A Response to the ESCB/CESR Consultative Report on the Standards for Securities Clearing and Settlement Systems in the European Union

by

THE BRITISH BANKERS' ASSOCIATION

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Representing over 300 member banks from more than 60 countries

Introduction

The British Bankers Association (BBA) is pleased to respond to the European Central Bank and CESR consultative report on Standards for Securities Clearing and Settlement Systems in the European Union.

The BBA is the main financial services trade association in the UK with over 250 members, 85% of which are involved in providing wholesale banking services in the UK capital markets. 75% of the BBA's members are of non-UK origin, representing 60 different countries. They see London as an important point of entry into the euro denominated securities markets and are therefore keenly interested in the efficient functioning of the clearing and settlement environment within Europe. All of our larger British based banks provide securities–based investment products to consumers in the UK as part of their retirement planning or general savings product provision.

ESCB/CESR objectives

We support the basing of the proposed standards on the CPSS-IOSCO recommendations, which implicitly recognise that clearing and settlement systems operate in the global context. We recognise that a pan-European, harmonised approach to CSD regulation should be developed, focusing on the CSDs role as a key infrastructure component. As it does this however ESCB-CESR should ensure that it continues to be in harmony with standards in other leading financial centres.

We also support the intention of the report to ensure that undue risks are not created by the operation of the clearing and settlement systems infrastructure and believe that any regulatory intervention should foster, not stifle, competition and innovation. Our members believe that a market-led approach to the harmonisation of technical and market practices, with the goal of facilitating interoperability between national systems is the most appropriate.

Interoperability is an important enabler of the evolution of clearing and settlement systems which will allow investors to select the clearing and settlement route that best meets their needs. This will, in due course, lead to a beneficial rationalisation in the number of institutions providing clearing and settlement services within the EU.

We recognise that ESCB-CESR report specifically acknowledges that issues related to competition do not fall within its mandate as they would be better dealt with by the relevant national and European authorities. We agree with this and therefore are unsure why objective 4 (which specifically references competition), the part of objective 7 referring to costs and objective 2's reference to 'efficiency' have been included. We recommend their deletion.

The ESCB-CESR approach is to embellish the recommendations themselves and add to the original explanatory memoranda. Whilst some of this extra material is helpful much of it calls for the establishment of requirements and processes that are best left to the market to determine. Whilst regulators should properly have an interest in the way in which risk in clearing and settlement systems is managed in order to enhance safety and soundness, there are many areas in which the market (comprising CSD operators, broker-dealers, intermediaries such as custodians and users of their services, such as fund managers), should be permitted to take the lead in the development of good practice. We attempt to highlight these in our analysis of the standards below.

Is a custodian a system operator?

We wish to take issue with the ESCB-CESR Group's view of the tasks that a custodian undertakes, as many of the Standards as currently drafted apply to custodians '*operating systemically important systems'*.

Custodians provide the services of safekeeping and administering of securities on behalf of a third party. The assets are actually 'safe kept' at the CSD. The 'administering' function performed by custodians involves corporate actions processing, income collection, and proxy voting amongst other things.

The Standards apply to operators, CSDs and ICSDs, and it should be the safety and soundness of the CSD which concerns both the ESCB/CESR Group and custodians as users of these infrastructure systems. It would be wrong however to apply the Standards to custodians as they do not 'operate' these systems but are merely participants in, or members of, the CSD. They abide by the rules of the depositories but have no direct day-to-day influence on how such depository operates.

Some of the issues touched on in the paper arise because CSDs, and particularly ICSDs, which seek to broaden their range of products and services outside of the traditional settlement of securities transactions activity. The Standards should, in our view, seek to ensure the safety and soundness of infrastructure services. If CSDs and ICSDs wish to engage in 'bank-like' activities (and we see no reason why they should not providing they compete properly with bank-owned custodians) those activities should be regulated by *importing*.

Such existing bank supervisory techniques already cover the potential systemic risks of the operational of financial failure of a large custodian, as follows:

> *Operational failure* risk is mitigated by requiring the senior management of banks to have proper systems and controls in place, and;
> *Financial failure* risk is mitigated by ensuring a bank has adequate capital adequacy and liquidity in place.

Exporting CSD focussed Standards to large custodians (as the Consultative Report seeks to do) in a sense, looks at the issue from the wrong end of the telescope.

Custodian banks are already intensely regulated, and have in place established policies and procedures to control risk. Effective regulation requires the avoidance of double regulation wherever possible and to this end the proposed Standards should not be applied to custodians where adequate regulation of the management of perceived risks is already in place. Our members would not welcome another layer of regulation being added to an already well regulated activity.

It maybe however be that we have not a contemplated a situation involving a custodian which could lead to excessive systemic risk which is not already covered by existing regulation – it would be helpful if the Working Group could provide an example which we could consider together, in order to identify shortfalls.

The Standards

Legal Risk

Standard 1: Legal Framework

The principles of Standard 1 are already included within existing banking regulations, so there is no need for the double regulation that would arise from applying Standard 1 to custodians.

The explanatory memorandum requires very full disclosure by the operator of the relevant system about the legal framework relevant for each aspect of the clearing and settlement process. The new paragraph 29 will impose a significant reporting burden, which is likely to be duplicative, on operators. We believe an explanation of applicable law of the operator holding the securities on a website, along with appropriate legal opinions should be sufficient for nearly all customers – those that require further clarification should undertake their own analysis, rather than rely on the operator. This is particularly relevant where precedent based legal systems as well as national statute impact the analysis.

We support the designation of CSDs and CCPs governed by the law of an EEA member state under the settlement finality directive which would reduce the need for disclosure in relation to applicable laws.

Pre-settlement risk

Standard 2: Trade confirmation and Settlement matching

We fully support the need for timely matching of trade confirmations which we believe invariably happens on trade date between direct participants on T+0. Trade matching with indirect participants requires more time and we would prefer that trade matching in this circumstance occurs (as per the original CPSS-IOSCO recommendations) no later than T+1.
We recommend that the reference to settlement matching (as distinct from trade matching) in this Standard should be removed to Standard 3.

Standard 3: Settlement Cycles

We recommend that the element of Standard 2 referring to settlement instruction matching be moved to this Standard. However requiring settlement instructions to be matched the day before settlement may impose significant costs where systems have to be upgraded. Matching on the day of settlement is just as appropriate, as more information is required in comparison to confirmation matching. Whilst we endorse the use of standard settlement instructions not all participants in the market have yet embraced them.

We expect that investors will dictate to operators the matching parameters they require and different solutions will continue to emerge in this regard. We therefore see no need to further tighten the CPSS-IOSCO recommendations that settlement instructions be matched prior to settlement.

We believe that the harmonisation of settlement cycles and the consequent coincidence of operating days and hours will greatly benefit the European securities markets, although moves to this end should be based on a sound cost/benefit analysis. Purely from a risk point of view

however the use of CCPs reduces the imperative to move settlement cycles to below T+3 as risk is transferred to the CCP on trade date itself. International experience has already demonstrated that changes to settlement cycles can be difficult to orchestrate.

Whilst recognising that harmonisation across all securities classes might be burdensome in the short term it should be a long term goal, with solutions generated by the industry in the light of benefits that improved cross product hedging and collateral utilisation would bring. Requiring (rather than encouraging) industry responses will be counterproductive, as sub-optimal solutions may be developed just to meet a regulatory edict.

We broadly, therefore, support the ESCB/CESR additions to the CPSS-IOSCO recommendations although point out that an aspiration for shorter settlement cycles may not be properly articulated in a Standard.

Standard 4: Central Counterparties

We have no comments on this section, which is a very complete explanation of the benefits of a CCP. To some extent, as this is already received industry wisdom, the extra wording may not advance understanding to any great extent. Were ESCB-CESR seeking to reduce the length of its document some of the new wording here could be pruned without any loss of the message being imparted, particularly as the European Association of Clearing Houses has developed standards which need not be duplicated by ECSB-CESR.

We note inclusion of the term 'custodial risks' in this paragraph 63 of the explanatory Memorandum to this Standard, which applies only to CCPs and CSDs. This new risk should be better defined to prevent it entering the risk lexicon in an imprecise way although we believe that this term actually refers to operational risk.

Standard 5: Securities Lending

We support the report's assertion that centralised securities lending facilities may not always be justified and recognise that custodians can fulfil an analogous role more cost effectively.

However the scope of this Standard includes CSDs. We strongly believe that CSDs in their role as infrastructure providers should not be able to take on any principal risk, especially credit/securities lending type risks which are not essential to their core function as an infrastructure provider, or if they are, only for a very short period of time to facilitate settlement. Such centralised lending which happens infrequently is distinct from the bulk of securities lending activity, as a principal, via a bank custodian. This is a bank-like activity, actively managed through rigorous counterparty and margin assessment processes, therefore the scope of this Recommendation should not apply to custodians.

Settlement risk

Standard 6: Central Securities Depositories

As in the preceding standard we detect a degree of drift in this standard which specifies that CSDs should 'avoid taking risk to the greatest extent possible'. As infrastructure providers CSDs should take no risk at all.

Standard 7: Delivery versus payment

Custodians do not operate settlement systems but are participants in them so should not be included in the scope of this standard.

Paragraph 91 concerns the relationship a direct participant has with its clients. We do not consider that this customer relationship should be covered in the standards – rather market forces should be allowed to drive the point at which settlement between a participant in a CSD and the end client becomes final, according to contracts negotiated between, say, the custodian and its client.

Standard 8: Timing of Settlement Finality

We agree that intra-day finality will facilitate interoperability and re-use of securities. We believe the rules of the particular system should define the timing of settlement finality – there is no need for this to be backed up by new national legislation.

Again, as custodians are not operators of systems they should not be included in this standard.

Standard 9: Risk Controls in systemically important systems

We agree with the additional wording in this standard and believe that all of our members operating in this capacity already have risk mitigation procedures in place in line with those proposed in this section and are subject to completely adequate existing regulatory policies. Applying this standard to custodians would therefore result in duplicative regulation.

This standard should apply to CCPs – is their omission from Key Element 1 an oversight?

For the avoidance of doubt, as custodians do not operate systems, this standard should not apply to them. In particular Key Element 3, about the requirement to fully collateralise, does not need to apply to custodians as they have adequate risk control requirements that are fulfilled prior to credit being extended. Some but not all of this potential credit exposure may be collateralised, but the decision to collateralise or not will be taken in accordance with the bank's risk management practices and should not be implicitly required (even at a low level) by the standards.

Standard 10: Cash Settlement Assets

We support the principle that settlement in CSDs should be in central bank money – indeed it should be mandatory, not an option. Custodians however settle in commercial money, as they operate on behalf of the CSD's participants.

If a CSD is doing something that is 'bank-like' it should operate in commercial money and not be able to use its access to central bank money to its competitive advantage.

Operational risk

Standard 11: Operational reliability

Whilst it is important that all components in the clearing and settlement process should be robust we believe that extending Standard 11's scope to other entities, such as messaging systems and

network providers is unnecessary and that these matters should be covered contractually in separately negotiated Service Level Agreements or - for custodians which are banks - in the banking supervisors' review of its Systems and Controls.

As custodians are already well regulated with respect to operational reliability and Business Continuity Planning we support this Standard.

We are uncomfortable with the word 'proven' in line 5 of the standard as it implies a counsel of perfection. We suggest the substitution of the words 'generally accepted'.

Custody risk

Standard 12: Protection of customers' securities

We agree that customers' securities must be segregated and regularly reconciled to outside entities such as a CSD. However, we consider that whereas double-entry accounting is essential within a memorandum omnibus accounting system, single entry memorandum accounting is adequate within a designated account system, where each asset held is designated to a specific client.

Prescribing a particular accounting method may impede the development of customer facing custody solutions, reducing flexibility and possibly increasing costs if major systems re-design is required.

However it may be practically impossible to reconcile holdings in, for instance, collective investment schemes, every day and we recommend the wording of Key element 3 be amended to reflect the realities of reconciliation.

Other issues

Standard 13: Governance

We counsel that the use of the phrase 'dominant position' has a specific competition law meaning and, as ECSB-CESR Group's mandate does not extend to competition issues, this phrase should not be used. If a custodian has a market share sizable enough to be in a "dominant position" as defined under competition law, then it would be appropriate for competition authorities to take action, rather than intervene via the Standards. Custodians are intermediaries which provide customers access to infrastructures. They operate in a competitive domain and it is inappropriate to subject them to the same standards as market infrastructures, not only in governance but also in access (Standard 14) and transparency (Standard 17).

As custodians do not use, but only participate in, clearing and settlement systems, this Standard should not apply to them.

The BBA supports the Consultative Report's assertion that good governance is vital to the safe operation of clearing and settlement systems and comment particularly that the governance processes of CSDs and ICSDs should become more transparent and that, although many CSDs are not companies, they should abide by the principles of the Transparency Directive. They

should be encouraged to be more explicit about how users are represented, what is put to the vote, who has how many votes and how the voting process is to be managed.

However the boards of such institutions should not bear the sole responsibility for identifying public policy issues. Management of such entities may seek to operate them profitably in order to generate, among other things, further resource for the improvement of systems. They do this in the context of the regulatory regime established through legislation and regulatory practice. The authorities, not the boards of clearing and settlement systems, should bear the main responsibility for identifying public policy issues, by consulting key users and bringing forward any necessary changes to law or regulatory practice.

We re-iterate our strong preference for market led solutions to the harmonisation of technical and market practices. The authorities should help improve the European clearing and settlement environment by ensuring open access, by the robust examination of ant-competitive practices, and removing the legal and tax barriers hindering cross-border clearing and settlement.

Standard 14: Access

We wholeheartedly support the fair and open access by participants to clearing and settlement systems. We counsel ESCB/CESR to ensure that access to an individual system is not spuriously restricted by a particular national regulator on the grounds of systemic risk avoidance. For this reason we recommend the deletion of paragraph 153.

Standard 15: Efficiency

Fundamentally we believe that this efficiency standard relates to competition policy, which is not within the mandate of ESCB/CESR. The wording of this standard should not therefore be changed from the original CPSS-IOSCO recommendation.

Rather than being an objective in its own right (as in paragraph 168) we see interoperability between national systems as being an important enabler of the evolution of clearing and settlement systems which will allow investors to choose the system that best meets their needs.

We do not believe that this is best achieved by focussing on one standard alone. It is perfectly possible for a number of different communication protocols to co-exist and ESCB/CESR should not seek to promote just one standard - not least because of the risk of 'backing the wrong horse' in a global context.

Industry participants are completely aware of the benefits of seamless interoperability and are working hard to make this happen. This above all, is an area where the market should be left to lead the evolution of appropriate mechanisms to achieve this goal.

Standard 16: Communication procedures

We agree that straight-through processing (STP) has the ability to reduce risk and improve service levels for end users.

Market participants are also involved in much work to introduce ISO 15022 communication standards. This will improve the convenience with which different systems can be inter-linked and bring significant benefits in the development of straight-through processing to reduce operational risk and increase the efficiency of, for instance, collateral utilisation. The market

will however wish to weigh the costs and benefits of interoperability before embarking on the technical changes necessary to bring this about.

ESCB/CESR should definitely support the harmonisation of market practices by encouraging the development of standards, but it should not be the sole promoter of such standards. The participants that are most involved with the day-to-day running of clearing and settlement systems must necessarily develop these, in a time frame which balances the costs and benefits for all participants in the clearing and settlement systems.

Standard 17: Transparency

This Standard should apply to infrastructures, but not to custodians which operate in a competitive domain. We support the Consultative Report's assertion that transparency with regard to risks and costs will help market participants make decisions about which systems and services to use, thus promoting competition, although the requirement to update information should be applied pragmatically to avoid imposing an unreasonable reporting burden.

Standard 18: Regulation, supervision and oversight

We support the principles for the regulation, supervision and oversight of clearing and settlement entities and particularly the principle of lead supervisor/overseer, mutual recognition and the need for effective coordination between national regulators to eliminate regulatory gaps or duplication.

Standard 19: Risks in cross-border links

As custodians do not establish or operate links to settle cross-border trades this Standard should not apply to them.

End Note

We compliment ESCB/CESR on the drafting of the Consultative Report and the clarity with which comparisons have been made and deviations of the Standards from BIS/IOSCO's original recommendations highlighted.