EUROPEAN MONETARY INSTITUTE

OPINION OF THE EUROPEAN MONETARY INSTITUTE

(98/C 156/12)

Consultation from the Council of the European Union within the meaning of Article 109f(6) of the Treaty establishing the European Community and Article 5(3) of the Statute of the EMI relating to a proposal for a European Parliament and Council Directive on settlement finality and collateral security (the draft Directive).

CON/96/09

1. The above consultation was initiated on 10 July 1996 by the Council of the European Union which, for this purpose, submitted the text of the draft Directive together with an explanatory memorandum (Doc. COM(96), 193 final) to the EMI.

2. The EMI welcomes the draft Directive as being of crucial importance to the efficient and smooth functioning of payment systems. Adoption would also foster the stability of financial markets and institutions in general. Studies over the past few years on the legal aspects of payment systems identified the following five areas of particular attention:

   — validity and enforceability of bilateral and multilateral netting,

   — irrevocability of transfer instructions,

   — elimination of the retroactive effect of insolvency proceedings (abolition of the zero-hour rule),

   — mitigation of the potentially distortive impact of foreign law on arrangements governing participation in payment systems if either a participant and/or collateral are located in another jurisdiction,

   — abolition of impediments to the realisation of collateral provided in the framework of payment systems or monetary policy operations.

   All the above issues have now been addressed in the draft Directive.

3. The EMI supports the choice of a Directive for the same reasons as mentioned in the Commission's explanatory memorandum to its proposal for a Directive. The development of smooth and efficient cross-border payment systems to support the internal market as well as the conduct of a single monetary policy in stage three of EMU on the one hand, and the differences in the laws of the Member States on key features of payment systems on the other hand, require a degree of harmonisation which can only be achieved through a binding legal instrument establishing the general framework for such harmonisation.

4. The EMI would welcome application of the regime of the Directive to securities settlement systems in order to avoid systemic risks in the financial markets. These financial markets are to such a large degree interdependent that issues such as, for instance, irrevocability of transfer instructions and the abolition of the zero-hour rule cannot and should not be dealt with for payment systems in isolation. For example, the unwinding of the settlement in a securities settlement system may have a negative impact on the stability of financial markets and institutions in general and in particular on interconnected or associated payment systems.

   Payment systems and securities settlement systems are functionally interdependent through delivery-versus-payment mechanisms, now commonly used in most European countries in order to ensure that parties can (irrevocably) settle their obligations with the confidence that their counterparties have done the same, thus safeguarding the smooth functioning of financial markets. If the cash limb of such operations were final, and the Directive aims at this for payments, whereas the securities limb could still successfully be challenged by, for example, a liquidator, this could endanger the settlement of the operations concerned and give rise to systemic risk and, as a result, the stability of the financial markets

in general could be undermined. Also, in those Member States where the above mechanisms are supported through statutory and/or contractual provisions, adoption and implementation of the Directive must not lead to any unintended distortions of the equilibrium in the mechanisms through imposition of finality of payments but not for delivery of securities. Such problems can be avoided if the regime of the draft Directive also applies to securities settlement systems.

In addition, to the extent that securities settlement systems provide for netting, this should be supported by legislation for the same reasons as for which netting in payment systems is supported (see also paragraph 6, first indent). Finally, securities settlement systems should, to the same extent as payment systems, benefit from the draft Directive's provision that a foreign participant's rights and obligations in relation to participation in a payment system in another country, in case of such a participant's insolvency, are governed by the insolvency law of the country where that payment system is located. The same applies to the protective measures of the Directive for holders of collateral in the framework of payment systems, which could also be usefully applied to securities settlement systems.

The EMI is of the opinion that securities settlement systems should preferably be covered in the present Directive rather than in a separate Directive. Firstly, it is highly unlikely that such a separate Directive could successfully be negotiated in parallel and adopted and implemented before stage three. Secondly, it is undesirable that legislation on the same types of issues is dispersed over various pieces of Community legislation, not least because this could lead to inconsistencies. None the less, the EMI's primary concern with regard to the draft Directive is its timely adoption and implementation in order to safeguard the smooth functioning of payment systems in stage three of EMU. Extension of the draft Directive to securities settlement systems should therefore not be permitted to delay this process. It seems possible to avoid the delay, which would arise if a separate Directive were to be prepared by making various amendments to the draft Directive in order to cover securities settlement systems. This may be accomplished in different (not mutually exclusive) ways, namely: through adjustment of several core definitions (e.g. payment order, payment system); through the introduction of new definitions (e.g. to specify the scope of the terms securities, securities settlement systems and fund transfers through such systems); and, through appropriate references and expansion of the text in all relevant Articles. The EMI stands ready to provide drafting suggestions and to assist in analysing the implications of amendments to the present draft for the financial industry if this was felt to be appropriate. Finally, acknowledging that the Directive will be adopted through a co-decision procedure between the European Parliament and Council, and again with a view to the avoidance of delays, it is suggested that the Council informs the Parliament as soon as possible of its efforts to include securities settlement systems in the Directive in order to avoid delays during the second reading.

5. With regard to payment systems, the EMI's primary concern is that those systems where systemic risks may arise should all be covered. It is acknowledged that formulating a concise definition to catch all arrangements involving systemic risks is not a straightforward or easy task, particularly as such arrangements may vary in nature and form in Member States. The EMI is, though, at the same time of the opinion that the draft Directive should contain a more unambiguous indication as to the scope of its applicability and that the definition of the scope should be more clearly aimed to catch all systems which may incur or cause systemic risks.

The definition of 'direct participation' in Article 2(b), and particularly the words 'entailing responsibility for settlement', seem to imply a scope of applicability which is restricted to those payment systems which, in the EMI's Compendium on Payment Systems in the European Union of April 1996 (the 'Blue book'), are defined as funds transfer systems, i.e. '... arrangement[s] ... with multiple membership, common rules and standardised arrangements, for the transmission and settlement of monetary obligations arising between members'. In the opinion of the EMI, the Directive should indeed, as a minimum, cover such arrangements. However, the EMI understands from Article 2(h) of the draft Directive that its intended scope is not restricted to such systems and that indirect participation (or sub-participation), as well as correspondent banking are also meant to be covered. The EMI is of the opinion that, depending on the system, there may be good reasons to extend the scope of the Directive in order to cover payment arrangements which could, perhaps indirectly, lead to systemic risks, the very situation which the Directive seeks to prevent. This is particularly true for payment systems with indirect participants or sub-participants.

Caution may, however, at the same time be appropriate with regard to an unlimited extension of the protection of the Directive to any bilateral payment arrangements, if such arrangements do not have the potential to create any systemic risks. Therefore, as far as correspondent banking arrangements are concerned, the EMI is of the opinion that correspondent banking should be included to the extent that the protection of the Directive is needed to avoid systemic risk situations which might ensue from the role of correspondent banks in linking payment systems.

6. The EMI makes the following, generally supportive, remarks on individual provisions of the draft Directive. These remarks are to a large extent infuenced by the situation which entails the biggest threat to the smooth and efficient functioning of payment systems and securities settlement systems: the insolvency of a participant in such systems.

— *Article 3*

Doubts on the enforceability of netting under all circumstances, and particularly in insolvency situations, have in the past been a major obstacle to the development of funds transfer systems and in particular payment systems in certain jurisdictions. A clear legal basis for netting would therefore assist greatly in facilitating efficient payment systems. This would eliminate the risk that a liquidator of an insolvent participant may successfully require unwinding of net positions and the inherent uncertainties about real exposures between participants thereby eliminating a further element of systemic risk from systems which currently operate on a net basis and which have members from a number of jurisdictions, some of whose insolvency laws may currently not respect netting. This would have a beneficial effect on the stability of financial markets and institutions. The EMI therefore fully supports the proposal that netting is made enforceable through this Directive,

— *Article 4*

Irrevocability of transfer orders is indeed a prerequisite for the smooth and efficient functioning of payment systems. Irrevocability serves the need to safeguard the technical functioning of a payment system. It does not, however, preclude the issuer of a payment order (or its liquidator), after execution of that payment order, from making a claim equal to the value of the payment if the underlying circumstances of the transaction give grounds for doing so. The draft Directive recognises this principle, which is welcomed by the EMI,

— *Article 5*

The zero-hour rule (entailing retroactive effect of a bankruptcy to 0:00 hours on the day of the insolvency) exists in various Member States and threatens the efficient and smooth functioning of payment systems, and the EMI therefore supports the fact that this issue is now being dealt with in a conclusive manner through the draft Directive,

— *Article 6*

The fact that rights and obligations arising from, or in connection with, participation in a payment system shall be determined by the insolvency law of the country where such a system is located contributes to legal clarity. It is important, however, to ensure that the draft Directive and the winding-up Directive are not inconsistent on this point.

Also, the EMI notes with satisfaction that Article 6 and Article 2(1), when read in conjunction with each other, provide for two possibilities in terms of applicable (insolvency) law: the law chosen by the participants in a payment system to govern their payment arrangements or, in the absence of a choice, the law of the Member State where the settlement takes place. For cross-border payment systems, it is important that these two possibilities are maintained, as in cross-border payment systems settlement agents may be located in different countries and a specific country of location of the payment system does, therefore, not exist. In this connection, the EMI understands that Article 6 of the draft Directive will support the adoption of the most appropriate legal construction and the choice of the applicable law for the Target system which is presently being constructed by the EMI and the national central banks of the Member States,

— *Article 7*

The requirement that collateral provided in the framework of participation in a payment system or in the framework of monetary policy operations may be realised in accordance with the terms of a participation or credit agreement is again a further prerequisite for the smooth and efficient func-

tioning of payment systems and the conduct of monetary policy. Interference with such realisation would not only endanger the smooth and efficient functioning of payment systems, but also the stability of financial markets and institutions as a whole. Also, Article 18 of the Statute of the ESCB/ECB obliges the ECB and the national central banks of the Member States to require 'adequate' collateral in the framework of their credit operations. This requirement cannot be fulfilled, if under circumstances where collateral had to be realised, namely insolvency situations, realisation could not take place in accordance with the terms of a participation or credit agreement due to constraints on such realisation under the laws of various jurisdictions. This is particularly important where the single market, the creation of the Target system and the conduct of a single monetary policy in stage three logically will lead to the extended use of remote access to payment systems and possibly to monetary policy operations as well as to cross-border use of collateral. A *conditio sine qua non* for such possibilities is, without prejudice to other conditions, that collateral may be realised in accordance with the terms of the participation or credit agreement. The EMI therefore fully supports the objective of Article 7 of the draft Directive.

The text of this Article as it reads now may, however, lead to confusion where the term 'pledge' is used. Other types of operations to provide collateral such as repurchase transactions and other arrangements specific to particular Member States should be covered as well (see the second full consideration in the recitals to the Directive and the broad definition of collateral security in Article 2.1). The EMI suggests that this, for reason of legal clarity, be made clear in the draft Directive.

7. The EMI agrees that this opinion may be made public by the Council of the European Union at its discretion.