ASSOCIAZIONE BANCARIA ITALIANA

CONTRIBUTION TO THE

ESCB/CESR CONSULTATION ON "STANDARDS FOR CLEARING AND SETTLEMENT SYSTEMS"

Italian Banking Association

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1. Introduction

The Italian Banking Association agrees with the aim of the joint ESCB/CESR Working Group (the Working Group), namely aiming to greater security, integration and efficiency in transactions on European exchanges, and welcomes the opportunity to contribute to the consultation and express its point of view on the standards drafted.

This document provides the Working Group with remarks of a general nature. Comments on some of the individual proposed standards appear in the annex, where the observations, though specific, reflect the general problems.

Three key problems emerged from the analysis of the documents published by the Working Group for public consultation: (a) the lack of a uniform legislative framework for clearing and settlement within the EU; (b) the functional approach; and (c) the neutral position of the standards with respect to the business models adopted by national and international central securities depositories.

It should be noted that every observation in the present document concerning national securities depositories (CSDs) and international central securities depositories (ICSDs) refers to central depositories that offer settlement services as well as traditional central depository services.

2. Lack of a uniform legislative framework in Europe

Imposing standards on institutions providing clearing and settlement (CSDs, ICSDs, CCPs, etc.) that operate in different national legislative and regulatory frameworks, even though they are all engaged in the same activity, compromises the principle of the level playing field. There is also the risk of the standards being implemented at national level in ways and according to timetables that are not the same in all the member states, owing to their non-binding nature. This would maintain rather than overcome the current fragmentation of markets.[1]

[1] Consider the standards on Alternative Trading Systems (ATSs) adopted by the CESR back in July 2002. They are now in effect in some EU countries, Italy among them, but still await introduction in others.

The need for harmonization of the general framework was underscored by the European Parliament in its January 2003 resolution addressed to the Commission, which concurrentlywith the ESCB-CESR consultation is considering a directive governing clearing and settlement systems, in view, *inter alia*, of the conclusions of the Giovannini Group's Second Report.

ABI agrees with this need and is of the view that a European directive on clearing and settlement is fundamental for greater harmonization without prejudice to the different roles of different operators.

3. The functional approach

The document presented by the Working Group is based on a reworking of the recommendations put forward in CPSS/IOSCO's November 2001 paper, essentially by an extension of scope. That is, the standards proposed by the Working Group would apply not only to clearing and settlement system operators but also to systematically important custodians, such as banks providing securities custody services that by reason of their size (measured by the share, at domestic and/or European level, in the relevant markets) and quantitative importance in the settlement process may concentrate high levels of risk.

According to the Working Group, this broadening of scope is grounded in the need to ensure greater transaction security in European markets, characterized by the presence of entities other than CSDs that centralize typical "infrastructural" activities (e.g., central depository and dematerialization of securities, management of settlement procedures) and "accessory" activities (securities lending, credit facilities, fiscal agent).

The Working Group has therefore adopted a "functional" approach that classifies institutions according to the functions they perform, regardless of their legal form or legislative and regulatory position. In ABI's view, this approach would be ineffective in attaining the objective of improving security transactions in European markets, for the reasons set out below.

First of all, the Working Group's approach ignores the historical separation of roles between market participants and clearing and settlement system operators, lumping together institutions of a different nature and with different purposes.

Until now distinct institutions have operated in the clearing and settlement industry: custodian banks, performing securities custody and administration services for their clients, and central depositories, both domestic and international, which provide central administration of the securities deposited and, in many cases, also the management of clearing and settlement systems.

CSDs (and ICSDs), often user-owned or cooperative corporations, are system infrastructures, like the infrastructure serving the payment system, and access to their services must therefore be available to all market participants in equal measure and without discrimination. Moreover, by reason of their particular role in the financial system, CSDs and ICSDs have consolidated their position as a sort of *de facto* monopoly, recognized in a number of countries as a legal monopoly as well.

By contrast, custodian banks are for-profit companies providing customers with credit and custody services. They differ from the operators of clearing and settlement systems in the following respects:

1. They are subject not only to national rules of banking supervision, but also to the standards drawn up by the BIS on capital adequacy (Basel I and, soon, Basel II).

2. As users of the services provided by the operators of regulated markets, central counterparty systems and settlement systems, banks are required to comply with the rules of each of those institutions, in particular as regards the adoption of risk monitoring systems in every phase of post-trading (custody and administration of securities, clearing and settlement operations).

3. Whereas CSDs must allow access to users according to the established general rules, custodian banks supply services "accessory" to clearing and settlement that generate risk and they must therefore be able to evaluate the users of their services and possibly differentiate their access procedures according to the risk assumed.

4. They must have systems for both credit and counterparty risk control, such as the contingency systems for securities services introduced when the euro was adopted and the computer adaptation for Year 2000, which in addition to backup for operating systems and procedures in many cases also call for duplicate computer systems and procedures in different geographical locations.

5. Because they are banks, they are strongly capitalized and their own funds are substantially larger than the equity of CSDs.

6. Operating in a competitive market, they are obliged to constantly improve the quality of the services they offer to customers both domestically and internationally.

Secondly, the notion of systematically important custodian is borrowed from an SEC and Federal Reserve document on business continuity planning[2], which introduces the notion of "core clearing and settlement organizations".

This definition includes, along with clearing and settlement systems, private sector firms that provide clearing and settlement services and have a market share likely to generate a systemic risk in case of default, owing to a lack of safeguards. It was introduced as part of an analysis of the technologies capable of ensuring continuing operation of clearing and settlement institutions in the occurrence of extreme events (like those of 11 September 2001). The Working Group's adoption of the same definition to establish standards that are much broader in scope (covering such matters as right of access, governance, securities lending and transparency) is therefore improper and misleading.

Lastly, the custody services supplied by banks, like credit facilities, are already governed in Italy by specific supervisory provisions of the central bank. The addition of new rules with the standards for "systematically important custodians" creates over-regulation that is likely to increase the costs borne by the banks to conduct their activity in compliance with the rules governing participation in the financial markets.

In brief, ABI would like to highlight that standards, in their present draft, apply identical regulations to different operators, some of which are commercial enterprises already in

competition with one another, while others are typically infrastructural and should therefore be competitively neutral at least vis-à-vis the banks. In this regard, the functional approach implies that the operators in question are comparable, contrary to what emerges from the facts.

4. Neutrality regarding the business model of CSDs

The standards proposed by the Working Group do not appear to give adequate weight to the risks engendered by the possibility of CSDs having bank status, which would enable them, in addition to their traditional activity, to offer typically banking services.[3]

As mentioned, CSDs are market infrastructures providing public service that often forms a natural monopoly. The possibility for them to provide services in direct competition with custodian banks alters the principle of the level playing field within the system.

Services involving an exposure of CSDs to a system participant should be totally prohibited. One has only to consider the case of a default of a CSD that could be propagated to other market participants. Among other things, this possibility stands in clear contrast with Standard 6, which requires that "CSDs should avoid taking risks, to the greatest practicable extent".

Furthermore, this approach is shared by the Giovannini Report, which states that: "From the perspective of efficiency, there is a much stronger case for consolidation of entities performing essential core functions, like the maintenance of the integrity of the issue and functions with large scale economies, like netting, clearing and settlement. *These functions do not involve the provision of credit facilities. In contrast, it can be argued that value-added banking functions are not essential to the basic clearing and settlement process, and concentration risk is reduced if these functions are provided by multiple banks in a competitive environment.* Public policy makers will have an interest in ensuring that whatever

[2] Federal Reserve Bank and Securities Exchange Commission*, "Interagency White Paper on Structural Change in Settlement on Government Securities*", 2001.

[3] This is the case of ICSDs that also offer services of securities lending and borrowing, collateral management, money transfer and credit facilities either directly, by virtue of the fact they are banks, or via a bank belonging to the same group.

the business model of any consolidated entity, it respects the balance of risk, efficiency and fair competition."[4]

It therefore seems inadvisable for CSDs and ICSDs to enter in securities lending or to provide liquidity services on own account, in view of the risk that this activity would introduce into the system. What is more, even if these transactions were fully collateralized, particular importance should be given to the typical elements of risk connected with the collateral provided (types of instrument, haircut percentages, legal agreements, concentration of the exposure).

By contrast, it would be proper to permit CSDs and ICSDs to engage in securities lending acting as agent, since this does not introduce any risk into the system, provided that such activity is instrumental to closing out the settlement cycle and consequently does not offer operators strategic opportunities in competition with the market in securities lending.

The Working Group should then highlight the risks of a model that allows CSDs (and ICSDs) to provide typically banking services jointly with post-trading services and promote a clear-cut distinction between the role of CSDs and custodians.

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[4] Giovannini Report, Brussels, 16 April 2003, pp. 27-28

Annex

Observations on some of the individual "Standards for Securities Settlement Systems"

The observations below reflect the approach according to which the standards are not applicable to custodian banks. Nevertheless, the notes provide information on the conduct of the banks with regard to the specific standard.

Standard 1 - Legal framework: This standard does not take account of the fact that some CSDs and ICSDs have the status of banks, like all custodians. Banking activity is regulated at national and Community level and banks are subject to strict controls on their risk management. Even if CSDs with bank status come under the present rules on the exercise of credit, the combination of roles should be avoided (even if this is accomplished through legally separate structures belonging to the same group), because it entails an assumption of risk on the part of CSDs, with potential adverse effects on the entire system.
Furthermore, to ensure connection between payment systems and securities settlement systems, provision should be made for supervision on the part of a specific authority and oversight by the European System of Central Banks.

Standard 3 - Settlement cycles: This standard would appear to refer to trades concluded in regulated markets and not to include OTC transactions.

Standard 5 - Securities lending*:* It is important that CSDs not enter in securities lending by directly assuming the associated risks but only perform such operations on a fully collateralized basis for the purpose of closing out the settlement cycle.[5]

Standard 6 - Central securities depositories (CSDs): ABI agrees that CSDs, which are in the nature of "service infrastructures", should not absolutely assume risks, for the protection of the assets of their members.
However, the possibility that they may engage in typical banking activities (see Standard 1) clashes with that principle.

Standard 7 - delivery versus payment (DVP): ABI agrees with what is provided for CSDs.[6]

Standard 9 - Risk controls in systemically important systems : In banks, risk management is already regulated and entails a heavy charge on own funds.[7] This is not the case with CSDs,

[5] As regards the lending services provided by custodians in order to optimize the flows and utilization of securities and cash, the operating procedures should not obligatorily provide for full collateralization, since the counterparty "risk" is a factor the custodian considers and evaluates upon selecting the counterparty to the transaction, according to the procedures and rules typifying banking activity.

[6] Custodians that carry out transfers of securities against cash between accounts of depositor customers have full control and management over the customers' cash and securities accounts and already implement the control procedures of DVP.

[7] This refers to the system for measuring capital adequacy introduced by the Basel Accord, for which the (credit or market) risk that a bank assumes in performing its activities must be quantified and backed by capital.

which as market infrastructures cannot take on credit risk (which would harm participants) and hence apply full collateralization of all risk positions.[8]
By contrast, ABI agrees with the extension of full collateralization of securities to guarantee the settlement of transactions in CSDs and ICSDs.

Standard 10 - Cash settlement assets: Settlement of the transactions concluded in the markets must always be done in central bank money. If market participants do not have direct access to accounts of the central bank, they can access such accounts through a cash settlement agent. The latter will be duly evaluated and overseen according to the rule established by the central bank.

Standard 13 – Governance: Forms of "governance open to users" of settlement systems (CSDs and ICSDs) are acceptable.[9]

Standard 15 – Efficiency: Preferably, all "service infrastructures" should be of a non-profit nature, given that their principal objective is to ensure the operational certainty of procedures and reduce the costs for participants.

Standard 16 - Communication procedures, messaging standards and straight through processing: The standardization of messaging services for securities transactions should take account of the standards already developed by users (SPMG ISO 15022), for the purpose of limiting the impact of technological changes on the banks and the costs borne by users for the implementations carried out by market infrastructures (CSDs, CCPs and SSSs) or imposed by regulators.

Standard 17 – Transparency: Uniformity of market rules should minimize the risks related to the processes supported/provided by CSDs and CCPS and provide transparency of the economic and other conditions of the services provided.
The services provided by the banks are provided under a regime of competition and subject to the rules established by the relevant regulators.

Standard 18 - Regulation, supervision and oversight: Entities with the same status (e.g. banks) must be subject to the same rules.
This standard needs to be examined in close connection to the Standard 1 (legal framework) and the comment on Standards 3 (settlement cycles) and 13 (governance).
Note, however, that in order to ensure connection between payment systems and securities settlement systems, provision should be made for supervision of the settlement systems.

[8] It is ABI's position is that the scope of the standards of full collateralization of transactions should not extend to custodian banks, considering: (i) the experience of these banks in managing lines of credit and monitoring their use by customers; (ii) the capital adequacy requirements to which they are subject (Basel I and II), and (iii) the sophisticated risk monitoring systems they have installed to check the exposures and activities of their borrowers. Moreover, dealings between custodian banks and their "commercial bank" counterparties are further guaranteed against the risk of the latter's default by contracts allowing the custodian in this event to retain the securities that it administers. In short, the entire range of operating practices safeguarding the efficiency and competitiveness of custodian banks makes extending the full collateralization standards to the settlement operations performed by these banks unwarranted.
[9] Extending this standard to systematically important custodians that provide customer services in a competitive environment is in patent conflict with the private nature of the banks.

Standard 19 - Risks in cross system links: In determining the procedures for links, CSDs (through appropriate consultation with banks) must take into due consideration the standards already in use at intermediaries, so as to make their use less costly and provide incentives for access to the various clearing and settlement services provide by international CSDs.