

Unblocking the plumbing - Clearing and Settlement

Summary:

- *There is general agreement in the market that the cost of cross border settlement – in particular for equities - remains too high.. Much progress has been made in understanding the so-called technical issues of the “plumbing” of the European financial markets. There has been a wide and open debate involving stakeholders and authorities over the last few years although there are still a variety of views as to how costs can be reduced most effectively.*
- *Market practitioners generally agree on the objective of an efficient, safe, transparent and integrated system. There is not yet a consensus on which final scenario is more desirable: a single infrastructure service provider or a reduced number of interconnected service providers competing with each other. Moreover there is still a lot of concern whether a directive would contribute to the achievement of progress.*
- *The main practical initiatives from the authorities over the last two years are (i) the establishment of the CESAME group chaired by DG Internal Market and of its three working groups looking at legal barriers, fiscal barriers and the functional definitions within the industry and (ii) the launch by DG Competition of a general inquiry into the relationships between trading, clearing and settlement systems, the results of which were published on 24 May 2006.*
- *At the same time the market has made considerable progress in removing the nine private sector Giovannini barriers to low cost cross-border clearing and settlement, one of which has already been effectively removed (Barrier number 8).*
- *As the options for further stock exchange consolidation in Europe develop, the focus of the post-trade discussions has shifted from settlement to clearing and to the respective merits of horizontal versus vertical integration of trading, clearing and settlement systems.*
- *DG Internal Market has recently announced that it will decide whether to propose any new legislation by July 2006. Any resulting proposal for a draft directive is expected in the last quarter of 2006 or start of 2007. There is still uncertainty as to when the Commission will publish its full Regulatory Impact Analysis (“RIA”). At the end of May, parts of what could be the final RIA were made public and are available for comments but it is not a formal consultation process.*

Introduction

There is a wide consensus that cross-border settlement costs in the EU - particularly for equities - are significantly higher than domestic ones, even if it is still impossible to have a reliable and objective quantification of the excess costs. Different parties, including the Commission, have estimated, using different methodologies, the extra cost for Europe of not having a fully integrated European clearing and settlement system and reached figures of excess cost ranging between €2 and €5 bn (total expenditure related to securities trading for EU15 is estimated by Mercer Oliver Wyman at €40 bn). These estimates give a snapshot of the market as a whole, and do not reflect the significant differences of costs and efficiency that exist between different products and services.

The industry and the authorities have worked towards reducing these costs by way of a range of solutions, including the following: supporting harmonisation of market practices and legal and fiscal frameworks; interoperability¹; and consolidation of providers.

- Many efforts have been made in the **harmonisation** process, whereby the private sector has made good progress on the so-called Giovannini barriers. There has been considerable involvement both by associations (including the European Central Securities Depository Association – “ECSDA”, the European Association of Clearing Houses – “EACH”, the European Securities Forum – “ESF” and the European Credit Sector Associations - “ECSAs”²) and individual suppliers (e.g. SWIFT and Euroclear). One barrier (relating to the use of security codes-

¹ Interoperability is “The ability of entities along the clearing and settlement processing chain to communicate and work with service providers and other participants without special effort on the part of users.” (The Group of 30, 2003).

² The ECSAs are the European Banking Federation, FBE, the European Savings Banks Group, ESBG and the European Association of Cooperative Banks, EACB.

barrier number 8) has already been removed. During the CESAME group meetings, the Commission has acknowledged the progress made by the market in removing particular Giovannini barriers³, and is now concentrating on how recommendations in these areas could be implemented quickly.

- The objectives of **interoperability** are to improve communication between systems through harmonised standards and common technical protocols, to achieve more efficient connections between system platforms, to guarantee non-discriminatory access rights between central counterparties (“CCPs”) and Central Securities Depositories (“CSDs”) with no exclusive arrangements at trading level and to harmonise rules and practices across Europe. The effectiveness, and therefore success, of interoperability solutions will depend to a large extent on the achievement of the harmonisation process. Interoperability is already quite widespread; there are around 60 links between CSDs within the euro-zone alone. However, most of these links are free of payment because the CSDs lack access to central bank money and to the intra-day liquidity provided by the central banks. Unless these constraints can be removed, interoperability between CSDs (while important) will always remain sub-optimal. Interoperable links also exist at CCP level.
- Despite the potential for further moves, the **consolidation** process has slowed after the creation of the NCSD (Swedish and Finnish CSDs), of the Euroclear Group (ICSD in Belgium and CSDs of France, Belgium, Netherlands and the UK), of Clearstream (ICSD in Luxembourg and CSD in Germany) and of the creation of the LCH.Clearnet group further to the merger of LCH. Ltd and Clearnet SA.

Not only the costs but also the safety and soundness of EU clearing and settlement arrangements are a major concern for European authorities. Clearing and settlement providers are subject to strict rules set out by their local regulators and are overseen by their national central banks. Following an international initiative by IOSCO and the Committee on Payment and Settlement Systems of the Bank of International Settlements (CPSS), the European System of Central Banks (“ESCB”) and the Committee of European Securities Regulators (“CESR”) launched an initiative to develop the CPSS-IOSCO standards to mitigate risk in clearing and settlement in Europe. These ESCB/CESR standards (see *Annex*) have faced strong challenges and have not been approved by the ECB or CESR. The European Parliament has questioned the legal basis of the work of CESR and the ECB on clearing and settlement.

The Commission is assessing whether these standards, that broadly adopt a risk-based functional approach, could form the basis for the common regulatory and supervisory framework it wishes to establish.

The European Parliament’s View

In response to the second Communication of April 2004, the European Parliament adopted a resolution on “Clearing and Settlement in the EU” (rapporteur Mrs. Piia-Noora Kauppi).

This report:

- Recognises the existence of inefficiencies in the clearing and settlement area (fragmentation in a multiplicity of domestic systems, insufficient harmonisation, high costs of cross-border transactions...);
- Supports the principle of the Regulatory Impact Assessment (“RIA”) carried-out by the Commission and that new regulation should be conditional on the result of this RIA;
- Takes a pragmatic approach and supports the work of the different clearing and settlement working groups put in place by the Commission (CESAME, Legal Certainty group and FISCO group);
- Is critical of the work of ESCB/CESR in this area (particularly its uncertain legal basis and lack of transparency) and requested the implementation of the ESCB-CESR standards to be postponed until after the decision on the potential proposal of directive on clearing and settlement;

³ In particular Barriers 1 (information technology and interfaces), Barrier 3 (corporate actions), Barrier 4 (intra-day settlement finality) and Barrier 7 (settlement deadlines and opening hours/day).

- Encourages the Commission to use its powers under competition law to guard against any abuse of a dominant position or other anti-competitive behaviour without pre-judging the need for ex-ante competition rules to prevent any wrongdoing.

Nevertheless, MEPs hold a variety of views on how to approach the clearing and settlement debate and how to solve the main issues. Clearly there is not a unanimous position regarding the tools to achieve this.

The Commission's View

In the area of clearing and settlement, the Commission is promoting an efficient and safe EU securities clearing and settlement system and a level playing field between providers of clearing and settlement services.

In April 2004 the Commission published a second Communication⁴ in which, in order to achieve its objectives, it proposed the following measures:

- Monitor the private sector's removal of the market practice and technical barriers identified by the Giovannini Reports
- Address the legal and fiscal barriers identified by the Giovannini Reports
- Ensure continued effective implementation of competition law
- Adopt, subject to a regulatory impact assessment, a framework directive on clearing and settlement covering:
 - open access (non-discriminatory access conditions and comprehensive access rights to EU clearing and settlement systems)
 - the adoption of a common regulatory and supervisory framework that ensures financial stability and investor protection, leading to the mutual recognition of systems
 - the implementation of appropriate governance arrangements

The Commission affirms that it is not taking any view on the structure of the clearing and settlement industry and has indicated that it will not deal with structural issues ("vertical" versus "horizontal" consolidation), governance models ("user owned" versus "publicly quoted") or financial models ("for profit" or "cost plus"). These are topics that are for market forces, or in extremis for the competition authorities to resolve.

The Commission's RIA will analyse three options, namely: (1) taking no legislative action, (2) proposing a framework directive and (3) more structural intervention. The RIA will seek to compare the impact of these three options on the four main policy areas: (a) market barrier removal, (b) access to settlement and clearing systems, (c) consistent supervision of these systems and (d) competition and governance issues. To demonstrate that a directive is justified, the RIA should provide evidence of the value of a directive in lowering cross-border costs, taking into account the costs of implementing new rules in comparison with the benefits for the market as a whole. These benefits could include monetary savings, greater stability and/or reduced risk.

The Commission recognises that the market is on the right track in delivering a detailed work plan to remove the private sector Giovannini barriers and is now keen to see the implementation of those standards already agreed by the market (ECSAs, ECSDA, Euroclear, ESF, SWIFT, etc).

MiFID also refers to clearing and settlement in Article 34. This gives a right of access of an investment firm in one Member State to the clearing and settlement system of another and on a non-discriminatory basis. In addition, it requires exchanges to offer all their users the option to designate the system in which they want to settle their transactions.

To date, the Commission has not given any guidance on how they wish Member States to implement the requirements of Article 34, though some think that if they do so this would be material in improving cost effective cross border clearing and settlement in the EU.

⁴ Communication from the Commission to the Council and the European Parliament – "Clearing and Settlement in the European Union - The way forward" - COM/2004/0312 final

On 7 March, the Competition and Internal Market Commissioners issued a joint statement in which they promised that they would act unless there was further action from the industry before the summer. The Commission is putting pressure on the operators and giving them a 'last chance' to avoid a directive. It is not entirely clear what the operators are expected to do in such a short period of time.

The Industry's View

There is broad agreement among market practitioners (shared with regulators) that the objective is to achieve an efficient, safe, transparent and integrated system. *There is not yet a consensus on how to achieve this objective and on which final scenario is more desirable:* a single infrastructure provider or a reduced number of interconnected service providers competing with each other. These differences of view are rooted in historical differences in the evolution of national markets which have produced different structures and regulated entities active in clearing, settlement and custody throughout the EU.

The view of market users

- Some believe that the traditional functions executed by CSDs and CCPs mean that they are market infrastructures, which provide certain central functions for the industry that other providers cannot or do not offer. While they support the consolidation of infrastructures to achieve higher efficiency, they have voiced concerns that infrastructures providing commercial services may use their dominant position to the detriment of competition. They are also concerned about the systemic risk implications of infrastructure service providers undertaking credit risk-taking activities. These intermediaries support a more comprehensive directive that includes provisions for the separation of commercial activities (in particular banking separation), from central functions.
- These market players support risk-based functional regulation that addresses financial risks (when the same function represents the same risks, it should be regulated in the same way, regardless of the provider of that function) but are concerned that it may be inappropriately applied to address competition issues that are best tackled by ex-ante competition rules. They would like the Commission to avoid double regulation in any future directive and take into account existing EU regulations, especially prudential regulation of banks.
- Other market users appear to be exclusively focused on the final objective of a less fragmented and more efficient clearing and settlement industry. They share the opinion that risk and competition concerns are outweighed by the large cost savings derived from consolidation and that effective steps can be taken to mitigate and control them without resorting to new legislation. Some intermediaries have also argued that vertical ownership (where a stock exchange owns a clearing system and a settlement system) increases the power of those exchanges to raise prices and allow them to reduce competition in the competitive components of the trading and post-trading chain. Governance is at the centre of their concerns as they would like to see users interest better represented within infrastructure service providers. Some of these intermediaries argue for the creation of a single CCP in Europe as they believe it could facilitate the dismantling of the vertical structures. But even those users that are supporting the views that something must be done to address vertical silos and to create a single CCP are not always convinced of the benefits of a directive.
- Market users active mostly in the wholesale bond markets underline that cross-border trading and post-trading in this market work fairly well in structural terms. They warn that any interference with post-trade structures – and even if rooted in the best intention of bringing down costs – need to be very well-calibrated in order not to jeopardise the global competitiveness of Europe's bond markets.

The views of the infrastructure providers

- Infrastructure service providers and some users believe that the focus should be on removing the Giovannini barriers, as the main source of additional cross-border costs, and that a limited directive that focuses on addressing the legal and fiscal barriers and on consistent regulation might be helpful. They regard the European clearing and settlement industry as a competitive market where CSDs, ICSDs and intermediaries compete with each other on different bundles of services with varying intensity, depending on the level of settlement activity undertaken by

intermediaries (internalisation), which varies in each Member State. They believe that existing national and European competition laws already provide an adequate safeguard for the maintenance of a fair and level playing field in Europe for clearing and settlement services. Infrastructure service providers, while they share the view that double regulation of providers should be avoided, strongly support a functional approach to regulation that should therefore logically apply *mutatis mutandis* in the same way to all providers of clearing and settlement services (CCPs, CSDs, ICSDs and intermediaries/agent banks). Indeed, some parties argue that the current debate on possible post-trading legislation focuses exclusively on one category of providers and overstate the impact of infrastructure service providers on the major sources of costs in this industry. According to a study⁵ from Morgan Stanley and Mercer Oliver Wyman, further confirmed by DG Competition own findings, around three-quarters of costs arise in the brokerage layer and infrastructures capture around 10% (with the rest arising in custody and data services).

- Owners of integrated trading, clearing and settlement systems defend their model, and highlight the benefits in term of increased economies of scope and the avoidance of double marginalisation. In any case they support the view that the debate on post trading costs should be independent of ownership structures.

Nearly all of these positions described above have remained stable over the last few years. Thus, there are still significantly divergent views among market participants on the level of the desired combination of regulatory initiatives and market forces, and more particularly on whether a directive is needed and what it should cover. However, while there are differences on the remedies, the majority agree that the legal and fiscal barriers are at the core of the excessive cross-border costs.

⁵ Equity Research paper of June 2003 entitled "Structural Shifts in Securities Trading: Outlook for European Exchanges"

Annex - Historical background

A Single Market in financial services has long been an objective of the European Union. In a Single Market, financial institutions authorised to provide financial services in one Member State would be able to provide the same services throughout the EU, competing on a level playing field within a consistent regulatory environment. Such a Single Market in financial services would “act as a catalyst for economic growth across all sectors of the economy”, estimated to generate a long-run increment to GDP of 1.1% based on a prospective reduction in the cost of capital (report for the Commission by London Economics).

When in May 1999, the European Commission published the Financial Services Action Plan (further endorsed by the Lisbon European Council in March 2000), no specific regulation was foreseen for clearing and settlement, but a long list of initiatives took place outside of the FSAP:

- In March 2001, based on the power granted by Article 11 of the Treaty, the European Commission launched an ex-officio investigation into clearing and settlement by sending a first round of request for information to members of clearing and settlement agencies, trading platforms and banks.
- In October 2001, the European System of Central Banks (“ESCB”) and the Committee of European Securities Regulators (“CESR”) established a Working Group to define standards aimed at increasing the safety, soundness and efficiency of securities clearing and settlement activities in Europe. The working group comprises representatives from the European national central banks, the European Central Bank, the Members of the CESR and the CESR secretariat. It was jointly chaired by the ECB and by CESR; the European Commission sat on the Working Group as an observer. The basis for their work on standards was the CPSS/IOSCO Report “Recommendations for securities settlement systems” issued in November 2001.
- The Giovannini Group, a group established in 1996 to advise the Commission on financial integration and the efficiency of euro financial markets, produced its first report in November 2001, identifying 15 technical market practice, legal and fiscal barriers to low cost cross-border settlement. A second report in April 2003 set out action plans and allocated responsibilities for removing these barriers.
- DG Internal Market issued a first communication to the European and the European Parliament in March 2002 “Clearing and Settlement in the European Union: Main policy issues and future challenges” (COM/2002/0257).
- The European Parliament responded to the first Commission’s consultative comment on clearing and settlement in December 2002. The resolution passed in January 2003 (“Andria report” - PE 315.011 A5-0431/2002).
- In January 2003, The Group of Thirty⁶ (“G30”) released its second report on clearing and settlement, “Global Clearing and Settlement: A Plan of Action”, that sets out 20 recommendations⁷ that it believes are needed to create the framework for an interoperable global network of clearing and settlement infrastructures, which is both robust and efficient. The report came out 13 years after the last set of G30 recommendations (1989), which were due to be implemented by 1992.
- As part of DG Competition’s general inquiry and its assessment of the compatibility of the structure of clearing and settlement with the EC rules on competition, in March 2003 the Commission issued a statement of objections to Clearstream, contending that Clearstream had refused to supply services to Euroclear and had undertaken discriminatory pricing. Clearstream has disputed the findings and is currently contesting the decision.

⁶ The Group of Thirty – Consultative Group on International Economic and Monetary Affairs, Inc was established in 1978, as a private, non profit, international body composed of very senior representatives of the private and public sectors and academia. It aims to deepen understanding of international economic and financial issues, to explore the international repercussions of decisions taken in the public and private sectors, and to examine the choices available to market practitioners and policymakers. The Group is supported by contributions from private sources: foundations, banks, non-bank corporations, central banks, and individuals.

⁷ The report recommends a series of wide-ranging measures, including the creation and implementation of global standards in technological and operational areas, improvements in risk management practices (mitigating risks), further harmonisation of global legal and regulatory environments, and improved governance for providers of clearing and settlement services. The focus of the G30 report is global, rather than regional, and therefore is not always relevant to Europe’s advanced infrastructure.

- In April 2004, the European Commission issued its second Communication to the Council and the European Parliament, "Clearing and Settlement in the European Union - The way forward" (COM/2004/0312).
- The ESCB/CESR standards which extended the CPSS-IOSCO standards, were published in October 2004 and adopted a functional approach to the regulation of providers of securities settlement services. This proved controversial as many banks feared that they would be caught by duplicate regulation. The standards have not yet been implemented and are currently 'on ice' pending the final agreement of CESR and the ECB.
- In July 2004, as a follow-up to its Communication, the Commission established the Clearing and Settlement Advisory and Monitoring Expert Group (CESAME), followed, in early 2005, by the establishment of the Fiscal Compliance Experts Group (FISCO) and the Legal Certainty Group that, inter alia, work with the industry to remove the so-called Giovannini barriers. In April the FISCO Group produced a fact finding report which identifies the key tax issues and has already started to work on a Report which will look at ways of tackling the problems that have been identified. The report is due for the beginning of 2007. The Legal Certainty Group which has a mandate to analyse issues of legal uncertainty relating to the integration of EU securities clearing and settlement systems, and advise the Commission accordingly, is still in the process of considering the comprehensive responses contributed by its members in response to its questionnaire about the legal framework for securities in the European Union. It is expected that the group issue its initial report in the course of the summer and it seems that the group is considering recommending to the Commission to propose legislation in the area of legal effects of book entry securities.
- The new European Parliament adopted a report to respond to the second Commission Communication in July 2005, "Report on Clearing and settlement in the European Union" (PE 353.491 – A6-0180/2005; Rapporteur: Piia-Noora Kauppi)
- In September 2005, DG Competition launched a general inquiry into the trading, clearing and settlement sector to analyse in particular the "vertical silo" issue and assess where exclusive arrangements are put in place between service providers of the trading chain: stock exchanges, central counterparties, central securities depositories, international central securities depositories and also banks. DG Competition preliminary overview appears to be that: (a) competition at all levels of the infrastructure value chain is possible and beneficial (including at the CCP layer); (b) wherever competition is impeded they will examine and if necessary take action; and (c) they are still examining the effects of trading, clearing and settlement on downstream markets where most of the costs in the clearing and settlement industry appear to be. DG Competition issued their conclusions on 24 May 2006 for consultation.
- In May 2006 DG Competition published a first set of conclusions drawn from the questionnaires regarding competition in trading, clearing and settlement in the EU: two days prior, DG Internal Market published a "Draft Working Document on Post-Trading" comprising a preliminary summary on its work regarding definitions, reactions to the Communication and analysis of possible actions and also aiming at quantifying the benefits of post trade cost reductions in general. This document is not the RIA and does not specify whether the Commission intends to propose a directive and what its content would then be.
- Commissioners Kroes and McCreevy are expected to announce the further policy approach by the Commission in the plenary session of 5 July, including the decision whether or not to propose a draft directive. Such a directive proposal would then be made public towards the end of the 2006 or early 2007.

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 Secretariat of the Financial Industry Committee.

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