EUROPEAN CENTRAL SECURITIES DEPOSITORIES ASSOCIATION

May 18, 2002

Response to the call for contribution from CESR-ECB on the joint work in the field of clearing and settlement systems.

ECSDA wishes to thank the European System of Central Banks and the Committee of European Securities Regulators for the opportunity to provide input on the joint work in the field of clearing and settlement and to actively participate in the process of delivering an adequate regulatory framework for an integrated European financial market.

General

1. The purpose of the present document is to respond collectively to the request for contribution in those areas where there is unanimous agreement among ECSDA members. In many cases ECSDA members will provide their own views on the issues raised by the CESR-ECB paper.

2. ECSDA also notes that the European Commission has recently announced that an "ad hoc" communication on clearing and settlement will soon be published: some of the comments included in the present document, therefore, might require revisions or updates once the communication has been made public.

3. ECSDA welcomes the joint initiative of CESR-ECB which we consider appropriate to the achievement of the goal of allowing a free and non-discriminatory access to all post trading infrastructures across Europe as stated in the proposed ISD revision. The instrument of recommendations/standards seems to be the best approach in order to promote a flexible and easy to update regulatory framework for clearing and settlement taking into account the rapid rate of change intrinsic to this industry.

Nature of the recommendations

4. As capital markets develop and securities are increasingly used as collateral, CSDs have become a core element to ensure the efficiency, safety and soundness of the European financial markets. The new trading/asset allocation patterns, as well as the use of securities as a major collateral tool for monetary policy operations, intraday liquidity provisions for payment systems, Clearing House margins and interbank financing operations, have contributed to boost cross border transaction volumes. Therefore, common standards and a clear legal framework are essential preconditions for ensuring that the development of a European integrated financial market will be supported by the smooth functioning of the European CSDs' infrastructure.

5. In ECSDA' view, however, European legislators should avoid the temptation to issue detailed legislation in the field of clearing and settlement, limiting themselves to setting very high level principles in order to promote a level playing field and to remove obstacles and barriers to a full and open access to European clearing and settlement services. On the other hand, ECSDA recognises that this approach requires to be supplemented by recommendations/standards which make applicable and effective the high level principles.

6. ECSDA supported the CPSS-IOSCO recommendations on Securities Settlement Systems but noted that those recommendations set minimum standards which in most cases are already met by European systems. Therefore, ECSDA considers it important that a set of minimum standards which better reflects the state of the art at the European CSDs[1] is developed and is fully supportive of the CESR-ECB initiative.

Addressees.

7. Primary responsibility for the safe and efficient management of a CSD lies with the operator of the system itself; therefore ECSDA believes that the operators of the CSD should be the addressees of the recommendations. ECSDA considers that there

[1] For the purpose of the present paper the acronym CSD is used to include also securities settlement systems (SSS).

should be mechanisms in place for identifying shortfalls from minimum standards and for ensuring rapid action to address these shortfalls. To this extent, ECSDA considers that promoting market discipline through full disclosure is the primary mean to ensure that adequate standards and policies be adopted at all levels of the value chain: ECSDA fully supports the principle of transparency, which is the most efficient tool to protect investors' rights. Compliance to minimum standards and best practice should be assessed through the publication of *disclosure frameworks*, whose quality and reliability should be vetted by competent authorities.

Scope

8. Commoditisation of settlement and other related activities due to technology enhancements (as it has already happened in other fields) has driven market participants to extend the reach of their activities to include the whole range of services in the value chain of trading-clearing-settlement-custody. On the other hand, practical reasons justify the extension of the range of services offered by CSDs: e.g. the efficiency of the settlement process (particularly where cross border transactions are involved) might be enhanced if carried out by a credit institution where the latter is allowed to manage cash accounts on behalf of its participants and to provide credit in order to increase settlement liquidity. As a consequence, the differences between markets, intermediaries, global custodians, ISCDs and NCSDs have blurred. In the light of this trend, the current approach of regulating each subject/legal entity might not be the ideal one as it tends to have a distorting effect in the present scenario. A move towards a *functional* approach to regulation might provide a better response to the industry's needs: i.e. identifying the appropriate set of rules according to the specific function independently from the nature of the entity that performs it. This approach would imply, among other things, that the recommendations/standards be applicable to the activities of custodian banks where they can be considered "systemically relevant".

9. Furthermore, such regulatory approach should be *risk oriented*, being based on the assessment of all main risks involved in the clearing, settlement and custody activities, *establishing the obligation* to implement adequate measures to control and

mitigate those risks. However, the operator of the system should be free to choose the measures it considers most appropriate to manage the identified risks. The responsibility to issue more precise and binding indications should be left with the regulators if, and only if, the "market measures" fail to meet the proposed goals. ECSDA believes that such a regulatory framework is the most adequate instrument to address the needs of multi-functional subjects.

Objectives.

10. ECSDA agrees that regulators should deal with all the highlighted topics. As mentioned under the previous caption, a methodology based on risk assessment and risk mitigation should supply the basis for the development of the Group's recommendations. In our view, the creation of a level playing field between participants and service providers, closely connected with the integration of the EU securities markets infrastructure, stands next in the priority line. Efficiency should be principally assessed by the market, except in those cases where a monopoly situation might inhibit this mechanism.

Risks and weaknesses

11. Legal risk is clearly an issue upon which to focus, especially since cross-border transactions are acquiring an increasing importance for CSDs/ICSDs. However, in order to avoid the creation of rigidities that could hinder rather than promote interoperability, regulators should provide an high level framework establishing principles and policy objectives, leaving to the more flexible tool of recommendations and standards the identification of more detailed guidelines. We share the view that segregation of assets and the adoption of scrupulous reconciliation procedures (increasingly essential considering dematerialised securities scenarios) are the main topics to be addressed when discussing custody risk.

12. Settlement risk is the main source of systemic risk within CSDs and therefore has generally received a great deal of attention from both regulators and operators of these systems. Settlement risk can be minimised by:

a. linking the settlement system to a payment system in order to ensure DVP and,
b. ensuring that the completion of final and irrevocable transfers occurs as soon as possible.

Both these measures have been extensively discussed in the IOSCO-CPSS recommendations. However, this is an area where the CESR-ECB group might wish to devote particular attention, taking into account that the standards set forth in the above mentioned recommendations are already met by most CSDs in Europe.

13. DVP is commonly defined as "the simultaneous and irrevocable transfer of securities and cash". This definition looks at the DVP process as it were a temporal relationship rather than a logical one. We note that the aim of DVP mechanisms is to ensure that a situation where one party of a transaction has received securities/cash without having paid/delivered cash/securities to its counterparty never occurs during the settlement process. As correctly recognised in the CPSS-IOSCO recommendation No.7, this result can be achieved without the simultaneity of the transfers. It is true that during the time the process is completed the participants are exposed to the asset commitment risk. This risk concerns the time period during which a participant's assets, either cash or stock, are frozen within the CSD and payment system pending final settlement of the underlying transaction(s). To this extent, the timing when the transfer of cash/securities becomes final and irrevocable is crucial: the sooner the transaction becomes final and irrevocable, the lower is the asset commitment risk.

14. We would also like to point out that the existence of DVP mechanisms as a measure to manage systemic risk is crucial for the direct participants of the settlement system only. On the other hand, what really matters where a direct participant settles on behalf of other market participants (so called: indirect participants) is that the direct participant has in place risk control measures that will prevent that difficulties at the indirect participant will impact the settlement process.

15. As already indicated in other consulting documents, the need for intraday settlement finality is also strongly supported by ECSDA, as end-of-day net settlement may be

insufficient for large and complex markets. The use of central bank money versus commercial bank money significantly increases the security of the cross border clearing and settlement process. Finally, as far as *operational risks*, the key factors to be taken into account are still basically the ones identified in IOSCO's Recommendation No. 11: special emphasis should be given to the establishment of contingency procedures/disaster recovery plans and to the adoption of adequate protection measures to guarantee the authenticity of instructions and the integrity of data. Consideration might also be given to the Basel 2 forthcoming recommendations concerning operational risk within the banking environment and the ways to monitor and reduce it.

Settlement cycles.

16. ECSDA supports the current IOSCO-CPSS recommendation that clearly recognises that shortning settlement cycles is neither costless nor without certain risks (increase in the number of failed transactions). We note that where cross border activity is relevant, such reduction would require substantial investments in order to improve existing infrastructures. Therefore, costs and benefits of reducing the settlement cycle should be carefully evaluated, taking into account the needs of the system's users and the existence of other measures to control pre-settlement risk.

Structural issues.

17. On the complex subject of achieving market integration ECSDA feels that no unique or "theoretical" answer can be given, and that it would be imprudent for the regulators to attempt to identify and impose a model for the organisation and corporate governance of the infrastructures. Solutions are to be sought by the players, with the only governing principle that market solutions must be compatible with the overarching public interest. As correctly recognised by the IOSCO CPSS report (Rec. No. 13) there is no single set of governance arrangements which is applicable to all different markets and regulatory schemes; however, there are some basic requirements (such as those listed in the explanatory text in the recommendation No. 13 mentioned above) that should be met regardless of the corporate structure of the institution, that is whether it is a mutual or for-profit entity.