Fédération Bancaire Française (FBF)

Association Française des Entreprises d'Investissement (AFEI)

Association Française des Titres (AFTI)

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Contribution to the ESCB/CESR Group's consultation

In response to the ESCB/CESR call for contributions on clearing and settlement

The major market participants in France met under the umbrella of the FBF (Fédération Bancaire Française –French Banking Federation), the AFEI (Association Française des Entreprises d'Investissement –Investment Firms Association) and the AFTI (Association Française des Titres – French Securities Association) to discuss the matters suggested by the ESCB/CESR Group, regarding the implementation of standards in the fields of securities settlement and clearing activities. The outcome of this consultation is summarised below.

An annex presents the reactions of the market participants to some orientations of the ESCB/CESR working group.

The nature of the recommendations

What should be the legal nature of the recommendations and/or standards to be issued by the Group? Are there issues for which a European legal instrument is deemed appropriate? Are there recommendations and standards that should be adopted by national law?

Regarding the nature of recommendations, the market participants suggest that this framework should not be strictly or systematically based on a legal reform. In line with this consideration, the contributors consider that the Giovannini Report recommendations could be followed in order to define the nature of standards. Thus, these recommendations should be mostly business-oriented, i.e. shaped by market participants according to their needs, whereas legal interventions should be strictly limited to the matters that can not be dealt with by the market professionals. However, the market participants emphasise that the business-oriented recommendations must be inciting enough to be respected.

In keeping with the principles defined above, the major market participants distinguish three ways to shape standards:

- legislative interventions,
- establishing best business practices,
- and market's initiatives.

Regulators and market professionals should define jointly the scope of intervention of each standard setter. In association with regulators, the market professionals should define the scope of their intervention. The intervention of regulators is particularly necessary in order to distinguish clearly market-oriented activities, submitted to business practices, and public utilities, submitted to regulatory or legal interventions. This distinction is particularly relevant for Clearstream and Euroclear.

Legislative interventions: the intervention of lawmakers and regulators should not be systematic, since the scope of intervention of market professionals needs to be as large as possible. However, strong legal reforms are necessary in the fields where market professionals are unable or unqualified to take decisions.

For instance, clear and strong principles must be defined and enforced by lawmakers regarding the matters of finality and of ownership transfers.

Business practices: a discussion about the aim of standards is necessary between business professionals and regulators, in order to shape business practices and templates. In addition the market participants underline that these recommendations should be strong enough to be inciting and respected by the markets.

The market participants suggest that market professionals should address some topics like ensuring the security of trades. For instance, a guarantee could be provided by the adoption of business best practices regarding central counterparties and delivery versus payment. Nevertheless, since these matters are also in the scope of law, a close co-operation between market professionals, regulators and the legislator is inevitable.

Market's initiatives: the scope of competencies of market's initiatives needs to be strictly and clearly defined. The contributors underline that the missions entrusted to the market should be highly relevant in order to avoid inefficiency and an unjustified enlargement of the market's competencies.

For example, matters regarding clearing and settlement could be both in the scope of competency of the market and of the business practices setters. On the contrary, matters that are strictly in keeping with the lawmaker's competencies must not be submitted to the markets' initiatives.

Furthermore, the contributors consider that the final recommendations should not define the operational modality of implementation. In contrast, operational implementation should come under lawmakers, business practices designers and the market forces.

Addressee

Who is the appropriate addressee of the possible standards or recommendations to be drawn up by the Group: the regulators, the systems, the operators or the users? In such cases where standards and/or recommendations are addressed neither to regulators nor to legislators, what are the appropriate incentives for their implementation and compliance?

Regarding the destination of the recommendations, the major market participants consider that the largest scope of entities should be concerned. Therefore these recommendations should apply to regulators, systems, operators and users. In addition, in order to avoid inefficiency and misunderstanding, the contributors state that recommendations should expressly indicate who is concerned by the enforcement of the standard/law.

Concerning the standards that are not addressed to lawmakers and regulators, the contributors believe that business practices could be defined in order to ensure the enforceability and the respect of the recommendations.

Scope

Do you agree that the scope of the Group's work includes any entity providing clearing and settlement services or associated aspects and is not limited to any particular type of service provider? More specifically, do you agree that central securities depositories (CSDs), international central securities depositories (ICSDs), CCPs, custodians and registrars are included? Do you think that some standards should apply on a differentiated basis to these parties given that the scope of their business is not directly comparable? Should standards apply to other parties? If so, which standards and to which parties? With regard to custody and safekeeping services, what are the advantages or disadvantages of a distinction being drawn between custody services, on the one hand, and clearing and settlement on the other? Do particular considerations apply where custody and safekeeping services are provided by credit institutions or investment services firms? With regard to the securities covered, do you agree that sovereign and private debt, equity and other securities, as well as depository certificates, receipts, derivatives, etc., are included, or where would differentiation be necessary? Should some standards/recommendations be specifically addressed to cross-border transactions? If so, which ones?

According to the contributors, the scope of the recommendations must be as broad as possible. The major market participants welcome the proposal of the Group to consider that not only CSDs, ICSDs and CCPs are in the scope of recommendations, but also custodians, according to a functional approach. They add that SSSs should also be concerned by the enforcement of these recommendations.

In addition, in order to ensure the best enforcement and efficiency of the recommendations, the participants think that the enforceability of standards could be drawn according to a concentric model. The heart of the system, which is strongly exposed to risk, should comply with adamant standards and laws in order to reduce and eliminate risks, whereas peripheral activities could be submitted to more flexible standards, for example bilateral conventions or business practices. This pattern, with different levels of enforceability aims at promoting the best and the most adapted monitoring of risks.

The contributors believe that different standards are necessary when activities are different. In line with this statement, the market participants welcome the proposal of the Group regarding the distinction between the activities of custody on one hand, and the clearing and settlement business on the other hand. This distinction would ease the identification of risks and enable to shape standards monitoring. Nonetheless, the contributors think that this kind of differentiation must be studied seriously before being implemented, in order to avoid an unjustified and harmful multiplication of rules.

Concerning credit institutions and investment firms that provide custody services, the contributors consider that the customers' and custodian's assets should be segregated. They also regard as crucial the definition of specific standards and the implementation of a passport for custodians.

The contributors believe that all kinds of securities should be covered, and they consider that a differentiation according to the type of securities is necessary. In addition, in order to establish a level playing field and to enable further harmonisation, the definition of business practices seems unavoidable, particularly regarding complex financial instruments. Moreover, the recommendations should take into account the link between cash and securities, which may lead to some differentiation for financial instruments used as collateral in monetary policy operations, money market operations or to provide liquidity in payment systems, in order to improve the convergence of these two different environments.

This differentiation is also necessary regarding pledge and repo operations, since repo allows a finer tuning of collateralisation than pledge, thanks to a shorter mobilisation and safer legal conditions of ownership.

Finally, the contributors suggest that cross-border trades should be submitted to specific standards.

Objectives

A priori, the objectives of central banks and securities regulators in the field of securities clearing and settlement systems could be summarised as follows: 1) risk mitigation, including investor protection, for both the system and the users; 2) efficiency, including for cross-border activities; 3) creation of a level playing field between participants and service providers, irrespective of their legal status or their geographical location; 4) promotion of integration of the EU securities markets infrastructure. Do you agree? Do you consider that these objectives are sufficient?"

The market participants welcome the four propositions made by the ESCB/CESR regarding the objectives of central banks and securities regulators.

1) Regarding the first suggestion, they consider that risk mitigation depends not only on regulators but also on market organisations. This suggestion is particularly relevant for operational risks. Therefore, they consider that operators of market infrastructures should carefully consider the mitigation of operational risks, in keeping with the Basle 2 requirements. Moreover, the major market participants strongly believe that key infrastructures, such as Swift, should not be privatised. Such a privatisation would hamper risk mitigation, since shareholders' private interests and regulators' objectives might be divergent and contradictory.

2) Regarding the efficiency objective, the market participants underline that an equilibrium is necessary between efficiency and costs. Costs reduction must remain consistent with efficiency, which should remain the first objective of the recommendations. Nonetheless, in keeping with this principle, the contributors believe that costs should be as limited as possible. The contributors insist on the need to adopt a medium or long term vision in order to build a systematically stable type of organisation and to provide for a sustainable development in the long run.

3) The different national legal frameworks could be detrimental to the level playing field, for instance when they involve dramatic differences in access conditions. Therefore, in order to harmonise rules and to create a level playing field, a European passport should be created, not only for custodians, but also for trustees.

4) The integration of the EU securities infrastructure is an important objective. Nevertheless, the market participants have some doubts on the merits of a horizontal approach that would require a perfect interoperability of the systems. They consider that the three layers – trading, clearing and settlement – have to be compatible and integrated in order to maximise the efficiency and mitigate the risks. Nevertheless, such an integration does not require that one of the layers owns the two others (the so-called "vertical silo" structure).

Access conditions

Are you aware of access conditions to specific service providers, which could be considered discriminatory? If so, where do the main problems lie? Do you consider that the present rules do/do not establish a level playing field in

this respect? Do they relate to the access criteria of the system or to other conditions such as operational features? If so, which ones?

Currently, according to the contributors, access conditions are not discriminatory in the Euro area. It does not appear that remote membership to SCSS is generally not obstructed by legal criteria or intentional obstacles. For the settlement of the cash leg of securities transactions, credit institutions can have an account in a foreign central bank of the EU without owning a branch in this country.

In most cases, difficulties are linked to a lack of operational harmonisation and to incompatible processes. Therefore, in order to ensure the best connection of systems, an operational harmonisation is necessary.

Risks and weaknesses

What are the most relevant factors to risks and weaknesses in terms of clearing and settlement of domestic and cross-border transactions (i.e. legal, settlement, custody and operational risks)? As far as legal risks are concerned, what kind of problems can different legal approaches create? When looking in particular at cross-border transactions, how does the existence of different jurisdictions and the involvement of several actors such as local agents, global custodians, foreign CSDs or ICSDs in the process of cross-border clearing and settlement affect the nature and magnitude of these risks? What would be the most appropriate manner of addressing these issues? As far as custody activities are concerned, do you agree that the segregation of assets and the reconciliation of positions are the most crucial issues to be addressed? As far as settlement risk is concerned, do you agree that the definition and timing of finality (including the need for intraday settlement finality), delivery versus payment, access to central bank money as settlement assets for systemically important systems and conditions of use of central bank money versus commercial bank money are the most crucial issues to be addressed with regard to clearing and settlement of domestic transactions? What specific impact could these issues have on clearing and settlement of cross-border transactions? Finally, as far as operational risks are concerned, what are the main factors to be considered?"

The existence of different legal frameworks and the involvement of many actors increase the magnitude of risks. According to the major market participants, a business-by-business analysis is necessary to harmonise processes and rules. Thanks to this procedure, harmonisation could be achieved through the definition and the implementation of business practices, and only if necessary, via legislative interventions. One topic, which strongly requires harmonisation of procedures and rules, is the management of corporate events.

As far as custody activities are concerned, the contributors think that the segregation between own and customers' assets is essential, but the so-called "external segregation" at the level of the CSD is not a priority. They strongly believe that better methods can be used to mitigate risks. For example, the definition of terms and conditions applicable to the services of custodians towards their customers and the implementation of rigorous monitoring procedures are more efficient. Therefore, the contributors think that the definition of standards and the implementation of rigorous control are unavoidable for custodian activities (and equivalent).

Regarding settlement risks, the definition and timing of settlement finality is crucial. In keeping with this statement, contributors consider that convergence is indispensable. Moreover, harmonising processes and using central bank money is fundamental in order to ensure the proper functioning of a model in which there are several systems and central banks.

Finally, regarding the management of operational risks, the contributors suggest that a strong co-operation should be organised between the different European financial centres. For example, since Clearnet and Euroclear operate on three different financial centres (Brussels,

Amsterdam and Paris), a common crisis committee with direct correspondents on the three centres is necessary to deal with a crisis.

Therefore, as domestic crisis can have systemic effects via links with foreign correspondents, branches and partners, the contributors consider that this kind of committees should be widespread in Europe in order to manage efficiently crisis that involve central institutions based on multinational network structures.

Settlement cycles

What are the arguments for and against harmonised and/or shorter settlement cycles? It appears, for instance, that while a very short cycle could increase settlement default rates, a longer cycle could increase uncertainty and settlement risk. Is there a need to adopt different settlement cycles for different securities, such as for equities and government debt instruments, etc?"

The market participants are in favour of a full harmonisation and of a shortening of settlement cycles. A shortening of settlement cycles, from T + 3 to T + 2, would reduce uncertainty and mitigate settlement risks. However, the contributors are not favourable to a sharp shortening of settlement cycles: they consider that a move from T + 3 to T + 1 could increase operational risks. Therefore, a reasonable move from T + 3 to T + 2 is preferable, since it decreases financial risks, does not entail expensive changes and does not increase operational risks. T+2 should become a general standard but SSSs should also be able to settle on shorter cycles, even intraday, when the type of operation requires it (for instance OTC trades on bilateral agreement). Moreover, the contributors believe that such a reduction should be regarded as an opportunity to harmonise settlement cycles in Europe, and consequently ease cross-border operations.

Structural issues

The structure of the securities clearing and settlement industry in Europe has been hotly debated recently. An integrated market can be achieved via a number of routes, with concentration, interoperability and open access being the most obvious alternatives. What are the arguments, if any, for a public policy intervention relating to (i) centralised or decentralised structures for infrastructure and service providers; and (ii) the governance structure of infrastructure and service providers? Are custodians, CCPs, CSDs and ICSDs to be considered as commercial firms, driven by regular competition, or should they (or some categories of these entities) be considered as utilities whether or not they operate within a monopoly environment? Does the same reasoning apply to the provider of trading services?"

According to market participants, the opposition between horizontal and vertical integration is no longer relevant. They consider that the architecture of the industry should be based on an asymmetric model: the existence of many trading platforms is not problematic. In contrast, the central counterparty(ies) must be as consolidated as possible in order to offer the best mitigation of risks and to maximise efficiency. Finally, the number of SSSs should be very reduced and they have to adopt common standards and harmonised business practices. The contributors consider that in this model, the local anchorage of CSDs should be maintained when necessary.

Finally, providers of trading services should be submitted to clear regulations in order to ensure a fair competition between providers.

Annex

The outcome of the consultation of the French major market participants is summarised below.

Recommendation 2: Trade confirmation

The participants underline that in Europe automatic trade confirmation arrangements are less widespread than in the US and this could make more problematic a move to T + 0 for all kinds of operations. Confirmations use different means like fax or Swift, and sometimes are considered as implicit with the introduction of the operations in the SSS.

A further development of trade confirmation arrangements and a greater harmonisation of market practices appear to be a precondition to a move to T + 0.

Recommendation 3: settlement cycle

The market participants are strongly in favour of the harmonisation of settlement cycles in Europe, especially in order to ease cross-border settlements. However, harmonisation does not mean that a unique settlement cycle should be set up for all kinds of operations: settlement cycles can be different with regard to the different categories of financial instruments and transactions, provided that a European standard can be found for each type of operation. Therefore, it is suggested that a mapping of instruments and operations be done in order to set European standards or best practices for settlement cycles applicable to each instrument. The harmonisation is required for transactions traded on regulated markets. Regarding OTC trades, although a certain degree of flexibility should be left, harmonisation is also necessary to unify fragmented markets and secure cross-border settlements.

Regarding the shortening of settlement cycles to T+1, the market participants underline that the costs and benefits of such a reform should be carefully assessed. Firstly, the market needs for moving to T+1 have still to be confirmed. Shortening the settlement cycle is not the only efficient arrangement to be implemented in order to mitigate settlement risks. Furthermore, particular attention should be paid to the risks implied by such a change, in the current European framework. Increasing STP and improving interoperability among systems is a pre-requisite to reducing settlement cycles. A shortening of settlement cycles, which would not be co-ordinated could raise technical difficulties and liquidity risks in European cross-border settlements.

A shortening of settlement cycles to T + 2 is possible in France for transactions made on regulated markets. This move to T + 2 would neither entail expensive investments nor jeopardise the security of the settlement process. In addition, it would allow the harmonisation of French and German settlement cycles. However, even if such an effort can be regarded as a first step toward T + 1, the participants assert that a shortening to T + 1 is neither a short nor a medium term objective, since this dramatic shortening would substantially increase operational risks. In any case a systematic use of STP procedures is a precondition before considering a move to T+1. One of the reasons of the decision taken by the US market to move to T + 1 is the wish to drive the modernisation of the infrastructures but the implementation, that has been postponed now to 2005, has brought to light some

complexities, in particular the existence of several settlement cycles for different kinds of operations.

Next, considering the statistics on the observed length of settlement cycles, it appears that in France 2 out of 3 OTC transactions are settled in two days at the most (T+ 2), and nearly all operations are settled in less than T+ 3. Therefore, France seems able to reduce settlement cycles to T + 2 without increasing operational risks. Furthermore, the settlement cycles are heterogeneous and sometimes do not fully comply with the standard for a given type of operation, it could be longer or shorter. However, the participants consider that longer intervals could not be considered as abnormal, in particular when they depend on an agreement between the seller and the buyer. Therefore, the participants claim that in order to safeguard this flexibility, standards should not be compulsory for OTC operations. They suggest that a typology of transactions (instruments/ regulated markets/ OTC) should be designed and it should be made clear when the fulfilment of the standard is mandatory or simply advisory.

Finally, the market participants raised the question of the starting point of settlement cycles. It depends in particular on whether or not the matching is ensured before or after posting the trade to the SSS. They propose to define clearly the starting point of settlement and to examine the possibility of standardisation in this respect at European level. This question is essential to understand the precise meaning and the real length of a settlement cycle. Accordingly, an accurate definition of the starting point (what is the deadline to post a trade for settlement to the relevant securities settlement system ?) could be the first step towards the definition of harmonised settlement cycles.

Recommendation 5: Securities lending

The market participants reached a consensus on the usefulness of securities lending in order to ease the settlement and reduce the number of fails. Nevertheless, they consider that securities lending arrangement existing in the different European countries are not always clear and transparent from a legal and an accounting point of view, in particular automatic lending facilities provided by certain CSDs to their participants are not always transparent, for example the precise identification of the securities that have been lent is not possible. Therefore they strongly insist on the necessity to define a clearer and more harmonised framework for this type of operations by CSDs. The possibility of lending customers' securities with the consent of the clients that exist in certain European countries should be analysed and probably harmonised in order to reduce operational and financial risks.

Recommendation 7: DVP

Concerning Delivery versus Payment, the market participants raise two key points :

- are the national definitions of DvP equivalent in Europe and do they provide similar consequences ?

- are the national DvP infrastructures and processes compatible in Europe ?

The current situation in Europe does not seem to lead to a positive answer for both questions. Therefore, some harmonisation of DvP seems necessary.

The market participants highlight that an optimal DvP infrastructure should comprise:

- real time gross DvP arrangement in central bank money for both the settlement of the Eurosystem credit operations and the OTC wholesale trades between financial intermediaries on fixed-income securities,

- and a netting system for the settlement of the bulk of retail transactions, mainly on equities.

This infrastructure may be provided in two different ways at the domestic level. The first solution is to offer two systems, one RTGS SSS plus a netting system, being secured against the default of its participants. The second solution would be to implement in the field of SSSs the concept of "hybrid system", already applied in several payment systems, which combines continuous final settlement in central bank money and netting devices.

For OTC large-value transactions, the participants consider that systems based on several batches are not sufficient in particular to facilitate the smooth settlement of cross-border transactions. Real-time gross settlement systems ensure the more efficient DvP functionality for large-value transactions, when they provide - like the Euroclear France RGV system – practical collateral management and liquidity saving devices (self-collateralisation functionality). However, it does not seem currently possible to settle all types of transactions through RTGS SSSs. In particular, the fact that equities are not until now generally admitted as eligible collateral by the Eurosystem does not permit to envisage the settlement of equities trades through RTGS process in central bank money, in an easy and cheap manner.

Regarding the different models of DVP the market participants consider that some forms of netting (of the model 2 or 3) will remain necessary for the settlement of equities as long as the collateral policy of the Eurosystem will remain unchanged. The fact that bonds can be largely used as collateral to obtain intraday credits in central bank money makes possible the use of real time procedures (model 1). It is not true for the settlement of equities because these types of assets are generally not accepted as collateral by the euro area central banks. Therefore, the market participants suggested that the collateralisation of equities should be authorised in order to ease cash settlement.

Recommendation 8: Timing of settlement finality

Concerning the timing of settlement finalities, the market participants laid emphasis on the crucial question of intraday finality. They consider that intraday finality is definitely necessary in order to guarantee the finality of cross-border transfers.

For systems operating on the basis of multiple batches, a shortening of intraday settlement and the generalisation in all European countries of night processing would contribute to improve the settlement of cross-border trades.

In France, there is one SSS which offers the possibility for the participants to choose between two different services of settlement: in the first stream the securities operations are settled on a real-time gross settlement basis (model 1) all the day long. Consequently, the finality occurs as soon as the availability of securities and cash is checked. The second stream operates on a gross basis for the securities and on a net basis for the cash leg (model 2). In this stream, the finality occurs thrice a day: the cash leg is settled once in the morning and twice in

the afternoon. But in practice, the finality is achieved in the morning for the large majority of transactions, that is to say 70 % at 11 a.m.

At EU level what appears important to the participants is to give a very precise definition of settlement cycles. They consider that the definition in term of days is no more pertinent in the European context. It would be necessary to agree not only on a target day for the settlement completion but also on a **target hour**, for example T + 2 at ten a.m. (T + D at x, x being the hour of the final settlement).

With regard to the number of finality hours, it is suggested to increase it to roughly 4 per day, in order to comply with the cross-border needs (and more particularly with the Euronext requirements, since the harmonisation of settlement cycles in France, Belgium and the Netherlands is necessary to achieve a single order book for the Euronext markets). In addition, the first cash settlement should occur earlier in the morning, i.e. in the first part of the morning, and ideally at 7 a.m. However a 7 a.m. settlement could disadvantage the small and medium-sized credit institutions and investment firms that depend on larger institutions for intraday financing. Moreover, since for equities transactions the securities leg is dealt with during the night of T+2 / T+3 in the French system, some participants suggest to consider a nightly cash settlement in order to speed up the settlement of the operations.

Regarding the relationships of financial intermediaries with their customers and the possibility for them to be informed of the finality of their operations the practices vary. Nevertheless, it appears useful to forward the customers, especially large ones, with information on the final settlement of their operations. With some customers, generally large foreign ones, specific contracts called “contractual settlement” could be used. According to these contracts the delivery of the securities and the payment at settlement date are guaranteed, even in case of default of the counterparty. In the later case the custodian has to substitute itself to the defaulting party and in case of non delivery to find the missing securities (by borrowing them or using its own securities) in order to avoid an artificial creation of securities. In such contracts it would be advisable to take into account the normal time for the final settlement of the operations and to let the customers informed of the operations that remain unsettled.

Recommendation 12: Protection of customers’ securities

The participants agree unanimously on the need of assets segregation. At a minimum the CSDs should offer the possibility to segregate the assets of the CSD participant from those of its customers. CSDs could also offer its participants the possibility to segregate the assets of the customers in specific accounts, this could complement the segregation they have to do on their own books. In France, these options are available at the CSD, but the practices vary according to the participants.

In addition, the market participants consider that the financial intermediaries have to be subject to an efficient supervision of the safe keeping on their books of customer’s assets. They consider that the existence in certain European countries of standards, like in France (the “cahier des charges du conservateur”), that have to be fulfilled by custodians to protect customer’s assets should be generalised. Furthermore, they are in favour of a formal procedure of agreement of intermediaries that offer custody services with the creation a European passport for this type of activity.