clearstream

Consultation of the Joint Working Group between the European System of Central Banks and the Committee of European Securities Regulators in the field of clearing and settlement, started on 15/03/2002

1. General Remarks

Deutsche Börse and Clearstream welcome the efforts made by public authorities within the European Union to ensure the efficient and proper functioning of securities clearing and settlement arrangements. We believe that the collaboration project between the Committee of European Securities Regulators (CESR) and the European System of Central Banks (ESCB) will provide an important contribution to the discussion on the reduction of the regulatory burdens in cross-border clearing and settlement in Europe. In addition, especially the European Commission is undertaking an inquiry on the regulatory environment of clearing and settlement in Europe. We highly recommend that these projects be sufficiently linked to each other. It should be clear for which purpose each project serves.

According to our recently published analysis[1], we estimate that higher costs in cross-border trading of approximately 1.7 billion Euro are directly caused by ”regulatory translation”. Another 2.6 billion Euro are derived from other sources, such as different languages, cultures, or market practices. The Giovannini-Report, published in November 2001, has listed in detail the barriers for cross-border clearing and settlement in Europe: different taxes, rules for corporate actions, information technology, etc. By bringing this together with the adaption of the CPSS/IOSCO ” Recommendations for Securities Settlement Systems“ to the European environment and the analysis of central counterparties (CCPs) and clearing houses respectively clearing activities in Europe, there are a large range of topics on the agenda of European regulators. Deutsche Börse and Clearstream are pleased to present their view on these topics.

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[1] Deutsche Börse Group/Clearstream International, White Paper on “Cross-border equity trading, clearing & settlement in Europe“ (2002); available under ” http://deutsche-boerse.com/INTERNET/EXCHANGE/ex_news.nsf/Web+WhatsPublikationen/FCC01131C09E6C78C1256B900051AE53/$FILE/White-Paper_online_d.pdf“.

2. Answers

2.1 Nature of Recommendations

Concerning the share of responsibilities between the European and the national regulator(s), we recommend that the European regulator focus on cross-border issues such as access, timing of settlement finality, operational reliability, communication procedures, and standards. The overall aim of a European regulation should be the harmonisation of national rules to reduce the regulatory barriers to cross-border trading, clearing and settlement, but not to artificially intervene into market structure. In contrast, national regulations may be more appropriate in certain cases to govern domestic issues, such as the protection of customers' securities and oversight.

As to the question of the European recommendation and/or standards' legal nature, to be issued by the Group, this would depend on the content and purpose of the said recommendation and/or standard. If this embeds founding principles – such as the IOSCO Recommendations – largely accepted and already complied with by the industry, then this could take the form of a legally binding rule (decision or even a regulation). Should these recommendations and/or standards go further and contain very concrete and detailed measures of the above mentioned founding principle's implementation, then they should preferably be adopted in the form of recommendations, without limiting service providers in their flexibility to implement these recommendations. Indeed, this would grant a greater flexibility in the decision making process, which could take into consideration the rapid changes in the financial and technical environment.

We recommend the Group issue standards on a high level basis, in order to support a level playing field. This should lead to a "European passport", granting European-wide recognition to clearing-houses, ICSD's and CSD's for fulfilling the national requirements.

2.2 Addressee

Whether nationally regulated or regulated at supranational EU level, for us the objectives appear to be harmonisation with the several areas identified by Giovannini Group. We believe that this contribution is to be regarded as the main reference in the work of the CESR and ECB.

Unless the intent to reinforce the role of the ECB as a Pan-European overseer for the smooth operations of the securities settlement system is clearly expressed, this should be addressed to national regulators, who will have to evolve their national statutes along the lines decided at the EU level. As far as cross-border issues are concerned, we are of the opinion that they should be governed, rather than by standards/recommendations addressed to the systems, operators and users.

With a view to answering the question of the appropriate incentives for the implementation and compliance of such norms, one should keep in mind the following constraints that players in the cross-border clearing and settlement industry encounter: "the costs and complexity of any change to the pre-existing infrastructures" and "the critical mass".

On account of the above, one could easily understand that a system, or its operators, might be reluctant to develop new functionality or adapt to new recommendations/standards, when these could lead to a significant increase in its running costs. This issue is even more acute in the current environment of extensive requirements by the market, specifically to the clearing and settlement services (efficiency, safety, openness, and fair pricing), along with the growing competition among the players involved in the consolidation process.

In this context, we would recommend that systems, operators, as well as users, jointly commit to the implementation of recommendations and/or standards. Consequently, the demand of counter-productive users could be avoided, and this is in the very best interest of all interested parties.

2.3 Scope

We support the idea that standards and recommendations should be addressed to all entities involved in the clearing and settlement process. From our perspective, standards relating to CCPs and CSDs/ICSDs have the highest priority, due to the specific services being provided.

In general, we recommend standards and recommendations be issued in relation to specific functions, regardless of the quality of the service provider performing these services. Therefore, the same standards should apply to all players involved in clearing, settlement, custody, risk, along with collateral management, regardless of whether said services are performed by CSDs, ICSDs, CCPs or other players. As a consequence thereof, no distinction should be operated, depending on whether custody and safekeeping services would be provided by credit institutions or investment services firms.

Analysing the clearing and settlement industry, one will easily notice that the CCP concept is increasingly becoming more important. Following the "functional" approach mentioned above, a differentiation between products that are processed by a CCP is not necessary, as the standards should be closely related to the CCP's ervices. From a CSD/ICSD's point of view, a distinction between shares and bonds is necessary due to the differences related to corporate actions.

One should have a separate view on clearing houses and CSDs/ICSDs when analyzing local vs. cross border business to identify appropriate standards. From a clearing house's point of view, a distinction between local and cross border business is not necessary. However, that does not apply to CSDs/ICSDs, where the specificity of cross-border transactions should duly be taken into consideration.

2.4 Objectives

We fully agree on the objective of risk mitigation as a core task for central banks and securities regulators. We appreciate and support the promotion of the EU securities market infrastructure's integration and the creation of a level playing field, as it supports a free market. From our point of view, the role of efficiency, particularly in cross-border business, has to be improved by harmonization of national jurisdictions, instead of regulatory supervision.

2.5 Access Conditions

We are not aware of any discriminatory access conditions to specific service providers. Nevertheless, there are differences in national jurisdictions concerning the recognition of clearing houses. These differences impact the level playing field and we recommend European standards to force harmonization, as was described under caption 2.1.

2.6 Risks and Weaknesses

The most relevant risk factors we see are operational risk, which (we agree on common definitions that see legal risk as a part of operational risk) and, especially from a CCP's point of view, counterparty risk. We see differences in legal approaches concerning a number of issues, including finality of payment and securities transfers, cross-border handling of corporate actions, (multilateral) netting agreements, pledging securities, and transferring full ownership. Due to these differences, cross-border business is both complex and is difficult to implement efficient processes. In addition, if the cross-border legal framework is inadequate or if its application uncertain, it can increase counterparty and operational risk. Finally, there is no doubt that the more actors are involved in different jurisdictions, the more effort it needs to manage the legal risk. To address those issues,

market participants should seek to agree on common industry standards (as was outlined under caption 2.2), as long as local laws and regulations support appropriate harmonization efforts.

However, these risks were significantly reduced by means of the directive 98/26/EC on settlement finality in payment and securities settlement systems containing clear rules for conflict of laws for specific occurrences. In this respect, one should also mention the EU collateral directive, which was agreed to by the Council of Finance ministers on 6 March 2002, and was transmitted to the European Parliament for a second reading. Should this directive be adopted as it currently stands, it would represent a significant step forward in the harmonisation of the rules applicable to cross-border collateral.

CCPs were designed to significantly reduce the counterparty risk. It is vital that both adequate risk tools and control are in place. Most CCPs run highly sophisticated risk margin systems and have adequate margin flows and default procedures in place. Although this procedure is common practice in the CCP industry, we foresee it as a basic requirement for managing counterparty risk.

We agree that as far as custody activities are concerned, the segregation of assets is an important issue to be addressed. The same applies to CCPs. Also, reconciliation is a crucial issue and must be ensured for by any involved party. In terms of reducing reconciliation risk, an efficient value chain between all involved parties (members, CCP, CSDs/ICSDs) is of the highest importance. Additionally, from a CSD/ICSD's point of view,the harmonization of corporate actions should be taken into consideration.

As far as settlement risk is concerned, we absolutely agree that the definition and timing of finality, delivery vs. payment, and the discussion of central bank money/commercial bank money systems are very important issues to be addressed. Finality deals with the question of transferring full ownership and must be solved as quickly as possible. Indeed, differences in local legal systems create uncertainty for the buyer/seller in cross-border business. With DvP, the risk of transferring securities and payments becomes interdependent. This is of vital importance, in order to reduce risk. Due to its central position in the financial industry, a CCP/CSD is obliged to minimize risk. As a result, it should operate with central bank money, even though in some cases it might be required to additionally make use of commercial bank money. For example, to solve the problem of opening hours and access to cash settlement systems. As to the impact of these issues on the clearing and settlement of cross-border transactions, one should ensure that the timing and finality of batches in the latter transactions are properly synchronised with the timing and finality of domestic transactions.

As far as operational risks are concerned, we think that the main factors are: IT infrastructure (availability of hardware, software, network, …), human risk (failures, loss of knowledge due to fluctuation of staff , …), business processes (possibility of failures due to low automation level, losses due to inefficient processes, …), project risks (risk of achieving goals not in time/not in budget) and legal issues (compliance with rules & regulations, fraud, ...).

2.7 Settlement Cycles

We agree that harmonized settlement cycles are an objective. To reduce settlement risk, settlement cycles should be shortened. Nevertheless, it is necessary to take into consideration the practicability on member side of such an aim – not only do shorter settlement cycles depend on the clearing and settlement industry, but also strongly on banks' operating procedures and their own client base. We therefore recommend settlement cycles to approach T+2 or shorter. We do not see the necessity of different settlement cycles.

2.8 Structural Issues

Any clearing and settlement infrastructure, whether centralised or decentralised, on private or public initiative, purely domestic or international, must currently cope with several difficulties. These

include the very high number of intermediaries in the chain process, the multiple systems interfaces, the desynchronised process and trade cycles in different markets, the multiple risks, the different tax regulations, the different requirements for market listings, and the issuance of securities, etc.

Most of the players are of the opinion that a further consolidation of the clearing and settlement industry is necessary. However, in our opinion, such consolidation could be achieved in different ways, but the two following questions will have to be addressed regardless:

Centralised (monopoly) vs. decentralised (competition) structure

We strongly promote the idea that a decentralised competitive structure is best suited to fulfill the key requirements for the development of an efficient European clearing and settlement structure. Although a monopoly would undoubtedly achieve the greatest economies of scale, we do not believe that it would serve the best interests of the customers, who will not be in a position to require lower costs and further developments. In so far, we absolutely agree with the results of the CEPS study, that in terms of cost efficiency, a monopoly is not necessarily superior to competing entities.

For profit vs. non profit (utility)

A competitive market only provides benefits to an industry if there are incentives to compete. These are provided by the two main drivers of the market: the customer willing to pay a price for a service/product, and the investor willing to get the best return for his investment. We believe that these two interests will be most efficiently satisfied in a for-profit organisation, specifically within the clearing and settlement industry.

Concerning the secondary securities markets the regulatory barriers are lower (cf. the “remote membership”) as it is the case with clearing and settlement facilities. Therefore, from our point of view, the role of trading services providers is not as ”exclusive“ as the role of clearing and settlement services providers, and consequently, we suggest to discuss them separately.

Frankfurt, May 2002