

## RESPONSE TO THE CONSULTATIVE REPORT OF JANUARY 2001 OF THE CPSS/IOSCO JOINT TASK FORCE: "RECOMMENDATIONS FOR SECURITIES SETTLEMENT SYSTEMS"

Clearstream International welcomes the considerable effort put into the development of "Recommendations for Securities Settlement Systems" by IOSCO and the CPSS, which will make a very valuable contribution to enhancing the stability of the international financial system. We strongly welcome the Joint Task Force's initiative to modernise industry standards.

As one of the larger SSSs, we have made many contributions to the securities markets related elements of the EU Financial Sector Action Plan, and to the recommendations of the Wise Men appointed by the EU-ECOFIN. Work on these recommendations will continue. But as a global SSS, we are contributing also to the building of world-wide standards through relevant professional associations and other groups.

The notes below contain our most obvious suggestions. Please be assured that if the Joint Task Force wish us to contribute further to the finalisation of the recommendations, we will be glad to assist you.

We believe our industry is undergoing major changes, having to do with exponential growth of cross-border securities transactions, technological advances, new entrants in trading places/mechanisms, and accelerating cross-border integration of market participants. The challenges for SSSs are thus to eliminate or minimise risks in keeping with the most demanding standards, and to ensure adequate capacity with increased efficiency.

Consistent with our practice of exchanging views on market policy matters with our regulators/supervisors, we have transmitted a copy of this note to the CSSF and the Banque Centrale du Luxembourg, and to the BAKred and the Bawe and the Deutsche Bundesbank.

The following observations are primarily directed at seeking clarification on various points, together with some comments on issues that may arise when implementing specific standards.

### Recommendation 1: Legal Framework

Clearly, Clearstream International has no direct control over the legal framework in which it operates, other than in terms of advocacy. However, we certainly support the recommendations made.

With respect to the list of key questions for this recommendation (Section 5 of the document), question 2 (j) refers to "the protection of the interests of beneficial owners". We would simply comment that international market practice generally makes no distinction between the legal owner and the beneficial owner of securities. Clearstream International is therefore only able to do so where our customers specifically notify us that certain assets deposited in our system are owned by their clients .

### Recommendation 2: Trade Confirmation

Clearstream International is supportive of moves encouraging early confirmation, as this facilitates earlier matching of settlement instructions and consequently greater settlement efficiency. But again, international market practice is not something we can directly influence.

### Recommendation 3: Settlement Cycles

Our systems already support settlement on T+ 0 and so we would be able to support any move by the markets towards shortening settlement cycles from T+ 3. However, in the context of international markets and cross-border trading in particular, we anticipate that a shorter settlement cycle might well pose problems for a number of market participants. It is clearly therefore for the market as a whole to come to a view on this matter. In particular, the foreign exchange markets maintain a two-working-day convention for spot foreign exchange, which shows no sign of changing. Since many cross-border trades will involve a foreign exchange component as cash is moved from one country to another, the two-day spot convention means a significant shortening of the cycle might not be easy in international markets without changes in foreign exchange market practice.

Clearstream International is currently working closely with participants of the German domestic market in an effort to define best practice and market behaviour which encourages greater settlement efficiency. To this end performance targets and incentives, including monetary penalties, are currently being considered. We are therefore pleased to note point 3.14 of the recommendations which supports such an initiative. Going forward, this may be an area where there would be benefit in having more specific supervisory review to encourage best practice and consistency of approach.

A related point is that the discussion of this recommendation does not really differentiate between exchange-traded and over-the-counter trading. In the latter case, except under ISMA rules, there may not be an available mechanism for imposing penalties. This might be an area requiring further attention in the future.

### Recommendation 4: Central Counterparties

We believe that it would be helpful if this recommendation spelt out a clearer distinction between a pure "clearing" function within a clearing house and the risk taking/management function of a central counterparty, as there is some confusion in the market-place on this point. Clearstream International is a clearing and settlement organisation, not a central counterparty and it may help to spell out our view of these processes.

We agree with the definition adopted by IOSCO:

"Clearing and settlement systems are systems providing the process of presenting and exchanging data or documents in order to calculate the obligations of the participants in the system, to allow for the settlement of these obligations, and the process of transferring funds and /or securities." <sup>1</sup>

This function is quite distinct from the role of providing novation of contracts between market counterparties in order to stand between them, with its inevitable assumption of credit risk. We believe that the risk function inherent in a central counterparty is difficult to reconcile with the crucial importance of the integrity of the settlement function. In its capacity as a clearer, however, Clearstream International has been developing an "International Trade Concentrator" functionality, which could be supplied as a service to any central counterparty. In essence, Clearstream provides the netting and related calculations to the central counterparty as an application service provider. This builds on Clearstream International's long-standing expertise in this area, without requiring Clearstream International to take the principal risk of standing between the trade parties, which of course is taken by the central counterparty. We believe that this offers an efficient separation of

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<sup>1</sup> Objectives and principles of securities regulations, September 1998, page 47

functions between the clearer and the risk manager. By integrating information about client transactions with information about corporate actions in respect of the security in question, the international trade concentrator functionality will permit a central counterparty to be in full control of its risk exposures.

#### Recommendation 5: Securities Lending

We believe that efficient lending and borrowing facilities reduce failed settlements and improve the efficiency of the securities markets. As a practical suggestion, we believe that one of the largest contributions to the enhancement of the securities lending market would be if all custodians were encouraged to include securities lending clauses in the account opening documentation used with the end customer. In many cases, the need for custodians to revert to the client to amend existing documentation before lending is permitted within the SSS is a major hindrance.

#### Recommendation 6: Central Securities Depositories

The recommendation for immobilisation/dematerialisation within a CSD has been a G30 recommendation for more than 10 years now, and is well on its way in most markets. However, as a practical matter, in the cross-border arena, it may be worthwhile clarifying in the standards the role of the "issuer" versus "investor" CSD. The former is the CSD chosen by the issuer to maintain the central records in respect of that issue. The latter is the CSD where the investing client has chosen to hold its securities and should handle a position in the issue through an account at the issuer CSD. The issuer CSD should also be the single initial channel for new issues processing.

This, in turn, would permit further progress in respect of corporate events. Consideration might be given to broadening the recommendation to include the concept that the issuer CSD should be the initial and main channel of information regarding publication of information and the handling of corporate events.

#### Recommendation 7: Delivery Versus Payment

With regard to the comment in paragraph 3.29 "Achievement of DvP for direct participants in the SSS does not eliminate principal risk exposures between direct participants and their customers", we presume that it is understood that it is not the role of Clearstream International to manage relationships between its participants and their customers. This matter is referred to again later in the context of Recommendation 12.

#### Recommendation 8: Timing of Settlement Finality

Whilst the emphasis here is on real-time or intra day processing in relation to specific aspects of risk reduction we feel it is appropriate to also note that there are real liquidity benefits available from a rapid batch processing in comparison with real-time processing.

As noted in an ECB study "Settling in real time is more costly in SSSs, ... the idle balance which needs to be held on the securities side is larger than the one held on the cash side and thus the implementation of an RTGS system is more costly."<sup>2</sup>

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<sup>2</sup> "The Euro Area Securities Clearing and Settlement Infrastructure: Recent Changes and Issues for Debate", Ignacio R. Terol & Daniela Russo, Directorate General Payment Systems, European Central Bank, paper prepared for the conference on "The Operational Framework of the Eurosystem and Financial Markets" held at the ECB in Frankfurt, 5 -- 6 May 2000.

This is in fact supported by an internal analysis conducted by the then Deutsche Börse Clearing in March 1997. Although a relatively brief study, it identified that rapid batch processing was almost 7% more efficient in terms of liquidity use than a pure real-time gross settlement alternative.

We therefore feel it would be appropriate, for completeness, to also include some comment on liquidity issues within this section.

#### Recommendation 9: CSD Risk Controls to Address Participant Defaults

We believe that the assumptions behind the Recommendation's discussion of deferred net settlement systems need to be clarified. There is a key difference between systems that use a "technical netting algorithm" or "chaining" before running each settlement batch and those that do not. In the latter case, as stated in 3.34, a failure to settle could involve an unwind. In the former case, however, where the system checks to see if any given set of trades can collectively be settled, securities settlements cannot be made if the requisite funds/securities are not available. A failure by any given participant does not prevent the settlement batch from being run, since that participant's trades are simply taken out of the batch. Thus many of the concerns raised in this discussion are not applicable to the former type of system.

Aside from this point our one area of comment here is in relation to the recommendation that SSS credit exposures be fully collateralised. We feel consideration needs to be given to the implications of such a view in a cross-border environment where collateral movements are not yet necessarily fully optimised, and also to the cost implications (Recommendation 15 regarding cost-effectiveness refers).

Clearstream International does provide its customers with some short-term banking facilities, which are generally fully collateralised. However, unsecured financing, which is essentially very short-term, is provided to a select group of banking institutions who maintain the highest credit ratings. This plays an important part in smoothing cross-border settlement confirmation flows which are typically not as timely as purely domestic (internalised) settlements. To require the movement of collateral to cover such unexpected delays would raise difficult operational issues. Thus the systemic risk incurred is at least in part offset by the reduction of liquidity risk elsewhere. Conversely, if Clearstream abstained from providing any unsecured credit, this would simply shift the liquidity risk out into the market.

Whilst the recommendation does acknowledge that there can be some exceptions to the principle of full collateralisation, the circumstances permitted i.e. to central banks or supranational organisations, are perhaps too restrictive. We feel it is vital that the role of unsecured financing, albeit occasional, and to the most creditworthy participants is appropriately acknowledged.

#### Recommendation 10: Cash Settlement Assets

While in principle the use of central bank money for settlement purposes is highly desirable, it does have certain implications. As such, Clearstream International is pleased to note that this recommendation recognises the validity of using commercial bank money for settlement and, indeed, that in many cases it may be more practicable to do so.

We certainly agree with the observation that access to central bank accounts is not always possible for a CSD member – and note that this effectively excludes some pure securities firms, which are not also Banks, from participating. Also that there may be a mismatch in hours of operation, which is

particularly the case where an SSS is seeking to settle with finality outside of TARGET opening hours. Unless central bank money can be transferred 24 hours a day, a securities settlement system that operates during the night would be unable to achieve delivery versus payment at that time.

As you are fully aware there are a number of considerations that affect the use of central bank and commercial bank money. In particular, we would again note the potential liquidity benefits to participants that may exist within a commercial bank money settlement model, providing flexible access to liquidity, particularly in other currencies, as well as enabling the use of a Settlement Verification Algorithm, as referred to in respect of Recommendation 8. We were wondering to what extent this section might allude to some of them at greater length.

With respect to the comment in paragraph 3.41 that limited purpose banks should "strictly limit any non-settlement activities", this is certainly Clearstream International's policy, provided that it is understood that "settlement activities" includes the custodial role of a central securities depository.

Further, Clearstream International does provide its customers with some short term banking facilities. The requirement for these facilities, together with the occasional need for unsecured exposure, is discussed under section 9, but should be considered here also.

#### Recommendation 11: Operational Reliability

It may be relevant to note that many of these issues will be addressed in the new Basel Capital Adequacy framework and it is to be hoped that there will be consistency between the latter and these settlement system recommendations.

#### Recommendation 12: Protection of Customers' Securities

We fully agree with this recommendation. Indeed, the issue is of such importance to customers that we feel a CSD's policies and procedures in this respect should also be subject to some form of external review and monitoring to ensure compliance.

#### Recommendation 13: Governance

With respect to paragraph 3.56, where it is suggested that "The desire of owners to maximise profits may cause some... CSDs to fail to commit sufficient resources and capabilities to risk management... [and] may also conflict with users' need for an efficient, safe service obtained at minimum cost", in fact Clearstream International believes that the reverse is true.

In recent years mutually-owned institutions across Europe have been converting to shareholder-owned institutions precisely because of the need to raise needed resources in the form of capital to meet the escalating investment requirements of today's technology. In some cases, also, a perceived benefit has been to achieve the flexibility to adapt quickly to rapidly changing conditions. This phenomenon can be seen not merely in stock exchanges in the UK, Germany and Italy but also in building societies/savings banks and insurance organisations.

In this context, Clearstream International believes that it would be preferable for the recommendation to focus on the benefits to be achieved from effective governance requirements, rather than pressing a case for one form of corporate structure over another.

#### Recommendation 14: Access

We would mention that whilst an SSS can set access criteria for participation in the SSS, there may be additional features of the market, such as a requirement to use Central Bank money settlement, for example, which may in practice restrict participants using the services of the SSS. Such market practices will generally be outside the control of the SSS itself.

#### Recommendation 15: Efficiency

Clearstream International fully endorses this recommendation. Indeed, any securities settlement system that fails to be cost-effective has limited long-term survival prospects. It should, however, be noted that cost-effectiveness has several dimensions of which the cost per transaction executed is only one.

In the current market environment in Europe, it is as important that the securities settlement system is investing in technology and linkages with the other components of the European infrastructure. Today's investment cost (and hence higher transaction cost) becomes tomorrow's efficiency. Likewise, a bare-bones system might be extremely cheap in terms of cost per transaction executed but could impose other costs on users. An analogy is the "total cost of ownership" of a computer system, compared with its initial purchase price.

This is an important factor when assessing two systems, as the costs imposed on users may not be directly comparable and may not have a direct correlation to the respective efficiency of the systems.

Furthermore, we would comment that, as far as Europe is concerned, the current fragmentation is a source of substantial costs to market participants.

#### Recommendation 16: Communication Procedures and Standards

The ISSA 2000 Recommendations refer not merely to ISO 6166 and ISO 15022 but also to ISO 9362 in respect of a global client and counterpart identification methodology (BIC) there may be merit in also including a reference to that standard in this Recommendation.

#### Recommendation 17: Transparency

This topic is likely to be covered by Pillar 3 of the new capital adequacy regime and it is to be hoped that there will be consistency between the two frameworks.

#### Recommendation 18: Regulation and Oversight

Clearstream International has no problem with this section which is essentially a recommendation addressed to national authorities. But this recommendation would gain if it also took into consideration the needs of cross-border settlement. Here, the recommendation should be for better harmonisation and integration as differences in regulatory structures are one of the greatest impediments to integrated markets. National differences and difficulties associated with them are leading to useless costs without adding to investors' protection.

#### Additional Comment – Scope of Recommendations

It is evident that a number of the recommendations, whilst relevant to the process of settlement of securities, are not entirely within the control of SSSs themselves.

1. Legal framework
14. Access issues
18. Regulation and oversight

In this respect our reply assumes that these issues are not directed solely at SSSs, but also refer to their legal and institutional environment as well as other third parties. Whilst we note that this aspect is referred to in section 1.10 of the Introduction, the title of the document may, however, appear a little misleading. For greater clarity perhaps the title should refer not to SSSs, but only to Securities Settlement. .

From the introduction we also note that references to SSSs primarily mention domestic settlement systems and CSDs who also have cross-border activity. As an ICSD, our situation is not always directly comparable and we are necessarily affected to a much greater extent by the issues and challenges of operating in a multi-currency, multi-jurisdictional, cross-border environment. However, with this in mind, we reiterate our full support for the recommendations as they relate to an ICSD.

9 April 2001