

Citigroup Response to ESCB-CESR Draft Standards for Securities Clearing and Settlement Systems in the European Union

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Background

Citigroup is active in the business of providing securities services for clients in 23 EU Member States and over 70 markets worldwide. As custodian, our clients include institutional investors, corporations, broker dealers, global custodians, international central securities depositories ("ISCDS") and national central securities depositories ("CSDs").

On 1 August 2003, the working group established by the Governing Council of the European Central Bank ("ECB") and the Committee of European Securities Regulators ("CESR") to work together in the field of securities clearing and settlement (the "Group") launched a public consultation inviting interested parties to provide comments on the consultative report entitled "Standards for securities clearing and settlements in the European Union" (the "Consultative Report"). Citigroup responded to the Consultative Report in October 2003.

Following the above consultation exercise, the Group published in May 2004 "Draft Standards for Securities Clearing and Settlement Systems in the European Union" (the "Draft Standards"). The Group has requested that in responding to the Draft Standards, contributors raise only fresh issues arising from changes to those Standards and not revisit ground already covered in their responses to the Consultative Report. Citigroup stands by the comments made in October 2003 but has not repeated them here. Citigroup's response to the Draft Standards is set out below.

Response

1. INTRODUCTION

Citigroup welcomes the ESCB-CESR Draft Standards for Securities Clearing and Settlement Systems in the European Union as a valuable and constructive step forward in promoting the safety and uniformity of the infrastructure underpinning securities clearing and settlement in Europe.

In particular, Citigroup welcomes the following aspects of the new material introduced by the Group:

- Express recognition of the pivotal role of CSDs and the importance of regulating their activities in order to minimise systemic risk (for specific comments on some aspects, we would refer you to paragraph 4 below);
- Strengthening of governance requirements under Standard 11 Operational Reliability;
- Recognition that Standard 13 Governance and Standard 14 Access, designed for CSDs and CCPs, are not applicable to custodians.

2. CLARITY OF TERMS

2.1 *Meaning of "system"*

We would urge that the Group reviews the Draft Standards to ensure clear and consistent use of key terms throughout. It is essential that there is no possibility of differing interpretation of the key terminology in the Standards, as this is likely to result in mismatch in regulatory treatment at a local implementation level.

In particular, we would direct the Group's attention to the key term "system", which is used throughout the Draft Standards in the context of custodians which "operate systemically important systems". This term requires precise definition to ensure clarity and consistency in application of each of the Standards. In order to ensure that the Standards are applied consistently in all EU Member States, it is essential to be able to identify "systems" and their operators. In particular, it is implicit in the Standards that some custodians may be regarded as operators of "systems". National regulators, who are invited to apply the Standards, will need clarity on this issue.

Citigroup does not believe that it is the usual role of a custodian to "operate" a "system", for the reasons set out below. However, if in a particular case (one example may be where an operator of an ICSD provides access to national CSDs, acting as operator of a "system" in some respects and as a custodian in others) this possibility exists, national regulators will need to understand that it is exceptional and to have a certain litmus-test to distinguish between such cases and other, more usual, activities of custodians. The final version of the Standards should make these points clear. We urge the Group to clarify the meaning of "system" and to contrast the activities of a "system" with those of

a “custodian”. The role of a custodian in the clearing and settlement market comprises four main elements:

- Holding of securities for clients (which in the context of a dematerialised environment means ensuring that a record of title to the client's securities is maintained by the custodian on the books of a higher-tier entity);
- “Safekeeping”, which in the clearing and settlement context entails ensuring that the intermediary can always deliver to the client's order the number of securities to which the client is entitled as against the intermediary;
- Transmitting delivery and receipt instructions relating to settlement across the books of another entity; and
- Processing corporate actions.

These activities are not those of a system. Nor does the incidental possibility¹ of making a transfer of securities across a custodian's own books change the fundamental activities of the custodian into those of a “system”.

We consider it to be of major importance that the meaning of "system" used in the Draft Standards is consistent with the definition contained in the Settlement Finality Directive² ("SFD"), and it is made clear in the Standards that this is the case.

A "system" for the execution of transfer orders is defined in the SFD as a "formal arrangement" between "participants" with "common rules and standardised arrangements". On the basis of the above definition and our understanding of the roles and obligations of various institutions involved in clearing or settlement, a clearing and settlement "system" in this context includes the arrangements between a central counterparty or CSD on the one hand, and its members ("participants") on the other³. However, it is important to note that the role of a non-CSD intermediary (such as a custodian bank) would not be defined to be the same as a "system"⁴.

We believe that this analysis is accurate and should be applied to the Standards.

Moreover, we do not think it would be safe or acceptable to allow either of the following situations to develop:

- "Systems" exist which are acknowledged to be systems and regulated as such, but are not eligible for designation and protection under the SFD

¹ As explained in Citigroup's October 2003 response to the Consultative Report, this is completely accidental and cannot be mandated or encouraged by a custodian.

² Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems.

³ For the purposes of the SFD, the operator of the system (CCP or CSD) is in effect deemed to be a participant.

⁴ It may well be possible for an intermediary to be "systemically important" due to the value and size of transactions in which it is involved. However, this does not mean that the intermediary is a "clearing and settlement system"

- "systems" are given the privilege of designation and protection under the SFD but, despite this, fall outside the scope of regulation proposed under the Draft Standards.

Failure to achieve consistency between the SFD and the Standards would introduce new areas of systemic risk and leave investors uncertain as to the degree of protection given to their transactions in the market.

2.2 ***Conformity with proposed Directive on Clearing and Settlement***

We refer to the recent Communication from the Commission to the Council and the European Parliament on Clearing and Settlement in the European Union (the "Communication") in which the Commission proposes the introduction of a framework Directive relating to the clearing and settlement market. One of the core proposals in the Communication, which Citigroup welcomes, is that the Directive should introduce common functional definitions of clearing and settlement activities.

We would urge the Group to consider including in the Standards an undertaking to review, and where necessary revise, terms used in the Standards and the Glossary to ensure that they conform with definitions laid down by any subsequent Directive.

3. **APPLICATION OF BASEL II FRAMEWORK**

We understand from Paragraph 15 of the Introduction to the Draft Standards that the Group has concluded that the new Basel II framework is likely to provide the most convenient vehicle to address risks associated with the settlement activities of systemically important custodian banks. In light of the discretions available to competent authorities under Pillar 2 of the Basel II framework (to impose additional regulatory capital charges on banks which are deemed by the regulator to carry higher risk profiles) and Pillar 3 (to promote publication of responses to risk management), we request further clarity from the Group as to the implications of the above statement, including clarification that:

- (a) The Group does not contemplate the automatic assumption that supervisory action is needed in every case where a custodian is perceived to be systemically important. This would be inappropriate, since any regulated institution (including a custodian bank) which is perceived by its regulator to be of systemic importance is already subject to appropriate supervision in that regard;
- (b) It does not follow from "systemic importance" that additional capital is the appropriate, or only, means to manage the risks. The automatic imposition of any additional capital charge on systemically important custodians would significantly impede banks' competitiveness in the market; or
- (c) The Group does not contemplate the publication of any assessment that a particular institution is "systemically important". This would introduce moral hazard and thus be counterproductive.

4. **STANDARD 9: CREDIT AND LIQUIDITY RISK CONTROLS**

4.1 ***Assumption of credit risk by CSDs - concentration of risk***

In light of the systemic importance of CSDs due to their vital role in the overall settlement process, we are most concerned by the Group's proposal to allow a CSD an unfettered right to extend credit to participants.

Because of the pivotal role of a CSD, we question the prudence of allowing such an entity to assume credit risk in any event, but we are additionally concerned by the following additional risk. We believe that provision of credit to participants by a CSD for any purpose would attract a greater degree of risk than if such credit were provided to those participants by commercial banks. This is because if the CSD were to have an unfettered right to provide credit services to participants it may become the credit provider of choice to a significant number of participants, which would result in a potentially unlimited concentration of credit risk in the CSD. Yet CSDs do not have the capital, liquidity or diversity of operations to support unlimited credit activity. They would depend on the securities held for participants as collateral. Using such securities as collateral is inappropriate except for the limited purpose of covering credit advanced as a necessary element of the settlement process. Utilisation of securities as collateral by CSDs would introduce intolerable systemic risk: a CSD which has to enforce on collateral would have to reconcile the conflicting responsibilities of (i) maintaining the integrity of the securities issue; (ii) obtaining the best price for the enforced collateral; and (iii) holding the collateral securities for its own benefit instead of its participants'. Furthermore, it would be imprudent for any institution to rely exclusively on collateral as the sole technique for credit risk mitigation unless the credit is strongly linked to the performance of the collateral itself⁵. By contrast, if this service was not offered by the CSD, the participants would borrow instead from their choice of commercial bank, hence spreading the credit risk across a range of banks. We urge the Group to carefully consider the implications of this additional risk factor.

4.2 ***Securities lending by CSDs***

We also question the appropriateness of granting CSDs unlimited freedom to engage in securities lending activities. Due to a CSD's special position in the market, for the reasons given below, we believe that this would lead to anomalous consequences which would introduce unnecessary concentration of risk and unfairly hamper free competition in the securities lending field.

A securities lending facility should distinguish fails coverage and lending to support a short selling strategy. "Fails coverage" is where expected incoming securities do not arrive in time to satisfy an outgoing delivery requirement and is usually of a very short duration. We agree that there is a useful role to be met by a lending facility in this regard, although a centralized lending facility need not act as principal and assume risk

⁵ If a CSD were to extend credit to a participant purchaser of securities, it will most naturally rely on the securities received by that participant as collateral for the loan. Lending on this basis would only be prudent if both of the following circumstances are applicable: (a) the value of the securities is approximately equal to the purchase price; and (b) the value of the securities maintains at that level following default of the purchaser. However, there can be no guarantee the price agreed between purchaser and seller represents the current market value of the securities at the time of the transaction, nor can there be any guarantee that the value of the collateral will remain at an acceptable level following default of the purchaser. Moreover, extending credit on these terms does not provide the CSD with collateral in addition to the purchased securities if a "hair cut" is applied to take into account market and currency risk.

for the service to be efficient. "Short selling" is where a market participant intentionally sells a security he does not own; there are no expected incoming securities to unwind the loan. The risk associated with short position-taking should not be shouldered by the centralised lending facility. Standard 9, or (perhaps more appropriately) Standard 5 should make it clear that recourse to the centralised lending facility is appropriate only where the operator of the facility is notified that there has been a short-term failure of an incoming expected delivery.

If a CSD were able to engage in securities lending it would be in a significantly more advantageous competitive position than other non-CSD lenders by reason of privileges gained in its role as central securities depository. In its role as a depository the CSD will have unique market knowledge in respect of the identity of holders of specific securities. This will be of invaluable assistance in its role as securities lender since it will be able to source potential lenders much more effectively than its non-CSD competitors. We believe that allowing a CSD to use the privileges arising from its role as a securities depository to gain a competitive advantage over its competitors in the provision of an ancillary service is unfair. We urge the Group to reconsider this issue carefully.

4.3 *Intraday Exposure*

We note that the Group recommends that "the possibility to increase the level of collateralisation of [custodian banks'] credit exposures, including intraday credit, should be envisaged"⁶. We strongly believe that, as long as a bank has risk management controls in place to monitor potential overnight exposure to individual customers and in aggregate does not exceed prudential limits, the level of intraday exposure should not be relevant for capital adequacy requirements. We attach as an Annex to this paper a brief description of how intraday exposure arises and how such exposure is currently managed. We urge the Group to recognise expressly that this issue is already under proper and effective control.

4.4 *Custodians do not "create" credit or liquidity risk*

The Introduction and paragraph 14 of Standard 9 refer to "risks the custodians create for the financial system". Citigroup would disagree with the proposition that custodians *create* credit or liquidity risk.

Whilst robust operational risk management techniques are required in relation to custodian functions, they do not "create" credit or liquidity risks which are not already present in the market. We would urge that this is clarified in the Draft Standards.

4.5 *Clarification as to application of collateralisation requirements*

The second sentence of the second paragraph of Key Element 1 states that "Credit exposures (including intraday and overnight credit) should be fully collateralised whenever practicable...". We assume that this comment is intended to apply only to CSDs; clarification on this in the text would be helpful. We assume that the Group does not intend that any other entity extending credit should be fettered in its ability to use the full range of risk management techniques available.

5. **APPLICATION OF STANDARD 12 TO INVESTMENT FIRMS**

We question whether it is appropriate to extend Standard 12 to "investment firms". As custodian services provided by investment firms are regulated under the Investment Services Directive we do not understand the implications of additionally applying this Draft Standard. It would be helpful if the Group clarified this position and in particular if the Group could confirm whether Standard 12 is designed to impose a standard on custodians higher than that contemplated by the ISD.

⁶ Standard 9: Introduction; Key Element 4 and Paragraph 114.

Intraday Exposure Arising from Securities Settlement

1. SUMMARY

Intraday exposure created by payments related to securities settlement is not different from exposure created by payments completely unrelated to securities (“clean cash payments”). Banks play a central role in providing intraday liquidity to all types of institutions to enable the smooth functioning of the financial markets.

Although there is uncertainty regarding whether funds will be received at the end of the day that would “close out” the intraday exposure, it should be noted that a bank is exposed to its customer only if the expected funds ultimately do not arrive. As long as a bank has risk management controls in place to monitor the potential overnight exposure to individual customers and in aggregate does not exceed prudential limits, the level of intraday exposure should not be relevant for capital adequacy requirements.

Unique features of intraday exposure related to securities settlement include:

- The ability of the bank, in the event of a customer’s bankruptcy, to retain and possibly even liquidate securities not paid for by the customer to cover the exposure. This can be achieved through commercial contract or statutory right in some jurisdictions.
- The intraday exposure of each member of a securities settlement system to that system or its cash settlement bank. This exposure also holds true for certain cash payment systems. The risk management, solvency and liquidity of securities settlement systems is essential for the stability of the entire market, because of their function as market infrastructures.

2. HOW INTRADAY EXPOSURE ARISES

Intraday exposure (also called daylight overdraft) arises when a bank makes (or irrevocably commits to make) a payment on behalf of a customer whose cash account contains insufficient funds, with the expectation that at a later time during the business day the customer would receive funds into its account which would then cover the shortfall.

The essence of intraday exposure is that it is not expected to result in an actual credit extension by the end of the business day.

3. WHAT PURPOSE IT SERVES

Intraday exposure is the typical way in which banks provide liquidity to assist the smooth functioning of the financial markets. Because banks are willing to make a payment in anticipation of the receipt of funds based on the financial condition of their customers, customers expecting a receipt of funds on S (settlement day) can use these funds on the same day to make payments, before the funds can actually be confirmed as received by the bank.

Without intraday credit, a customer would need to have confirmed and sufficient funds in its account in advance of the bank being able to make a payment. If the payment system in the market clears at the end of the business day, the customer would need to have funds in its account on S-1 (the day before settlement day) that equals its anticipated payments on S. This results in an overnight funding cost to the customer, as well as the customer's exposure to the bank holding the deposit.

4. **CAN THE EXPOSURE BE AVOIDED**

If the expected funds do not arrive by the close of the payment system's operating hours, an overdraft in the customer's account with the bank results. The intraday exposure becomes an overnight credit extension at the point in time when it is certain that the expected funds did not arrive during the business day and the bank is therefore obliged to record it in its balance sheet.

The timely arrival of the funds is not completely under the control of the customer (because the timing can depend on the actions of the payer and the payer's bank), although the customer is ultimately responsible for ensuring his account is funded.

5. **HOW BANKS CONTROL THE EXPOSURE**

Banks typically manage credit exposure to their customers by knowing their customers' financial condition and business, and setting a limit on the amount of credit it is prepared to extend to each customer. Different credit limits are established for intraday exposure, overnight credit, and longer term loans. These limits typically take into consideration the customer's business needs and habitual pattern of funds transfer, are reviewed periodically and reset as necessitated by changes in the customer's financial condition or business requirements.

A bank's payment system is typically linked to its risk management system so that the credit usage by customer is continuously monitored against the credit lines established. Where the lines are close to be exceeded or actually exceeded, established escalation procedures would commence within the bank to ensure proper approval of any excess credit exposure.

Risk management techniques are usually the same for intraday exposure related to clean payments (which do not involve securities) and intraday exposure related to securities settlement.

6. **UNIQUE FEATURES OF INTRADAY EXPOSURE EXTENDED FOR SECURITIES SETTLEMENT**

Intraday exposure associated with payments related to securities settlement have the following additional characteristics:

- If a bank had paid for securities on a customer's behalf leading eventually to an overdraft in the customer's cash account, and the customer subsequently did not repay the bank, the commercial contract with the customer may give the bank the right to retain and possibly sell the securities for which the customer had not paid. The proceeds of the sale would go towards reducing the owed amount. This

mitigates the risk of providing intraday liquidity for securities settlement and differentiates it from clean cash payments.

- A user of the securities settlement system incurs intraday exposure to that system and its cash settlement agent for the total value of its securities delivered (and from which payment is expected from the system acting as cash clearinghouse for its members). A securities settlement system which settles in commercial bank money may not be able to make the payment, due to its insolvency or the insolvency of its cash settlement agent. Banks providing securities services as an intermediary typically assess their exposure to each settlement system of which they are a member, as well as the system's cash settlement agent. It is worthwhile noting that banks are exposed to cash payment systems in the same way and also assess their exposure to those systems.

7. INTRADAY EXPOSURE OF “NARROW BANKS” WITH LOW LIQUIDITY

A related issue, which is beyond the scope of this note but which merits separate examination, is whether a bank's lack of liquidity affects the nature of its daylight exposure. Securities settlement systems which are “narrow banks”, such as ICSDs, regularly lack the pool of liquidity of banks which have diversified business portfolios that would enable them to pay funds before the expected funds arrive. ICSDs which have a high volume of fixed income securities settlement typically have large liquidity needs (due to the high value of fixed income securities transactions, the propensity of repo transactions, and a trading client base which typically does not hold excess funds). ICSDs may need to obtain liquidity from larger banks which are prepared, subject to appropriate remuneration, to make payment on the ICSDs' behalf before funds are received. Where an ICSD's financial situation causes its cash settlement banks to withdraw liquidity, or where a cash settlement bank itself has problems providing liquidity to the ICSD, the systemic impact on the financial system can be very substantial.