risks, subject to specific regulation (Basel 2, bank supervision) at the level of each institution and which can evolve over time in relation to the level of concentration.

These risks are however spread across different institutions thanks to the competition between them. In every respect these risks are isolated within the domain of financial intermediaries and cannot spill over to the infrastructure, the central pillar of settlement in each country.

4. ICSDs are financial intermediaries with a specific central role for Eurobonds, which requires stronger risk management control, without actually eliminating risk. In terms of risk, they cannot be the equivalent of CSDs.

ICSDs (Euroclear Bank and Clearstream Luxembourg) are hybrid entities which perform at the same time an infrastructure role – for Eurobonds only- and a financial intermediary role for all other securities (equities, bonds, etc). Their role of infrastructure is certified by their SSS (Securities Settlement System) status. Yet these entities are essentially financial intermediaries which, like other custodians, offer banking services - such as credit lines. Transactions settled within the ICSDs are in commercial bank money, including for Eurobond activity. In this context ICSDs must manage the classic banking risks of financial intermediaries: credit and liquidity risk. The risks of ICSDs are also more difficult to manage insofar as (unlike other financial intermediaries), the assets on ICSDs accounts are rarely the property of the account holder.

So as to allow the ICSDs to participate in the Eurosystem and make Eurobonds eligible collateral for the European Central Bank, the ECB imposed specific rules on the ICSDS in terms of collateralisation. Indeed all participants in the Eurosystem are entities free of any financial risk (CSD, National Central Banks); the ICSDs are the only two exceptions.

Nevertheless, these specific rules, such as those concerning collateralisation, do not remove banking risks, it can only mitigate them. Thus the contagion risk – the spreading of banking risk to the Eurobonds infrastructure – persists.

It is worth noting that the ICSDs have a limited financial base and collateralisation is the only method at their disposal to manage their risks.

Credit risk: the limits of collateralisation

The ICSDs consider their credit risk marginal as they cover their exposure with virtually 100% collateralisation using an in-house logarithm. The measures taken are satisfactory for a financial intermediary but have characteristics that leave credit risk unresolved. These characteristics are detailed in annex 2, and are related to the types of eligible guarantees (ten times the number accepted by the ECB for the same geographic area), the valuation of those guarantees, but also importantly to the legal risk of requalification of those guarantees in case of default. As shown in the Regen study[4] credit risk mitigation is essentially built around a legal engineering of complex contracts executed under various jurisdictions. Given the complexity of these structures, they can probably be disputed. In any case the risk algorithm takes into account future – and hence uncertain – factors to calculate credit lines for the various clients. (see details of the algorithm in annex 1). They thus offer credit lines

[4] Regen Consultants : « Eurozone payment and securities settlement systems interdependence » February 2004

guaranteed on assets that are still in the process of registration. The algorithm also takes into account matched/confirmed sales against cash effected internally or via the bridge with the other ICSD. This factor exacerbates the contagion risk between the different clients of the ICSDs, this risk being all the greater as ICSDs internalise 80% of their transactions.

Thus in spite of strong risk management, the risk of contagion from one of the participants to the whole system persists and the risk of default for the whole infrastructure exists. It is worth noting that bank financial intermediaries do not use collateralisation as the sole method of managing risk; they can also rely on their own regulatory capital

Large structural liquidity risk dependent on credit lines granted by settlement banks

The ICSDs have little liquidity of their own. Furthermore, as they are not the owners of the securities on deposit with them, they cannot use these to obtain liquidity from banks, including central banks. In this context the ICSDs have no liquidity risk as long as purchase and sale transactions remain internal. On the other hand, if a client of the ICSD wishes to transfer cash (for example following a sale of securities) to his account with another bank, the ICSD must effect a payment without likely having the necessary liquidity. It must obtain a credit line from financial intermediaries which will make the payment on behalf of the ICSD. The liquidity of the ICSDs today relies entirely on their capacity to obtain unsecured credit lines. What level of risk will these banks accept? What if one of these banks is in difficulty and cannot supply the liquidity requested by the ICSDs? What would happen if a large client of the ICSD defaults and the settlement system itself is compromised? (see comments on credit risk) Will agent banks continue to supply the same credit line?

Contrary to the domestic model where transactions are settled in central bank money, participants in the ICSD settlement systems have a liquidity risk vis à vis the ICSD and to its cash settlement agents.

This risk is a reality which financial intermediaries are today carrying. For large transactions it is not rare that the ICSDs only transfer requested funds at the end of the day, even though their settlement cycle has finished. Financial intermediaries must therefore support an additional – intraday - financing cost.

The ICSD model performs its intermediary role well, however as an infrastructure it remains structurally riskier than the CSD model and creates additional costs for the market.

Furthermore, considering the **international links (outside Europe) that the ICSDs maintain, the ICSDs can spread risk coming from outside Europe into the European sphere** – an additional risk of contagion.

5. The generalisation of the ICSD model will increase risk for the market as well as potentially costs.

By not clearly distinguishing the functions of intermediaries and CSDs, **the CESR/ESCB standards accept the progressive transformation of national CSDs into ICSDs**, **and privilege commercial bank money.**

The contagion risk - that banking risks spill over to the infrastructure - would thus exist, without any indication of the benefits for the whole system. The core principle of risk segregation between intermediaries and the infrastructure that guarantees a risk-free infrastructure would be questioned.

But beyond this systemic risk, the market and the authorities will also have to take into account **a concentration risk**, bearing in mind the monopoly position of CSDs. Indeed, banking risks will no longer be spread among the settlement system participants but concentrated on the CSD, financial intermediaries being excluded from this activity as they would no longer be able to compete with the CSD. The core principle of spreading financial risk would thus also be questioned. Furthermore, the market would have no alternative to the CSD, even if its creditworthiness deteriorates. It is worth noting that the US Federal Reserve has recently issued recommendations to limit its concentration risk exposure. It in fact considers that the market for liquidity and short term financing is too concentrated

in the US (in particular due to triparty repo concentration) and wishes to implement measures to decrease this concentration risk.

Finally this model can also **spread systemic risk to other settlement systems** (cash payment systems in particular). ICSDs, using commercial bank money, cannot guarantee to participants of the settlement system cash payments on the Central bank account in central bank money at anytime and whatever the amount.

The Euroclear group proposes juxtaposing the CSD with the ICSD, the CSD offering domestic securities services only ('domestic' service) and the ICSD offering both domestic and international securities ('full' service). **The consequences in terms of risk of this proposal are in fact identical (systemic risk, concentration risk, contagion risk for other settlement systems), as in reality it privileges and generalises the ICSD model**. Indeed, if the ICSD system is as efficient as those of the CSDs, which should be the case as in the Euroclear proposal the ICSD and CSDs would use the same system platform, and thus they are equally efficiency, financial participants, and in particular broker dealers, will prefer to centralise their activity in a single place - the ICSD. Settlement liquidity will rapidly shift from the CSD to the ICSD, as we have seen for the German, Portuguese, Dutch and Irish government debt markets. This centralisation of activity in the ICSD will de facto **lead to the end of central bank money**. If settlement liquidity is no longer within the CSD but with the ICSD, market participants will tend to close their account at the CSD level which will decrease the use of central bank money. Furthermore, as the liquidity of each market participant will mostly be in the ICSD, these will centralise their treasury management around their cash accounts at the ICSD and no longer around their cash accounts at the Central Bank. The use of central bank money would therefore be limited to cash payment systems managed by Central Banks. However, we can reasonably assume that if all market participants maintain their main cash accounts at the ICSD, they will also process their commercial payments through the ICSD's settlement systems. The use of cash payment systems in central bank money would be even more limited.

The generalisation at the European level of the ICSD model is thus structurally riskier than the CSD model, and can only lead to an increase in overall risk for the market which could even affect the financial stability of Europe, considering the key role of securities settlement systems in guaranteeing the efficiency and liquidity of European financial markets.