

IMPROVING CLEARING AND SETTLEMENT BENEFITS FOR AN INTEGRATED MARKET

Summary: In the words of the 2001 Giovannini Report, the ‘*clearing and settlement process is an essential feature of a smoothly functioning securities market, providing for the efficient and safe transfer of ownership from the seller to the buyer*’.

As a priority under the Financial Services Action Plan the Commission is studying how to ensure the development of an efficient and secure clearing and settlement structure in the EU. Following the Giovannini Report a Commission Communication in May 2002 launched a consultation on how to develop possible solutions, including possible EU legislative action. The European Parliament recently adopted a Resolution calling upon the Commission to take legislative initiatives that would require structural changes to the current infrastructure.

The benefits of a better functioning clearing and settlement system are evident for the integration process in Europe; the question is what is the right balance to be struck between market-led action and user/owner initiatives, and legislative action to remove costly barriers.

Clearing and Settlement in the EU: What Needs to be improved?

By and large, national structures for clearing and settlement in the EU Member States are cheap and efficient. In contrast, over recent years, a gap in efficiency has appeared in clearing and settlement at international level (known as “Cross-Border”), particularly in relation to equities. This has been highlighted in a number of reports, including the First Giovannini Report on Clearing and Settlement in the EU.¹ While domestic clearing and settlement systems have consolidated on a national basis, fragmentation of post-trading infrastructures still represents a major obstacle to cross-border trading and thus has a restraining effect on pan-European investment. Demand for cross-border trade in securities has increased, but not enough has been done to remove obstacles; hence the solutions that have been put in place so far to facilitate such activity are costly and inefficient, prohibiting many investors from participating in cross-border activity. Financial market participants, investors and policy makers have therefore identified rationalisation of clearing and settlement structures as a key step in delivering integrated EU capital markets.

What is Clearing and Settlement?

The clearing and settlement process provides for the safe transfer of ownership of securities from the seller to buyer. Clearing and settlement of a typical securities transaction involves the following basic steps:

- **Confirmation** of the terms of the securities trade (Pre-clearing)

¹ Report of the Giovannini Group (2001), ‘*Cross-Border Clearing and Settlement Arrangements in the European Union.*’ The Giovannini Group is a forum of financial market participants, which advises the European Commission on financial markets issues. It was formed in 1996 to focus on identifying inefficiencies in EU financial markets and propose practical solutions to improve market integration. DG ECFIN provides the secretariat for the group.

- **Clearance** of the trade by which the respective obligations from the buyer and seller are established, this can involve both 'netting' and 'novation' by a CCP (Clearance)
- **Delivery** of the securities from the seller to the buyer (Settlement)
- **Reciprocal payment** of the funds (Settlement)
- **Custody**, safekeeping and administration of the securities (Post-settlement)
- **Registration** of ownership of securities on a legal record – notary function (Post-settlement)

As a result of historically different starting points and their organic development, the entities involved in the clearing and settlement process vary from country to country but can be summarised as follows:

Clearing Houses: Provide the basic clearance function but can also act as a central counterparty (CCP) fulfilling two additional functions:

- Novation: where the clearing house interposes itself between both parties to a trade (buy and sell), to remove counterparty risk;
- Netting: calculation of net positions, the CCP offsets all obligations and reduces all outstanding residuals to single debit/credit between itself and each member. This reduces the number of settlements and thus reduces both settlement costs and risk. In some countries, particularly but not exclusively the ones not disposing of a CCP, the netting function is carried out by a CSD (see following paragraph).

Central Securities Depository (CSD): Provides the primary settlement functions and also notary and custody functions, which are all described above. Local CSDs often used to operate on a utility basis but many have recently been privatised. They are distinct from banks or investment firms and, given the systemic importance of their function are often supervised by national central banks. CSDs offer investors, firms and intermediaries open access and inter-operability (i.e. communication between exchanges, clearing houses and depositories) under secure and safe conditions (central bank money, provision of collateral by central banks).

International Central Securities Depository (ICSD): ICSD is akin to a CSD for Eurobonds (emerged from the expansion of the Euro capital market since the late 1960s) and a settlement system for various domestic securities, usually through direct or indirect (through local agents) links to local CSDs.

Custodians: Since membership of numerous CSDs, ICSDs, etc. implies substantial costs, investors may choose to use Agent Banks (which have direct or indirect membership to those entities) as custodians.

About Cost and Efficiency

The high costs of cross-border clearing and settlement stem from differing market practices/rules, often due to the various national legislative frameworks and taxation, differing I.T. communication protocols and the multiple systems connectivity needed to make different parts of the infrastructure interact. Since investors rarely have direct access to foreign systems, local or international intermediaries or global custodians (Agent Banks) intervene in the process to provide this link. Such intermediaries are critical to the functioning of cross-border clearing and settlement, but again imply a significant cost to investors. As a consequence, the more

intermediaries and clearing and settlement systems involved, the more complex and expensive the provision of cross-border post-trade service.

According to the First Giovannini Report ('Giovannini I'), there are currently 19 national CSDs and 2 ICSDs operating clearing and settlement functions within the EU. Compared to domestic services, cross-border post-trade services incur additional costs resulting in fees that are 42% higher than those in domestic trades². The additional costs are identified in Giovannini I as 'direct costs' (higher fees), 'indirect costs' (extra back-office facilities) and 'opportunity costs' (compensation for inefficiency across the borders). Despite the inherent limitations of such a comparison, due to the varying nature of the service provided by different providers, Giovannini I nonetheless clearly identifies the additional burden faced by pan-European investors in dealing with different technical requirements and market practices, different tax regimes and legal systems, as the major reason for the inefficiency of clearing and settlement within the EU. The costs of such inefficiencies are ultimately borne by Europe's investors.

Barriers Identified in the First Giovannini Report

The 15 barriers identified in Giovannini I were grouped into 3 categories:

1. Technical/market barriers:

- National differences in information technology and interfaces
- National restrictions on clearing and settlement resulting in use of multiple systems
- Differences in national rules relating to corporate actions, beneficial ownership and custody
- Absence of intra-day settlement finality
- Impediments to remote access to national C& S
- Differences in settlement periods
- Differences in operating hours/settlement deadlines
- Differences in securities issuance practice
- Restrictions on the location of securities
- Restrictions on the activity of primary dealers and market makers

2. National differences in tax procedures:

- Domestic withholding tax regulations serving to disadvantage foreign intermediaries
- Transaction taxes collected through a functionality integrated into a local settlement system

3. Issues related to legal uncertainty:

- The absence of an EU-wide framework for the treatment of interests in securities
- National differences in the legal treatment of bilateral netting for financial transactions
- Uneven application of national conflict of law rules

The first category of barriers mainly requires a great deal of industry effort in order to be overcome although public support may be required to eliminate restrictions on the location of securities and on the activities of primary dealers and market makers. The second and third categories touch on issues where the EU institutions at present have limited competence (if any) and therefore require action at the national level. In relation to legal uncertainty, the EU Collateral Directive (to be implemented in national law by end 2003) will help remove some uncertainty – albeit only for securities which are used as collateral and for collateralisation in

² See Commissioner for Competition Policy, Mario Monti's Speech, 'The Integration of European capital market Infrastructures and Competition law', 5 December 2002.

respect of risks which are related to clearing and settlement. Additionally, there is growing consensus amongst market participants and infrastructure institutions, that ratification of the Hague Convention, with the concept of "PRIMA" (Place of Relevant Intermediary Approach) can be influential in addressing the concerns on legal certainty.

Commission Communication on Clearing and Settlement³

The Communication considers the current arrangements for clearing and settlement in the EU and sets out some policy objectives to achieve further integration, along with possible measures to realise those objectives. In particular, the Communication:

- focuses on the barriers identified by the Giovannini Report and considers how each of these sets of barriers can best be removed, and by whom;
- addresses questions on whether it will be necessary to define clearing and settlement activities at EU level in order to address any identified problems of level playing field between market operators for clearing and settlement activities.

The Communication does not address the question of what form of market infrastructure is needed in the EU. Rather, it examines how to create the conditions needed for market forces to deliver the most efficient solution.

Giovannini I and the Commission Communication on Clearing and Settlement were generally well-received by financial market participants, who in particular welcomed the Commission's conclusion that the solution of technological and systems-related issues and the process of consolidation should be left to the market to deliver. A broad consensus exists that the solution must include *less* infrastructure. This does not necessarily mean a single central infrastructure but does imply considerable further consolidation, which has already started. Other critical factors include simplified connectivity to common system platforms, interoperability between markets/systems through common standards and common technical protocols, free and open access to infrastructure, convergence of market rules and practices, transparent pricing, and a focus on user needs (which is seen to be of particular importance in delivering improved services and reducing costs).

European Parliament Resolution of 15 January 2003 (The Andria Report)

In January 2003, the European Parliament adopted a motion for Resolution (Andria Report) largely supporting the analysis of the Giovannini Group. The motion encouraged market participants to cooperate in order to eliminate technical IT barriers and called upon the Commission to bring forward a proposal for a directive to eliminate legal and tax differences among Member States. Furthermore, the motion calls for core settlement services to be provided by a user-owned body run on a non-profit basis and for ICSD/CSDs to perform national and cross-border core settlement services on an exclusive basis whilst "value-added" services should be carved-out and provided by operationally and legally separate entities. The motion was also very ambitious in targeting (though only on a long-term basis) the harmonisation of securities codes in Europe. It recommended the creation of a group of experts studying the different national legal frameworks for securities and advising on how to overcome discrepancies in Europe.

³ COM (2002) 257; Communication 'Clearing and settlement in the European Union. Main policy issues and future challenges'

The Role of Competition Policy and “Level Playing Field” Issues

The investor community seeks cost reduction and increased efficiency in the post-trade space. To some extent this is being delivered, with technology playing an important role. Choice and competition are key drivers of innovation and cost reduction in the clearing and settlement area. For that reason, market participants see a need for strong competition policy in this area both to ensure that new entrants can compete to provide services and to ensure that entities with a significant market position do not abuse that position to the detriment of users.

The Commission’s 2001 Annual Report on Competition Policy highlights that DG Competition, during its enquiry, has identified a number of possible competition concerns in the field of clearing and settlement, namely: discriminatory pricing and application of dissimilar conditions to equivalent transactions by some settlement systems; and exclusive arrangements between exchanges and clearing and settlement systems (vertical silos⁴). DG Competition’s enquiry is expected to conclude in early 2003.

Over recent decades, International Central Securities Depositories, entities originally dedicated to servicing the international Eurobond market, have offered clearing and settlement functions in addition to their original functions (i.e. maintenance of cash accounts, financing of transactions, risk management, custody and settlement services in commercial money, funding). ICSDs have pursued a strategy aimed at providing custody and settlement on a European- (and world-) wide basis through acquisition and consolidation of parts of local infrastructure. Some intermediaries have voiced concerns that in the longer term, the consolidation of clearing and settlement infrastructure in this manner may give rise to competition concerns. However, other market participants take the view that such concerns are outweighed by the cost-savings derived from consolidation and that steps can be taken to ensure these concerns are mitigated.

Next Steps

The Giovannini Group is expected to publish a follow-up report in early 2003 containing recommendations for the removal of impediments to cross-border securities trading. Soon afterwards, the Commission is expected to release a further Communication, setting out policy options for future action. Legislative proposals in this area, if indeed they are deemed necessary, are not expected until late 2003. Some are of the opinion that a legal initiative is needed for the creation of a European passport for clearing members. More immediately, the draft proposal for an updated Investment Services Directive aims to facilitate the removal of certain barriers by mandating open access to clearing and settlement systems. In the meantime, consolidation of infrastructure continues in fits and starts and technical solutions to reducing costs are gradually

⁴ ‘Vertical silos’ are entities that integrate trading, clearing and settlement functions under one single ownership. According to a report by the Centre for European Policy Studies (*The Securities Settlement Industry in the EU – Structure, Costs and the Way Forward*, by K. Lannoo and Mattias Levin, 2001), “Their structure allows easier transactions since they remain within a single organisation and so increasing speed, safety and risk management whilst reducing costs. On the other hand, vertical silos may reduce user choice of settlement systems and thus the competition with other CSDs for the same service; they also ensure insufficient price transparency in the transaction chain by enabling trading systems to vertically subsidise (decreasing the fees of settlement in order to entice clients to use a particular trading system). The cost of this subsidy is borne by the users of the trading system and the competition on trading characteristics (spreads and services) may be distorted.”

being found. The key challenge over the coming years is for the market to develop the most efficient solutions in response to the needs of market players and for the governments to progressively remove any remaining legal and tax barriers to cross-border clearing and settlement.

Briefing notes are prepared by the Industry Advisory Committee to the European Parliamentary Financial Services Forum. For further information on the subjects raised in the briefs please contact the Chairman, Members or Secretariat of the Advisory Committee.

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