

Clearing and Settlement - Market Change and Public Interest

Summary: *The clearing and settlement systems and processes in Europe are fragmented across many national and international providers, which results in the cost of cross border transactions being significantly higher than the cost of domestic transactions. This can discourage pan-European investment strategies and trading. This problem was recognised some years ago and is being addressed by many official and/or market led initiatives aimed at identifying and addressing barriers to efficiency and also operational risk concerns.*

Most recently in March 2004, DG Markt published a Communication that outlined its proposed approach to addressing this problem titled: "Clearing and Settlement in the European Union – the Way Forward" and invited the European Parliament to endorse this approach.

1. Background

When the Financial Services Action Plan was drawn up in 2000, it was conceived that regulation of securities clearing and settlement processes in the EU should be covered as part of the Investment Services Directive upgrade. After public consultation, the Commission decided that impediments to cross-border clearing and settlement required specific focus and DG Markt, DG Ecfm and DG Competition have all been involved in exercises to review the dynamics of the market. The European Parliament and market practitioners also took initiatives in this area.

In summary, the clearing and settlement sector has witnessed the following developments:

- The Giovannini Group meeting under the auspices of the Commission, published its first and second reports in 2001 and 2003 respectively, which identified 15 mainly national barriers and suggested practical steps to address each of these
- In 2001, DG Competition performed a broad review of the clearing and settlement sector. Subsequently, an infringement decision was adopted against Clearstream in June 2004, but no fines were imposed. Clearstream is currently appealing the decision. In August 2004, DG Competition published for consultation an overview report about the securities markets infrastructure in the EU 25 countries.
- DG Markt has also published two Communications on this topic (2002 and 2004).
- The European Parliament adopted a Resolution in January 2003 (ECON Report known as the Andria Report) which highlighted the problems with clearing and settlement arrangements for cross-border transactions;
- In 2003, the Group of Thirty (G-30) (an international body of 30 individuals who collectively represent expertise in global financial services regulation) issued recommendations looking at the global issues related to clearing and settlement.
- In October 2004, the ESCB/CESR Working Group produced standards for clearing and settlement systems in the EU which are based on CPSS-IOSCO recommendations for securities settlement systems and include additional requirements deemed necessary for the European context;

A broad consensus exists among both industry and regulators that the desired end state for the structure of clearing and settlement systems in the EU must be less complex if it is to become more efficient. This does not necessarily mean a single central clearing or settlement system, like the DTCC (Depository Trust & Clearing Corporation) model in the US, but does imply harmonisation of market practices and legal and fiscal frameworks and further rationalisation and consolidation of providers. Critical factors to achieve this include: harmonised connectivity of common system platforms; interoperability between markets/systems through harmonised standards and common technical protocols; free and open access to infrastructures; convergence of rules and practices; transparent pricing; and appropriate governance structures addressing user needs (i.e. improving services and reducing costs), as well as systemic risk concerns.

There has already been some market-led progress towards achieving some of these goals. There has been considerable involvement by EU financial institutions, both individual banks and service providers and by associations. This includes work by ECSDA (the European Central Securities Depository Association) and EACH (European Association of Clearing Counterparty Houses) to move towards harmonised systems and processes and also work led by the European Securities Forum and the European Banking Federation. Examples of this work include the harmonisation of opening days and opening hours of Central Securities Depositories (CSDs) to be compatible with Target 2. In addition, there has been some consolidation of institutions involved in the market, for example the creation of Euroclear Group incorporating the CSDs of France, Belgium, Netherlands, UK and Ireland, the creation of LCH.Clearnet, and the consolidation across the Swedish, Finnish and Baltic markets. These are important steps but there is still a great deal more to be done, in terms of the delivery of common technical settlement platforms and harmonisation of market practices including in the field of taxation.

EU financial players, in particular the securities and banking industry, are working closely with regulators and the Commission to help shape a realistic and balanced future vision for the clearing and settlement infrastructure in Europe.

The Commission's View

The Commission's most recent Communication identifies the following measures and policies as the key to the achievement of its stated objective of "the creation of EU securities clearing and settlement systems that are efficient and safe and which ensure a level playing field among the different providers of clearing and settlement services":

- (a) the liberalisation and integration of existing securities clearing and settlement systems through the introduction of comprehensive access rights at all levels and the removal of existing barriers to cross-border clearing and settlement;
- (b) the continued application of competition policy to address restrictive market practices and to monitor further industry consolidation;
- (c) the adoption of a common regulatory and supervisory framework that ensures financial stability and investor protection, leading to the mutual recognition of systems;
- (d) the implementation of appropriate governance arrangements.

As specific follow-up to its Communication, the Commission intends to conduct a regulatory impact analysis (expected in the summer of 2005), before deciding whether to propose a directive on clearing and settlement. It sees the directive as a complement to the market-led removal of the barriers identified in the Giovannini Reports. Together these initiatives should provide a secure legal framework with common requirements across the EU. Such a framework would, the Commission believes, lift barriers to cross-border business on the basis of mutual recognition of the various national clearing and settlement systems (i.e. relying on home country supervision).

The Commission states that if a Directive is proposed, it will be a Lamfalussy-style initiative establishing principles of:

- comprehensive rights of access and choice;
- a common regulatory framework; and
- appropriate governance arrangements.

Industry's View

The development of the clearing and settlement infrastructure clearly requires a combination of regulatory initiatives and market forces. There are differing views among market users and infrastructure providers as to where and/or when additional legislation may be required. In particular, the infrastructure providers believe that the focus should be on removing the Giovannini barriers and that, while a directive that focuses on consistent regulation might be helpful, existing national and European competition law already provides an adequate safeguard for the maintenance of a fair and level playing field in Europe.

Some intermediaries believe that the functions executed by CSD's & CCP's (central counter parties) should be acknowledged as essential utilities for the industry. They have voiced concerns that, in the longer term, the consolidation of the clearing and settlement infrastructure and wider provision of services (including risk-based services) by the infrastructure providers may unduly distort competition (thereby risking the possibility of abuse of a dominant position) and may raise issues of systemic risk.

However, other market participants take the view that such concerns are outweighed by the large cost savings to be derived from consolidation and that effective steps can be taken to mitigate and control competition and risk concerns that have been identified.

There are additional concerns that the Commission should take into account the existing EU legal framework and regulations, especially prudential regulation of banks, in any future directive so as to avoid what could become duplicate regulation which could affect the competitiveness of EU players and markets compared to non-EU entities. The recent approval of the ESCB-CESR Standards for Clearing and Settlement adds complexity to the EU initiative and has raised questions about the risk of increased cost caused by having to implement multiple changes. However, CESR/ECB have indicated that these standards will not yet enter into force: a consultation round with industry is foreseen in 2005.

Most industry participants are strongly advocating the view that a directive, if any should be high level only and not prescriptive. These market participants believe this is essential in order to ensure that a very fast moving market environment is not prevented from making the rapid developments necessary to compete in the broader international markets by an inflexible fixed regulatory structure.

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

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