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COMMISSION STAFF WORKING DOCUMENT

SUMMARY OF THE IMPACT ASSESSMENT

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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}
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Introduction

Any trade of securities on or off a securities exchange is followed by a *post-trade* flow of processes that leads to the settlement of the trade, which means the delivery of securities against cash. These processes are typically undertaken by so called "post trading infrastructures", including Central Counterparties (CCPs) for *clearing* and Central Securities Depositories (CSDs) for *settlement*.

CSDs are important institutions in the post trading area in that they generally ensure the recording, safekeeping and settlement of securities – the latter by operating so called securities settlement systems. CSDs also play a crucial role for the collateral market, especially for monetary policy purposes – almost all of the eligible collateral for monetary policy operations in the EU, especially in the Euro area, flows through securities settlement systems. Securities settlement systems in the EU settled approximately €920 trillion worth of transactions in 2010 and were holding almost €39 trillion of securities at the end of 2010.

CSDs are therefore *systemically important* for the markets they operate in, and are becoming more interconnected due to the increase in cross-border transactions in Europe; by some measures cross-border trading represents around one third of total securities transactions in the European market. CSDs, and post trading processes in general will become even more closely interconnected with the advent of Target2 Securities (T2S), a project launched by the Eurosystem that should provide a common platform for securities settlement in Europe (T2S is scheduled to start in 2015).

The EU market for CSD services is very fragmented, with over 30 CSDs and two ICSDs (International CSDs – Clearstream Banking Luxembourg and Euroclear Bank). By comparison the entire US securities market is served by only two CSDs, DTC and FedWire.

Political mandate and stakeholder consultation

The EU Commission services have worked on post trading issues for more than 10 years. This work was endorsed by a Resolution of the European Parliament of 2003 on a consultation by the Commission on clearing and settlement, and outlined by a Communication from the Commission to the Council and the European Parliament of 2004 on clearing and settlement in the EU.

More recently, political support has been demonstrated:

- In a joint letter of 8 June 2010, Chancellor Merkel and President Sarkozy invited President Barroso to consider the possibility of harmonisation of settlement periods in Europe;

- The ECOFIN Council of 2 December 2008 emphasised the need to strengthen the safety and soundness of securities settlement systems and agreed that EU legislation is needed to address legal barriers relating to post-trading, including barriers of access to CSDs.

The need for appropriate standards for CSDs is also agreed internationally:

- Recommendations for settlement systems were adopted by global banking and securities regulators (CPSS-IOSCO) as early as 2001. These were adapted by European regulators (ESCB-CESR) in 2009;

- In October 2010 the Financial Stability Board re-iterated the call for updated standards for more robust core market infrastructures, including CSDs, and asked for the revision and enhancement of existing standards.

The Commission services have engaged in extensive consultations with stakeholders, including regulators, CSDs and CSD participants. A public consultation was held from 13 January to 1 March 2011 and received 101 responses.

Overview of the issues

While generally efficient and safe within national borders, national post-trading systems combine and communicate less efficiently and less safely *across* borders, which means that an investor faces higher costs and higher risks when making a cross-border investment. For example, cross-border settlement costs are up to four times higher than domestic costs.

The impact assessment report identifies three key issues: higher *risks* and higher *costs* for cross-border settlement and *unlevel playing field* for competition for CSD services. These are the consequences of a number of drivers, briefly described below.

Different market practices concerning the organisation of settlement

(a) Different settlement discipline practices

Practices differ as to whether or how various settlement discipline measures, such as promotion of early settlement, monitoring of settlement fails, incentives for timely settlement, penalties and buy-in obligations are used in different EU markets. This leads to an increased number of *settlement fails* for cross-border transactions and favours *regulatory arbitrage* (in particular in a competitive situation post-T2S).

Definitions of settlement fails differ as well, thus affecting the ability of a market participant, a CSD or a regulator to understand areas of risk, identify mitigating measures and act accordingly, especially in a cross-border environment.

Industry initiatives have been taken to harmonise some of these market practices, but progress has been relatively slow. The ESCB-CESR recommendations also include certain principles regarding settlement discipline, however for the large majority of measures there is no implementation plan.

(b) Different settlement periods

Settlement of most securities transactions does not happen instantaneously, but generally a number of days after the trade date; most securities in Europe settle on T+3 or T+2, that is three or respectively two days after trade date. Different settlement periods create a number of problems for cross-border transactions: (a) additional operational *risk*, (b) increased funding *costs,* for instance for investors buying securities in a T+2 market and selling them in a T+3 market, and (c) *disruptions for corporate actions* by creating confusion about which investors are entitled to dividends. Longer settlement periods cause uncertainty and increased counterparty risk for investors.

An industry-led Harmonisation of Settlement Cycles (HSC) working group was created in 2009 under the auspices of the Commission services to assess the need for and preferred option for harmonisation. The group recommended harmonisation at T+2.

Different rules for CSDs

CSDs in the EU are regulated at national level and Member States have adopted different solutions for this. For instance some countries do not allow their CSDs to carry out banking activities while in other countries CSDs can provide certain banking services, which introduce additional risk into CSDs operations.

The ESCB-CESR recommendations provide supervisors with guidelines for assessing the safety, soundness and efficiency of CSDs, however these guidelines are of a general and non-binding nature.

The different rules, coupled with the barriers of access described below, lead to the *fragmentation* of the EU post trading market. This fragmentation results in the cross-border settlement of transactions relying on complex holding chains, with consequences for the *safety* and *efficiency* of such transactions. Lack of efficiency translates into higher costs for cross-border settlement when compared to domestic settlement, as well as increased operational and funding costs for investors who are not able to place their assets in a single liquidity "pool".

The different rules and the barriers of access also contribute to the *virtual monopolies* enjoyed by domestic CSDs, at least for certain services and securities, such as notary services for equities.

Barriers of access to CSDs

(a) Access of issuers to CSDs

The freedom for an issuer to choose its CSD is still limited in many Member States, especially as concerns equities. These restrictions contribute to a *lack of competition* between CSDs and *fragmentation* of the EU market, with all the consequences described above.

(b) Access between CSDs and between CSDs and other market infrastructures

In an increasingly cross-border environment CSDs and other market infrastructures (such as trading venues and CCPs) need to access each other in order to compete on a level playing field basis. These rights of access are not guaranteed by EU or national legislation.

The European associations of CSDs, exchanges and CCPs signed a Code of Conduct in 2006, which set some general principles in this respect, but on a voluntary self-imposed basis and only for equities.

The EU's right to act

EU action appears appropriate in terms of subsidiarity for the following reasons:

- The problems defined above relate essentially to cross-border issues. Consequently, the effectiveness of remedies implemented in an autonomous and uncoordinated way by individual Member States would likely be very low in a cross-border context;

- The systemic nature of CSDs and their increasing interconnection in Europe calls for coordinated action;

- Certain aspects of the identified problems are covered by the existing acquis *communautaire*, notably the Financial Collateral Arrangements Directive, the Settlement Finality Directive, the Market in Financial Instruments Directive and the Capital Requirements Directive (CRD). Any new proposal would need to tie in perfectly with these EU measures. This can be best achieved in a common effort.

Objectives

The goal of the impact assessment is to investigate the possibility of finding solutions at EU level to the problems outlined above. The strategic objectives are to increase safety, efficiency and level playing field for cross-border CSD services. The report also defines concrete operational objectives:

(1) Enhance framework for settlement – by (1.1) improving cross-border settlement discipline and (1.2) harmonising settlement periods;

(2) Introduce consistent rules for CSDs across Europe – by harmonising (2.1) the licensing framework, (2.2) the prudential and organisational rules, and (2.3) the authorisation and supervision regimes of CSDs;

(3) Remove barriers of access to/from CSDs – this refers to both (3.1) access between issuers and CSDs as well as (3.2) between the CSDs themselves and between CSDs and other market infrastructures.

Policy option(s) and instrument(s)

The impact assessment sets out and analyses a number of policy options for each operational objective, and compares them against the *status quo*.

(1.1) For cross-border settlement discipline, the following options have been considered: obtaining additional commitments from the industry, introducing common settlement principles, prescribing the use of standard settlement discipline processes or introducing measures that address the whole trading/post-trading chain. The option of introducing binding common principles at EU level has been retained on the basis that it promotes standardisation and safety, yet allows innovation and flexibility in a changing market environment. This is the option favoured by the HSC working group as well.

(1.2) For settlement periods, the options considered have been T+1, T+2 and T+3. In line with the HSC working group conclusion, the T+2 option appears to have more merit as it reduces counterparty risk and collateral requirements and it encourages greater automation; these are ongoing benefits, while the implementation costs for market participants are one-off and are only marginally higher than for a T+3 harmonisation.

(2.1) For the licensing framework, the report compares a mutual recognition of CSD services across the EU with an EU licence (and passport). An EU licence (and passport) has been retained as the best way to achieve level playing field and competition between CSDs. This is in line with the views of the large majority of respondents to the public consultation, although the views differ as to the scope of the licence, notably whether such a licence should include banking services, where CSDs take principal risk.

Regarding such banking services, the report compares an integrated model, whereby a CSD provides certain banking services subject to stricter requirements for these services than under the CRD (for instance full collateralisation of credit) and a segregated model, whereby such banking services are provided by a separate credit institution, with no limitation on scope of activity, but subject to the same prudential requirements for these services. The segregated model has been retained on the basis that it mitigates risk spillover from the banking activities to the other CSD activities and thus ensures that CSDs have a low risk profile more suitable for such systemically important infrastructures. This important benefit does not appear to be outweighed by the implementation costs of this measure, which are mainly legal/transaction costs for setting up a separate legal entity and renegotiating existing contracts.

(2.2) For the prudential rules, the report considers two main options of introducing such rules: by introducing common principles in EU legislation, with detailed technical standards to be developed by ESMA in cooperation with the ESCB, or by prescribing detailed common rules in legislation. In line with stakeholders' views, the first option has been retained because it allows: (a) flexibility in adapting detailed measures to market circumstances, (b) better alignment with international standards, and (c) involvement of the ESCB in setting such measures – this is important in managing regulatory burden for CSDs, since the settlement systems they operate are overseen by central banks.

(2.3) For the authorisation and supervision framework of CSDs, the report considers several options: national authorisation/supervision of CSDs with involvement of other Member States authorities, where applicable, national authorisation/supervision with involvement of ESMA, a combination of these two options or authorisation/supervision by ESMA. The combination of national/authorisation supervision with involvement of other Member States authorities and of ESMA has been retained on the basis that it would allow authorities to be directly involved in the authorisation and supervision of CSDs with cross-border activities in a flexible way that does not put unnecessary regulatory burden on the smaller CSDs, while ensuring a certain standardisation of this cooperation for the larger CSDs.

(3.1) Introducing a right of issuers to issue securities in the CSD of their choice contributes to the opening of the market provided by the EU licence. This is reinforced by an obligation that listed securities are entered in book entry form, which would also increase settlement efficiency and facilitate the shortening of settlement periods as book entry securities are much easier to deliver than paper based securities. The impact on the few markets that still use paper-based securities could be mitigated by setting an implementation date that allows those markets to adapt.

(3.2) Access rights between CSDs and between CSDs and other market infrastructures are also important to accompany an EU licence.

Many of these policy options are inter-related. The combined results could be:

- In the short term, more competition between CSDs, with expected benefits for cross-border service quality and fees. This could translate into immediate benefits for issuers, but the translation of CSD fees into lower costs for investors may be undermined if the competition results in more fragmentation in the short run;

- In the medium to long term, more consolidation of the market and less fragmentation (shorter cross-border holding chains), with benefits in terms of lower risk and costs for cross-border settlement. This could translate into lower costs along the whole post trading chain to investors;

- Overall, the proposed policies could facilitate issuers' ability to raise capital and investors' ability to place their funds more safely and cost effectively, with wider benefits for the economy.

It is not obvious to quantify these benefits. The Commission services draft working document on post-trading of 2006 gave some estimates based on the cost differences between cross-border and domestic transactions and between European and US transactions (derived from the available studies at the time, mostly dated 2001-2004):

- Between €2 billion and €5 billion of aggregate excess post-trading cost for investors;

- Approximately €700 million of additional cost reductions from market consolidation.

These numbers give an indication of orders of magnitude but probably over-estimate the potential benefits of legislation today because the gap between cross-border and domestic costs has decreased and T2S is expected to further reduce both domestic and cross-border costs.

In view of the preferred options and of the need to ensure that the legislative framework is applied uniformly throughout the EU, a Regulation is deemed as the most suitable policy instrument to achieve the desired objectives.

Monitoring and evaluation

Ex-post evaluation of all policies is a top priority for the Commission, as the market is constantly changing. The evaluation will in particular test whether the measures are still effective and efficient against the objectives developed above. The report proposes a monitoring and evaluation framework that combines regular monitoring by ESMA, industry surveys and external studies. The report also proposes the monitoring of other areas where problems were identified but EU intervention is not currently proposed, such as internalisation of settlement outside designated and notified settlement systems.