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ESCB – CESR Working Group

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**Responses to the second consultation on clearing and settlement**

Cod.Attività ABI: FI1110

The Italian Banking Association (ABI) is pleased to respond to the second consultation announcement on ESCB-CESR Standards for Securities Clearing and Settlement Systems in the European Union.

The enclosed response reflects the point of view on clearing and settlement issues of the Italian banking systems.

ABI's offices are at your disposal for any further information you might require.

Kind regards.

THE GENERAL MANAGER
(Giuseppe Zadra)

*Enclosure*

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ASSOCIAZIONE BANCARIA ITALIANA

# CONTRIBUTION TO THE SECOND ESCB/CESR TASK FORCE CONSULTATION

# "STANDARDS FOR CLEARING AND SETTLEMENT SYSTEMS IN THE EUROPEAN UNION"

**Italian Banking Association**

June 2004

The working group of the European System of Central Banks and the Committee of European Securities Regulators released for public consultation in September 2003 a draft paper on "Standards for Securities Clearing and Settlement Systems in the European Union". The paper lays down 19 standards designed to improve the security and efficiency of those systems.

The Italian Banking Association took part in the consultation to represent the position of the Italian banking industry. The main concerns expressed can be summarized in the following three points:

- The suggested standards apply both to operators of clearing and settlement systems and to banks that provide securities custody services that are "systemically important" or "dominant".[1] This has the effect of imposing the same regulations on different types of agent, some of which are already in competition with one another and subject to specific supervision and others of which are infrastructures and should accordingly be competitively neutral, at least vis-à-vis banks.

- The task force standards do not appropriately consider the risks stemming from the possibility that central securities depositories, and especially international central securities depositories, may have the status of banks, which enables them to provide, in addition to their traditional post-trading activities, quintessentially banking services (securities lending, credit extension, etc.). This coincidence of activities not only distorts the level playing field but may also engender high risk exposure for the CSDs themselves, with potentially system-wide propagation.

[1] Banks that perform clearing and settlement activities comparable in volume and value with those of central securities depositories.

– The imposition of standards on institutions that provide clearing and settlement services (CSDs, ICSDs, CCPs, etc.) and that, while all engaged in the same activities, nevertheless operate under different national legislative and regulatory frameworks, aggravates the position of some and advantages others. The Italian banking industry accordingly maintains that the issue of the European directive on clearing and settlement is an indispensable prerequisite to ensuring greater harmonization without prejudice to the different roles played by different operators.

On 5 May 2004 a second draft of the ESCB-CESR paper was released. The new version is partly revised in accordance with the observations made in the course of the consultation. Our comments on the new version of the standards follow.

First of all, the standards still apply to systemically important banks. However, they are now defined as "custodian banks operating systemically important systems", i.e. banks that have their own settlement infrastructure for their own clients and sub-custodians, whereby they can settle transactions internally rather than going through a CSD.

However, this new definition is not such as to resolve the basic problem highlighted in the first consultation. The term "infrastructure", in this context, can engender great confusion. Moreover, the possibility of internal settlement creates confusion over the concept of internalization and book entry, and between those of global custody, sub-custody and CSD. There is a lack of clear definition of roles and functions that jeopardizes the work done.

Further, the identification of banks operating systemically important settlement systems is left up to the national authorities, which will define such banks according to

whether or not their activity may entails risks for the stability of the financial system. This choice – simply shifting the problems to the national level for solution – heightens uncertainty for the custodian banks in understanding the scope of the standards. Also, it would appear to conflict with the objective of fostering European convergence in the clearing and settlement field and thus favour regulatory arbitrage. Finally, it should be noted that the new version of the paper includes as subject to the standards also "settlement agent banks", "cash settlement banks" and "entities acting as custodians". The latter in particular, in the absence of a precise definition, further increases uncertainty as to the precise scope and confines of the standards' application.

Next, the new version of the standards allows CSDs to take a higher degree of risk. In particular, they omit the general recommendation, formerly contained in Standard 6, that in order to minimize system risks central securities depositors must avoid risk as much as possible. Further, the full collateralization of the CSDs credit exposure is compulsory "whenever practicable" and in any event can be discarded in specific cases or where subject to adequate risk control measures. This provision threatens to remove the stringency of the full collateralization requirement.

On the other hand, we appreciate the recognition the custodian banks are subject to European regulation and, in particular, that the Basel II framework is adequate to coping with the risks associated with the settlement activities of banks operating systemically important systems. In addition, the full collateralization requirement (formerly laid down in Standard 9) has now been removed for depository banks, with the provision that national regulators and supervisors ascertain the adequacy of risk mitigation policies.

[2] Specifically, the example given is that of German government securities, most trading in which is settled at the level of the custodian banks with no entry or effect on the accounts of Clearstream.

Finally, the new version of the standards provides a glossary. Though praiseworthy, this could potentially conflict with the analogous initiative undertaken by the European Commission in its own communication on clearing and settlement released in April.[3] Therefore, the consistency of the definitions given in the two documents must be verified; otherwise, they will cause increased uncertainty in the application of the standards.

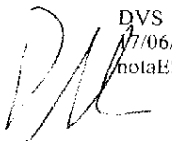
In conclusion, we must note that, as regards the concerns of the banking industry expressed during the first consultation, the basic perplexities communicated to the ESCB/CESR task force in December have not been dissipated. In particular, we must reiterate that the standards are the result of an imperfect understanding of the basic operational functions (sub-custody vs. CSD, centralized vs. bilateral securities lending) and of the lack of a comprehensive reference model. The idea that the standards can be neutral and generic, adaptable to any and every type of definition or organization on the part of different agents (infrastructures and participants) still appears totally impracticable.

Even where the task force has intervened in positive fashion, its action appears to be essentially the result of a series of compromises, not the product of a strong, clear, structured indication of the way in which the industry must work, in the light among other things of the goals of creating a domestic area for Europe and promoting risk segregation and cost efficiency as the result of competition between public and private organizations.

Lastly, the release of the second communication on clearing and settlement by the European Commission, which envisages a framework Directive to realize an efficient, integrated and safee European market, raises serious doubts as to the advisability of setting standards at a time in which the construction of a common European clearing and

[3] Communication of the European Commission to the Council and Parliament, "Clearing and Settlement in the European Union – Future Prospects", published 28 April 2004.

settlement regulatory structure is being initiated. It would thus be reasonable to wait for the conclusion of that process and make consistent use of the work done by the Working Group in the framework of the Lamfalussy procedure.



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