EUROPEAN CENTRAL BANK

22 July 2004

COMMUNICATION ON CLEARING AND SETTLEMENT - THE EUROSYSTEM'S RESPONSE

1. The Eurosystem's response to the Communication on Clearing and Settlement

The Eurosystem strongly supports the Commission's objective of creating a safe, efficient and integrated EU clearing and settlement infrastructure. In principle, the Communication identifies the key issues that need to be addressed in the field of clearing and settlement in order to enhance integration and reduce systemic risk. The present infrastructure for securities clearing and settlement transactions in the EU remains insufficiently harmonised, highly fragmented and inefficient for cross-border activities. Although some consolidation has been achieved, there remain a very large number of service providers with limited competition between each other. Pan-European investors are required to access many national systems that provide different types of services, have different technical requirements and market practices, and operate under different legal and supervisory frameworks. The ongoing fragmentation of the infrastructure results in additional cost for securities transactions and could become a source of financial instability. Therefore, the Eurosystem agrees with the Commission that the existing barriers to efficient EU clearing and settlement arrangements, as identified by the "Giovannini Group", must be eliminated, which will require the combined efforts of the private and public sectors. In addition, the Eurosystem agrees that some parts of the clearing and settlement industry deserve more careful attention from a competition policy perspective. Finally, in order to ensure the smooth operation of markets and to guarantee financial stability, the Eurosystem shares the Commission's view that a sound regulatory framework is essential.

Against this background, the Eurosystem welcomes the initiatives specified in the Communication.

In particular, the Eurosystem supports the establishment of two expert groups on tax and legal issues as well as the establishment of an advisory and monitoring group to tackle all "Giovannini barriers" for which the private sector has sole or joint responsibility, and stands ready to contribute to the work of these groups. The Eurosystem understands that the participation of the CESR and the ESCB in the monitoring group will not jeopardise their continuing cooperation in the area of supervision and oversight of securities clearing and settlement systems in order to follow-up on the ESCB/CESR Standards. The Eurosystem in principle supports the adoption of a framework directive on clearing and settlement mainly

for the following two reasons. First, a directive can complement the market-led removal of the "Giovannini barriers", which is a necessary condition for competition to come fully into effect. Second, the effective and consistent implementation of the ESCB/CESR standards, as well as any other harmonisation measures that may be proposed by the expert groups, may require changes to the national legal framework that lie outside the power of national supervisory authorities.

The role and responsibilities of central banks

In general, the Communication underestimates the concerns and responsibilities of the central banks as regards a safe and integrated securities infrastructure.

The interest of the Eurosystem for securities clearing and settlement systems stems from four main reasons.

First because of the size of the payments made through securities settlement systems, the latter have the potential to affect the functioning of payment systems. Since the Eurosystem is, according to the Treaty, in charge of "promoting the smooth operation of payment systems", it must extend its oversight of payment systems to the securities infrastructure.

Second, according to the Treaty, the Eurosystem can grant credit only against "adequate collateral". In this respect, the inappropriate functioning of the securities infrastructure could seriously impact the ability of the Eurosystem to conduct monetary policy and to operate the TARGET system.

Third, the soundness and efficiency of the securities infrastructure in the euro area is a n important pre-condition for financial stability, for the confidence of the users and, ultimately, for the confidence in the currency.

Fourth, some of the national central banks, which form an integral part of the Eurosystem, have explicit legal responsibilities in the field of securities clearing and settlement.

In the light of these responsibilities, the Eurosystem carefully monitors and assesses the securities infrastructure. International standards for securities settlement systems recognise explicitly the role of central banks in this field, together with that of securities regulators and other relevant authorities.[1] The Commission is thus invited to refer to, and recognise explicitly, the responsibilities and tasks of the ESCB and the Eurosystem, especially their role for the oversight of the securities clearing and settlement

[1] In the Committee on Payment and Settlement Systems (CPSS) – International Organisation of Securities Commissions (IOSCO) Technical Committee Recommendations for Securities Settlement Systems of November 2001, Recommendation 18 sets out that central banks and securities regulators should cooperate with each other and with other relevant authorities in the effective regulation and oversight of securities settlement systems. Securities regulators, central banks and, in some cases, banking supervisors will need to work together to determine the appropriate scope of application and to develop an action plan for implementation.

infrastructure stemming from their above mentioned responsibilities and from the powers and responsibilities of the participating NCBs.

The relations between the work of the Commission and the work of ESCB/CESR

The Eurosystem expects that this framework directive does not duplicate the work of the ESCB/CESR. Rather, in line with the four-level approach embodied in the "Lamfalussy procedure", the directive should set up high-level principles to be concretised by level two implementing measures. To this end, close co-operation between the Commission and the central banks will be essential. In particular, the Eurosystem agrees with the Commission that the ESCB/CESR standards might form the basis of such level two measures.

At the same time, the Eurosystem would like to draw the Commission's attention to the fact that, within the current comitology structure, no group or committee comprises representatives of both securities commissions and central banks. However, any group or committee that will be mandated to actually define the level two implementing measures will require, by nature, the combined efforts of securities commissions and central banks. A possible solution therefore could be to give a joint mandate to the ESCB and the CESR.

Competition and the creation of a domestic infrastructure for the euro

The Eurosystem shares the Commission's view that competition can only come into effect if all service providers and investors enjoy comprehensive rights of access to and choice of all clearing and settlement systems. However, to function properly, competition requires systems to be interoperable in order to minimise costs to the users in switching from one system to another. Given the huge economies of scale and network externalities inherent in clearing and settlement, further consolidation and integration of clearing and settlement systems can be expected to accelerate significantly.

In this context, it is important to note that currency areas have traditionally developed their own coherent domestic infrastructures for payment systems as well as securities clearing and settlement systems. The Eurosystem expects that the integration process will help to develop an efficient domestic infrastructure for the euro which allows for an adequate degree of competition among completely interoperable systems. As the Governing Council of the ECB has already emphasised on a previous occasion[2], the domestic market infrastructure for the euro should logically be located in the euro area, as is the case with core infrastructures in other monetary areas. Defining a domestic system on the basis of currency enables public authorities (and the Eurosystem in particular) to ensure the smooth functioning of payment systems, efficient monetary policy implementation and financial stability. From an oversight perspective, given the systemic importance of the securities clearing and settlement systems, it is important that the

relevant main overseers are also located in the euro area. Furthermore, the location of clearing and settlement systems in the euro area would facilitate the provision, when deemed necessary and appropriate, of central bank money in euro. The Eurosystem invites the Commission to take note of and give adequate consideration to the Eurosystem's concerns in this regard.

The Eurosystem has repeatedly pointed out that the process of consolidation or integration of the clearing and settlement infrastructure should be driven by the private sector, unless there are clear signs of market failures, and agrees with the Commission that market forces will determine the "final" structure of the securities industry.

Risks undertaken by securities clearing and settlement systems

The Commission considers that it should be neutral as regards the opportunity for central securities depositories to offer intermediary and/or banking services and it intends to refrain from proposing or imposing any separation of the intermediary and banking activities eventually offered by CSD, as long as the appropriate regulatory/supervisory safeguards are established. The Eurosystem would like to underline the importance of *both* the neutrality principle *and* the need for appropriate safeguards in order to address public policy concerns, in particular the need to maintain and protect financial stability; in this respect, it should be ensured, at a minimum, that risks are properly addressed. In this respect, it can be helpful to clearly distinguish clearing and settlement activities since the two activities involve different types of risks and different potentials for systemic implications. It is also important that the functional definitions adopted clearly reflect the different activities. The Commission may benefit from the extensive work undertaken by the Eurosystem when assessing the securities settlement infrastructure (including links) with a view to its eligibility for Eurosystem collateral operations. In this respect, for the sake of consistency with other regulatory work, it is suggested to use the relevant definitions provided in the Glossary of the ECSB-CESR report.

Furthermore, at this stage, a high-level directive on clearing and settlement should not preclude any particular regulatory measure that might be needed to address public policy concerns in the light of such a comprehensive analysis. In general, any specific regulatory safeguards could be further developed in the form of level two implementing measures as foreseen in the Lamfalussy procedure rather than in the framework directive itself.

Against this background, the Eurosystem welcomes the fact that the Commission considers that securities settlement systems settling in commercial bank money should at least provide a choice for their participants to settle in central bank money, as agreed by the ESCB/CESR working group. This recommendation is in line with the policy guidance of the Eurosystem in this respect.

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[2] See the ECB's Press Release of 27 September 2001 on *the Eurosystem's policy line with regard to consolidation in central counterparty clearing* and the related policy position.

Regulatory and supervisory framework

The Eurosystem shares the Commission's view that a framework directive on clearing and settlement should address the adoption of an appropriate regulatory and supervisory framework covering all relevant service providers irrespective of their legal status. Again, the framework directive should define only high-level principles to this end, while specific measures for implementation may usefully be developed by the ESCB and the CESR at level two of the Lamfalussy procedure. In particular, the high-level principles should take into account the following two requirements:

- In the light of the multiplicity of relevant authorities such as regulators, supervisors and overseers in the various Member States, there is a need for a coherent and effective regulatory/supervisory/oversight framework, to be further specified by level two implementing measures, which comprises *all* relevant authorities acting together .
- Clearing and settlement activities entail risks that require adequate regulation. Therefore, if and to the extent that the current (and foreseeable) capital adequacy requirements might not be considered appropriate to cover credit risks (intraday and overnight) incurred by all institutions in the area of securities clearing and settlement (banks, CSDs with and without a banking licence, CCPs, general clearing members in CCPs), the Commission could envisage further prudential requirements. To this end, there is a need for a single, coherent and effective set of rules and regulations to be specified by level two implementing measures, based on the functional approach and applicable irrespective of the legal status of the supervised entity. In this context, the differentiation between and thorough understanding of the different functions and the maintenance of a regulatory playing field is of utmost importance.

As indicated in the Communication, supervision and oversight in the field of clearing and settlement is not yet regulated at the European level. Rules for cooperation between relevant authorities have mostly been established via bilateral Memoranda of Understanding. The ongoing structural change and parallel developments in payment systems require a closer focus on the coordination of supervision and oversight. In particular, the Commission has proposed to enforce cooperation under home country control, reproducing the traditional arrangements applicable to banking supervision. In the field of clearing and settlement, however, the applicability of the traditional division of tasks between home and host authorities will be less evident following further integration and consolidation. The Commission should also recognise that in each institutional case the needs may differ, as the importance of a system may vary from country to country. Roles may also vary by circumstances.

The systemic and cross-border characteristics of the clearing and settlement infrastructure imply that there will be authorities that have the responsibility for the supervision/oversight of securities clearing and settlement systems, both at the national level and in the cross-border context. Moreover, strong co-operation between all the relevant authorities is necessary to fulfil these responsibilities. To achieve this, it should not be excluded that co-ordinating functions could be entrusted to one of those authorities.

In conclusion, whether or not the oversight/regulatory/supervisory framework should be based on the home country principle and a coordinating authority depends on a range of different factors and needs to be adjusted to the specific cases. Therefore, the Eurosystem invites the Commission to concentrate on high level requirements for co-operation and to refrain from proposing any specific provisions in the framework directive as regards the effective organisation of oversight/regulation/supervision, but to mandate the ESCB and CESR to develop appropriate level two implementing measures to this end.

Governance

The Eurosystem takes note of the Commission's view that the adoption of appropriate governance arrangements can be helpful in achieving the overall objective of creating a safe, efficient and integrated EU clearing and settlement infrastructure. Governance arrangements aim primarily at ensuring that the needs and concerns of users are adequately taken into account. Given that the users have an interest in a safe, efficient and integrated EU clearing and settlement infrastructure, appropriate governance arrangements might therefore help to achieve this overall objective. However, governance arrangements cannot be sufficient in effectively addressing public interests. Indeed, private owners and users may very well, and often do, have interests that conflict with public interests. Governance structures may therefore fail to adequately address public policy concerns, such as competition and financial stability, and cannot be a substitute for adequate regulation by means of competition and banking law. Finally, the Eurosystem notes that the Commission's proposals in terms of governance arrangements are only addressed to securities settlement systems and central counterparties, but not to any other service providers. This approach is in contradiction with the functional approach and inappropriate for creating a level playing field.

The Hague Convention

The Eurosystem would like to point out that the recently-adopted Hague Convention deviates from the existing conflict of laws rules established by Community legal acts such as the Settlement Finality Directive and the Collateral Directive. Therefore, the potential impact of the Convention on the operation of systems and settlement finality requires close attention.

Certain provisions of the Convention will directly affect the Eurosystem legal framework (and in particular its collateral policy) and the respective implementing measures in the documentation of national central banks. It should also be noted that the wording of the Convention may give rise to different interpretations, meaning that the application of the Convention across Member States may also vary. Due consideration therefore will have to be given to the clarifications to be provided by the Explanatory Report to the Convention which is in the process of being finalised. Taking into account the importance of the robustness of clearing and settlement systems for the Eurosystem collateral framework and for financial stability generally, we would like to stress the need to ensure that the changes triggered by the Convention will be implemented without compromising the current level of legal certainty and

protection against systemic risk offered by existing Community law. In addition, inconsistent implementation or application by Member States should not lead to the introduction of uncertainties for the settlement of collateralised credit operations. A thorough impact analysis of the possible implications (both as regards Community law and national law in EU Member States) should therefore be undertaken before the signing of the Convention in order to avoid undesirable effects when the Convention is implemented and/or applied. In particular, the impact of the Convention on the consolidation of trading and settlement activities as well as on the law used in this context should be considered.

The Legal Certainty Project

The Eurosystem attaches at least as much importance to the soundness of the legal system as the Commission. This is particularly valid in the context of cross-border clearing and settlement where multiple legal jurisdictions are involved and where there is a need to identify clearly the national law applicable. As a consequence, the Eurosystem has a strong interest in the legal initiatives specified in the Communication, and in particular in the proposed Legal Certainty Project and the setting-up of a legal expert group entrusted with elaborating proposals regarding an EU-wide legal framework for the treatment of rights in securities held with an intermediary, corporate actions processing and the location of securities.

The Eurosystem agrees that demolition of the remaining legal barriers identified by Giovannini is critical in order to create an integrated securities market in Europe. The Eurosystem shares the view of the Commission that the netting and conflict of laws issues in relation to systems have sufficiently been resolved with the implementation by Member States of the Settlement Finality Directive and the Collateral Directive.

We note that the Commission intends to address legal issues separately from the topics suggested in connection with the proposed framework Directive. Here, the interrelation of the Legal Certainty Project with the proposed framework Directive and with existing EU legal acts (such as the recently adopted Directive on Markets in Financial Instruments or the Settlement Finality Directive) should be clarified. It is important that due to the close interrelationship between these respective subject matters, any potential mismatch or duplication of rules should be avoided. More specifically, investor protection and systemic stability are based on a stable legal environment that supports investors' rights and the integrity of systems, of which one example is the Settlement Finality Directive - the first EU harmonisation effort in the field of payment and securities settlement systems. In its Communication, the Commission recognises that standard setting "may not replace a proper legislative framework". As a consequence, a clear delineation between statutory legal rules and high level principles to be established in line with the Lamfalussy procedure would be warranted.

In particular, a high degree of statutory rules are required as regards: the exact nature and extent of investors' rights, and the protection of these investors' rights to the maximum extent possible; the full

transferability of such rights, including the protection of acquirers in good faith; and in general, the safeguarding of the legal certainty of a system of holdings of securities.

Moreover, the Eurosystem agrees that clear rules for transfers (and other disposals) of financial instruments are instrumental in safeguarding systemic stability and for the integrity of issues of securities. In particular, the definition of an unambiguous and harmonised moment for the transfer of rights is crucial; not only for the processing of corporate actions, but also for the general security of systems operating cross-border. As a further issue, the Eurosystem would like to raise the issue of adequate protection mechanisms against the creation of excess securities and the treatment of shortfalls. The creation of excess securities is mutually exclusive to the principles of systemic stability, the integrity of an issue and the protection of investors.

Finally, the Eurosystem agrees with the importance of taking into consideration the proposed clearing and settlement reform project with ongoing initiatives on a national and international level. However, we would like to stress that an EU problem implies an EU solution, and so although the experience of other important jurisdictions or international projects should be analysed and their findings taken into account, the specifics of the EU internal market have to be heeded. In particular, any new rules should be complementary to existing Community legislative measures such as the Settlement Finality Directive, the Collateral Directive and the Directive on Markets in Financial Instruments, while duly taking into account current investor protection provisions under most Member States' jurisdictions.

Specific comments

Some more detailed specific comments concerning specific aspects of the Communication are attached in Annex 1.

Annex 1: Specific comments

CURRENT SITUATION

p. 5

The use of the expression “Clearing and Settlement Systems” in the document and in future work (and in particular in the directive) can be misleading. Clearing and settlement services are very different, present different risks and are generally provided by different institutions.

The absence of a definition of “CSD” means that the text underestimates the services that CSDs provide to the issuers.

p. 6

The paragraph on clearing can be misleading.

- There is a need to clearly distinguish between settlement netting and netting by novation.
- Also the references to replacement cost risk are inappropriate.

p. 6

The paragraph on the channels for cross-border transactions does not mention the possibility of using branches of subsidiaries. (For operations with the central banks, there would be a fifth channel, i.e. the CCBM). The issues explained in the following paragraph on competition between CSDs and custodians are also valid in a domestic context (and not only cross-border).

THE COMMISSION OBJECTIVES

The paragraph on settlement of cash (p. 10) seems to take for granted that the cash leg can only be settled in central bank money.

The Eurosystem currently use only securities settlement systems (not clearing) for monetary policy operations. They are also used for intraday credit operations. (p. 11).

2.2 Common regulatory/supervisory framework

p. 20

The Commission considers that the supervisory model applied in the EU harmonised sectors of banking, investment services, etc. based on the home country control can also be introduced to coordinate the supervisory responsibilities of national authorities. The supervisory framework will also have to take into account the oversight activities performed by central banks. In this respect, other criteria should be considered that would adequately reflect the concerns of central banks on the stability of the currency.

Annex 2: Glossary

Replace the definitions with those of the ESCB-CESR Glossary.