

**Comments on ESCB–CESR consultative report
< Standards for securities clearing and settlement systems in the European Union >**

I. Preface

ABN AMRO Bank appreciates the opportunity to respond to ESCB–CESR’s invitation to react upon their consultative report of proposed standards for securities clearing and settlement in the European Union.

ABN AMRO Bank has provided its input into the current process of consultation through a number of representative associations. In order to avoid the consequent risk of unnecessary redundancy in the information flows launched towards ESCB–CESR, in this direct reaction we have tried as much as possible to restrict our observations to what we considered to be complementary information, either by deepening specific arguments used already, or by adding elements that, to our available knowledge, are new. Nonetheless, for the sake of clearness we have added our short answers to the list of questions as included in the document entitled “The scope of application of the ESCB–CESR standards”.

II. General comments

Our general comments mainly relate to the scope of application of the proposed standards, particularly to the application of some standards to “custodians operating systemically important systems” and other standards to “custodians that have a dominant position in their market”.

Systemically important systems

We appreciate ESCB–CESR’s effort to serve public interest by its striving after a regulation of post trade processing of securities in a way to reduce systemic risk to an adequately low level. We also agree to the implicit view that accidents happening to or caused by major custodians could have a systemic impact, in securities settlements, even more than in payments because of the more problematic provision of liquidity, and on account of the occurrence of chains of same day’s securities buys and sells by the same trading entity, which might act as a source for possible chain reactions from single fails. We do not conclude, as some market participants do however, that the degree to which custodians succeed in internalising securities settlements does really matter with regard to their probability of becoming a potential source of systemic risk. In respect of the system, a failed internal settlement is not in any way more serious than a failed external one, as with a failing custodian both kind of settlements will result in the beneficiary investor not receiving the securities that he was entitled to.

In spite of our opinion as reflected above, we do not share the view that the possibility of systemic risk stemming from major custodians should necessarily result into applicability of identical standards to on one hand CSDs and CCPs, and to on the other hand “systemically important custodians”. Custodians usually are banks, i.e. regulated credit institutions, in contrast with CSDs and CCPs, which generally are not. In accordance with that quality of credit institution, custodian banks are submitted to strict solvency requirements necessitating them to observe substantially higher capitalization than CSDs and CCPs do. Whilst the latter have to be prevented from causing or triggering systemic disasters by almost complete avoidance of any risk, for instance by demanding full collateralisation of all of their claims – existing or potential ones –, the former are used to more risk exposure in their regular course of business, which is, however, counterbalanced by additional capital. Application of the same rules as applied to CSDs and CCPs would be inadequate by the very negation of the different nature of custodian banks, where warrants for business continuity are simply constructed in a different manner and where regulation is attuned accordingly.

If, in spite of the foregoing observations, regulators would remain with the opinion that neither current solvency requirements, nor future ones stemming from Basle II, would suffice to create an adequate level of warranted business continuity for custodian banks of the indicated quality, we recommend to consider legal segregation of operations and systems as an additional precaution to improve business continuity of at least the settlement and clearing agency sections of the entities concerned.

To our aversion of applying identical standards to the heterogeneous securities processing community, we would make one exception, and that is for standard 11, which deals with operational reliability. Though Basle II also includes protection against operational risk, current regulation in that respect variegates a lot across member states. Moreover, we think that systemic importance carries with it a certainly stronger demand for operational reliability. Also, such approach would be in accordance with the U.S. Interagency Paper on the same issue.

Custodians that have a dominant position in their market

Though we agree to the principle that if competition can no longer guarantee fair trading, additional rules and supervision needs to substitute the otherwise more spontaneous incentives to stay fair, we are of the opinion that behavioural, prudential and systemic regulators, as embraced by ESCB-CESR, can only recommend such regulation, leaving it to the proper regulators and supervisors of competition and fair trading to draft standards and to implement regulation.

Even the behavioural regulator's duty to optimise the structure of the market to the benefit of the investor cannot, to our opinion, be invoked here, since the market concerned by that duty is the capital market rather than the market of post trade processing.

CPSS-IOSCO basis

We sympathise with the standards being based upon the CPSS-IOSCO recommendations. Standardisation is a precious matter, marking advance and opening new ways to increased prosperity. As such, it is no free lunch, as it demands an attitude that reflects readiness to compromise, to reciprocate taking by giving, and to respect already existing achievements as much as possible. In that context we do not understand small changes like for instance "contracts" into "contractual arrangements" in key element 4 of standard 1, "as soon as possible" into "without delay" in standard 2, neither larger changes like the implicit alternative definition of "securities settlement system". We do not admire the introduction of so many differences between recommendations and standards, which seem to serve particular linguistic and architectural aesthetics at the price of standardisation fading away, rather than the will to present a public sector example of the proper attitude to foster standards.

III. Comments by standard

Standard 1: legal framework

Key element 4 states, inter alia, that contractual arrangements related to the operation of the securities clearing and settlement systems should be enforceable even in the event of the insolvency of the operator of the system. This seems an impossible demand to us, in contrast with the Lamfalussy based standard regarding the insolvency of a (incl. the largest) system participant. If the owner of the factory is bankrupt, no regulator is able to accomplish continued production by the sheer force of regulation only.

Standard 2: trade confirmation and settlement matching

It seems inconsistent to us not to determine when indirect market participants are obliged to send a confirmation, but to oblige them to do it at trade date once they do send it. Moreover, we think this T+0 demand in respect of indirect participants is too restrictive.

Standard 7: DVP

In principle, DVP is an instrument to protect an investor against the failure of his counterparty (his direct counterparty or his interposed central counterparty) by reduction of an exposure on principal amount to an exposure on margin. To that goal a DVP effected by the CSD suffices, unless settlement is internalised by the custodian bank. The latter case, however, ESCB-CESR does not deal with in its explanatory memorandum anywhere.

Mind that the instrument has never been intended to protect the investor against a failure of his custodian bank or of the CSD used, and that consequently it is not suited to that purpose.

Standard 8: finality

Same remarks as for standard 7.

Standard 11: operational reliability

In some respects this standard lacks accuracy to provide true standardisation, with regard to recovery from disasters in particular. We were also surprised by the non-mandatory nature of the second ICT and operations site, as we do not see any alternative to recover from the possible integral end of one site. Though we deem it correct to submit all systemically important systems to stringent standards of operational reliability, given the existing comprehensive regulation in many countries, we think it makes no sense to apply standards of an inaccurate nature as parts of the one currently proposed.

IV. Answers to the specific questions

- 1) **Q** Do you agree that the scope of the standards should be extended to systemically important providers of securities clearing and settlement services other than CSDs and CCPs?
A Though systemic risk might, in specific cases, also stem from intermediaries, we think that differences in the nature of the businesses concerned renders it practically impossible to apply identical rules, not attuned to the specific nature of a business. A possible exception could be operational reliability, provided the proposed rules are upgraded to a more elevated level of accuracy.
- 2) **Q** Should the extension be to all custodians, or should it be limited to systemically important providers of securities clearing and settlement services?
A Within the limitations of our answer to the previous question, we recommend integral application in order to avoid an unlevel playing field.
- 3) **Q** What are the criteria along which – according to your opinion – the systemically important system could be defined? What would you consider to be the essential elements that should be a part of such a definition?
A Our answer to the previous question helps to avoid the adoption of arbitrary criteria. Anyhow, criteria should not include any quantification of internalisation of settlement with custodian banks, as to us systemic risk seems independent from internalisation.
- 4) **Q** Do you agree [with the proposed quantitative criteria]?
A See our answer to question 3. Anyhow, in view of a single European market we are no advocates of criteria based upon geographical submarkets.
- 5) **Q** Do you agree that three relevant markets can be considered – bonds, equities, and derivatives – or would a different categorisation be helpful?
A See our answer to question 3. Mind that derivatives markets do not seem included anywhere in the standards.
- 6) **Q** Which of the ESCB–CESR standards should apply to all systemically important custodians?
A See our answer to question 1 in combination with the one to question 2.
- 7) **Q** What would be the implications of extending the scope of the standards to cover systemically important providers of securities clearing and settlement services?
A As with any generalisation, the tool will have reduced degree of detail and fit to the specific nature and circumstances of its object.
- 8) **Q** Do you agree that standards 13, 14, 15 and 17 should apply to custodians with a dominant position in one market? If yes, how would you define a dominant position?
A1 Yes, but as standards they should be established by competition authorities.
A2 A position that allows for abuses which the standards concerned intend to prevent.