Opinion of the European Economic and Social Committee on the 'Proposal for a regulation of the European Parliament and of the Council on improving securities settlement in the European Union and on central securities depositories (CSDs) and amending Directive 98/26/EC'

COM(2012) 73 final — 2012/0029 (COD)

(2012/C 299/14)

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On 15 March 2012 the European Parliament and on 3 April 2012 the Council of the European Union decided to consult the European Economic and Social Committee, under Article 114 of the Treaty on the Functioning of the European Union, on the

Proposal for a regulation of the European Parliament and of the Council on improving securities settlement in the European Union and on central securities depositories (CSDs) and amending Directive 98/26/EC

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The Section for the Single Market, Production and Consumption, which was responsible for preparing the Committee's work on the subject, adopted its opinion on 12 June 2012.

At its 482nd plenary session, held on 11 and 12 July 2012 (meeting of 11 July), the European Economic and Social Committee adopted the following opinion by 110 votes to two with four abstentions.

1. Conclusions and recommendations

1.1 The EESC welcomes this Regulatory initiative. With the CSD Regulation in place, the Commission will have completed the three pillars of the new framework of financial infrastructure regulation in the EU: CSD, EMIR and MiFID/MiFIR.

1.2 The introduction of the Euro has been a catalyst for cross-border investment in securities and the smooth functioning of cross-border investment is predicated on common standards across the Union. A high degree of settlement discipline reduces counterparty risk, or more specifically liquidity risk and replacement risk. More importantly, it promotes investor protection; helping to ensure that transactions between buyers and sellers of securities are settled in a safe and timely manner. In this respect, the Regulation is an important step forward towards the completion of the Single Market.

1.3 A major change proposed in the scope of CSD activities is the prohibition from holding a limited banking licence. This will affect the two big international CSDs which use their banking capabilities to support the settlement and custody process on a very large scale. The EESC recognises that the weight of global opinion (G20, European Commission, IOSCO, etc.) is strongly in favour of splitting out the credit institutions. The Committee supports the Commission and believes that a standalone bank is the best outcome.

1.4 The proposal for a uniform settlement requirement at T+2 is very important. While it is likely that this can be achieved in the EU, a number of concerns will need to be addressed for global transactions.

1.5 The proposals require the dematerialisation of tradable securities. There is a transition period ending on 1st January 2020. Even so, Member States have made uneven progress in this regard and a political compromise may be needed.

2. Introduction

2.1 The Central Securities Depositories (CSDs) are systemically important institutions for the financial markets. Any trade of securities on or off a securities exchange is followed by post trade processes that lead to the settlement of that trade, which is the delivery of securities against cash. The CSDs are the key institutions that enable settlement by operating so-called securities settlement systems. CSDs also ensure the initial recording and the central maintenance of securities accounts that record how many securities have been issued by whom and each change in the holding of those securities.

2.2 CSDs also play a crucial role for the collateral market especially for monetary policy purposes. For instance, almost all of the eligible collateral for central bank monetary policy operations in the EU, especially in the Euro area, flows through securities settlement systems operated by CSDs.

2.3 Securities settlement systems in the EU settled approximately EUR 920 trillion worth of transactions in 2010, and held almost EUR 39 trillion of securities at the end of 2010. There are over 30 CSDs in the EU, generally one in each country, and two "international" CSDs (ICSDs – Clearstream Banking Luxembourg and Euroclear Bank), which are a subcategory of CSDs specialised in the issuance of international bonds, commonly known as "Eurobonds".

2.4 While generally safe and efficient within national borders, cross border settlement supporting cross border investment is more complex and attracts higher costs than domestic settlement. For example, the number of settlement fails is higher for cross-border transactions than for domestic transactions and cross-border settlement costs are up to four times higher than domestic settlement costs. In general, CSD costs are minimal within the overall costs involved in using all elements of the infrastructure, although they are an important cost for issuers.

2.5 These safety problems are the result of a number of factors, including:

— The length of the settlement cycle. The time between trade and settlement is not harmonised in the EU, creating disruptions when securities are settled cross-border.

— A small but substantial proportion of securities still exists in paper form. These are settled after a much longer settlement cycle, which increases the risk incurred by investors.

— Settlement fails, which are situations where a transaction fails to be settled on the intended settlement date, are not subject to deterrent penalties in all markets and where they exist settlement discipline measures differ widely between markets.

— While Directive 98/26/EC on settlement finality in payment and securities settlement systems (SFD)1 reduces the disruption to a securities settlement system caused by insolvency proceedings against a participant in that system, it does not address other risks of the system or the resilience of the CSD operating the system. Some CSDs are subject to additional credit and liquidity risks derived from the provision of banking services ancillary to settlement.

— Agreements between CSDs to link-up, while being considered as a first step towards the consolidation of the European settlement markets, raise safety concerns in the absence of specific prudential rules for such links. In addition, they increase the interconnectedness between CSDs, which justifies further the introduction of a common prudential framework.

2.6 The absence of an efficient single internal market for settlement also raises important concerns. Important barriers to the European post trading market continue to exist, such as for instance the limitation of securities issuers' access to CSDs, different national licensing regimes and rules for CSDs across the EU and limited competition between different national CSDs. These barriers result in a very fragmented market. As a consequence, the cross-border settlement of transactions relies on unnecessarily complex holding 'chains' often involving several CSDs and several other intermediaries. This has a negative impact on the efficiency, but also on the risks associated with cross-border transactions.

2.7 These problems are important as cross-border transactions in Europe, ranging from usual purchases/sales of securities to collateral transfers, continue to increase and CSDs become increasingly interconnected. These trends are expected to accelerate with the advent of Target2 Securities (T2S), a project launched by the Eurosystem to provide a borderless common platform for securities settlement in Europe, which is scheduled to start in 2015.

3. **Gist of the Proposed Regulation**

3.1 The proposed Regulation has two main parts: measures addressing all market operators in the context of securities settlement (Title II) and measures addressing specifically CSDs (Titles III, IV and V).

Securities Settlement

3.2 Title II imposes the so-called dematerialisation/immobilisation of securities, which is the issuance of securities in book entry form. This measure is aimed at increasing the efficiency of settlement, facilitating the shortening of settlement periods and ensuring the integrity of a securities issue by allowing for easier reconciliation of securities holdings. The proposed Regulation provides for a sufficiently long transitional period, until 1 January 2020, in order to allow market operators from the Member States where significant amounts of paper securities still exist to comply with this measure.

3.3 It harmonises the settlement period for the securities transactions across the EU. In Europe most securities transactions are settled either two or three days after the trading day, depending on each market. The settlement period will be harmonised and set at two days after the trading day, although shorter settlement periods will be allowed.

3.4 It harmonises settlement discipline measures across the EU. These consist of ex ante measures to prevent settlement fails, and ex post measures to address settlement fails.

Authorisation and Supervision of CSDs

3.5 Directive 98/26/EC defines already securities settlement systems as formal arrangements allowing transfers of securities between different participants. However, that directive does not address the institutions which are responsible for operating such systems. In view of the increasing complexity of such systems and risks related to settlement, it is essential that institutions operating securities settlement systems are legally defined, authorised and supervised along a set of common prudential standards.

3.6 CSDs will have to be authorised and supervised by national competent authorities of the place where they are established. However, in view of the increasing cross-border element of their activity, other authorities, related to the securities settlement system(s) operated by the CSD and to other group entities would have to be consulted. ESMA will have an important role in developing draft technical standards to harmonise the authorisation process and to ensure cooperation between authorities.

3.7 The proposal grants authorised CSDs a "passport" to provide services in the Union, either by providing directly a service in another Member State or by establishing a branch in that Member State. A CSD from a third country can be granted access to the Union if it is recognised by ESMA.

Requirements for CSDs

3.8 Since CSDs are systemically important and perform critical services for the securities market, they must be subject to high prudential standards to ensure their viability and the protection of their participants. The requirements for CSDs are grouped into several categories: organisational requirements, conduct of business rules, requirements for CSD services, prudential requirements and requirements for CSD links.

3.9 The conduct of business rules require that operations be non-discriminatory, transparent and strictly risk based and that a full disclosure of costs and revenues be made to the competent authorities.

3.10 The requirements for CSD services include obligations about the intra-day settlement of accounts and the segregation of accounts. Regarding cash settlement, the proposal requires CSDs to settle on central bank accounts whenever practical and available. Commercial bank money settlement is allowed, however, contrary to some current practices, it must be done via a separate credit institution that acts as settlement agent.

3.11 The prudential requirements for the CSDs themselves include important provisions on the mitigation of operational risk. Since CSDs would not be permitted to perform banking type of services directly, the key risk CSDs will face is operational risk. These provisions include appropriate measures to ensure the continuity of operations, including settlement, at all times. Capital requirements are also set by reference to operating expenses – CSDs should hold capital, retained earnings and reserves to cover at least six months of operating expenses.

3.12 The requirement for CSD links involves the setting up of identical settlement finality rules.

Access to CSDs

3.13 Opening up the market for CSD services and removing barriers of access is one of the objectives of this initiative. Three types of access are considered: (a) between issuers and CSDs, (b) between CSDs themselves, and (c) between CSDs and other market infrastructures.

3.14 The draft introduces the right of issuers to record their securities in any CSD authorised in the Union as well as the right for CSDs to provide services for securities that have been constituted under the law of another Member State.

3.15 A CSD should have the right to receive transaction feeds from CCPs and trading venues and those infrastructures should have access to securities settlement systems operated by CSDs.

Credit Institutions

3.16 When central bank settlement is not practical or available, CSDs may offer commercial bank money settlement to their participants. However, CSDs should not provide the banking services ancillary to settlement themselves, but should be authorised by their competent authorities to designate a credit institution to act as settlement agent to open cash accounts and grant credit facilities to facilitate settlement.

3.17 This separation between CSDs and settlement agents is an important measure to address and increase the safety of CSDs. Banking services ancillary to settlement increase the risks to which CSDs are exposed and therefore the likelihood of CSDs suffering a default or being subject to severe stress.

3.18 While the banking services are usually provided by some CSDs on intraday basis (are fully covered by collateral and other financial resources) and are limited to the services ancillary to settlement, the amounts handled are however significant and any default of such CSDs would have negative consequences for the securities and payments markets. The requirement to provide the banking services in a separate legal entity than the one which provides the core CSD services will prevent the transmission of risks from the banking services to the provision of core CSD services, in particular in case of insolvency or severe stress resulting from the banking services.

3.19 For the CSDs which currently provide banking services, the main costs associated with this measure are the legal costs involved in the setting-up a separate legal entity for providing banking services. The Commission believes that there are no less stringent alternatives to the separation of banking services, which would entirely eliminate the danger of transmission of risks from the banking services to the core CSD services.

3.20 In order to secure the efficiencies resulting from the provision of both CSD and banking services within the same group of undertakings, the requirement that banking services be carried out by a separate credit institution should not prevent that credit institution from belonging to the same group of undertakings as the CSD.

3.21 The competent authority should be able to demonstrate on a case by case basis the absence of systemic risk incurred by the provision of both CSD and banking services by the same legal entity. In such a case, a reasoned request could be made to the European Commission which may authorise the derogation. In any case, the activities of a CSD licensed as credit institution should be limited to the provision of banking services ancillary to settlement.

Sanctions

3.22 A stock taking of the national supervisory regimes in place has, for example, revealed that the levels of pecuniary sanctions vary widely among Member States, that some competent authorities do not have certain important sanctioning powers at their disposal and that some competent authorities cannot impose sanctions on natural and legal persons. Therefore the Commission proposes minimum set of administrative sanctions and measures should be available to the competent authorities, including withdrawal of authorisation, public warnings, dismissal of management, restitution of profits gained from the breaches of this Regulation where those can be determined, and administrative fines.

4. **EESC Perspective**

4.1 The EESC welcomes this Regulatory initiative. With the CSD Regulation in place, the Commission will have completed the three pillars of the new framework of financial infrastructure regulation in the EU: CSD, EMIR and MiFID/MiFIR. Together, these three instruments comprise a wide ranging and comprehensive coverage of the market. The Commission must take care to ensure that these instruments dovetail together without overlaps which could lead to varying interpretations of the new rules. It is also vital that these various legislative initiatives are coherent and consistent with each other in key areas.

4.2 ESMA will have responsibility for drafting technical standards for this new legislation, as well as for the other two pillars. The Committee notes the scale of tasks and responsibilities being assigned to ESMA in a relatively short time frame. Inter alia, these also include responsibilities for the regulation of Credit Rating Agencies, the supervision of the Audit sector, involvement with short selling and credit default swaps, supervision of the AIFM Directive. It is vital that ESMA has the headcount with the skill and the experience to carry out its tasks effectively.

4.3 With financial services firms being subject to new regulation, new supervision, new prudential requirements, etc, the CSD regulations will create another set of changes for the financial services industry. The EESC supports the introduction of these further changes, but urges regulators and supervisors, particularly ESMA, to be alert to potential problems which could be caused by regulatory overload.

4.4 The introduction of the Euro has been a catalyst for cross-border investment in securities and the smooth functioning of cross-border investment is predicated on common standards across the Union. A high degree of settlement discipline reduces counterparty risk, or more specifically liquidity risk and replacement risk. More importantly, it promotes investor protection; helping to ensure that transactions between buyers and sellers of securities are settled in a safe and timely manner. In this respect, the Regulation is an important step forward towards the completion of the Single Market.

4.5 Also in the context of the Single Market, the "passporting" proposal is to be welcomed as it will help to remove barriers to access while in the same vein, issuers will be given the right to record their securities in any CSD authorised in the EU. This breaking of national monopolies is also to be welcomed in the Internal Market.

4.6 The low risk approach to the definition of the CSD business model, combined with the fact that the model will in effect be limited by regulation, may be expected to have both positive and negative effects on CSD competitiveness and innovation. Opening up the cross border market will be an undoubted plus. Otherwise, CSDs are permitted to undertake a range of services so long as they contribute to enhancing the safety, efficiency and transparency of the securities markets. In addition to this and in order to further stimulate innovation, the EESC proposes that CSDs only be prohibited from owning non CSD businesses when such activities would be to the detriment of the CSD's risk profile.

4.7 One major change proposed for the scope of CSD activities is the prohibition of a CSD from holding a limited banking licence. This will affect the two big international CSDs - Euroclear and Clearstream - which use their banking capabilities to support the settlement and custody process on a very large scale. The scope of the banking activities is very limited, and it came through the recent crisis without any problems. Nevertheless, the EESC recognises that the weight of global opinion (G20, European Commission, IOSCO, etc.) is strongly in favour of splitting out the credit institutions. CSDs will be permitted to set up a bank with limited scope under group ownership. This is not expected to cause a major revision of the CSD business model.

4.8 Notwithstanding the Commission's stated view that there is no alternative to the separation of banking from the CSD's core business, the provision outlined in paragraph 3.21 above provides for a possible derogation when it is supported by the national competent authority. Although the possibility of the derogation exists, the Committee supports the Commission and believes that a stand alone bank is the best outcome.

4.9 The proposals require the dematerialisation of tradable securities. There is a transition period ending in 2020. Even so, Member States have made uneven progress in this regard and a political compromise may be needed.

4.10 Another key proposal is a uniform settlement requirement at T+2. While it is likely that this can be achieved in the Internal Market; a number of concerns will need to be addressed for global transactions. These include the complications created by foreign exchange, the possibility that stock may be on loan, time zone mismatches, different settlement cycles in the markets of other regions and the significant cost which may be involved to automate systems in order to make T+2 possible.

4.11 The Regulation basically requires all CSDs to put in place regimes which "fine" participants who do not settle on time, but the regime must be tailored to the instrument. Fining late delivery of illiquid or SME shares would have a detrimental effect on their market liquidity. Derogation should be considered for listed SMEs. The draft Regulation does not discuss the destination of funds raised by fines.

Brussels, 11 July 2012.

The President
of the European Economic and Social Committee
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