



EUROPEAN CENTRAL BANK

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**Summary of responses to the consultation on the report on
“Standards for Securities Clearing and Settlement Systems in the EU”
by the European System of Central Banks and
the Committee of European Securities Regulators**

This summary of the responses to the second public consultation on “Standards for securities clearing and settlement systems in the European Union” does not constitute a complete overview of all the opinions expressed by respondents. It has been drafted on a “best effort” basis and only highlights some of the more significant points made by the respondents. The full submissions are annexed to this summary. Neither the summary nor the individual submissions reflect the position of the ESCB-CESR Working Group or its members on the various issues.

This note summarises the responses to the consultation carried out by the European System of Central Banks (ESCB) and the Committee of European Securities Regulators (CESR) on the consultative report entitled “Standards for securities clearing and settlement systems in the European Union”. In May 2004 an amended version of the report released in August 2003 was distributed for further comments to the respondents of the first public consultation. The amended version of the report was also released for public consultation by the CESR on 5 May 2004. The ECB and CESR Secretariat subsequently received contributions from 39 representatives of custodian banks, domestic central securities depositories (CSDs) and international central securities depositories (ICSDs), central counterparties (CCPs), stock exchanges and various associations of market participants. The deadline for the consultation was 21 June 2004. Moreover, the report was also discussed at a public hearing organised by the CESR in Paris on 25 May 2004. Other hearings have been organised by the national authorities in some Member States.

This note is divided into two parts: the first part summarises the general comments, while the second summarises the observations on individual standards. For reasons of clarification and transparency feedback is given on some of the comments. The list of contributors is annexed to this summary.

1. GENERAL ISSUES

Almost all respondents expressed strong support for the initiative of the central banks and the CESR to establish common rules in order to promote the safety and efficiency of clearing and settlement activities in the European Union (EU). They also welcomed the second consultation, which enabled market participants to see what account the Working Group had taken of comments on the first

consultation. However, many respondents (and in particular the banking community) proposed that the consultation period be extended and the adoption of the final version of the report be delayed accordingly. In particular, some respondents were of the view that the publication of the standards should be linked to that of the assessment methodology.

Feedback: The ESCB-CESR report addresses some very sensitive issues on which there has often been strong opposition among interested parties. Ultimately certain compromises needed to be reached in order for the work to progress. Careful consideration has been given to the comments received in the last consultation round and approval of the report has been delayed until after the summer. With respect to the implementation of the standards it would not be reasonable to commence work on the assessment methodology before the standards have been approved.

Relationship with other regulatory initiatives

As in the previous consultation, concerns were voiced regarding the extent to which this initiative would duplicate the work of other initiatives. In this respect, several of the respondents called for harmonisation of the various legislative, regulatory and industry-led initiatives, especially as regards reporting requirements and operational standards.

There was a view that the standards constitute a “soft” law and that it would not be appropriate to implement such standards before the “hard” law has been passed (e.g. an **EU Framework Directive or other instrument on clearing and settlement**). The standards should therefore remain as recommendations, and could be used as a basis for implementing measures under Levels 2 & 3 of the Lamfalussy procedure.

One respondent proposed that the **ESCB user standards** be incorporated in the ESCB-CESR standards.

Finally, some market participants noted that there is a tendency to impose more **standards** on the industry in the EU than in the **United States and Japan**, thus impairing competition. One respondent recommended that the CESR engage in early discussions with the US Securities and Exchange Commission (SEC) before adopting the standards in order to ensure convergence between the United States and the EU.

Feedback: The basic objective of the ESCB-CESR Working Group was to transpose the CPSS-IOSCO Recommendations to the European context. In the course of formulating the ESCB-CESR standards, due attention has been paid to not weakening the existing CPSS-IOSCO Recommendations. The ESCB-CESR Standards are based on the current market situation and legal framework in the EU. In principle, the requirements of the ESCB-CESR standards are already part of the existing European regulatory framework.

The standards are not intended to pre-empt any future action that may be taken with regard to the regulation of these activities, in the event of a European Commission initiative in this field. In fact, central banks and securities regulators in the ESCB-CESR have individually expressed their general support for this initiative. Until a European Directive or other instrument is put in place, however, the need remains to adapt the CPSS-IOSCO standards to the EU through ESCB-CESR. The fact that the standards do not replace a possible directive or another initiative is underlined in the new

version of the report. Needless to say, any change in the European legislation will have to be reflected in the ESCB-CESR standards.

As regards the tendency of the standards to produce unfair competition effects for European players vis-à-vis non-European players, it should be stressed that the European regulators do not intend to interfere in the existing market situation. Before any hard and fast measures with significant cost implications were imposed, a cost-benefit analysis would be undertaken, to which the private sector will be associated.

With respect to the ESCB User Standards, it is envisaged that they will consist of the ESCB-CESR standards and a limited number of additional requirements in order to take into account specific concerns of the Eurosystem, which are not relevant in the context of the ESCB-CESR report.

Scope of application

As far as the scope of application is concerned, two main issues were pointed out.

First, one respondent noted that using the word ***securities*** in the title of the standards might lead to misunderstandings, taking into account that several standards (e.g. Standard 4) involve operations with ***derivatives***.

Second, one respondent argued that the standards applying to CSDs should be clearly distinguished from those applying to CCPs. In this respect, it was suggested that CCPs be left outside the scope of application of the standards and that standards for CCPs will be set out later on, on the basis of CPSS-IOSCO recommendations for CCPs.

Feedback: With regard to the first issue, the report now clarifies when financial instruments other than securities are addressed. With regard to the second issue, the ESCB-CESR report calls for an evaluation of the benefits and costs of having a CCP, while not being prescriptive as to whether a CCP should be introduced or not. The reasoning is similar to that of the CPSS-IOSCO Recommendations for SSSs. The risk control measures that a CCP should introduce will be reflected in the CPSS-IOSCO Recommendations for Central Counterparties report, which is expected to be finalised by the end of 2004. The ESCB and CESR will then consider how to apply these recommendations in the European context.

CSDs and custodians

As regards the application of the standards to CSDs and custodians, as in the previous consultation the reactions of the market can easily be grouped into two clearly defined positions: the banks and their relevant associations strongly oppose the proposal to include custodian banks in the scope of the standards, whereas the (I)CSDs, some stock exchanges and securities dealers associations strongly favour extending the scope to cover all systemically important entities, including custodian

banks. The main arguments for and against the proposed scope of application can be summarised as follows:

The banking community argued that a distinction should be made between infrastructure and intermediaries. In particular, (I)CSDs are considered to be infrastructures responsible for the ultimate change of ownership when transfers of securities occur, while custodian banks, as intermediaries, cannot offer finality of ownership transfers.

Second, the systemic risks associated with the operations of (I)CSDs are different in kind and degree from the types of risk associated with the “typical settlement-related” activities of custodian banks. In this respect, the banking community continued to disagree with the explanation of custodian activities provided in the introduction to the report and, in particular, criticised the new Paragraph 14 for not being precise enough in its scope.

Third, the banking community stressed the fact that CSDs are not currently subject to European regulation, while custodian banks are already subject to comprehensive banking regulations both at the national and the European level. They are subject to stringent monitoring and undergo frequent audits and supervisory examinations. For this reason it is considered neither necessary nor appropriate to impose new rules on the banking industry.

Fourth, the banking community claimed that the ESCB-CESR’s approach treats CSDs, ICSDs and custodian banks in a similar way. They insist that (I)CSDs de facto operate in a monopoly situation (i.e. they have a “public utility” function), while custodian banks compete among themselves. It was suggested that the regulators should recognise this situation when defining rules, in particular where they relate to efficiency, transparency, governance access and some technical standards such as DVP. This point will be discussed under the comments on Standard 7.

The (I)CSDs and stock exchanges endorsed the extension of the standards to all entities operating systemically important systems, including CSDs, ICSDs, CCPs and custodian banks. They argued that, in reality, there is no difference between services being offered by and settlement taking place at the level of the (I)CSDs or at the level of custodian banks.

Second, the ICSDs and the stock exchanges stressed that it would be misleading to compare the systemic risks associated with the **whole** operation of (I)CSDs with the risks associated with the “typical settlement-related activities” of custodian banks. If focus is given to the settlement-related activities, the associated risks are the same, irrespective of the institution providing the service.

Third, they noticed that (I)CSDs are indeed subject to European regulation. When they have banking status – and provide credit services – they are subject to the same regulatory regime as any other bank. When they do not have banking status they do not provide credit facilities and are normally subject to some form of (national) regulation. Moreover, (I)CSDs and stock exchanges stressed that any differences in the regulatory environment between (I)CSDs and custodian banks would promote a shift of settlement activities from (I)CSDs to custodian banks, thereby increasing systemic risks. However, one CSD was of the view that core services must be regulated separately from value-added services. One respondent asked whether risks associated with the settlement activities of custodian

banks would be expressly mentioned in the Basel II framework. The same respondent asked for clarification on how the standards will be applied to registrars, settlement banks and providers of trade confirmation and matching services.

Fourth, some stock exchanges noted that the *de facto* monopoly situation in the management of the issuance of securities (i.e. the so-called notary function) had not proven to result automatically in a monopoly of settlement services. On the contrary, the German *bunds* case has proven that securities can be issued exclusively in one CSD (in this case Clearstream Banking Frankfurt) and settled in another CSD (in this case, Euroclear).

Feedback: The ESCB-CESR Working Group recognises that banks are in competition with CSDs for the settlement function. Banks claim that this competition is unfair. However, the fact that a single entity may do CSD and banking business is a consequence of the current state of national legislation in the EU, which is not harmonised. In some Member States this is allowed, while in others it is not. The Group had no option but to take the present situation as the starting point for elaborating the standards.

The Working Group has considered carefully the addressees of each individual standard. One of the underlying objectives of the Group has been to avoid provoking any major shift of business from one entity to another, but to ensure instead the safety and efficiency of securities clearing and settlement in the EU.

The compromise reached by the Working Group consists in, on the one hand, limiting the credit activities that CSDs with a banking status may undertake, thus restricting the circumstances in which they can provide uncollateralised credit. Banks, on the other hand, are invited, in particular, to control their intraday credit exposures and to consider the possibility of increasing collateralisation. No additional requirement is imposed at this stage. Both the supervisory review process under the Basel II framework and the EU framework on capital requirements allow supervisory authorities to assess different types of banks in accordance with their individual overall risk profile.

Systemically important custodians

Two broad concerns were raised regarding the enforceability of the standards on custodian banks. The first concern related to the **definition or identification of custodians** to which the standards are applied, while the second concern addressed the **manner of enforcing the standards**.

Regarding the first concern, the banking respondents stressed three elements:

- The identification of “systemically important banks” would lead to a two-tier custodian market and it would therefore be preferable to treat all custodians equally.
- The need to define a systemically important custodian may only arise when dealing with operational risk, as was the case for the G30 recommendations. However, the US example of “sizeable intermediaries and custodians”, as described in the US Interagency Paper, was not

considered appropriate as regards extending a large number of ESCB-CESR standards to custodian banks.

- There are no explicit criteria for identifying “systemically important” systems.

By contrast, CSDs considered that significant custodians should be included in the ambit of the report. CSDs also suggested that the list of operators of systemically important systems should be disclosed to the public, whereas one banking respondent did not support such an idea.

As regards the **enforcement of the standards**, the comments received expressed three concerns. First, the application of the standards should not result in overregulation of custodians, which are already subject to national banking regulations. Second, coordination between authorities is necessary in order to avoid custodians with a significant share of cross-border activity being over-burdened through regulation. Finally, there is a need to ensure a level playing-field in the application of standards across the EU. In particular, it has been pointed out that if the identification of systemically important systems is left to individual national regulators, this could also contribute to an uneven playing-field.

Feedback: The need to define relevant custodians arises not only in respect of operational risks but also with regard to financial risks. This has been recognised in the US Interagency Paper, as well as in the Assessment Methodology of the CPSS-IOSCO recommendations, in which it is indicated that local authorities may consider applying some of the recommendations (including 5, 7 and 9) also to relevant custodians.

The Group took note that in modern economies, custody and settlement business has become a banking “niche”. This has led some of the banks providing custody and settlement services to become more relevant than others in terms of systemic risks. The Group intends to analyse whether or not this requires regulatory action. If this is deemed to be the case, the Group will discuss the issue in more depth with banking supervisors and market participants.

Any possible rule would be formulated in such a way as to minimise the risk of:

- *double regulation;*
- *creating an uneven playing field; and*
- *putting EU-based banks in an unfavourable position in global competition.*

In particular, the ESCB-CESR intends to elaborate the methods for determining when a custodian is deemed significant. The designation of significant custodians would not be determined on the basis of quantitative criteria alone. It should rather be the result of a process based on coordination, primarily involving the relevant national authorities and aimed at the overall assessment of the position in the market.

The application of banking regulatory framework is dealt with under Standard 9, while coordination among supervisors is the subject of Standard 18.

Definitions

Several respondents noted that the definitions used in the glossary were inconsistent with those in the European Commission's communication.

One respondent argued that there were three different types of market participants: providers of commercial value-added services (all custodians, including ICSDs in their banking activity), providers of notary services (CSDs and, in respect of part of their activity, ICSDs), and providers of guarantee services (CCPs). ICSDs, which provide both notary and commercial services, should be subject to appropriate standards specific to each of their two types of activity.

One respondent urged the group to clarify what is meant by the term "system", as the definition of this term lays the foundation for much of the report. The same respondent argued that a distinction should be made between a "system" operated by a CSD and that operated by a custodian bank.

Feedback: The Glossary has been carefully revised. Both the ESCB-CESR Working Group and the European Commission have expressed their intention to cooperate closely with a view to ensuring consistency of terminology in their future work. This will be done in particular in view of the forthcoming assessment methodology.

With respect to the term "system" the text has been revised and addresses "significant arrangements" for the settlement of securities transactions that can be operated by CSDs, CCPs and custodians. As mentioned in the previous paragraph, the criteria for the identification of these arrangements will be further clarified in the follow-up work.

Implementation of the standards

One respondent noted that no indication had been provided of the time frame for achieving compliance with the standards. Another respondent felt that compliance with the standards should be assessed regularly (but not annually) and that the assessment of ESCB-CESR standards should be carried out together with the assessment against the ESCB user standards. Finally, several respondents requested clarification on whether or not the standards are intended to be enforced before an assessment methodology has been developed.

Feedback: The periodicity of the assessment will be addressed in the assessment methodology. No formal assessments will take place before the assessment methodology has been developed. In the context of developing the assessment methodology, a number of open issues will be further analysed, in close cooperation with market participants.

2. COMMENTS ON INDIVIDUAL STANDARDS

Standard 1 (Legal framework)

Two banks suggested that Standard 1 should be endorsed after the adoption of an EU Framework Directive. One respondent noted that the adoption of the Hague Convention may create a situation in which intermediaries are allowed to choose the applicable law, whereas the ESCB-CESR standards recommend that such choice should not be provided. One ICSD proposed that Standard 1 should

also be addressed to all entities performing securities issuance, safekeeping and registration. It did not agree with “relevant jurisdiction” being referred to as the “jurisdiction in which a security handled by the system is issued”. In addition, this ICSD suggested that almost all the relevant information on a CSD should be included in the system rules (and not in the additional documents). Several market participants stated that custodians must be excluded from the ambit of this standard. One respondent did not support assimilating the custodians into infrastructures, especially with regard to the obligation to publicly disclose procedures and contractual provisions. On the other hand, some respondents argued that custodians should at least be subject to some of the transparency requirements. Finally, one bank stated that Standard 1 supports the use of non-negotiable and non-commercial contractual provisions, which is inconsistent with promoting competition in the market.

Feedback: The specific transparency requirements applying to significant custodians are now listed explicitly. With respect to the comment on the Hague Convention, the explanatory memorandum merely states that the “ideal” situation is one whereby the choice of law is identical to the law governing the system.

Some guidance is provided on how the conflict of law could be minimised, leaving the choice of appropriate arrangements to market forces. This “ideal” situation should not hinder competition, as it is nowadays standard market practice in accordance with the Settlement Finality Directive.

Standard 2 (Trade confirmation and settlement matching)

A CSD representative proposed that Standard 2 should be addressed directly to regulated markets rather than to settlement systems. In addition, the same respondent suggested that this standard should be applied to custodians in order to allow them use of procedures safer than those currently used in matching instructions from indirect participants. One respondent argued that some European CCPs operate a settlement date netting procedure, in which all outstanding transactions for a certain date are netted and the resulting settlement instructions are sent to the CSD on the actual settlement date. This practice is therefore in conflict with the requirement that instructions should be matched no later than the day before settlement. Finally, a respondent supported same-day confirmation/affirmation for both direct and indirect market participants.

Feedback: The standard addresses operators of matching utilities, irrespective of whether these systems are operated by a CSD, a stock exchange (regulated market) or another market service provider. It has been clarified that the requirement for same-day trade confirmation is not applicable to systems in which trading instructions are subject to netting as part of the clearing process, for example a CCP which operates settlement data and netting procedures. The trade confirmation requirements will be further analysed in the context of the assessment methodology.

Standard 3 (Settlement cycles)

One respondent suggested stating that the standard should require that a CSD be closed for new transactions when TARGET is closed. A banking representative argued that system users do not need

to be subject to this standard. Finally, two respondents argued that CCPs should be excluded from the application of the standard, since the length of settlement cycles does not depend on the procedures of CCPs.

Feedback: Closing a CSD for new transactions when TARGET is closed could potentially have a negative impact on current commercial transactions in night settlement systems. It has been clarified that Standard 3 is addressed to CSDs, to CCPs where relevant, to operators of regulated markets and to market participants. Undertaking a cost-benefit analysis of the harmonisation of settlement cycles, operating days and hours as well as of the shortening of settlement cycles is primarily a task for market participants and, in particular, for system operators and users. However, public authorities should consider stepping in and conducting the cost-benefit analysis if there is no market initiative within an appropriate time frame. In any event, market participants should be invited to participate in any initiative taken.

Standard 4 (Central counterparties (CCPs))

Some respondents suggested that the ESCB-CESR standards should preferably not cover CCPs. In addition, one market participant proposed that CCPs should be taken out of the scope of the standards and that a separate ESCB-CESR document on CCPs should be created. Moreover, it suggested that a distinction should be made between CCP clearing and CSD clearing. One respondent recommended that the CCPs and clearing members should be regulated under a bank licence. Some respondents noted that key element 2 does not clarify whether it is addressed to the market or to the authorities. In addition, it is unclear which institutions should carry out the cost-benefit analysis.

Feedback: As mentioned in the introduction, the CPSS-IOSCO Recommendations for Central Counterparties are expected to be finalised by the end of 2004. The ESCB and the CESR will then consider whether and how to apply these recommendations in the European context. With respect to the cost-benefit analysis, it has been clarified that it should be conducted by the market itself and that it is intended only for the establishment of a new CCP.

Standard 5 (Securities lending)

One respondent proposed not to extend standard 5 to CSDs at all. A custodian bank representative urged that the reference to custodians be removed. Respondents from the banking community were of the view that CSDs normally provide securities lending only to correct settlement failures (which is not reflected in the Standard's text). Moreover, it was further argued that the standard should explicitly mention that a CSD should not act as principal in securities lending. One respondent proposed that this standard should promote bilateral or tri-party securities lending throughout Europe to minimise delivery failures. In addition, it urged for clarification on the issue of whether the creation of debit balances should be prohibited at the CSD, agent or client level, and whether the

statement refers to cash or stock balances. It was also of the view that for the smooth functioning of markets (e.g. in relation to stock splits), debit balances should be allowed. One respondent suggested clarifying that CCPs do not provide securities lending but use it themselves. Therefore, the application of the standard to CCPs is not justified.

Feedback: It has been specified that the standard applies to securities lending in connection with the securities settlement process for avoiding settlement failures and expediting the settlement of securities. Securities lending could be developed either to lend securities automatically when a settlement failure would otherwise occur due to a lack of securities, or to lend securities only when participants actively decide it is necessary. However, while securities lending may be a useful tool, it presents risk to both the borrower and the lender. The securities lent or the collateral may not be returned when needed, because of counterparty default, operational failure or legal challenge. The addressees, and in particular national legislators, should take appropriate measures. The possibility of limiting the ability of CSDs to take risks in securities lending will be subject to further analysis.

Standard 6 (Central securities depositories (CSDs))

One respondent was of the view that CSDs need to be able to offer CCP services as part of the current market model. Some respondents noted that the definitions of “CSDs” and “CSD functions” are unclear. Several respondents from the banking community argued against CSDs being allowed to take on credit and liquidity risk. If CSDs were to develop a banking activity, it should be fully segregated from the core activity of the CSD. By contrast, an ICSD argued that (I)CSDs cannot avoid credit risks. It proposed not to use the term “CSD functions” and questioned whether the ultimate settlement takes place in the books of the CSD. In addition, the ICSD stated that Standard 6 should apply explicitly to registrars and, more generally, to custodians operating “systemically important systems”. A CSD stated that the standard limits the activities of CSDs and puts them at a disadvantage in relation to custodians. Finally, some CSDs questioned their ability to guarantee the integrity of an issue for securities not deposited at the CSD.

Feedback: As mentioned in the introduction, as a consequence of the current state of national legislation in some EU countries, a single entity is allowed to perform both CSD and banking business. One of the underlying objectives of the Group has been to ensure safety and efficiency within the current legal framework. Only a Directive could harmonise the CSDs’ legal regimes throughout Europe. As regards the addressees, it is specified that the standard is addressed primarily to CSDs and in part also to other entities performing CSD functions, including registrars and common depositories.

Finally, with respect to the integrity of an issue, it has been clarified that the rules applicable to a CSD (or an entity performing certain CSD functions) only apply to the securities deposited in that particular CSD (or the entity performing certain CSD functions).

Standard 7 (Delivery versus payment (DVP))

Taking into account that most current links between CSDs are free of payment (FOP), an ICSD asked for more details to be provided on the timing of the introduction of the DVP requirement in the case of links between CSDs. Another CSD argued that if the standards become effective before the introduction of TARGET2 in 2007 it should be pointed out that in the interim phase FOP links might be sufficient. One respondent proposed that the standard should define how to differentiate between DVP at a CSD level and DVP at a custodian level.

Banking representatives urged that this standard should not be applicable to custodian banks and their clients. By contrast, a CSD argued that custodians should ensure DVP settlement. One respondent proposed that a single DVP model should be agreed for cross-border transactions. CCPs argued that there should be adequate infrastructure in place which does not require a CCP to pre-fund the cash side of the delivery.

Feedback: The text concerning DVP in links is addressed in standard 19 of the new version of the report. The assessment methodology will further clarify the requirement regarding moving from FOP to DVP.

The possibility, and the usefulness, of asking significant custodians to organise DVP settlement will be subject to further analysis.

Standard 8 (Timing of settlement finality)

One ICSD proposed allowing the retransfer of securities if adequate risk management procedures and controls are in place. In their view, if the suggestion is not accepted, the standard should also apply to custodian banks, a view that was opposed by the banking community. A banking representative argued that finality is the major distinction between a CSD and a bank, a fact that should be recognised in the text. A respondent suggested that reference should be made to cash settlement agents in the key elements, as granting intraday finality is also important in those systems that do not at present offer settlement in central bank money.

Finally, some respondents representing CCPs would like CCPs to be excluded from the scope of this standard, as they do not ensure the finality of settlement between the seller and the buyer of securities transactions.

Feedback: Finality makes settlement irrevocable and unconditional. The ESCB-CESR is of the view that a participant should not be able to retransfer securities until its right to hold these securities is irrevocable and unconditional. Otherwise, if one transaction has to be unwound, multiple transactions would be unwound in turn, creating a high potential for systemic risks. A participant which wishes to retransfer securities before its ownership over these securities is final would thus need to make use of securities lending facilities (see standard 5).

The report makes clear that it is for the system to decide on the finality rules, provided that these are in line with the legal framework. It is not the role of the ESCB-CESR to assign a prerogative over providing finality to any one agent.

Finally, CCPs have been excluded from the standard, as they are not providers of intraday finality.

Standard 9 (Credit and liquidity risk controls)

Almost all respondents from the banking community strongly opposed the idea of CSDs being allowed to take on credit risk. The main reasons were concentration of (systemic) risk and conflicting responsibilities on the part of CSDs. On the other hand, some CSDs would like to be allowed to use more sophisticated risk management techniques than just collateralisation.

One respondent also challenged the requirement that eligible collateral should be of investment grade quality. It was proposed that this requirement be extended to include collateral that is considered eligible according to internal rating models in line with the Basel II Capital Accord.

According to one respondent, the standard contains more stringent provisions than those described in the European Commission's Communication on the future Directive on clearing and settlement (the latter does not prevent CSDs from granting credit). The same respondent also argued that if Basel II applies uniformly to custodians and to CSDs having banking status, this should be mentioned in the standard itself and not just in the footnote.

One respondent argued that as long as a bank has risk management controls in place to monitor potential overnight exposure to individual customers and, on aggregate, does not exceed prudential limits, the level of intraday exposure should not be relevant to capital adequacy requirements (Introduction, key element 4). The same respondent also challenged the wording in the preamble and in paragraph 114, namely that custodians *create* risks for the financial system. Another respondent from the banking community argued that the standard creates double regulation (with Basel II), as intraday exposures are handled in the same way as any other credit risk. Some participants argued that full collateralisation is too costly for banks and will reduce their global competitiveness. Moreover, collateralisation should remain solely in the context of Basel II and not the ESCB-CESR. Several respondents from the banking community stated that introducing collateralisation requirements only for sizeable custodians creates arbitrary competitive consequences. Finally, one respondent would like a more detailed description of the scope of the reporting of settlement-related exposures to relevant authorities and, at the same time, pointed out that such reporting is likely to involve a high level of cost.

***Feedback:** With regard to the proposed inclusion of risk management measures other than collateralisation, the proposal of one respondent has been taken on board. The quality of the collateral should either fulfil a minimum credit rating, that is be considered as "investment grade", and should be sufficiently liquid, or should be considered as eligible collateral by the Internal Rating Based (IRB) systems, which have been approved by supervisors in the context of the Basel II Capital Accord. In addition, a more prominent role in the text has been given to the Basel II framework, since it applies uniformly to both custodians and the CSDs with a banking status. As regards double regulation, the ESCB-CESR Working Group has shown strong willingness to avoid it, inter alia, by extensively consulting banking supervisors. It is difficult to compare Standard 9 with the Commission's initiative, given that the latter has not yet been finalised.*

The banks should aim at exploring the possibility of increasing the level of collateralisation of their credit exposures; full collateralisation, however, is not required. Finally, as regards the possible

creation of arbitrary competitive consequences, it should be kept in mind that significant custodians are not actually directly competing with the non-significant ones.

The Group makes it clear that it does not intend to impose additional rules on bank custodians before a more thorough analysis has been conducted within the framework of the assessment methodology. Market participants will be associated to this work. Any possibly decision would have to be made in agreement with banking supervisors and would take place within the Basel II framework.

Standard 10 (Cash settlement assets)

A couple of respondents from the banking community argued that the standard is not in line with the TARGET2 specifications, which require settlement in central bank money. According to one respondent, the standard effectively allows CSDs to use commercial bank money. Some respondents from the banking community proposed as a compromise that all new settlement services developed by (I)CSDs should be based on central bank money, thus allowing a transition period for existing settlement services in commercial bank money. Another respondent argued that the standard implicitly identifies a risk line between two types of CSD: those based solely on central bank money and those that also use private cash agents.

Feedback: The standard explains that the use of central bank money is strongly encouraged (“whenever practicable and feasible”), but it is recognised that it is not always possible, especially in the case of foreign currency cash settlement. This issue will be tackled further in the context of formulating the assessment methodology. In addition, TARGET2 specifications explain how central bank money can be used, not when it should be used.

Standard 11 (Operational reliability)

Many custodian banks opposed the “two hour rule” as being too restrictive. One bank argued that a distinction should be made between infrastructures and service providers. One ICSD would like the statements on outsourcing to be further clarified, especially regarding which authority or jurisdiction is the relevant one. A couple of respondents stated that custodians are already subject to prudential rules imposed by banking regulation (notably the Basel II Capital Accord). A central counterparty claimed that some specific aspects for CCPs are not taken into account and suggested referring to the CPSS-IOSCO recommendations for CCPs.

Feedback: It has been clarified that the “two hour rule” is a recommendation rather than a strict requirement, i.e. all reasonable measures should be undertaken to resume business no later than two hours after the occurrence of a disruption. Operational requirements should equally refer to all critically important service providers without special distinction. The Basel II Capital Accord applies to all custodians with a banking licence, while Standard 11 applies only to significant custodians (including non-banks) in addition to CSDs, CCPs and other providers of services critical for securities clearing and settlement.

Standard 12 (Protection of customers' securities)

A custodian argued that, as investment firms are already regulated under the Investment Services Directive (ISD), the implications of applying the standards in addition are not understood. Another custodian argued that client accounts with banks can run debit balances of stock and that it is the responsibility of the bank/broker to manage overall balances and ensure that debit stock balances are covered via securities lending transactions. An ICSD argued that securities debit balances should be allowed if they occur for local market reasons beyond the control of the (I)CSD. Another respondent from the banking community expressed concerns related to contractual settlement. The same respondent also argued that segregation may be useful for operational reasons, but that it is insufficient for prudential reasons and for the objective of protecting assets from claims. It would be more appropriate to identify convergent high-level business practices with which to manage such crises efficiently. A couple of participants stated that, with respect to reconciliation, the case is clear within the EU; however, there might be problems with reconciliation at least once a day with CSDs in non-EU countries/different time zones. Finally, central counterparties asked to be excluded from the standard, as they do not offer custody services.

Feedback: The standard applies to all entities holding customers' securities accounts, including investment firms. In no case should securities debit balances or the creation of securities be allowed by entities holding securities in custody. Doing so would no longer ensure the integrity of the issuance (i.e. that the nominal value of the total amount of securities in the market equals the debt/equity of the issuer) and would weaken confidence in securities markets. As regards the reconciliation of customers' securities holdings with the respective holdings in CSDs in non-EU countries, the impact of (foreign) bank holidays and different cut-off times, it is stated that in such instances reconciliation should be made on a day-by-day basis as soon as possible. Finally, as regards CCPs, the standard is addressed to them only in the event that they directly handle assets pledged to them by their customers.

Standard 13 (Governance)

One respondent proposed that the standard acknowledge that issuers may participate in the decision-making processes, for example on the board or at the level of a technical committee. A central counterparties representative suggested that the key elements be replaced by an explicit reference to existing governance codes and, moreover, that all references to "public interest requirements" be deleted. The same respondent also argued that disclosure of management incentive schemes is inappropriate for commercially-oriented companies.

Feedback: The standard welcomes the appointment of independent board members (including representatives of issuers). "OECD Principles of Corporate Governance" have been added as an explicit reference.

Standard 14 (Access)

One ICSD felt that separate and independent appeal procedures are complex and unjustified for user-owned and user-governed groups. Moreover, the access criteria mentioned in the standard should be indicative and should not prevent more subjective criteria in relation to risks such as reputation risk. The ICSD also proposed deleting paragraph 162, since it refers to EU competition law rules, which already provide sufficient safeguards for access-related issues. In addition, the respondent stated that “in the case of the insolvency of a custodian...” there should not be any automated procedures for the designation of another custodian, which cannot be imposed by the client. One respondent argued that the standard in its current form is not appropriate for CCPs. Finally, one respondent argued that the standard should also address the equality of access for custodians to a CSD vis-à-vis the internal access of an ICSD bank to its CSD function.

Feedback: With regard to the access criteria, the standard permits the refusal of access on grounds of risk as well as in separate cases, e.g. legal issues, lack of adequate supervision or money laundering problems.

Standard 15 (Efficiency)

Some respondents argued that, in general, the standard is redundant because pricing behaviour is scrutinised by antitrust and competition authorities. In line with this comment, some participants argued that the standard is useful only for systems in the form of public utilities, i.e. not for areas of the market place in which competition is already in place. However, one respondent requested that the text recognise that achieving efficiency would require intervention by public authorities and national governments.

Feedback: It has been clarified that relevant authorities (including governments) should seek to remove impediments to efficiency and interoperability that might arise from tax and accounting policies, legal restrictions, inadequate legal underpinning of or ambiguities about the treatment of efficient practices, or lack of harmonisation in central bank practices. In relation to public intervention, the standard states that “the primary responsibility for promoting the efficiency and controlling the costs of a system lies with its designers, owners and operators. In a competitive environment, market forces are likely to provide incentives to control costs.” The standard does not claim competence in competition issues.

Standard 16 (Communication procedures)

One respondent argued that a complete change of the existing IT standards would entail significant costs at the domestic level.

Feedback: The standard does not necessarily imply major changes of standards at the domestic level. In addition, it states that markets should move towards interoperability and STP in an effective, cost-minimising manner.

Standard 17 (Transparency)

Banks argued that the requirement to price services and functions separately is inappropriate for areas of the market-place in which competition is in place, i.e. it should only apply to monopolistic service providers. Moreover, the banks strongly rejected the idea of making risk control measures known to the public, as this would not be possible without giving away confidential information and, thus, competitive advantages. Several respondents from the banking community also stated that custodians are already subject to numerous regulatory reporting requirements and will be subject to further obligations under the Basel II Capital Accord (notably on Pillar III).

Feedback: The disclosure of pricing shall be made available by the CSDs and CCPs only. The disclosure of information on the risk exposure policy and risk management methodology is aimed at enhancing safety and risk awareness among participants. The level of disclosure of risk control measures will be addressed in the assessment methodology. In the case of custodian banks, the Basel II Capital Accord should be used as minimum requirements for the disclosure of information.

Standard 18 (Regulation, supervision and oversight)

One respondent would welcome further clarification of paragraph 197¹ (of the first sentence: “[...] extending to the entire group, including those entities in the group that would not be supervised”) and 201 (on the coordination of groups of CSDs through a “structured co-operation mechanism” allowing local authorities “to carry out the supervisory and oversight tasks, including peer review and assessment, of the areas of common interest of the group according to national law and regulations”). Moreover, the same respondent asked for clarification on the apparent discrepancy between paragraphs 197 and 201 on the one hand and 199 and 200 on the other hand.

Feedback: The wording of the explanatory memorandum has been modified significantly. It states that the relevant authorities should have the competence and the resources to carry out in an effective manner regulation and supervision on a solo and/or consolidated basis, as well as oversight on a solo and/or group basis, irrespective of the legal status of the supervised entity. A co-operation framework may be put in place in order to minimize the regulatory burden. In the fields in which the existing EU coordination schemes are applicable, authorities will follow these arrangements. In the fields that are not so covered, relevant authorities will enter into negotiation to coordinate these activities aiming at agreeing to formal Memoranda of Understandings.

¹ The paragraph numbering corresponds to the version of the report that was submitted for public consultation in May 2004.

Standard 19 (Risks in cross-system links)

The CSD community argued that the standard should also apply to the links that are operated by custodians through (I)CSDs. One bank argued that (I)CSDs should fully disclose to participants a comprehensive and appropriate risk analysis of all links. Another respondent suggested that relayed links should be as short as possible, as they are a potential source of additional risks. Finally, one respondent expressed its belief that the standard was too abstract and would need more detailed recommendations.

Feedback: The standard applies to links between CSDs. Where custodians act as intermediaries in links between CSDs, the standard also applies to them. With respect to relayed links, key element 6 states that “relayed links should be designed and operated in a way that does not increase the level of risks or reduce the efficiency of cross-system settlement”. More detailed recommendations on the standard will be provided in the assessment methodology.

ANNEX: LIST OF RESPONDING ORGANISATIONS

- (1) Association Française des Entreprises d'Investissement (AFEI)
- (2) Association of Danish Mortgage Banks
- (3) Association of Global Custodians
- (4) Banca Intesa
- (5) Barclays
- (6) BNP Paribas
- (7) Borsa Italiana Group
- (8) British Bankers' Association (BBA)
- (9) Bundesverband der Deutschen Volksbanken und Raiffeisenbanken
- (10) Bundesverband Deutscher Banken
- (11) Citigroup
- (12) Deutsche Börse Group
- (13) DnB NOR Bank
- (14) Euroclear
- (15) European Association for Listed Companies (EALIC)
- (16) European Association of Central Counterparty Clearing Houses (EACH)
- (17) European Central Securities Depositories (ECSDA/CEECSDA)
- (18) European Financial Services Roundtable (EFR)
- (19) European Savings Banks Group
- (20) European Securities Forum
- (21) Federation Bancaire de L'Union Europeenne (FBE)
- (22) Federation Bancaire Francaise (FBF)
- (23) Finnish Bankers' Association
- (24) French Association of Securities Professionals (AFTI)
- (25) Hellenic Bank Association
- (26) Hessian Ministry of Economics, Transport and Regional Development
- (27) Iberclear
- (28) Italian Banking Association (ABI)
- (29) KAS BANK
- (30) London Investment Banking Association (LIBA)
- (31) London Stock Exchange (LSE)
- (32) Nordea Banks
- (33) Omgeo
- (34) SEB Sweden
- (35) State Street Bank
- (36) Svenska Handelsbanken
- (37) UBS
- (38) Verband der Auslandsbanken in Deutschland
- (39) VP Securities Services