**Narodowy Bank Polski, Domestic Operations Department - Comments on *Draft Technical Standards for the Regulation on improving securities settlement in the European Union and on central securities depositories – Discussion Paper*, prepared by ESMA.**

In connection with article 6 and 7 of the proposal for a regulation of the European Parliament and the Council on improving securities settlement in the European Union and on central securities depositories (CSDs) (Regulation) in its *Draft Technical Standards for Regulation on improving securities settlement in the European Union and on central securities depositories – Discussion Paper,* ESMA proposes that all CSDs in Europe should use procedures facilitating settlement of transactions in financial instruments to improve securities settlement and prevent settlement fails. In principle, the concept is valid, as it prevents an adverse phenomenon of settlement fails in the securities market. It is worth noting, however, that in the securities settlement system operated by central banks using such procedures is unjustified and problematic due to the specific nature of central banks and their special status among institutions engaged in clearing and settling transactions in securities. Taking the example of the Securities Register (SR) operated by Narodowy Bank Polski (NBP) we will present issues connected with the SR functioning and arguments for a possible exclusion from use of the above mentioned procedures, or their appropriate adjustment, as the present proposals are, in many cases, inadequate or impossible to be implemented by such systems.

In the Polish legislation the possibility of operating a depository is clearly defined. Pursuant to article 3 item 21 of the Act on trading in financial instruments, “depository for securities” shall mean a system for the registration of dematerialized securities, comprising securities accounts, omnibus accounts and deposit accounts kept by entities authorised to do so under the provisions of the Act, maintained by the National Depository for Securities. At the same time, the Act allows clearing and settlement of transactions and the registration of securities issued by the State Treasury or NBP in a separate system operated by NBP. Therefore, despite the fact that the activities of the SR are, in principle, covered by the definition of CSD set forth in article 2 item 1 of the Regulation, i.e. the SR constitutes a clearing system for T-bills and NBP money bills and accounts and deposit accounts for securities are maintained in it, NBP is of the opinion that there exist fundamental reasons for excluding such a system from the obligation to meet some of the rules. The reasons are, among others:

1. The above mentioned Regulation defines CSD as “a legal person that operates a securities settlement system” while SR is not a legal person, it is not a separate organisational unit, it is a system that operates within the structure of NBP in one of the departments. It is NBP – which operates SR – that has a legal personality. Hence, it should be said that in accordance with the definition NBP is a central depository, which is hardly acceptable. The activities of NBP and the internal organisation are managed by the Management Board of NBP, headed by the NBP President as the Management Board Chairman. The key purpose of NBP activities and its tasks are set forth in the Act on Narodowy Bank Polski. To sum up, SR is not a legal person and does not have the capacity to independently enact law on its activities (all legal acts that regulate the functioning of SR are resolved by the Management Board of NBP).
2. Pursuant to Polish legal provisions in force (the above mentioned Act on trading in financial instruments enumerates the securities that may be registered in the system) SR is a registration and settlement system used only in relation to:
3. Treasury bills,
4. NBP bills.

Referring to point 2) 1 above, SR plays a double role for Treasury bills:

- issuing agent for Treasury bills – NBP, acting on behalf of the Minister of Finance, is the entity responsible for servicing the issue of Treasury bills,

- system, in which Treasury bills are registered on accounts and deposit accounts.

The number and value of Treasury bills in circulation is determined by the Minister of Finance who finances the State budget deficit with the issue of bills.

Referring to point 2) 2 above – SR for NBP bills is, first of all, a tool used to implement monetary policy. The issuer of NBP bills is NBP. By issuing NBP bills the Bank regulates liquidity of the banking sector and influences money market interest rates. NBP bills may be purchased by banks and only banks can trade in these instruments – this is a financial instrument designated only for the banking sector. In addition, NBP bills are commonly recognised as securities but do not have the characteristics of securities, as they do not have the ISIN code and are not homogeneous, which means that its distinguishing feature is its type (e.g. a 2-day bill, a 7-day bill) and not the date of maturity, as various bills may mature on the same date. Pursuant to the above mentioned Act on trading in financial instruments (article 2, para 1, point 2), being a money market instrument it is a financial instrument other than a security.

1. Very limited scale of SR activities:

* accounts and deposit accounts are operated by SR only for two securities – treasury bills and NBP bills;
* at present, 45 entities are participants of SR. Pursuant to the By-laws (implemented in accordance with a resolution of the Management Board of NBP), the participants are banks holding a current account with NBP and two entities other than banks – KDPW (the National Depository for Securities) - in this case it acts only as purchaser of Treasury bills on its own account and the Bank Guarantee Fund (BFG) - an entity that contributes to the safety and stability of banks. It also operates the deposit guarantee scheme in Poland;
* turnover on the secondary market in 2013 (combined trading in Treasury bills and NBP bills) – the value of transactions settled in SR amounted to PLN 288 billion (approximately EUR 70 billion) with the number of transactions standing at 2,582;
* transactions are settled only in PLN;
* SR does not conduct cross-border settlements.
* SR is not operationally connected to other depositories – it does not hold accounts for other depositories and does not have accounts in other depositories.

Taking into account the purpose SR serves (primarily NBP monetary policy), changes in this respect are not justified.

In line with the above information, the activity of SR is very specific and limited in terms of its scope – the number of participants is small and well defined, there are only two types of securities for which accounts and deposit accounts are held, and transactions in the secondary market are limited in terms of both value and number. **It should also be noted that there are a number of factors of an economic and technical nature that make it necessary to exclude some systems from the obligation to meet all the principles set forth in the Regulation. Since 2011, not a single SR transaction has been reported as unsettled; in previous years, the number of unsettled transactions was negligible (for example, in 2010 only three such transactions were recorded).** This result is due to, on the one hand, the small total number of transactions settled in SR, and, on the other hand, the set of tools applied in the system to counteract potential settlement fails, which includes: the use of STP, compulsory matching of settlement instructions, continuous settlement (RTGS), real-time query tools which give the participant information on the status of the transaction (status of instruction execution) and the account and deposit account balance, and securities lending (at the request of the participant). It can therefore be assumed that the procedures and tools used in SR to counteract settlement fails are correct and sufficient. The introduction of additional mandatory requirements, which constitute more sophisticated methods of avoiding settlement fails, such as: the use of optimisation algorithms, inter alia applying technical netting, partial settlement of a transaction, recycling of settlement instructions by the CSD in order to settle any failed settlement instructions in a later settlement procedure, substituting a failed settlement instruction with a number of smaller instructions, mandatory use of communication standards (e.g. ISO 20022 message format), seem unjustified (the cost of implementing new solutions is inadequate to the potential benefits).

The above changes would require significant modifications of information systems that support SR, and therefore adaptation to all the technical requirements imposed by ESMA would be expensive and not beneficial in any way. If no settlement failures are recorded, increased spending on tools reducing the risk of their occurrence is not justified.

The implementation of the above changes would require significant modifications of IT systems that support SR, and therefore adapting to all technical requirements imposed by ESMA would be expensive and would not lead to the effects justifying the cost incurred. Since there are practically no settlement failures, increased spending on tools reducing the risk of their occurrence is not justified.

Some of the principles proposed by ESMA would prove impossible to implement. For example, the immediate matching of settlement instructions (T-2 - two days before the settlement) would prove most problematic, as the settlement of the sale of NBP bills by NBP to banks under open market operations is conducted on a T+0 basis (operation carried out on a given day is settled on the same day); transactions carried out ​​in the secondary market between banks are also concluded and settled on the same day. The principle of matching settlement instructions in the T-2 mode cannot be applied in this case.

It would be equally impossible for SR to operate the buy-in mechanism. The central bank is not legally authorised to carry out activities necessary to apply such a procedure. It should also be noted that the majority of transactions (around 95%) in Treasury bills and 100% of transactions in money bills are concluded on the OTC interbank market and the buy-in process may not, therefore, be carried out by CCP or trading venue.

Given that SR does not conduct commercial activities and is not a "for-profit" organisation (as it is a part of NBP), fees for managing accounts and deposit accounts in SR are no higher than the costs incurred (the cost of maintaining IT systems supporting tasks that NBP performs in this regard – on-going maintenance, changes and modifications – constitute a large share of total expenses). In a situation where NBP would have to incur significant expenses due to the adjustment of IT systems to the requirements imposed by ESMA, the governing bodies of NBP would be forced to raise the fees for maintaining accounts and deposit accounts in SR, which would be disadvantageous for its participants. This would be inconsistent with ESMA’s declaration set forth in Chapter III.I, point 10 of the *Discussion Paper* which says that implementing the standard reducing the number of instructions that fail to settle should be achieved without inflicting unnecessary costs on the CSDs and their participants.

It should be mentioned that the small number of transactions settled referred to above, results partly from the decreasing issues of Treasury bills. This is the consequence of the strategy of public debt management adopted by the Minister of Finance. The implementation of the goal of the strategy, i.e. minimising the cost of debt servicing, required the introduction of changes in its structure. The risk of refinancing the public debt was reduced considerably, inter alia by the increasing role of medium- and long-term bonds in funding lending needs, and a parallel decrease in the role played by Treasury bills. At present, the Minister of Finance has suspended the issue of bills, which, however, does not translate into a total resignation from using this instrument. A flexible approach to influencing the structure of funding in terms of instruments used is one of the factors influencing the correct strategy implementation. The significant role of NBP in the cooperation with the Minister of Finance should be emphasised. NBP has been the issuing agent of Treasury bills since 1995 and has been carrying out tenders for bills and keeping their register in accordance with an agreement with the Minister of Finance. This activity of NBP is positively viewed both by financial market participants and the Minister of Finance. Should the cost of these operations increase significantly, NBP will be forced to transfer a part of the expenses onto the Ministry of Finance or even resign from performing this function altogether. Both solutions are not beneficial from the Ministry of Finance point of view.

Given that all procedures and tools preventing settlement fails are assumed to be designated for institutions carrying out only deposit operations aimed at optimizing the process of securities settlement, bearing relevant expenses with a simultaneous maximization of profits generated from their operations, please consider introducing relevant provisions in the standards that would enable a system like SR – having a small turnover and insignificant number of unsettled transactions (sometimes none) – to use the existing procedures and tools that effectively prevent settlement fails, or, alternatively, in accordance with the principle of proportionality, secure a situation where the obligations imposed by ESMA would not lead to the need to incur additional costs.

To emphasise the differences resulting from the specific nature of securities registering systems on accounts and deposit accounts, we would like to present a comparison of certain aspects of SR and CSD (KPWD) operations:

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| **SR** | **CSD (KDPW)** |
| * no legal personality, * type of securities registered in SR are limited by law, * no independent governing bodies, * “non profit” operations, * no capacity to enact law, resolutions adopted by the Management Board of NBP, * operates in the structure of the central bank, * the commonly binding legal provisions do not provide for the central bank to impose pecuniary penalties on SR participants who do not settle their transaction under SR, * in SR there is only one type of participation, * no cross-border connections with other securities registering entities, * around 2,600 transactions settled per annum. | * has legal personality, * depository for all dematerialized securities available on the market, * has governing bodies in place, * “for profit” operations, * Independently adopts resolutions and other regulations related to the participation in CSD, * is an independent organisational unit subordinated only to the ownership supervision and the Polish Financial Supervision Authority, * has the capacity to impose sanctions and pecuniary penalties, * many types of participation in CSD, * has cross-border connections with foreign deposit and settlement institutions, * around 18 million transactions are settled per annum. |