



EUROPEAN CENTRAL BANK

THE SCOPE OF APPLICATION OF THE ESCB-CESR STANDARDS

1. In October 2001 the Governing Council of the ECB and the Committee of European Securities Regulators (CESR) established a co-operative framework in the field of securities clearing and settlement. A joint Working Group (hereafter referred to as “the Group”) was set up, composed of representatives of the ECB and of the 15 European Union (EU) national central banks and of the members of the CESR.
2. The Group has focused on defining common standards aimed at increasing the safety, soundness and efficiency of securities clearing and settlement activities in Europe. It is currently finalising a set of standards (hereafter referred to as the “ESCB-CESR standards”) for providers of securities clearing and settlement services. These standards are based on the CPSS-IOSCO report “Recommendations for securities settlement systems” issued in November 2001. In this context, the Group is facing the challenge of identifying the entities to which the ESCB-CESR standards should be applied. This is due to the fact that the CPSS-IOSCO recommendations were developed for use worldwide and it was left to the national authorities to specify the entities or the functions to which they should apply.
3. The Group is currently discussing the possibility of dividing up the future ESCB-CESR standards as follows:
 1. The standards on legal framework (S1), trade confirmation (S2), settlement cycle (S3), communication procedures (S16) and regulation and oversight (S18) are of a general nature and would, where appropriate, apply to a broad range of service providers and market players such as CSDs¹, CCPs, custodians, market participants, regulators, etc.
 2. The standard on custody risk (S12) would apply to all entities involved in the business of holding customers’ securities accounts, such as CSDs, registrars, CCPs and custodians.
 3. The standards on CCPs (S4) and CSDs (S6) would exclusively apply to institutions providing CCP and CSD services respectively, and to their participants.
 4. The standards on securities lending (S5), delivery versus payment (S7), settlement finality (S8), risk control measures (S9), cash settlement assets (10) and operational reliability (S11) would apply to all operators of systemically important systems.
 5. The standards on governance (S13), access (14), efficiency (15) and transparency (17) would apply to CSDs and CCPs. Moreover, since these standards aim at ensuring that the operators of securities

¹ For the purpose of this note, the term CSDs covers both national CSDs and international CSDs.

settlement systems do not use their market strength to discriminate against other market participants or to overprice their services, the Group has also considered the possibility of extending the scope of those standards to custodians that have a dominant position in their market.

6. Finally, the standard on cross-system links (S19) would apply to CSDs and systemically important settlement systems establishing links.
4. The difficulty that the Group is currently facing is how to define the criteria for identifying “systemically important” institutions. In principle, systemic importance can be implied from two different circumstances:
 1. An institution is systemically important if it operates a core, and often unique activity in the settlement process and ensures key functions for financial stability and the smooth functioning of the financial markets. In other words, it operates a systemically important system.
 2. An institution can be systemically important if it settles amounts so large – in terms of volume and value – that its failure could potentially jeopardise the smooth functioning of payment and settlement systems, as well as the stability of financial markets.
5. Following the first definition, CSDs and CCPs can be viewed as systemically important because they provide core functions in the issuance, custody, clearing and settlement process. Their systemic importance therefore derives from the central role they play and the nature of their functions, rather than from the size of their operations.
6. Custodians, or at least the major custodians, may belong to the second type of systemically important institutions.

Criteria for identifying systemically important custodians

7. The Group is seeking to elaborate on the following four criteria in order to identify systemically important custodians.
 1. The magnitude of the activities, and as a consequence the potential risks and impact on the market that the failure of such an institution would have. It is assumed that the systemic impact is correlated to the value and volume of the transactions handled by the custodian, in relation to the size of the market concerned (e.g. equities, bonds and derivatives). Care should be taken when using size thresholds, since these could be circumvented through branches and subsidiaries.
 2. The number of systems (operated by CSDs) to which the institution is linked, since this has an influence on the transmission of a given problem to the rest of the financial system, and to other systems, countries and currencies.
 3. The nature and number of the custodian’s clients. The failure of a custodian whose customers are large financial institutions, including non-banks, may have a detrimental impact on market liquidity. Moreover, the possibility of contagion is higher when the custodian’s clients are intermediaries that

can, in turn, contribute to spreading liquidity and credit problems to other market participants. From an investor perspective, the concept of systemic importance is more linked to the number of investors who might suffer in the event of the institution defaulting.

4. The possibility of being replaced in the event of failure. Custodians whose core settlement functions cannot quickly be performed by another organisation in the event of operational or financial failure are more likely to be considered systemically important, as their failure could result in gridlock.

A proposal

8. In developing a business continuity framework, the US regulators (Federal Reserve, Comptroller of the Currency and the Securities and Exchange Commission (SEC)) recently published an “Interagency Paper on Sound Practices to Strengthen the Resilience of the US Financial System”. In this paper, the American regulators define “core clearing and settlement organisations” and firms that play a “significant role in financial markets”. The term “core organisations” includes not only market utilities such as the US CSDs (Fedwire systems for Government bonds and the Depository Trust and Clearing Corporation (DTCC)), but also private sector firms that provide clearing and settlement services, when their market share is significant enough to present a systemic risk in the event of their sudden failure to continue those activities because there is no viable immediate substitute. The definition of “significant” organisations includes, as a guideline, firms that consistently clear or settle at least 5% of the value of transactions in the “critical market”.
9. On the basis of the criteria identified above and taking into account the US example, the Group is currently considering drawing the following distinctions:
 1. A systemically important provider can be defined as an institution that has a share of [5%] at EU level or [25%] at domestic level (or lower, at the discretion of the national authorities), in the relevant markets;
 2. For the purpose of this definition, three relevant markets would be distinguished: bonds, equities and derivatives.

Some methodological aspects (e.g. how to avoid double accounting, whether the definition of participants should refer to a single entity or a group, etc.) would need to be further specified in the follow-up work.

10. Even in instances where a custodian falls below the agreed thresholds, the relevant authorities could nevertheless decide that it is systemically important on the basis of criteria 2, 3 and 4 above.

11. Issues to be addressed

1. Do you agree that some of the scope of the standards should be extended to systemically important providers of securities clearing and settlement services other than CSDs and CCPs?

2. Should the extension be to all custodians, or should it be limited to systemically important providers of securities clearing and settlement services?
3. What are the criteria along which - according to your opinion – the systemically important system could be defined? What would you consider to be the essential elements that should be apart of such a definition?
4. Do you agree that systemically important providers could be defined as institutions with a business share of [5%] at EU level or [25%] at domestic level (or lower, at the discretion of the national authorities) in each relevant market?
5. Do you agree that three relevant markets can be considered – bonds (public and private), equities and derivatives – or would a different categorisation be helpful?
6. Which of the ESCB-CESR standards should apply to all systemically important custodians?
7. What would be the implications of extending the scope of the standards to cover systemically important providers of securities clearing and settlement services?
8. Do you agree that standards 13, 14, 15 and 17 should apply to custodians with a dominant position in one market? If yes, how would you define a dominant position?