

Z E N T R A L E R K R E D I T A U S S C H U S S

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Response
of the *Zentraler Kreditausschuss*
to
CESR-ESCB Standards for Securities Clearing and
Settlement Systems in the European Union
(Ref.: CESR/03-247)

October 2003

EG-CLEA

Dear Mr. Kazarian,
dear Mr. Moeliker,

as Zentraler Kreditausschuss¹ we would like to thank you for the opportunity to comment on the Standard for Securities Clearing and Settlement Systems in the European Union (Ref. CESR/03-247).

I. General points

We share the view held by the CESR/ESCB working group which sees the need for a homogenous regime in the field of securities clearing and settlement including custody thereof, whenever central settlement systems are involved. This need is particularly owed to the plans for the creation of a harmonised financial market within the EU. Having said this, due to the envisaged enlargement of the target group, we feel that the approach chosen by the CESR/ESCB to introduce a harmonised supervisory regime for systemic risks at a level that is below the European legislation (i.e. below the level of regulations or directives) by way of a ‘soft law’ is not conducive to the goals. On the ground, i.e. in daily prudential supervision practice, a ‘soft law’ may, in principle, indeed provide a greater degree of flexibility. Yet, it is also a conspicuous fact that many of the standards proposed by CESR/ESCB touch upon fundamental issues related to competition policy and that these standards therefore have a **strong political dimension**. This generally applies to the approach championed by CESR/ESCB with regard to extending the supervisory approach to include non-infrastructure providers such as custodian banks operating ‘systemically important systems’. If such banks, for instance, should be legally obliged by standard #9 to completely collateralise credit lines as a general rule, then this is a matter relating to EU legal policy and such matters should be discussed and decided upon within the European bodies (Commission, Council and

¹ The ZKA is the joint committee operated by the central associations of the German banking industry. These associations are the *Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR)*, for the cooperative banks, the *Bundesverband deutscher Banken (BdB)*, for the private commercial banks, the *Bundesverband Öffentlicher Banken Deutschlands (VÖB)*, for the public-sector banks, the *Deutscher Sparkassen- und Giroverband (DSGV)*, for the savings banks financial group, and the *Verband deutscher Hypothekenbanken (VDH)*, for the mortgage banks. Collectively, they represent more than 2,500 banks.

Parliament) and not exclusively within European Central Banks and prudential supervision authorities (for securities).

This begs a broader question, i.e. whether CESR/ESCB have the competency for a definition and supervisory implementation of all of the 19 standards in their entirety. Unfortunately, the Consultation Paper does not contain any statements on this matter. Within the framework of the public hearing on 2 October 2003 in Paris, there was merely the information that one was in touch with the European Commission concerning this matter and that, in the last analysis, based upon its right to initiate EU policy, it was up to the European Commission to proactively take care of individual standards or of all standards in their entirety and to cover such issues as it deemed fit under a proposal for a directive. We would, however, welcome it if the CESR/ESCB in its final paper could give a personal assessment if, when and why they feel that all standards should fall under their jurisdiction and on which grounds they feel entitled to issue legally binding recommendations for prudential supervision practice.

Within the framework of prudential supervision standards (for securities), we feel that the planned extension of the scope of application to custodian banks is too far-reaching. From our point of view, the CESR/ESCB working group lacks the democratic legitimisation for such an undertaking. Furthermore, in their capacity as investment firms and banks, custodian banks are already subject to a specific legislation and prudential supervision so that large parts of the standards are already covered. Firstly, we should like to mention the Investment Services Directive; secondly, there are the comprehensive risk control and risk mitigation mechanisms under Basel I and the forthcoming Basel II provisions (which will be) translated into European legislation. Hence, the proposed standards also give rise to the risk of duplicate regulation in this respect. Currently the European Commission is still investigating whether there is any need at all for additional regulatory activity in the field of securities settlement within the EU. Hence, it is recommended that the CESR/ESCB working group should first wait for the forthcoming results and deliverables. At this juncture, we would also like to point out that, in many respects, the standards affect the field of prudential

banking supervision. In this respect, too, this may beg the broader question of the scope of the working group's mandate for regulatory matters. The jurisdiction should remain with the banking supervisor whenever the forthcoming provisions affect banks.

The CESR/ESCB working group considers using the terminology 'systemically important' systems/custodians in order to clearly define the standard's scope of application. The standards should serve a functional approach. On principle, any such approach is useful. Having said this, the practical implementation of such an approach will only be plausible if it really covers services that are indeed comparable. CSDs and CCPs are central, national infrastructure providers for securities clearing and securities settlement transactions. Hence, with a view to these fundamental activities, they regularly present a monopoly. Contrary to this, custodians compete with each other via their service range. Furthermore, in terms of securities settlement transactions, they are dependent upon CSD and CCP services and therefore constitute the largest users of this kind of infrastructure. Hence, there are fundamental differences between CSDs and CCPs on the one hand and custodians on the other hand. Covering custodians under various standards, therefore, ignores this fundamental difference.

The CESR/ESCB regulatory approach is new and goes well beyond the recommendations of CPSS/IOSCO without providing detailed and logical, objective reasons for this in the explanatory memorandum of the Consultation Paper. In our view, the grounds provided to date are not satisfactory, i.e. that custodian banks form part of the value-added chain 'clearing and settlement' is not a sufficient explanation. Apparently, the CESR/ESCB assume that custodian banks operating 'systemically important systems' run inherent systemic risks which are not sufficiently addressed by existing prudential supervision law (at least this is our understanding of paragraph 11 of the Consultation Paper). Furthermore, there is an attempt to justify the functional prudential supervision approach by the principle 'same business – same regulation' (cf. also paragraph 11).

Both lines of argumentation, in our view, remain relegated to the sphere of a hypothetical outline. Concerning individual standards such as e.g. standard #9, the further Consultation Paper lacks any explanation why the general prudential supervision control regarding cash and solvency matters should not be sufficient with a view to the systemic risks inherent in the operation of ‘systemically important systems’. As has been pointed out earlier, there are fundamental differences in the activities of CSDs, CCPs and of their users (custodian banks). For this reason, the conclusions drawn by CESR/ESCB according to the principle ‘same business – same regulation’ are unjustified. It would therefore be inappropriate to transfer the CPSS/IOSCO recommendations, which had been prepared with a view to securities settlement systems, to the specific idiosyncrasies of custodian banks without any adjustments. At various points in our comments on individual standards, we shall explicitly highlight specific problems resulting from this approach.

Hence, in terms of legal policy, there is no sufficiently robust case to back the functional approach. Furthermore, the differentiated approach outlined in the paper ‘Scope of application’ will not be feasible in practice.

Whenever the standards relate to CSDs and CCPs, we welcome the fact that they are based on the 19 recommendations of CPSS-IOSCO on the securities settlement systems dated November 2001 thus ensuring compatibility with the latter. At the same time, this takes account of the increasing globalisation of financial markets which, for several years now, has been constantly on the rise. The standards present a decisive step towards the action plan for overcoming inefficiencies in cross-border securities settlement transactions within the EU proposed by the Giovannini group in its second report dated April 2003. Whenever assessments are considered as a tool for tracking the implementation progress of the recommendations/standards, duplication with existing supervisory regulations should be avoided. In order to clarify the nomenclature, we would like to suggest additionally including at least the glossary contained in Annex 5 of the CPSS/IOSCO recommendation.

II. Comments on the ‘Scope of Application of the ESCB-CESR/Standards’

As has already been pointed out in our general comments under I., as long as there is no sufficient democratic legitimisation for such an undertaking and as long as this kind of supervisory approach lacks a sufficiently objective explanation, we reject an application of the standards to non-infrastructure providers. This concerns both, the coverage of operators of ‘systemically important systems’ and also ‘custodians that have a dominant position in their market’.

III. Comments on the standards

Standard #1: Legal framework

Concerning the scope of application, we see no need to equally cover ‘custodians’ under this standard, since the legal requirements for such custodians – i.e. being investment firms – are already clarified by the ISD in an unambiguous legal manner. What is more, for obvious confidentiality reasons, a disclosure of bilateral contractual relations with customers of the custodians cannot be legislated in a reasonable manner. The situation is different with regard to a monopoly provider such as CSDs because the market participant is dependent upon such services.

Page 15, ‘Key elements’, item one should therefore read as follows:

‘1. This standard is addressed to CSD’s and CCP’s ~~and custodians operating systemically important systems.~~’

We, furthermore, suggest clarification of item number two:

‘2. As a general matter... public and accessible to the market.’

In addition to this, the added provision under item 5, according to which the system operator should identify any potential conflicts of law ‘for each aspect of the clearing

and settlement process' prior to cross-border transactions may result as too far-reaching. A clarifying note limiting the scope of this provision appears necessary.

Furthermore, from our point of view, it would be helpful to include a reference to the proposed plan of action submitted by the Giovannini Group in the explanation provided on page 18, paragraph 35. One such clarification might be worded as follows:

'This could be achieved with the EU Securities Account Certainty Project proposed by the Giovannini Group in its second report of April 2003.'

Standard #2: Trade confirmation and settlement matching

With regard to the provisions on indirect market participants, we feel that –given the different trading hours at the various international markets - the suggested cycle T+0 is too tight for handing in the trade confirmation. In our view, a cycle of one working day max. would be more appropriate; such a working day would have to be calculated on the basis of the respective market's stock exchange trading hours. For instance, if a trade execution were to take place at 7.58 p.m. (end of trading: 8.00 p.m.) the trade confirmation should be there by 8.00 p.m. on the following working day, the latest. We therefore suggest leaving the second sentence of the standard in the CPSS-IOSCO language:

'... it should occur as soon as possible after trade execution, preferably on T+0, but no later than-T+1.'

A corresponding amendment would also be necessary on page 20, 'Key Elements' under item 3.

Standard #3: Settlement cycles

We share the CESR/ESCB working group's view that a harmonisation of the settlement cycles is, on principle, advantageous. Yet, we only see a need for harmonisation through the supervisor in the field of stock exchange tradings; a freely negotiable settlement

period is and remains appropriate and fit for purpose as far as the OTC area is concerned. We also suggest covering only certain product groups (shares, bonds, derivatives) in the harmonisation efforts. What is essential here, however, is the fact that a harmonisation must not be carried out at all costs, but that, instead, there is a meaningful cost/benefit ratio for all stakeholders involved. It is particularly necessary to ensure that a harmonisation does not mean a mere adjustment at a lower level, but that such adjustment is generally conducive to the envisaged trend towards shorter settlement cycles (with regard to shares, the T+2 regime, e.g., is indicative of such a trend in Germany). We therefore suggest that the presentations on page 23 ff be adjusted accordingly and/or complemented.

Again, concerning this standard's scope of application, we see no need to cover custodians. Along with the operators of the trading systems, the responsibility for compliance with the settlement cycles primarily also lies with the clearing agency (CCP) and with the central settlement agency assigned by the market. The system users, regardless of their relevance for the overall market, need to comply with the market rules laid down by the system operators and therefore do not need to be made subject to any special standard.

Standard #4: Central Counterparties (CCPs)

We strongly welcome the fact that the implementation of central counterparties is accompanied by an analysis of the cost-benefit ratio. Yet, a careful analysis is recommended so that the specific benefit of a central counterparty does not become mixed up with aspects, which could also have been achieved without involving such a central counterparty. We see the specific benefit of a central counterparty in the enhanced risk management for trading transactions that have been concluded, but which have not yet been completed so far. However, the enhancement of the settlement rate, which above all also depends upon the counterparty's delivery performance, is not a typical benefit inherent only in a central counterparty, although the existence of such a kind of institution equally lends itself to the implementation of sanctioning mechanisms.

Concerning the explanations and possibilities listed for CCP risk mitigation, we would welcome it if on page 31, paragraph 63, the last sentence went beyond a mere reference to the possibility of using central bank money but if, instead, such use of central bank money was stipulated as a specific requirement. Hence, the last sentence may read as follows:

‘However the CCP should avoid these counterparty and concentration risks ~~do not materialise if the CCP uses~~ by using the central bank for money settlement... ‘

In this context we would also like to point out that in the area of securities settlement, free access to central bank money at equal conditions both for domestic and foreign system participants alike, is of crucial importance for the creation of a level playing field. From the point of view of the market participants, only having to keep one central bank account as a cash account for the settlement of securities transactions within the EU is the envisaged goal.

Standard #5: Securities lending

In terms of this standard’s scope of application, we feel it is essential that all entities providing central lending systems be covered hereunder whenever the potential counterparties do not know each other. This is the only instance where it is justified to impose specific requirements in order to offset potential risks resulting from such a scenario. For securities lending transactions of credit institutions in bilateral relations with the customers we do not only feel that such provisions are redundant but we also regard them as an overregulation since hereby one subsection of the credit institutions’ lending business becomes subject to disproportionately stringent rules. We therefore suggest the following amendment of page 32, ‘Key Elements’, item 1:

‘1.... including CSD’s, CCP’s and principals to centralised securities lending arrangements ~~custodians operating systemically important systems~~. ‘

Furthermore, we suggest the following clarification of the wording under item 8:

‘8. In no case ~~should~~ can debit balances nor the creation of securities ~~securities creation~~ be allowed. Customer’s asset ~~should~~ may be used only with an explicit consent. ‘

In the further deliberations of this standard, in lieu of the uncommon term *securities creation* there should be an explanation to the effect that no artificial creation of securities may be carried out but that securities lending may only be performed by means of existing securities.

Standard #6: Central securities depositories (CSDs)

We agree to the standard in its proposed form.

Standard #7: Delivery versus payment (DVP)

In our view, due to their special monopoly situation, this standard should only be applied to central depositories. With a view to the risk addressed hereunder, credit institutions are already sufficiently covered by existing risk mitigation provisions (Annex II of the Capital Adequacy Directive). We therefore suggest the following amendments on page 40, ‘Key Elements’:

‘1. This standard is addressed to CSDs ~~and custodians that operate systemically important systems~~.

....

3. All securities transactions against cash at the level of CSDs ~~and systemically important systems~~ should actually be settled on a DVP basis only.’

Standard #8: Timing of settlement finality

From our point of view, like with standard #7, the original intention was to only address central depositories in their specific function for the respective market. Accordingly, on page 43, ‘Key Elements’ item 1 should read as follows:

‘This standard is addressed to CSDs ~~and custodians that operate systemically important systems.~~’

We furthermore suggest a more stringent wording under item 2, i.e. changing ‘should’ into ‘has to’.

In the explanatory memorandum accompanying this standard as well as in the subsequent summary, reference is also made to the necessary compatibility with the opening days of TARGET. Like in the foregoing text, we feel it is necessary to declare these opening days as a ‘benchmark’ only because we explicitly advocate against any national special regimes presently existing under the TARGET system. A harmonisation to the benefit of all market participants can only be achieved in the absence of special regimes. A corresponding amendment is recommended for paragraphs 96 (page 44) and 103 (page 46).

Standard #9: Risk controls in systemically important systems

Here, due to their monopoly status and the corresponding special significance for the overall market, we again propose limiting the scope of application of these standards to the central depositories; this is due to the fact that the users of these systems - being credit institutions referred to as ‘systemically important systems’ - are already subject to comprehensive risk management provisions like e.g. through the Basel Committee’s ‘Principles for the management of credit risk’ dating back to the year 2000. Detailed quality targets with regard to risk management and risk control will also be contained in the European implementation of Basel II. In Germany, already today, there are sufficient supervisory provisions (e.g. § 25a paragraph 1, German Banking Act, minimum requirements with regard to commercial acts, minimum requirements with regard to the lending business carried out by banks). It is one of the bank management’s elemental tasks to make lending decisions and to decide how such loans should be collateralised. Therefore, it is in the bank’s vested interest to carry out a comprehensive credit assessment. Furthermore, the requested full collateralisation of loans within the framework of securities settlement transactions would imply a disproportionate and

costly overregulation (cf. also our comments on standard #5 ‘Securities Lending’), especially in view of the fact that this would only subject one sub-section of the lending business to disproportionately stringent rules. Whenever the standards address the issue of capital adequacy for credit institutions, we would like to refer to Article 3 of the Capital Adequacy Directive. With regard to credit institutions, there is no need for any additional provisions beyond this. We therefore suggest replacing the term ‘systemically important systems’ designating the addressees (both in the standard itself and also in the further description pp. 47- 50) by ‘CSDs’.

Standard #10: Cash settlement assets

Here again, given the existing ISD provisions for investment firms, we do not think that it will be necessary to expand this standard’s scope to include custodians. As a result, page 51, ‘Key Elements’, item 1, should read as follows:

‘1. This standard is addressed to CSDs and ~~custodians that operate systemically important systems~~, more specifically, to the cash payment arrangements....’

Since this is presently not yet a standard for all clearing and settlement systems, we strongly endorse the emphasis on access to money of the central bank of issue. We also and in particular subscribe to the necessity for central banks to enhance access conditions to central bank money pointed out on page 52 under paragraph 115 (cf. also our comments on standard #4).

Standard #11: Operational reliability

In order to minimise operational risks we suggest adding as a further item to the standard ‘(vi) frequent audit of the procedures’.

With a view to the target group, we feel that – also as far as this standard is concerned – there is a sufficient degree of regulation for investment firms, for instance as a result of the mandatory duty to participate in the depositor and investor compensation scheme pursuant to Art. 10 of the amended draft Investment Services Directive. With regard to

the credit institutions concerned here, we should also like to draw attention to the ‘Sound practices for the management and supervision of operational risk’ of the Basel Committee of February 2003. Via the second pillar of Basel II (Supervisory Review Process), respectively via the corresponding EU provisions, the Basel Committee recommendations create comprehensive and binding standards for operational risk management by credit institutions. Hence, page 54, ‘Key Elements’ item 1 could be verbalized as follows:

‘1. ‘This standard is addressed to CSDs and CCPs ~~and custodians that operate systemically important systems.~~’

In addition to this, from our point of view, it may be useful to include infrastructure providers in the group of addressees specified in item 1, such as, for instance, SWIFT or other Telcos.

Furthermore, during the further fine-tuning of the standards, we feel it will be necessary that the aspect of outsourcing mentioned on page 57 in paragraph 133 be specified in greater detail. There should be a detailed specification of both, the functions that are eligible for outsourcing and also the competent prudential supervision authority.

Furthermore, we advocate in favour of a clear wording of item 3, second sentence by replacing ‘should be’ with ‘is’.

By way of further clarification, we also see the need to replace the expression ‘should seriously consider’ (paragraph 130 on page 57, second sentence) with ‘must’.

Standard #12: Protection of customers’ securities

We basically support the proposed standard and, in order to create legal certainty within the EU concerning financial instruments deposited abroad on behalf of the customer, we see the need for a uniform harmonisation of the national legal regimes within the EU. From Germany’s point of view, due to existing national differences, at present the

German custodian bank needs to get the cumbersome so-called 3-point declaration of the foreign depository protecting the customer's vested rights with regard to 1st: insolvency of the depository, 2nd: third party access rights and 3rd: interference of the depository itself with the customer's legal position. Once there is a uniform legal regime clarifying the aforementioned issues beyond any legal doubt, this laborious practice will become redundant. Furthermore, in this case it will be necessary to verify to which extent a further regulation is necessary at all. In Germany, for instance, the law on custody accounts already contains provisions for the protection of customer's securities. In addition to this, in Germany – in the event of a custodian's insolvency - the customer's rights to his securities are protected through German insolvency legislation. Similar provisions can also be found in other European states.

Standard #13: Governance

Here, we suggest keeping the wording proposed by CPSS/IOSCO with regard to the target group CSDs and CCPs. Securing a suitable corporate governance which aims at safeguarding the interests of shareholders and creditors falls under the original remit of Corporate Law, notably of the Stock Corporation Law. Any other supervisory regulation of the governance for public interest requirements, as stipulated in Standard #13, is only realistic for those infrastructure providers who are in a monopoly-like situation and who are not faced with any competition by other providers but who, instead, assume the function of a public utility. This is not the case for custodians with a dominant position. Here, supervisory legislation on governance would constitute an undue infringement upon the entrepreneurial freedom of these custodians. Therefore, the addressees specified on page 63, 'Key Elements', item 1, should read as follows:

“1. This standard is addressed to CSDs, and CCPs ~~and custodians with a dominant position in a particular market.~~”

Furthermore, in order to take account of e.g. the Stock Corporation Act, we feel it is necessary to amend the disclosure obligations under item 3 as follows:

“3. Objectives and major decisions should be disclosed to owners – if not already regulated in another specific law (e.g. Germany: Stock Corporation Act) -, users....”

These disclosure obligations should be limited to, if applicable, system users and to the competent prudential supervision authorities. We furthermore explicitly welcome the fact that, in this standard, there has not been any commitment to any settlement model in particular.

Standard #14: Access

Due to their monopoly situation for the overall market, the scope of this standard, too, should remain limited to central depositories and central counterparties. Otherwise, for certain investment firms competing with each other, this would lead to a de facto obligation to accept contracts regardless of the potential customer’s risk assessment. This would constitute an unjustified interference with the freedom of contract and would curtail the banks’ capacity to select their customers on the basis of their financial standing or on the basis of other criteria. Accordingly, on page 65, ‘Key Elements’ item 1 should read as follows:

‘1. This standard is addressed to CSDs, and CCPs ~~and custodians that operate systemically important systems~~.

We furthermore suggest adding the following clarification on page 65 under paragraph 153:

‘... that do not meet the non-discriminating minimum requirements...’

Standard #15: Efficiency

Here, again, we feel it is sufficient to limit the group of addressees - in line with standard #14 - to CSDs and CCPs. For custodian banks competing with each other, this will be redundant. Here, the sheer necessity of having to provide customers with an adequate cost-benefit ratio will lead to efficiency gains. Yet, this may not be the case for

monopoly providers like CSDs, on whose services all market players are dependent. In the explanatory memorandum of this standard, under paragraph 168, there is once more explicit mention of efficiency gains as a result of standardisation. In our view, this aspect should not only refer to the securities side – and therefore to the CSDs as depositories of the units – but it ought to equally refer to the money side. Hence, it may be worth considering expanding the group of addressees to include the European system of Central Banks (ESCB).

Standard #16: Communication procedures, messaging standards and straight-through processing

In our view, a harmonisation can only be achieved through a binding timetable for the implementation of new (ISO) standards, like e.g. the formatting standard ISO 15022. This timetable should, however, only be agreed in close consultation with the market players concerned. On these grounds, the following wording is suggested for page 72, paragraph 175:

‘All involved parties, such as exchanges, CSDs, CCPs, ~~systemically important systems~~ and ~~relevant~~ all market participants...’

Standard #17: Transparency

We feel that, on balance, this standard is too far-reaching and therefore advocate in favour of keeping the wording of CPSS/IOSCO for this standard. As a result, on page 73, ‘Key Elements’, item 1, item 2 and item 4 should be reworded as follows:

‘1. This standard is addressed to CSDs, and CCPs ~~and custodians with a dominant position in a particular market. For this standard to be effective it also needs to be applied by other providers of securities services, such as trade confirmation services, messaging services and network providers.~~

2.... ; the information should include the main statistics ~~and the balance sheet~~ of the system’s operator.

....

4. ~~CSDs, and CCPs and custodians with a dominant position in a particular market~~
should publicly...’

If and when the term 'main statistics' refers to general ratios concerning the offered services (e.g. number of transactions) we agree to the disclosure obligation, which, nowadays, has probably already become a standard market practice.

Standard #18: Regulation, supervision and oversight

We agree to the proposed standard including the home Member State principle suggested in paragraph 194 on page 77, which is modelled on the ISD.

Standard #19: Risks in cross-system links

We feel that the establishment of a corresponding obligation for certain system users is too far-reaching. As a result, the scope of application specified on page 79, 'Key Elements', item 1, should read as follows:

‘1. ~~‘This standard is addressed to CSDs and custodians operating systemically important systems that establish cross-system links.’~~

Yours sincerely

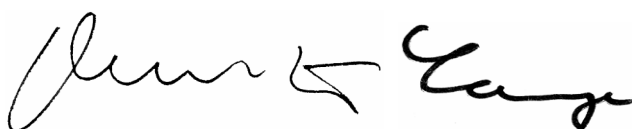
For the Zentraler Kreditausschuss

Federal Association of German Cooperative Banks/

Bundesverband der Deutschen

Volksbanken und Raiffeisenbanken e.V.

by proxy

Two handwritten signatures in black ink. The signature on the left is 'Pleister' and the signature on the right is 'Lange'. They are written in a cursive, flowing style.

(Dr. Pleister)

(Dr. Lange)