



COMMUNICATING THE FUTURE

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Policy paper

## Eurozone payment and securities settlement systems interdependence:

Will consolidation initiatives lead to contagion; who is accountable?

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**The research project:**

***John Gilchrist is the sole sponsor of this research project and the cost of the research and interviews and any related expenses have been borne by reGEN to ensure independence.***

**The audiences:**

*There are many 'market forces' institutions interested in this subject as are many supervisors and overseers. However, given the second premise<sup>1</sup> and the vital role that Eurozone payment systems in society, it is considered that such a fundamental public policy issue will be of interest to a wider variety of audiences, spanning trade, industry and commerce.*

***Further, in the absence of clear delegated power, it is considered appropriate to use this policy paper to bring the issue of the convergence of PSs and Payments Embedded SSSs and the combining of Eurozone activities with non-Eurozone ICSD activities thus exposing the Eurozone to risk<sup>2</sup>, to the highest ranking EU authority<sup>3</sup> so that they can make an informed decision on consolidation; if something goes wrong, they may well be held to account.***

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<sup>1</sup> The second premise: 'that combining Eurozone with non-Eurozone activities, as is the case with current Payments Embedded SSS/ICSD consolidation initiatives, gives rise to unnecessary risk and creates the potential for Eurozone contagion'.

<sup>2</sup> Whereas the Eurozone activities are able to benefit from various EU arrangements, non-Eurozone ICSD activities rely on international contract law and a complex web of contracts, agreements and procedures – in legal terms it consists of thousands and thousands of pages – all of which would need to be independently reviewed to assess risk to the 'system'.

<sup>3</sup> The Council of Ministers is the highest level political committee composed of ministers from Member States. The ministers responsible for a certain policy area will meet to discuss measures relating to that area. For example, the ECOFIN Council, composed of economics and finance ministers, meets to discuss measures relating to economics and finance.



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## List of abbreviations

CCP	Central Counterparty
CESR	Committee of European Securities Regulators
CSD	Central Securities Depository
The Commission	European Commission
The Council	The EU Council of Ministers
DVP	Delivery versus payment
ECB	European Central Bank
ESCB	European System of Central Banks
EU	European Union
FSAP	Financial Services Action Plan
GTCs	General Terms and Conditions
ICSD	International Central Securities depository
NCB	National Central Bank
PS	Payment System
Payments Embedded SSS	Payments Embedded Securities Settlement System
RTGS	Real-Time Gross Settlement
TARGET	Trans-European Automated Real-time Gross Settlement Express Transfer system

## Highlights

The purpose of this paper is to examine the interdependence of Eurozone payment systems (PSs) and securities settlement systems (SSSs) the latter hereafter generally referred to as Payments Embedded SSSs.

- *The findings of this paper are summarised by two premises.*
  - *The first: by redefining SSSs as Payments Embedded SSSs allows for ‘legal certainty’ at the European and national level, using existing EU treaties and protocols and oversight mechanisms as used by the ECB, ESCB and NCBs, and;*
  - *the second, that combining Eurozone with non-Eurozone activities, as is the case with current Payments Embedded SSS/ICSD consolidation initiatives, gives rise to risk and creates the potential for Eurozone contagion.*
- Eurozone Payments Embedded SSSs are *essential infrastructures* whose fate cannot be left to squabbling *intermediaries* such as agent and custodian banks, investment banks, ICSDs and stock exchanges; that is not good governance at EU level.
- The highest ranking EU authority is urged to intervene so that they can understand the risks being run in combining Eurozone and non-Eurozone activities as is currently the case in Payments Embedded SSS/ICSD consolidation initiatives; in the absence of clear delegated authority, it is they who may be held to account in the event of a failure.
- *Consolidation of Eurozone Payments Embedded SSSs and issues arising in respect of their integration with non-Eurozone ICSD activities must be supervised by an appropriate EU body with a clear mandate.*
- If work commenced today to define a Securities Settlement Directive, its path would be political and hazardous and take upwards of four years during which time consolidation initiatives will give rise to continual perceptions and accusations of abuse and increase the potential for Eurozone contagion.
- There should be a shared vision of a single Eurozone Payments Embedded SSS utility.
- The use of the term ‘system’ in PS and Payments Embedded SSS refers to a governance/legal structure, which should be regarded as having five distinct components when it comes to the assessment of risk and to ensure appropriate supervision, namely; an operator, participants, technical agents and suppliers, rules and contracts and, a legal and regulatory environment.
- The Eurozone must create a solution based on ‘legal certainty’ where supervisors fully understand all aspects of risk impacting ‘system’ operators and their technical agents.
- In the context of Payments Embedded SSSs, European legal arrangements, contracts and rules should combine to create ‘legal certainty’. For this reason Payments Embedded SSSs’ business activities should be restricted to the Eurozone. It should be noted that ICSDs use international contract law as a basis for their risk management – this is complex and cannot be regarded as ‘legally certain’.
- The legal environment governing Eurozone Payments Embedded SSSs should be covered by European treaties and protocols, directives and any complementary national legislation and progressively simplified over time as an EU objective. The ECB, ESCB and NCBs should subject Payments Embedded SSSs to appropriate oversight as is currently the case with PSs. Payments Embedded SSSs should adopt the same risk-averse approach.
- ICSDs operate under international contract law, using a plethora of complex contracts, master agreements, service level agreements, operating instructions, and manuals of procedure, impacting participants, technical agents, and key suppliers located in many countries, spanning many different market practices and regulatory requirements.
- In the context of this paper, a Payments Embedded SSS relates to a utility organisation which provides RTGS and collateral for monetary policy operations where such has been notified to the Commission; these systems are deemed to have converged with PSs. In this context, agent and custodian banks and ICSDs, as credit institutions, are very different.
- There is a fundamental difference between a Payments Embedded SSS and agent/custodian banks and ICSDs. The former is *infrastructure* (essential to PSs and financial stability), the latter are *intermediaries and credit institutions*; CESR – ESCB must give due regard to this difference between infrastructure and credit institutions as intermediaries in respect of financial stability and contagion; the first should fall under the ECB/ESCB mandate, the latter under prudential supervision, each held to account.
- The mechanism for the ICSD’s risk mitigation process is complex. Participants have to accept and sign the ICSDs’ contractual GTCs while the ICSDs place obligations on their cash correspondent and domestic intermediary banks using a combination of contract and manuals of procedure; in this way they seek to avoid risk.

## Highlights (continued)

- The world of the ICSDs is essentially built around legal engineering and a complex web of contracts, interlinking participants in around 80 countries to over forty national markets, using key technology and custodian and cash correspondent banks to effect settlement; it's innovative but not without risk. This web of contracts could rightly be perceived as '*constructive ambiguity*', it's transparent but extremely difficult to understand, constructed under international contract law with its foundation often in more than one legal jurisdiction; if successfully challenged in the event of a failure, it could have dramatic consequences.
- Payments Embedded SSSs and PSs have essentially converged; they are inseparable when it comes to concerns in respect of financial stability.
- In the UK, the Bank of England has applied the term Embedded Payment System in describing Crestco and the Banque Centrale du Luxembourg refers to SSSs Embedded with Payments in its oversight policy and procedures.
- In the context of the Eurozone, the Payments Embedded SSS operator should fully control, manage and audit its technical agent where relevant. In the new Euroclear plc proposal, the new operations and technology unit, containing the single settlement engine (Euroclear SA/NV) would own and control the SSSs within the group; this is akin to 'the tail wagging the dog'. The Payments Embedded SSSs should control the technical agents, providing operations and technology; ICSDs should have no involvement.
- Given that Payments Embedded SSSs have efficient technical platforms, it is considered that there should be no need to invest significant amounts of money in new technology platforms; existing platforms should be utilized, shared or licensed.
- The guaranty facility provided by the Deutsche Bundesbank, using Clearstream Banking Frankfurt, is an interesting arrangement between an NCB and a Payments Embedded SSS which overcomes the barrier of a credit institution in one country gaining access to another's NCB. This arrangement could be extended to other Eurozone countries with NCBs providing similar services thus creating an efficient solution, while eliminating a complex barrier.
- ***The Eurozone's critical success factor should be the avoidance of contagion within the Eurozone. This can best be served by ensuring 'legal certainty' within the Eurozone; as such, all non-Eurozone business should be isolated.***
- Valuation has become a barrier with the Euroclear Group and Deutsche Boerse Group/Clearstream valued at billions of Euros, deterring other Eurozone Payments Embedded SSSs from participating. Payments Embedded SSSs should be independent not-for profit utilities. This may eliminate barriers caused by valuation and conflict of governance, allowing for further consolidation of Eurozone Payments Embedded SSSs.
- Consolidation cannot be left to market forces. As ***essential infrastructure***, the Eurozone Payments Embedded SSS utilities, whether merged or stand alone, should be independent and protected from risks coming from non-Eurozone activities. As Payments Embedded SSSs, under ECB and ESCB related treaties and protocols, they should operate as non-banks with governance arrangements appropriate to a utility. While a failure of a Payments Embedded SSS should be regarded as extremely improbable under these arrangements, it should be appreciated that the issue of lender of last resort may become clearer, even if based on central bank mentality of constructive ambiguity.
- ***The highest EU authority is urged to implement a pragmatic solution, using existing European treaties and protocols to oversee Payments Embedded SSSs whereby the ECB, ESCB and NCBs have responsibility.***

***Will consolidation initiatives lead to contagion; who is accountable?***

***Why take the risk; the highest ranking EU authority needs to intervene, grant powers to the ECB and ESCB in respect of Payments Embedded SSSs, before current consolidation initiatives progress further; time is of the essence.***

## Purpose

The purpose of this paper is to examine the interdependence of payment systems (PSs) and securities settlement systems, the latter hereafter referred to as 'Payments Embedded SSSs', in the Eurozone; it concludes that the primary functionality of PSs and Payments Embedded SSSs has fundamentally changed with the introduction of the Euro.

Further, the paper analyses current consolidation initiatives between Payments Embedded SSSs and international central securities depositories (ICSDs)<sup>4</sup>

It concludes that their solutions are flawed and give rise to the potential for contagion within the Eurozone. It is believed that the interdependence of PSs and Payments Embedded SSSs has been clouded by smoke and mirrors with the addition of agent and custodian banks and CCPs and as such the paper discusses accountability in the event of a failure if current consolidation initiatives, combining Eurozone and non-Eurozone clearing and settlement activities, are allowed to proceed unhindered.

The paper proposes that Eurozone PSs and Payments Embedded SSSs have converged and must be independent utilities<sup>5</sup> to benefit fully from relevant Eurozone arrangements to create 'legal certainty'<sup>6</sup>. This can be achieved by placing Payments Embedded SSSs under the oversight of the European Central Bank (ECB), European System of Central Banks (ESCB) and National Central Banks (NCBs) using the arrangements governing PSs.

## Introduction

The regulation of the capital markets and the global diversity of commercial and infrastructure organisations, which support them, is a daunting task; the baggage of history carried by each national market wherein market practices, laws, regulations and cultures are all different does not make this easier. Within Europe, it is generally accepted that such national differences be eliminated and a more harmonised approach to regulation adopted. It is, however, somewhat ironic that we have to introduce a whole new corpus of legal arrangements and regulation, in order to remove the obstacles to a single market in financial services. Indeed in the grand European scheme, the European Council set the European Union (EU) an ambitious goal to become the most competitive economy by 2010. A significant component of

The findings of this paper are summarised by two premises.

The first: by redefining SSSs as Payments Embedded SSSs allows for 'legal certainty' at European and national level, using existing EU treaties and protocols and oversight mechanisms as used by the ECB, ESCB and NCBs, and;

the second that combining Eurozone with non-Eurozone activities, as is the case with current Payments Embedded SSS/ICSD consolidation initiatives gives rise to risk and creates the potential for Eurozone contagion.

Eurozone Payments Embedded SSSs are **essential infrastructures** whose fate cannot be left to squabbling **intermediaries** such as agent and custodian banks, investment banks, ICSDs and stock exchanges; that is not good governance at EU level.

***Consolidation of Eurozone Payments Embedded SSSs and issues arising in respect of their integration with non-Eurozone ICSD activities must be supervised by an appropriate EU body with a clear mandate.***

***The should be a shared vision to create a single Eurozone Payments Embedded SSS utility.***

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<sup>4</sup> The ICSDs referred to in this paper are Euroclear Bank and Clearstream Banking Luxembourg both located in Eurozone countries and for-profits motivated credit institutions. For completeness there is a third ICSD, SIS, located outside of the Eurozone in Switzerland.

<sup>5</sup> Payments Embedded SSSs are described in this paper as non-bank utilities which are governed as not-for-profit entities given that their primary role is the management and mitigation of risk; they would be subject to ECB, ESCB and NCB oversight.

<sup>6</sup> 'Legal certainty', is used throughout this paper to describe the use of existing legal arrangements being applied to the ECB and ESCB and relevant directives (Settlement Finality and Collateral) and Conventions (Hague) and any complementary national laws being applied to Payments Embedded SSSs.



this is the integration of the European financial market with an established deadline of 2005 for the completion of the Financial Services Action Plan (FSAP), which is a set of some 42 legislative and non-legislative measures.

However, when it comes to clearing and settlement, apparently, 'consolidation should be left to market forces'. Let's be honest, at the European level, the regulators do not appear to have the power to intervene; they have to rely on moral suasion and ambiguity, standards, rules, and regulations to influence settlement providers and operators. Good governance is cited as essential in the wake of high profile failures.

Good governance is also appropriate at the EU level when it comes to Payments Embedded SSSs, given their interdependence with PSs. Within the Eurozone, the hierarchy of power has a solid foundation so surely good governance in the form of leadership, delegation of authority, accountability and control must be a more appropriate approach than 'consolidation should be left to market forces'.

The highest ranking EU authority is urged to intervene so that they understand the risks being run in combining Eurozone and non-Eurozone activities as is currently the case in Payment Embedded SSS/ICSD consolidation initiatives; in the absence of clear delegated authority, it is they who may be held to account in the event of a failure.

Payments Embedded SSSs have developed an affinity with PSs, TARGET (Trans-European Automated Real-time Gross settlement Express Transfer system) and monetary policy operations. Central bank mentality and attitude to risk is of fundamental importance in seeking a logical solution to clearing and settlement.

This paper analyses the current issues, and the direction the Eurozone consolidation scenario is moving in and concludes that combining Eurozone Payments Embedded SSSs with non-Eurozone ICSD business activities risks failure as a result of contagion.

## Background

PSs and CSDs were established with national aims and arrangements, each country adopting variations in laws and regulations, market practices and processing mechanisms. These two systems were independent with the PSs protected by common rule which required the cash leg of a transaction to settle first; this to protect the payment system and the national central bank (NCB) from any risks, which may have materialized in, for example, securities settlement. This was hardly an ideal basis for the Eurozone.

The launch of the Euro required the re-examination of the infrastructure which would support it, for effecting payments and for mobilizing collateral; the protection of the PS and central banking mechanism remains a critical success factor. Further, the planned introduction of the single currency accelerated efforts to harmonise and consolidate PSs while the increasing role of the respective national CSD or SSS utilities within the payment system process was becoming clearer; they were fundamental to the management of risk in monetary policy operations.

The creation of TARGET established an EU-wide mechanism for central bank operations, regional and domestic interbank transfers; it remains an essential vehicle, creating a single Eurozone money market<sup>7</sup>.

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<sup>7</sup> There is only one privately owned and operated EU-wide payment system, processing interbank and commercial payments; this is operated by the European Banking Association and called Euro 1 which is subject to ECB and ECSB oversight.

## Systems

The term system is much abused; it can have many different applications and therefore definitions.

Since one of the main interests of a supervisor is systemic risk, or factors giving rise to systemic risk, the question arises - what constitutes a system? A 'system', in the context of PSs and Payments Embedded SSSs, should be regarded as a governance/legal structure, having five distinct components, namely, an operator, participants, technical agents and suppliers, rules and contracts and, a legal and regulatory environment.

Supervisors' interest are in systems, which individually or cumulatively involve large amounts of funds for payments or against payment securities settlement and which are necessary for monetary policy operations and the mitigation of risk within them. Similarly supervisors are interested in the operators of any such systems where the participants do, or have the potential to, incur significant involuntary exposures to one another when engaged in payment, or against payment securities settlement activities or could have system-wide consequences, even if the values involved do not give rise to major systemic risks.

The supervisor of a system must be interested in many forms of risk and concerns need to be identified, quantified, and understood by the various constituencies, which comprise the system. As well as the concern for the operator and its operational and IT infrastructure, the supervisor needs to understand the legal framework governing the system as well as understanding participant contracts, operator rules, operating procedures as well as reviewing proposals for changes. In addition, the supervisor should ensure the monitoring of changes in the scale or nature of the payments or, where relevant, the securities processed against payment and changes to operator management procedures.

This is essential in the context of defining risk and therefore examining aspects of Eurozone financial stability and the potential for contagion.

### The operator

The operator<sup>8</sup> is the Payments Embedded SSS' legal entity, providing products and services to participants, often using technical agents and suppliers and operating in a legal and regulatory environment which can be wider than the home state, e.g. the Eurozone.

As a Payments Embedded SSS, the operator would be notified to the Commission by the relevant national supervisor, and be able to provide services for TARGET monetary policy operations and benefit from any EU arrangements e.g. The Settlement Finality Directive.

The use of system in PS and Payments Embedded SSS refers to a governance/legal structure, which should be regarded as having five distinct components when it comes to the assessment of risk and to ensure appropriate supervision, namely;

- An operator,
- participants,
- technical agents and suppliers,
- rules and contracts and,
- a legal and regulatory environment.

The Eurozone must create a solution based on 'legal certainty' where supervisors fully understand all aspects of risk impacting systems, operators and their technical agents.

ICSDs operate under international contract law, using a plethora of complex contracts, master agreements, service level agreements, operating instructions, and manuals of procedure, impacting participants, technical agents, and key suppliers, located in many countries, spanning many different market practices and regulatory requirements.

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<sup>8</sup> For operators (and technical agents), particular emphasis should be placed on admissions, governance, customer manuals relating to products and services, IT, risk and risk mitigation, business continuity and external audit.

## Participants

Participants are the customers or clients of the Payments Embedded SSS which have contractual arrangements setting out obligations between participant and operator. The main users would be credit institutions effecting settlement in central bank money at the NCB and mobilizing collateral for monetary policy operations. Other Eurozone Payments Embedded SSSs and under central bank oversight of the relevant NCB, could also be participants.

## Technical agents

Technical agents (see footnote<sup>8</sup>) are deemed to be important for reasons of efficiency or stability and as such subject to NCB oversight. A technical agent is a supplier of service where an operator of a PS or Payments Embedded SSS has located a significant portion of its operational or IT infrastructure or where several payment- or securities settlement-related operational or IT infrastructures are centralized.

In the context of the Eurozone the Payments Embedded SSS operator should fully control, manage and audit the technical agent.

Lists of suppliers deemed to be providing essential services in the conducting of an operator's/technical agent's business should also be identified. Such suppliers would include important suppliers of IT hardware or architecture services, or other financial intermediaries as used by the operator/technical agent.

## Contracts and rules

Contracts include those necessary for the efficient functioning of the operator/technical agent e.g. contracts with participants, suppliers, insurance companies and IT hardware or architecture providers, among others.

Rules include procedures, which govern the efficient functioning of the operator/technical agent and include participants' handbooks, product and services instructions, suppliers' operating manuals and master or service level agreements among others.

In the context of Payments Embedded SSSs, European legal arrangements, contracts and rules should combine to create 'legal certainty'. For this reason Payments Embedded SSSs' business activities should be restricted to the Eurozone. It should be noted that ICSDs use international contract law as a basis for their risk management – this is complex and cannot be regarded as 'legally certain'.

## Legal/regulatory environment

The legal and regulatory environment would be defined by European arrangements, treaties, protocols and directives and any complementary national arrangements effected to comply with European arrangements.

The legal environment governing Eurozone Payments Embedded SSSs should be covered by European treaties and protocols, directives and any complementary national legislation and progressively simplified over time as an EU objective.

The ECB, ESCB and NCB should subject Payments Embedded SSSs to appropriate oversight as is currently the case with PSs. Payments Embedded SSSs should adopt the same risk-averse approach.

## Payment systems

A PS is an arrangement, which allows the users of the system to transfer funds. In today's rapidly changing financial markets, which have witnessed significant growth and change, central banks pay particular attention to PSs handling large-value payments. They have played an active role in the design and operation of such PSs, concentrating on the development of real-time gross settlement systems, which are considered to be the safest and most efficient PSs for large-value payments. It is widely understood that PSs are a critical component of the infrastructure of global financial markets.

Central to payment activities are the arrangements that facilitate the transfer of funds between the participants (those intermediaries which connect directly to the central operator or to each other). It is these arrangements, which constitute a PS. They include the networks, which link participants, the message routing systems, and the infrastructure contracts, rules and procedures. PSs and the central banks which oversee them are risk averse.

Risks in PSs take a variety of forms and are usually categorised as follows:

- **Credit risk:** the risk that a counterparty will not meet an obligation for full value, either when due or at any time thereafter.
- **Liquidity risk:** the risk that a counterparty will not settle an obligation for full value when due, but at some time thereafter.
- **Operational risk:** the risk that hardware or software problems, or human error, or malicious attack will cause a system to break down or malfunction giving rise to financial exposures and possible losses.
- **Legal risk:** the risk that unexpected interpretation of the law or legal uncertainty will leave the payment system or members with unforeseen financial exposures and possible losses.

In fulfilling its role an NCB will subject PSs to requirements, rules and regulations which are generally referred to as 'oversight'; a process which at the national level relies less on law but more on 'morale suasion'. This should not be confused with the role of the national prudential supervisor which fulfils its duty under national law. Oversight shares with prudential supervision the objective of financial stability. However, while prudential supervision conducts its surveillance at the institutional level, oversight looks at 'systems'.

At the national level no one would contest the NCBs' authority in respect of PSs.

## Payments Embedded SSSs

Historically, a utility providing securities settlement was referred to as a recognised clearing house or a central securities depository (CSD). Since the launch of the Euro, these terms have been replaced with preference given to the term 'securities settlement system'. Payments Embedded SSSs provide real-time exchange of cash and securities and the mobilisation of collateral for monetary policy operations.

Payments Embedded SSSs are critical components of the Eurozone. Weaknesses in Payments Embedded SSSs can be a source of systemic disturbances to securities markets, PSs and other Payments Embedded SSSs (systemic ripple).

Payments Embedded SSSs should be defined in a similar way to PSs with:

- agreed standards for, and mechanisms of transmitting securities (whether for RTGS or the movement of collateral) and payments messages between participants and, an agreement on the technical standards of the infrastructure;
- an agreed procedure of settling claims between participants, usually in the form of a safe settlement asset and,
- commonly agreed operating procedures and rules covering, for example, admission, and fee structures.

## International central securities depositories

The ICSDs, Clearstream Banking Luxembourg and Euroclear Bank, are unlike their national counterparts. They found their core business in the professional wholesale market for the cross-border processing of eurobonds and subsequently, internationally traded domestic instruments and between them they had largely overcome the barriers and managed the risks associated with this international market. The main reasons for this distinctive capability are as follows:

The mechanism for the ICSD's risk mitigation process is complex. Participants have to accept and sign the ICSDs' contractual general terms and conditions while the ICSDs place obligations on their cash correspondent banks and domestic intermediary banks, using a combination of contract and manuals of procedure; in this way they seek to avoid risk.

- there was a clear need, arising in the Eurobond market, for an efficient competitive solution which was based on the need to manage the risks inherent in cross-border processing,
- the innovative use of international contract law and the modern legal frameworks, in terms of financial services, of Belgium and Luxembourg, and;
- end to end contractual arrangements; customers GTCs, cash correspondent and agent banks (obliged to sign ICSD's contracts which included detailed manuals of instructions and operating procedures) to overcome the differences experienced in domestic market rules, practices and law.

Whereas, the ICSDs were gaining credit institution status, expanding globally into emerging and re-emerging markets using local depository banks and favouring commercial bank money and cash correspondent banks to effect payment and provide liquidity, the national Payments Embedded SSSs found themselves moving closer and closer to RTGS in central bank money as a way of mitigating risk and improving efficiency.

Further, while ICSDs based their system on internal book-entry transfer DVP with the simultaneous exchange of cash and securities within each system, this could not be replicated in the ICSDs' domestic links since their securities settlement was dependent on the settlement timescales and practices of the domestic market.

There is another aspect of interlinking – the so-called electronic Bridge between the ICSDs. This has allowed participants of both ICSDs to conduct business with each other but has been the subject of many disagreements between the two players. In essence vast amounts of business are processed efficiently each day - but there have always been concerns over risk. Further, the ICSDs process the bulk of the Eurobond market with securities administered in so called common depositories usually custodian banks.

The ECB voiced concerns in respect of undue custody risk<sup>9</sup> in respect of Eurobonds being used for monetary policy operations and the provision of collateral in TARGET. While some Eurobonds can be used as collateral for monetary policy operations, the process must now be administered in a national Payments Embedded SSS using a global note to replace those securities held in a common depository; a solution which appears to be more cosmetic than effective. In another settlement quirk, the ICSDs provide credit finance and securities lending facilities for 'fails management' so it is possible to settle a trade when counterparties have neither cash nor securities. The ICSDs have also diversified their offerings into tripartite repo, strategic securities lending and fund processing activities; services that national Payments Embedded SSSs would find challenging to say the least.

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<sup>9</sup> Standards for the use of EU securities settlement systems in ESCB credit operations. Standard 3: To limit custody risk as much as possible, SSSs must have a unique and direct relationship with the issuer or a direct link with an SSS which has this relationship. Where use is made of a depository, the SSS which has a direct link with the depository of the global or individual certificates shall be regarded as having a direct and unique relationship with the issuer, provided that there are adequate safeguards against custody risk.

## The EU legal and regulatory environment<sup>10</sup>

Prior to the introduction of the Euro, the legal and regulatory environment governing PSs and CSDs was a national process, producing many variations and therefore inconsistencies; again hardly a sound basis for the Eurozone.

### ECB and payment systems

While, the introduction of the Euro galvanized the NCBs in terms of cooperation whereby the ECB and the ESCB drew down powers from various EU treaties and protocols, their national prudential supervisory counterparts had no similar framework. At the European level the ECB and ESCB have undisputed powers governing PSs<sup>11</sup>.

### Clearing and settlement

Community legislative procedures are relatively complicated and 'Community Method', as it is generally referred to, gives the European Commission (the Commission) the exclusive right of legislative initiative, therefore it has the right to draft the first legislative proposal<sup>12</sup>. The next step is normally for the proposal to be adopted by European Council (the Council) vote. The European Parliament will be involved to a certain extent in making amendments to the proposal and even voting on it.

If work commenced today to define a Securities Settlement Directive, its path would be political and hazardous and take upwards of four years during which time consolidation initiatives will give rise to continual perceptions and accusations of abuse and increase the potential for Eurozone contagion.

The Treaty defines a number of legislative procedures which can be used;

- The Council and Commission can legislate together, without the participation of the Parliament; the Council would vote on the proposal from the Commission.
- In other areas, the Commission can legislate alone; this is rare.
- In some areas, where Articles permit the Council and the Commission to legislate without the involvement of the Parliament, the Council delegates its legislative power to the Commission.
- Several other procedures involve varying degrees of participation by the Parliament.
- The most complicated procedure is the co-decision procedure which is set out in Article 251 and under this procedure the role of the Parliament in the legislative process is considerably increased.

There is one further process used which has a bearing on the FSAP which is generally referred to as the 'comitology procedure' The Council has the power to establish committees which work together with the

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<sup>10</sup> This section draws on Chapter 1.4 of 'A Practitioner's Guide to EU Financial Services Directives' issued by City & Financial Publishing.

<sup>11</sup> Article 105.2 of the Treaty and Article 3 of the Statute ... 'the basic tasks to be carried out through the ESCB shall be: ... to promote the smooth operation of payment systems',

Article 105.5 of the Treaty which provides that 'the ESCB shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system' and,

Article 22 of the Statute according to which 'The ECB and national central banks may provide facilities, and the ECB may make regulations, to ensure efficient and sound clearing and payment systems within the Community and with other countries'

<sup>12</sup> Articles 192(2) and 208 give rights to the European parliament and the European Council respectively, the right to request the Commission to submit proposals to it, providing a counterbalance to the EC's right of initiative.

Commission in the preparation and adoption of legislative measures in question; the use of committees in this way is referred to as ‘comitology’. This is relevant in the context of the FSAP because of proposals, put forward in the report of the Committee of Wise Men, more commonly referred to as the Lamfalussy Procedure. This proposed a four-tier approach to European securities regulation, with two new committees, the European Securities Committee and the Committee of European Securities Regulators (CESR). This four-tier approach appears straightforward enough with Level 1 consisting of legislative acts, Level 2 covering implementing measures and in turn Level 3 comprises measures to improve the common and uniform implementation of Levels 1 and 2. At level 4 the European Commission will strengthen the enforcement of Community law in this area.

This is significantly more complex than the equivalent treaties and protocols governing the ECB, ESCB and PSs. It is interesting to note that while the Settlement Finality Directive and Collateral Directive have had relatively easy passage in no small part because of the need for these to be applied to avoid risk in TARGET and monetary policy operations, the Investment Services Directive, which attempted to include securities settlement, has floundered.

The legal and supervisory framework governing ICSDs business is complex, relying on a combination of prudential supervision and oversight and on international contract law as the main basis for protection against risk. Both ICSDs are located within the Eurozone, and whereas their Eurozone business activities are protected by the various EU arrangements, their international or non-Eurozone business is not.

The world of the ICSDs is essentially built around legal engineering and a complex web of contracts, interlinking participants in around 80 countries to over forty domestic markets, using key technology or custodian and cash correspondent banks to effect settlement; it’s innovative but not without risk. This web of contracts could rightly be perceived as ‘*constructive ambiguity*’ – it’s transparent but extremely difficult to understand, constructed under international contract law with its foundation often in more than one legal jurisdiction; if successfully challenged in the event of a failure it could have dramatic consequences.

## Current situation

Without leadership there is no vision; so who leads? Without legal protection there is the potential for risk; so who has responsibility for financial stability? And without clear rules and regulations there is the likelihood of abuse; so who has overall responsibility for creating a level playing field or for anticompetitive concerns arising? In a Europe full of unanswered questions, there are few volunteers for acting as lender of last resort in the current consolidation scenario. The focus of attention should be on PSs which play a critical role in the global financial infrastructure. Likewise, Payments Embedded SSSs have assumed a similar level of importance. That said, as it stands, the ECB and ESCB has no legal mandate for such systems. So if they are not responsible who will be held to account in the event of a failure? The responsibility for Payments Embedded SSSs must be assumed to reside with the highest ranking EU authority; as such they may be held to account in the event of a failure. PSs are too important to the financial stability of the Eurozone and beyond to expose them to risk and potentially to contagion arising in Payments Embedded SSSs if combined with ICSD activities.

In the absence of delegated powers, the highest ranking EU bodies are urged to fully understand the risks in combining Eurozone Payments Embedded SSSs protected by Eurozone arrangements and non-Eurozone ICSD activities covered by international contract law. Only then would they be aware of the implications of such consolidation.

It is generally accepted that clearing and settlement has risen above the category of back office plumbing and today Payments Embedded SSSs have attracted the interest of investors, credit

Efficiency is all well and good in terms of lower cost and better service but what if it comes at the cost of financial stability and fair play?

institutions, and regulators alike. No one can disagree with the striving for Eurozone efficiency that has driven the consolidation initiatives; it seems to be the main aim of many market players, hardly surprising when profits are under pressure or when comparisons are made with the US. These three aims, stability, efficiency and fair play, seem obvious requirements, and were taken for granted in the national markets of yesteryear but they appear to be in conflict when it comes to current Eurozone clearing and settlement consolidation initiatives and legal arrangements.

Payments Embedded SSSs are important and should be regulated in an appropriate way; they should strive to ensure financial stability and seek to avoid contagion, be efficient in terms of speed and cost rather than slow or expensive and they should provide free and fair access rather than be closed or restrictive. In other words Payments Embedded SSSs should provide a common stable, efficient and fair system; they should be protected by arrangements offering 'legal certainty' and protect themselves from contagion.

Payments Embedded SSSs and PSs are inseparable when it comes to financial stability.

TARGET serves as the primary mechanism for the Eurozone, overseen by the ECB and ESCB. There are also a number of complementary national Euro PSs, e.g. RTGS-L in Luxembourg and TBF in France; these are under the oversight of the respective NCB and aligned to the ESCB.

The Payments Embedded SSSs have no single overall Eurozone mechanism, although they provide essential services for TARGET, for monetary policy operations and the provision of collateral. Further, at the national level, Payments Embedded SSSs provide euro currency securities settlement in central bank money using RTGS, providing for the immediate reuse of cash and securities. These are privileged systems typically notified to the Commission so that they benefit from the provisions of any current and future directives, e.g. the settlement finality directive. In reality these Payments Embedded SSSs have become indistinguishable from PSs when it comes to financial stability.

Payments Embedded SSSs are essential components of the Eurozone payment system infrastructure and therefore important to financial stability; it is essential to protect them from the impact of contagion. In reality, there is a fundamental difference between Payments Embedded SSSs when compared to a complex mix of services supplied by investment, agent, custodian banks and ICSDs. Each offer distinctive solutions to clearing and settlement.

The first, Payments Embedded SSSs as an *infrastructure*, argues its case by providing RTGS in central bank money with the immediate and safe reuse of cash and securities – and by mobilising collateral.

The second uses complex *intermediary* combinations (investment, agent custodian banks and ICSDs), which glue together the very different market practices, cultures and tax treaties for investors moving cross-border. The ICSDs have critical mass in the Eurobond market and a very significant share of domestic bonds which are traded internationally; they have a relatively small market share in cross-border equity processing. In establishing settlement links, the ICSDs use agent and custodian banks to represent their interests in the various national markets around the world and, in turn, the agent and custodian banks are customers of the ICSDs, providing a substantial amount of their business. The agent and custodian banks have gained the high ground in cross-border equity processing.

This rather happy arrangement between agent and custodian banks and ICSDs appeared calm. However, that was the recent past. Since then, the Payments Embedded SSS/ICSD combinations have begun the consolidation process by merging – Euroclear Bank with the Payments Embedded SSSs in France, Belgium and the Netherlands - Clearstream Banking Luxembourg with the German Payments Embedded SSS. Some of the agent and custodian banks, under the banner Fair & Clear, have openly voiced concerns about potential unfair advantages being derived by the ICSDs given their control over Payments Embedded SSS.



Combining Payments Embedded SSS and ICSD is fundamentally flawed – the protection offered to securities clearing and settlement in the Eurozone is very different to that offered by complex international contract law arrangements as used by the ICSDs in their non Eurozone business activities – the latter is considerable. Can it really be said that providing settlement in, for example, Asian or South American debt and equity markets carries the same risk as the Eurozone, bearing in mind that the settlement finality directive and collateral directive are regarded as essential requirements to protect the Eurozone? There must be concerns over the safety of such contractual arrangements in the event of, for example, the insolvency of ICSDs’ custodian or cash correspondent banks in a market which lies outside of the Eurozone, giving rise to the potential for Eurozone contagion.

## Convergence

The Euro created an interesting challenge for central banks and their PSs. While the ECB and ESCB struggled to come to terms with TARGET’s dependence on Payments Embedded SSSs for monetary policy operations, the NCBS were insisting Payments Embedded SSSs adopt RTGS in central bank money as a way of reducing risk.

While it was generally accepted that PSs and Payments Embedded SSSs had become interdependent, two countries, the UK and Luxembourg publicly recognized this change.

In the UK the Bank of England has applied the term Embedded Payment System in describing Crestco and the Banque Centrale du Luxembourg refers to SSSs Embedded with Payments in its oversight policy and procedures.

In reality, only certain clearing and settlement functionality has converged and this relates to Eurozone transactions and the use of Eurozone collateral for monetary policy operations; like PSs this functionality relates to *infrastructure* and as such has become subject to central bank oversight in at least two countries.

The clearing and settlement functionality provided by agent and custodian banks and ICSDs has not converged with PSs; it is an *intermediary* functionality conducted by credit institutions which are subject to prudential supervision.

## Eurozone consolidation

The consolidation scenario is complex and the first movers, Clearstream Banking Luxembourg and Euroclear Bank, having merged with various European Payments Embedded SSSs, have not found it an easy process. Attempting to reconcile the expectations of the various stakeholders demonstrates the potential for conflict when an institution responds to a call for efficiency in terms of economies of scale, processing speed and cost while other stakeholders focus on financial stability and fair play and abuse of position.

Euroclear plc has been the front runner in the consolidation process and following its landmark merger with Sicovam (now Euroclear France), it merged with Necigef (now known as Euroclear Netherlands) and effected an agreement to insource the Central Securities Depository (CSD) activity of CIK (Belgium) from Euronext. Last year it finalized the merger of CRESTCo.

Euroclear plc, recently announced restructuring proposals, ‘to maximise client protection against systemic risk’ – but is this really the case? Euroclear plc plans to establish a new Belgian-based company called Euroclear SA/NV which would own and operate the so called Single Settlement Engine and provide shared services to all Euroclear group entities. It is also proposed that Euroclear Bank, (a credit institution), and each

In the new Euroclear plc proposal, the new operations and technology unit, containing the Single Settlement Engine (Euroclear SA/NV) would own and control Payments Embedded SSSs within the group; this is akin to ‘the tail wagging the dog’. The SSSs should own and control the operations and technology units; ICSDs should have no involvement.

of the national Payments Embedded SSSs (non-banks) - CRESTCo, Euroclear France and Euroclear Netherlands - would become sister subsidiaries of the new company.

While Euroclear is restructuring its governance arrangements, Clearstream Banking Frankfurt (CBF), a national Payments Embedded SSS, has announced payments interoperability.

The Deutsche Bundesbank has introduced a guarantee facility, allowing trading firms from participating countries to use central bank liquidity at their home central bank to secure securities transactions in CBF's night-time processing.

This is another example that Payments Embedded SSSs have essentially converged with PSs to respond to 'single market' needs.

Clearstream International with its subsidiaries, Clearstream Banking Frankfurt (a Payments Embedded SSS for domestic securities) and Clearstream Banking Luxembourg (an ICSD) was itself the subject of consolidation when it was acquired by Deutsche Boerse AG, drawing comment from various market spectators about negative aspects of so called 'vertical silos'.

The ICSDs appear to share a common aim of a single settlement engine or technology platform, which integrates the processing of domestic and international securities processing or put another way Eurozone and non-Eurozone clearing and settlement. The concept of this is straight forward enough – to avoid duplication of investment in IT development and related overhead cost and to use a technology push to create standards for clearing and settlement.

The use of a single hybrid<sup>13</sup> technology platform (or Single Settlement Engine) by the ICSDs in the guise of a non-bank subsidiary requires a complex array of master and service level agreements which lays down contractual obligations between it and other subsidiaries or sister companies.

### **Eurozone legal and regulatory environment**

It would be reasonable to imagine that if the ECB, ESCB and the NCBs have regulatory powers for PSs the same should be true for Payments Embedded SSSs; this is simply not the case. Unfortunately when European Treaties and protocols were drawn up, no one anticipated Payments Embedded SSSs.

The interdependence of PSs and Payments Embedded SSSs gives rise to public policy issues in three main areas.

- The **first** relates to the structure of payments systems and Payments Embedded SSSs and the implications for the stability of the Eurozone financial system as a whole.
- The **second** area is a concern for the efficiency and effectiveness of the Eurozone's financial sector in serving the needs of the Eurozone economy in terms of the attractiveness of Europe as a place to do financial business.

The guaranty facility provided by the Deutsche Bundesbank, using Clearstream Banking Frankfurt, is an interesting arrangement between an NCB and a Payments Embedded SSS which overcomes the barrier of a credit institution in one country gaining access to another's NCB. This arrangement could be extended to other Eurozone countries with NCBs providing similar services thus creating an efficient solution, while eliminating a complex barrier.

In reality, operations and IT outsourced to a service provider by Payments Embedded SSSs and by credit institutions could be perceived to be operating in a regulatory void, being more service provider than credit institution; as Technical Agents these must be carefully supervised.

- The **third** area is competition policy, where, as with other significant components of the economic infrastructure, there is a public policy interest in ensuring that a competitive environment exists and that any anticompetitive abuses are curbed.

Of course Article 105.5 states that the ESCB ‘shall contribute to the smooth conduct of policies pursued by competent authorities’ – enter the CESR into the debate. Unfortunately this does not really help.

The ESCB’s role in the CESR is confined to that of observer; it participates but has no voting rights – it must rely on moral suasion<sup>14</sup> to achieve its aims. The ECB has a duty to protect the PSs for reasons of stability and efficiency so why not Payments Embedded SSSs?

In the absence of any clear mechanism for clearing and settlement coming from the complex European legislative process, CESR-ESCB have taken a proactive stance (given the public policy issues above) and have issued standards for clearing and settlement systems in a consultation paper (see Addendum), defining two categories of institution, SSSs (these are referred to in this paper as Payments Embedded SSSs) and custodian banks. Now this creates an interesting scenario.

The inclusion of custodian banks clearly is related to concerns over the sizeable business they conduct in cross-border equity processing, both Eurozone and other internationally settled transactions – and presumably concerns about financial stability.

There is a fundamental difference between Payments Embedded SSSs and custodian banks or ICSDs. The first is *essential infrastructure* the latter are *credit institutions and intermediaries*; CESR – ESCB must give due regard to this difference between infrastructure and credit institutions/intermediaries in respect of financial stability and contagion.

While the standards create a genuine attempt to promote the safety and efficiency of clearing and settlement, they carry no formal EU blessing<sup>15</sup>. While the standards could form a basis for a new directive on clearing and settlement, they are not mandatory and while the regulators can decide to implement them at national level, it is difficult to see how they can be enforced or to understand what sanctions could be placed on regulators choosing to ignore them.

This is a bit like a football referee without a pea in his whistle.

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<sup>13</sup> Hybrid refers to combining Eurozone and non-Eurozone and RTGS and collateral mobility services with commercial bank money and a multitude of credit institution products and services, i.e. Payments Embedded SSS and ICSD products and services on the same IT platform.

<sup>14</sup> An application of pressure, but not force, by an authority (such as the ECB) to get members to adhere to a policy.

<sup>15</sup> CESR-ECB Consultative Report – Standards for securities clearing and settlement systems in the European Union, July 2003: “Although the standards are not mandatory because they do not have Community law status, the relevant regulators, supervisors and overseers will, within their respective competencies, monitor the implementation of the standards”. (point 7)

## Complications

- *The debate on clearing and settlement is being confused, using smoke and mirrors, to avoid the real issue; who is accountable.* The inclusion of agent and custodian banks, ICSDs and CCPs has moved the focus away from the need to protect PSs and the interdependence between them and Payments Embedded SSSs. In essence the debate may be being intentionally clouded when what is required is the delegation of clear powers to relevant EU bodies to make them accountable in the event of failure.
- At the EU level, securities clearing and settlement is being largely conducted in a regulatory void. Whereas a clear EU legal framework exists for PSs, there is no equivalent for Payments Embedded SSSs<sup>16</sup>.
- The importance of Payments Embedded SSSs was foreseen and this can be demonstrated by the ECB and ESCB interest in implementing, for example, the Settlement Finality Directive – but no real action has been taken to ensure an appropriate solution for the Eurozone.
- The absence of clear leadership, means that consolidation is being pushed by ‘for-profits’ motivated bodies which compete for business and seldom agree on such issues while authorities and regulators support the notion that ‘consolidation should be left to market forces’ – this is not good governance at EU level.
- The desire to secure the three aims of financial stability, efficiency and level playing field seem unlikely; indeed in the current consolidation scenario they are clearly in conflict. Indeed, the overriding critical success factor of avoiding contagion in PSs, and the Eurozone appears to be at risk.

## The Eurozone solution

### Mission & basic strategy

#### Overall mission

The overall mission of the Eurozone should be to create a single Eurozone Payments Embedded SSS utility<sup>17</sup> quickly, using existing legal and supervisory arrangements. Clearly such an entity should focus on financial stability and the provision of a level playing field.

The Eurozone’s critical success factor should be the avoidance of contagion within the Eurozone.

This can best be served by ensuring ‘legal certainty’ within the Eurozone; as such all non-Eurozone business should be isolated.

#### Basic strategy

The basic strategy should be to utilize existing Eurozone legal arrangements, i.e. those pertaining to the ECB, ESCB, covering PSs. Payments Embedded SSSs should be brought under relevant ECB, ESCB and NCB oversight and subjected to similar rigorous standards as applied to PSs (which are subjected to Core Principles – see Addendum), e.g. CESR standards for (Payments Embedded) SSSs.

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<sup>16</sup> The Eurobond market was created as a form of regulatory escape, operating in a regulatory void, using ICSDs for post-trade services whereas Payments Embedded SSSs operated under and were often protected by national law.

<sup>17</sup> It is believed that Payments Embedded SSSs would be more persuaded to join forces to create a Eurozone SSS when conflicts (governance and risk mitigation), as is the case with current Payments Embedded SSS/ICSD combinations, are removed; valuation is also a significant barrier.

The governance arrangements for Payments Embedded SSS operators, should be appropriate to that of an *essential infrastructure*.

Where Payments Embedded SSSs have outsourced their IT and operations to a subsidiary or third party, such should be defined as ‘technical agents’ and subjected to appropriate oversight requirements, essentially the same as those applied to the ‘operator’.

Given that most Payments Embedded SSSs have efficient technical platforms, it is considered that there should be no need to invest significant amounts of money in new technology platforms; existing mechanisms should be utilised, shared or licensed.

Given their business interests outside of the Eurozone, ICSDs should not be classified as Payments Embedded SSSs.

## The Eurozone way forward

### Eurozone consolidation

There are several approaches being adopted by Payments Embedded SSSs and ICSDs as they reposition in the Eurozone. The most prominent is the combining of multiple national Payments Embedded SSSs with the Brussel’s-based ICSD, Euroclear Bank; this lists credit institutions, exchanges and central counterparties as shareholders. Next there is the combination of a national Payments Embedded SSS (Germany) with the Luxembourg-based Clearstream Banking Luxembourg (ICSD) both wholly owned by Deutsche Boerse AG. Other Payments Embedded SSSs have chosen to either ‘go-it-alone’ or sit on the fence, adopting a ‘wait and see’ approach, while others are considering diversification. When it comes to governance, many different models are used some vertically integrated, some horizontal, hybrids, some institutions motivated for profit, some self-financing, not-for profit, etc.

In summary there is no prescribed formula for the Eurozone.

### The Eurozone solution

Any Eurozone initiative should be exactly that – limited to the Eurozone and to those Payments Embedded SSSs providing settlement in central bank money and collateral for monetary policy operations; as an *essential infrastructure* they should provide solid PS-related services. Such Payments Embedded SSSs can elect to merge, cooperate or link for the time being; their governing bodies, should be left to decide their preferred route. That said, as like organizations with similar purpose and governance, it is hoped that such entities will merge to create a central *infrastructure* Eurozone Payments Embedded SSS. In the meantime, Eurozone Payments Embedded SSSs should come under the oversight of their respective NCB, thus benefiting from clear legal arrangements provided for in the relevant European treaties and protocols which give clear powers to the ECB and ESCB. Further, EU directives and any agreed standards approved by the Council of the ECB would be uniformly implemented; the Eurozone would have the maximum protection from contagion, contribute to financial stability, be efficient and provide a level playing field for their users.

The ECB, ESCB and the NCBs are able to combine to lay the solid foundation required for Payments Embedded SSSs and to encourage them to merge into a single Eurozone Payments Embedded SSS infrastructure.

## Combining Eurozone and non-Eurozone business

The ICSDs, Euroclear Bank and Clearstream Banking Luxembourg, operate significant business activities outside of the Eurozone. It is interesting that they are described as depositories since they have no vaults and hold no securities; they are in fact just another form of agent or custodian bank, providing *intermediary* services. In the course of their business activities, ICSDs, custodian and agent banks, compete and cooperate and are exposed to and mitigate risks using contractual obligation which is without ‘legal certainty’;

as *intermediary* processes and as credit institutions, agent and custodian banks and ICSDs are subject to prudential supervision. This is particularly relevant given the current consolidation path involving Payments Embedded SSS/ICSD mergers. Such mergers give rise to several issues coming from non-Eurozone business activities.

Whereas Payments Embedded SSSs provide *infrastructure* services and a level playing field, agent and custodian banks and ICSDs compete as *intermediaries*. To allow Payments Embedded SSSs to fall into the hands of any one *intermediary* automatically gives rise to the potential for anticompetitive behaviour and given the monopoly nature of Payments Embedded SSSs as *infrastructure*, to accusations of abuse of position.

Further, the combination of Payments Embedded SSSs and ICSDs may be criticized in respect of *spillover*<sup>18</sup> potentially creating a totally unlevel playing field in respect of other Eurozone Payments Embedded SSSs.

Risk, whereby Eurozone and non-Eurozone business is combined or interlinked in a way that exposes Payments Embedded SSSs to risk or contagion, should be very carefully examined; indeed it seems to be an unnecessary risk. ICSDs utilize very different mechanisms for credit, liquidity, operational and legal risk mitigation.

Valuation has become a barrier with the Euroclear Group and Deutsche Boerse Group/Clearstream valued at billions of Euros, deterring other Eurozone Payments Embedded SSSs from participating. Payments Embedded SSSs should be independent not-for profit utilities. This is considered likely to eliminate barriers caused by valuation and conflict of governance, allowing for further consolidation of Eurozone Payments Embedded SSSs.

The clearing and settlement debate has been clouded with the inclusion of agent and custodian banks, CCPs and ICSDs; their inclusion has moved the focus away from the need to protect PSs and Payments Embedded SSSs.

*In essence the debate may be being intentionally clouded, using smoke and mirrors, when what is required is the delegation of clear powers, to relevant EU bodies to make them accountable in the event of failure.*

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<sup>18</sup> Side effects of an agreement or a merger between two or several firms, which affect competition between them in another relevant market than the one covered by the agreement or the merger in question. Spillover effects are referred to in Article 2(4) of the merger regulation, which concerns the creation of a joint venture that has as its object or effect the coordination of the competitive behaviour of undertakings that remain independent. In that case, the Commission shall appraise this coordination also taking into account whether two or more parent companies retain, to a significant extent, activities in a market which is downstream or upstream from that of the joint venture or in a neighbouring market closely related to this market.

## In conclusion

In reality, financial stability cannot be sacrificed. The US model with the DTCC as an infrastructure utility protected under a unified legal structure and with agreed policies and procedures which are acceptable to both central bank and prudential supervisor is an obvious model.

Eurozone Payments Embedded SSSs are *essential infrastructures* and must operate on the basis of ‘legal certainty’. Operators must be truly independent in terms of governance and encouraged to merge with other Eurozone Payments Embedded SSSs; they cannot be exposed by poor governance, risk or contagion. A single Eurozone Payments Embedded SSS would be required to provide a level playing field, focused on financial stability and seeking out efficiencies, whilst avoiding unnecessary duplication in IT investment and overhead expense and would benefit from a solid legal process at the European level.

The ICSDs non-Eurozone activities create the potential for legal challenge and contagion and in a merged form with Payments Embedded SSSs it is difficult to see how the latter can be fully protected. ICSDs, as *intermediaries* and credit institutions, should *not* be notified as SSSs<sup>19</sup> or subject to ECB, ESCB and NCB oversight but should fall under the relevant national prudential supervisor alone.

The pace of consolidation is rapid and while the role of the regulators cannot be ignored, the process of developing directives, rules and regulations is painfully slow. Pursuing ‘legal certainty’ and a harmonized approach via EU supervisory committees, and building consensus using new directives will take too long, require enormous investment and be prone to failure; it would increase the potential for contagion.

If left unchecked the current consolidation initiatives will continue to strive for efficiency and perhaps competitive advantage, retain a mix of Eurozone and non-Eurozone business, exposing Payments Embedded SSSs and PSs to contagion. At the same time, perceptions and accusations of abuse will be in evidence as combined Payments Embedded SSS/ICSD consolidation initiatives take hold and evolve, further delaying progress; this cannot be allowed to happen.

***The highest EU authority is urged to implement a pragmatic solution, using existing European treaties and protocols to oversee Payments Embedded SSSs whereby the ECB, ESCB and NCBs have responsibility.***

***ICSDs as intermediaries should not control or operate Eurozone Payments Embedded SSSs; these are infrastructures.***

Consolidation cannot be left to market forces. As *essential infrastructure*, the Eurozone Payments Embedded SSS utilities, whether merged or stand alone, should be independent and protected from risks coming from non-Eurozone activities. As Payments Embedded SSSs, under ECB and ESCB related treaties and protocols, they should operate as non-banks with governance arrangements appropriate to a utility. While a failure of a Payments Embedded SSS should be regarded as extremely improbable under these arrangements, it should be appreciated that the issue of lender of last resort may become clearer, even if based on central bank mentality of constructive ambiguity.

Ultimately there should be a single Eurozone Payments Embedded SSS.

Will consolidation initiatives lead to contagion; who is accountable?

Why take the risk; ***the highest ranking EU authority needs to intervene***, grant powers to the ECB and ESCB in respect of Payments Embedded SSSs, before current consolidation initiatives progress further; time is of the essence.

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<sup>19</sup> Any claim an ICSD had to being an SSS (for Eurobonds) was lost when the ECB and ESCB required that Eurobonds be administered in Clearstream Banking Frankfurt and Euroclear France which are both Payments Embedded SSSs.

## Addendum

### 1. Core principles

The Governing Council of the ECB has adopted the Core Principles as Eurosystem oversight minimum standards.

- I. The system should have a well-founded legal basis under all relevant jurisdictions.
- II. The system's rules and procedures should enable participants to have a clear understanding of the system's impact on each of the financial risks they incur through participation in it.
- III. The system should have clearly defined procedures for the management of credit risks and liquidity risks, which specify the respective responsibilities of the system operator and the participants and which provide appropriate incentives to manage and contain those risks.
- IV.<sup>1</sup> The system should provide prompt final settlement on the day of value, preferably during the day and at a minimum at the end of the day.
- V.<sup>1</sup> A system in which multilateral netting takes place should, at a minimum, be capable of ensuring the timely completion of daily settlements in the event of an inability to settle by the participant with the largest single settlement obligation.
- VI. Assets used for settlement should preferably be a claim on the central bank; where other assets are used, they should carry little or no credit risk and little or no liquidity risk.
- VII. The system should ensure a high degree of security and operational reliability and should have contingency arrangements for timely completion of daily processing.
- VIII. The system should provide a means of making payments, which is practical for its users and efficient for the economy.
- IX. The system should have objective and publicly disclosed criteria for participation, which permit fair and open access.
- X. The system's governance arrangements should be effective, accountable and transparent.

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<sup>1</sup> Systems should seek to exceed the minima included in these two Core Principles.



## **2. CESR-ESCB list of the Standards<sup>1</sup>**

### **Standard 1: Legal framework**

Securities clearing and settlement systems and links between them should have a well-founded, clear and transparent legal basis in the relevant jurisdictions.

Addressees: CSDs, CCPs and custodians operating systemically important systems.

### **Standard 2: Trade confirmation and settlement matching**

Confirmation of trades between direct market participants should occur as soon as possible without delay after trade execution, but not later than trade date (T+0). Where confirmation of trades by indirect market participants (such as institutional investors) is required, it should occur as soon as possible after trade execution, preferably on T+0, but not later than T+0.

For settlement cycles that extend beyond T+0, settlement instructions should be matched as soon as possible and not later than the day before the specified settlement date.

Addressees: Market participants and operators of systems for trade confirmation, affirmation and matching of settlement instructions.

### **Standard 3: Settlement cycles**

Rolling settlement should be adopted in all securities markets. Final settlement should occur no later than T+3. The benefits and costs of an EU-wide settlement cycle shorter than T+3 should be evaluated.

Addressees: CSDs, CCPs and custodians that operate systemically important systems and operators of regulated markets.

### **Standard 4: Central Counterparties (CCPs)**

The benefits and costs of a CCP should be evaluated. Where such a mechanism is introduced, the CCP should rigorously control the risks it assumes.

Addressees: market participants and CCPs.

### **Standard 5: Securities lending**

Securities lending and borrowing (or repurchase agreements and other economically equivalent transactions) should be encouraged as a method for expediting the settlement of securities.

Barriers that inhibit the practice of lending securities for this purpose should be removed. The arrangements for securities lending should be sound, safe and efficient.

Addressees: Entities providing securities lending services in connection with the securities settlement process, including CSDs, CCPs and custodians operating systemically important systems.

### **Standard 6: Central securities depositories (CSDs)**

Securities should be immobilised or dematerialised and transferred by book entry in CSDs to the greatest extent possible. To safeguard the integrity of securities issues and the interests of investors, the CSD should ensure that the issue, holding and transfer of securities are conducted in an adequate and proper manner.

In order to minimise systemic risks, CSDs should avoid taking risks to the greatest practicable extent.

Addressees: CSDs and registrars insofar as these entities perform for the function of securities issuance, the management of the issue and the transfer of securities through book entry.

### **Standard 7: Delivery versus payment (DVP)**

Principal risk should be eliminated by linking securities transfers to funds transfers in a way that achieves actual delivery versus payment.

Addressees: CSDs and custodians that operate systemically important systems.

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<sup>1</sup> Edited text version.

## **Standard 8: Timing of settlement finality**

Intraday finality should be provided through real-time or multiple batch processing in order to reduce risks and allow effective settlement across systems.

Addressees: CSDs and custodians that operate systemically important systems.

## **Standard 9: CSD Risk controls in systemically important systems**

Entities that operate systemically important systems need to put in place rigorous risk control measures in order to ensure that the probability of failing to provide timely settlement is negligible. Systemically important systems that extend intraday explicit credit to participants should employ robust risk mitigation measures and, whenever practicable, full collateralisation should be applied. Incomplete collateralisation must be complemented by additional risk mitigation measures such as minimum credit quality of the borrower, credit exposure limits and, on the part of the operator, an adequate minimum capital base and adequate internal risk control measures.

Operators of net settlement systems should institute risk controls that, at a minimum, ensure timely settlement in the event that the participant with the largest payment obligation is unable to settle.

Addressees: CSDs and custodians that operate systemically important systems and who extend credit explicitly to their participants. It is also addressed to operators of settlement systems that net the obligations arising among their participants and thereby generate implicit credit exposures.

## **Standard 10: Cash settlement assets**

Assets used to settle the ultimate payment obligations arising from securities transactions should carry little or no credit or liquidity risk. If central bank money is not used, steps must be taken to protect the participants in the system from potential losses and liquidity pressures arising from the failure of the cash settlement agent whose assets are used for that purpose.

Addressees: CSDs and custodians that operate systemically important systems and, more specifically, the cash payment arrangements for settling securities transactions in their systems.

## **Standard 11: Operational reliability**

Sources of operational risk arising in the clearing and settlement process should be identified, monitored and regularly assessed. This risk should be minimised through the development of appropriate systems and effective controls and procedures. Systems and related functions should be (i) reliable and secure, (ii) based on sound technical solutions, (iii) developed and maintained in accordance with proven procedures (iv) have adequate, scalable capacity and (v) have appropriate business continuity and disaster recovery arrangements that allow for timely recovery of operations and the completion of the settlement process.

Addressees: CSDs, CCPs and custodians that operate systemically important systems. For this standard to be effective, it also needs to be applied by other providers of services critical for clearing and settlement, such as trade confirmation, messaging services and network providers.

## **Standard 12: Protection of customers' securities**

Entities holding securities in custody should employ accounting practices and safekeeping procedures that fully protect customers' securities. It is essential that customers' securities be protected against the claims of the creditors of all entities involved in the custody chain.

Addressees: Entities holding customers' securities accounts, including registrars, CSDs, CCPs and custodians.

## **Standard 13: Governance**

Governance arrangements for entities providing securities clearing and settlement services should be designed to fulfill public interest requirements and to promote the objectives of owners and users.

Addressees: CSDs, CCPs and custodians with a dominant position in a particular market.

## **Standard 14: Access**

CSDs and CCPs and custodians with a dominant position in a particular market should have objective and publicly disclosed criteria for participation that permit fair and open access. Rules and requirements that restrict access should be aimed exclusively at the controlling of risk.

Addressees: CSDs, CCPs and custodians with a dominant position in a particular market. For this standard to be effective, it also needs to be applied by other providers of securities services critical for clearing and settlement, such as trade confirmation, messaging services and network providers.

### **Standard 15: Efficiency**

While maintaining safe and secure operations, securities clearing and settlement systems should be cost-effective in meeting the requirements of users, including interoperability at both the national and the European level.

Addressees: CSDs, CCPs and custodians with a dominant position in a particular market. For this standard to be effective, it also needs to be applied by other providers of securities services critical for clearing and settlement, such as trade confirmation, messaging services and network providers.

### **Standard 16: Communication procedures, messaging standards and straight-through processing**

Entities providing securities clearing and settlement services and participants in their settlement systems should use or accommodate the relevant international communication procedures and messaging and reference data standards in order to facilitate efficient clearing and settlement across-system. This will promote straight-through processing (STP) across the entire securities transaction flow.

Service providers should move towards STP in order to help to achieve timely, safe and cost-effective securities processing, including confirmation, matching, netting, settlement and custody.

Addressees: Entities providing securities clearing and settlement services, and participants. For this standard to be effective, it also needs to be applied by other providers of securities communication services, such as messaging services and network providers.

### **Standard 17: Transparency**

CSDs, CCPs and custodians with a dominant position in a particular market should provide market participants with sufficient information for them to identify and evaluate accurately the risks and costs associated with securities clearing and settlement services.

Addressees: CSDs, CCPs and custodians with a dominant position in a particular market. For this standard to be effective, it also needs to be applied by other providers of securities services, such as trade confirmation services, messaging services and network providers.

### **Standard 18: Regulation, supervision and oversight**

Entities providing securities clearing and settlement services should be subject to transparent, consistent and effective regulation, supervision and oversight. Central banks and securities regulators/supervisors/overseers should co-operate with each other and with other relevant authorities, both nationally and across borders (in particular within the European Union), in a transparent manner.

Addressees: Central banks, securities regulators and, where appropriate, banking supervisors.

### **Standard 19: Risks in cross-system links<sup>2</sup>**

CSDs that establish links to settle cross-system trades should design and operate such links to effectively reduce the risks associated with cross-system settlements.

Addressees: CSDs and custodians operating systemically important systems that establish cross-system links.

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<sup>2</sup> This standard does not cover links established by CCPs. These will be covered by the future work of the ESCB-CESR on CCPs.

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