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Consultation on ESCB-CESR Standards for Securities Clearing and Settlement Systems in the European Union

Efficient and safe arrangements for securities clearing and settlement are essential pre-conditions to the overriding goal of creating an integrated capital market within the EU. To this end, the ESCB-CESR has published "Standards for Securities Clearing and Settlement Systems in the European Union" (ESCB-CESR Standards) for consultation. As a key player in the EU securities markets, Deutsche Bank AG would like to provide feedback on the ESCB-CESR Standards and "The Scope of Application of the ESCB-CESR Standards". Deutsche Bank has approximately 69,300 employees and serves more than 13 million customers in 76 countries worldwide and is thus one of the leading international financial services providers.

Although we fully endorse the response to ESCB-CESR Standards of the Zentraler Kreditausschuss (ZKA), the joint committee operated by the central associations of the German banking industry, Deutsche Bank would like to provide further with you additional comments.

General Remarks:

Deutsche Bank is very interested in a harmonised framework for the European clearing and settlement infrastructure and thus welcomes the work of ESCB-CESR in this regard. When defining standards, ESCB-CESR tried to adopt a functional approach to regulation, which is also welcomed by Deutsche Bank. ESCB-CESR proposed a definition of the term “systemically important” institutions, which are to be subject to the same regulations without regard to the legal status of the institutions concerned. In reality, this approach would face a number of difficulties.

There is a functional difference between Central Securities Depositories (CSD) and custodian banks: a CSD is created to serve as an infrastructure for the entire market, whereas custodians serve as intermediaries within a competitive environment providing investor access to that infrastructure. An infrastructure and an intermediary have two very different market functions and thus should not be subject to the same standards.

The approach in regulating banks as infrastructure providers justified pursuant to the principle "same business - same regulations" consequently should only apply in this case if custodian banks provide a service comparable to CSDs both in quality and size. As this is, according to our knowledge, the case only for very few custodians, such concerns should be addressed on an individual case basis (institutional), i.e. via competition law instead regulating all banks. Thus, we object to the introduction of the concept of systemically important providers in the form proposed by ESCB-CESR.

The Group of Thirty in its Report on Global Clearing and Settlement defined systemically important institutions as “those market participants whose operational or financial failure has the potential to cause other organizations to fail and so to spread contagion through the entire financial system. In any particular market, infrastructure providers and particularly large or strategically important financial intermediaries are likely to be classed as systemically important.” Yet, this definition was limited to, for instance, business continuity and disaster recovery plans. The following arguments could be put forward against introducing the definition of systemically important providers as the trigger for the application of the standards:

- Deutsche Bank would welcome the execution of a cost-benefit analysis before implementing additional legislation. The risks described potentially caused by a custodian classified as systemically important, which are the reasons given for drafting the standards, are subordinate to the importance of overall stability in the event of a major player's default.

- Applying the standards to custodian banks that were originally designed for infrastructure providers would generate high costs for financial services providers as well as users (investors) and would thus work against the efficiency of the European capital market. For instance, (standard 9) requesting the full collateralization of credit extended ignores that custodian banks already deploy a wide range of protection measures to mitigate customer default (collateralization is only one of many risk mitigation measures). This standard would in effect imply that the extension of credit for securities settlement should be differently regulated than credit extension for any other purpose, which seems to be unjustified.

- The proposed standards raise fears that they could lead to a “double” regulation of banks as some standards overlap with existing banking regulations (and to some extent with the Investment Services Directive). Even if most ESCB-CESR standards are not in contradiction with other law, regulating the same circumstances within different laws entails costs (because in any case banks have to invest in staff and processes to ensure compliance with the respective laws) and uncertainties as to what exactly ESCB-CESR wants to prevent.

After these general remarks, Deutsche Bank would like to provide further input on the questions currently considered by ESCB-CESR as described in the document on “The scope of application of the ESCB-CESR Standards”.

Questions:

1. *Do you agree that some of the scope of the standards should be extended to systemically important providers of securities clearing and settlement services other than CSDs and CCPs?*

   The safety and efficiency of the clearing and settlement arrangements depends on the interplay of various institutions. As we disagree with the term "systemically important providers" as the trigger for the application of the standards, we propose to include all market participants additionally to CSDs and CCPs – but only where appropriate – in the scope of application: thus, all market participants should comply with the requirements laid out in standard 2, 4, 12, and 16.

2. *Should the extension be to all custodians, or should it be limited to systemically important providers of securities clearing and settlement services?*

   The entire set of standards should clearly **not** be applicable to all custodians but only to those custodian banks that provide a service comparable to CSDs both in quality and size.

3. *What are the criteria along which – according to your opinion – the systemically important system could be defined? What would you consider to be the essential elements that should be a part of such a definition?*

   For the purpose of identifying which institutions must ensure that they have adequate business continuity and disaster recovery plans in place, the definition of the Group of Thirty, for instance, could be used. For the purpose of extending the application of standards to custodian banks, we disagree with the concept of "systemically important system".

4. *Do you agree that systemically important providers could be defined as institutions with a business share of [5%] at EU level or [25%] at domestic level (or lower, at the discretion of the national authorities) in each relevant market?*

   The business share of a certain institution alone is insufficient to define whether that institution poses risk to the safety, soundness and efficiency of securities clearing and settlement activities. Therefore, we disagree with a fixed threshold. The consequence of such a concept would be that customers would be given an incentive to move away from custodian banks classified as systemically important to avoid the associated costs.

5. *Do you agree that three relevant markets can be considered – bonds (public and private), equities and derivatives – or would a different categorisation be helpful?*

   For the purpose of the definition of systemically important providers, ESCB-CESR intends to distinguish between three relevant markets: bonds, equities and derivatives. It may be useful to assign derivatives to the underlying product group as thresholds could be avoided with transactions in derivatives.

6. *Which of the ESCB-CESR standards should apply to all systemically important custodians?*

   Not applicable in light of our remarks and responses above concerning the objection towards the definition “systemically important provider” as the trigger for application.

7. *What would be the implications of extending the scope of the standards to cover systemically important providers of securities clearing and settlement services?*

   As ESCB-CESR has acknowledged, because of its limited competencies to enforce the standards, adopting them without prior clarification of this issue would pose high risk and uncertainties for the market as it is unclear which consequences would follow if institutions acted in contradiction to the standards.

   Overlap with existing regulations (e.g. banking regulations of custodian banks) causes additional costs for these institutions in applying the standards. Of course, these costs would ultimately have to be born by the investors. Furthermore, applying certain standards to custodian banks could be counterproductive to an efficient capital market: standard 9, for instance, proposes that custodian banks fully collateralize the extension of credit for clearing and settlement purposes. This could decrease liquidity as available collateral is limited.

8. *Do you agree that standards 13, 14, 15 and 17 should apply to custodians with a dominant position in one market? If yes, how would you define a dominant position?*

   In a competition law context, a dominant position is defined as a position of economic strength enjoyed by an undertaking which enables it to prevent effective competition from being maintained on the relevant market, giving it the power to behave to an appreciable extent independently of its competitors, customers and ultimately of its consumers.

   Clearly, a provider of clearing and settlement services enjoying such a dominant position should at least obey the principles laid out in standards 13, 14, 15 and 17.

   Seeing as there is only one CSD for a certain security, a CSD does have a natural monopoly. The question is whether there are institutions besides CSDs (and CCPs) which can be characterized as being in a dominant position. In order to rule on this, a simple business share analysis is insufficient (although it provides evidence of a dominant position), but rather an extensive analysis would have to determine the relevant market and whether substitutes are available. In most cases, there are alternative providers of custody services that can compete with the services provided by CSDs (and CCPs).

Comments on the respective standards:

Standard 1: The application of this standard should not lead to a discrimination of market participants that act as remote access members. Therefore, it may not only be necessary to make sure that there is a transparent legal basis for securities clearing and settlement systems but also that legal barriers for foreign participants are removed as far as possible.

Standard 2: Besides applying standards concerning the timing of trade confirmation and settlement matching, the standard should also make reference to a harmonised usage of these confirmations. Factors to be considered include the means of communication used (e.g. SWIFT), minimum requirements for a confirmation (e.g. standards for the content such as ISO 15022). This would provide the basis for automatic trade matching on T+0/T+1 and would thus decrease the fail rate on value date.

Generally, trade confirmation should indeed take place on T+0 and only in exceptional cases, such as trading after the close of official trading, should a trade confirmation occur on the next trading day (by 12 noon for instance).

Standard 3: Harmonizing settlement periods should be limited to exchange trades only and essentially to equities. Yet, harmonized operating hours would be welcomed and should be aligned to TARGET. Lowering fail rates requires a real or near time clearing between CSDs and ICSDs, which is not in place yet. Therefore, standards should focus on the reason for the high fail rates instead of artificially enforcing them. These reasons include the lack of automated matching and real time clearing.

Standards 4: Deutsche Bank would welcome if the ESCB-CESR working group would also consider achieving a level playing field by stipulating free access to central bank money both for foreign and domestic market participants.

Standard 7: We would encourage ESCB-CESR to investigate the issue of so called chaining, which concerns transactions covering both ICSDs and CSDs. Here, DvP may be infeasible.

Standard 8: We welcome the standard except the inclusion of custodian banks. Here, the market will likely solve this issue without the need for regulatory intervention as increasing costs for refinancing and lower interest from reinvesting will provide the necessary incentives to provide finality as soon as possible.

Standard 19: The concrete implications of this standard are difficult to assess. Therefore, we would ask ESCB-CESR to provide detailed examples on this issue.

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