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Response of the DACSI* to the draft recommendations CESR

The DACSI is pleased to contribute to the CESR public consultation regarding draft recommendations for Securities Settlement Systems (SSSs) and Central Counterparties (CCPs)

I) General remarks

1. The DACSI is pleased that the Recommendations attribute to the elimination of the Giovannini Barriers.
2. Several Recommendations are equal for CSDs and CCPs, for instance regarding Governance. The DACSI stresses that these recommendations should be kept in line, also after adjusting to the comments made. Therefore, we would suggest a set of (general) recommendations that apply to both CSDs and CCPs and a separate set of recommendations that are more specific for CSDs or CCPs.
3. The DACSI welcomes the strong emphasis put by the Recommendations on ensuring the safety and soundness of the post-trade infrastructures in the EU.
However, we regret that the Recommendations definitely lack stringency in the necessary ring-fencing of CSDs (and therefore of their participants) from liquidity and credit risk. Considering their central role to the market, CSDs should not be allowed to take credit risks and liquidity risk and the use of central bank money should be generalised. Services as securities borrowing and lending and granting credit lines should therefore not be part of the services offered by CSDs or CCPs and The CESR-ESCB Recommendations, concerned with encompassing all the existing national differences, do not make this necessary step forwards in the strengthening of safety and soundness of post-trade infrastructures.
4. The Recommendations cannot be the foundation of a Mutual Recognition process between Member States. By all means, the compliance with these minimal obligations by a European Infrastructure cannot be leveraged by it as a form of "European passport". If the compliance with these Recommendations allows the provision of cross-border infrastructure services throughout Europe, despite more stringent local regulations, then this set of Recommendations would reduce to the level of safety and soundness and induce regulatory arbitrage.
5. Regarding the issue of links between CSDs: whatever the number of so-called "relayed links", there should be only one system providing settlement finality for any transaction. Imposing uncertainty on the finality of the settlement would put the entire settlement at risk. The circulation of conditional finality throughout linked systems is the most dramatic way to propagate systematic risk, by submitting all participants of several domestic markets to unexpected unwinding of settlement with systemic domino effects.

*The Dutch Advisory Committee Securities Industry is the principal, not for profit association in The Netherlands for firms active in the securities industry. The Association represents the interests of its members on all aspects of their securities and securities related business - both domestic and international - and positions the Dutch view to the market infrastructures service providers and regulatory authorities in The Netherlands and the European Union.

II) Specific remarks

Part I

Recommendation 1: Legal Framework

Securities settlement systems, links between them or interoperable systems should have a well-founded, clear and transparent legal basis for their operations in the relevant jurisdictions.

The DACSI agrees with this recommendation and clearly supports the introduction of one European legal framework as proposed by the Legal Certainty Group.

Recommendation 2: Trade confirmation and settlement matching

Confirmation of trades between direct market participants should occur as soon as possible after trade execution, but no later than the trade date (T+0). Where confirmation of trades by indirect market participants (such as institutional investors) is required, it should occur as soon as possible after trade execution, preferably on T+0 but no later than T+1. Settlement instructions should be matched as soon as possible and, for settlement cycles that extend beyond T+0, this should occur no later than the day before the specified settlement date.

C1. The DACSI agrees that confirmation should occur no later than T+1. The term matching should be explained as it seems that pre-matching is meant. Matching (binding) should be possible up till the specified settlement date.

Recommendation 3: Settlement cycles and operating times

Rolling settlement should be adopted in all securities markets. Final settlement should occur no later than T+3. The benefits and costs of EU-wide settlement cycles shorter than T+3 should be evaluated. The operating hours and days of CSDs should be open at least during the operating time of the relevant payment system (at least during TARGET2 operating times for transactions denominated in euro).

The DACSI is of the opinion that there should be only one standard settlement period across markets (T+3). Exemptions should however be possible for certain type of transactions such as repo's and borrowing and lending. These exemptions should be agreed on by the market.

The DACSI agrees on the statement that CSDs should be open during the operating days of the payment system. With regard to the opening hours however, we feel that the operating hours of the CSD should be shorter (e.g. one hour) than the operating hours of the payment system for realignment of cash end of day. We also feel that DVP night-settlement (based on auto-collateralisation) should be possible on the SSS platform of the CSD.

Recommendation 4: Central Counterparties (CCP)

The benefits and costs of establishing a CCP should be evaluated. Where a CCP mechanism or guarantee arrangement has been introduced, it should be assessed against the ESCB-CESR Recommendations pertaining to CCPs or against the checklist for guarantee arrangements respectively.

The DACSI agrees that the benefits and costs of establishing a CCP should be evaluated. The number of CCPs should be as less as possible.

Recommendation 5: Securities lending

Securities lending and borrowing (or repurchase agreements and other economically equivalent transactions) should be encouraged as a method for avoiding settlement failures and expediting the settlement of securities. Barriers that inhibit the practice of lending securities for this purpose should be removed. The arrangements for securities lending should be sound, safe and efficient.

The DACSI is of the opinion that lending & borrowing should be encouraged for avoiding settlement failures. However, securities lending & borrowing is a commercial activity which involves risks and should as such not be offered by CSDs.

Recommendation 6: Central securities depositories

Securities should be immobilized or dematerialized and transferred by book entry in CSDs to the greatest possible extent. To safeguard the integrity of securities issues and the interests of investors, the CSD should ensure that the issue, holding and transfer of securities are conducted in an adequate and proper manner.

The DACSI is of the opinion that the services provided by the CSDs should be lean and mean and should mitigate counterparty risk.

B.3 *"They should avoid credit and liquidity risk to the greatest possible extent."*

The DACSI is of the opinion that "to the greatest possible extent" should be specified and is of the opinion that CSDs should only be exposed to operational risks.

Recommendation 7: Delivery versus payment

Principal risk should be eliminated by linking securities transfers to fund transfers in a way that achieves delivery versus payment.

The ultimate environment to avoid principal risk is a "risk free delivery against simultaneous payment".

Recommendation 8: Timing of settlement finality

Intraday settlement finality should be provided through real-time and/or multiple-batch processing in order to reduce risk and allow effective settlement across systems.

The DACSI fully agrees with this recommendation.

Recommendation 9: CSD Risk Controls to address participants failure to settle

CSDs that extend intraday credit to participants, including CSDs that operate net settlement systems, should institute risk controls that, as a minimum, ensure timely settlement in the event that the participant with the largest payment obligation is unable to settle. The most reliable set of controls is a combination of collateral requirements and limits.

The DACSI is of the opinion that the services provided by CSDs should be lean and mean and without any risks. Therefore CSDs should in principle not be able to provide credit to its participants and as such should not be allowed to provide credit lines at all. DACSI refers to the CPSS/IOCSO recommendations as guideline for this process and is not in favor of additional regulation or recommendations to prevent duplications.

Recommendation 10: Cash Settlements Assets

Assets used to settle payment obligations arising from securities transactions should carry little or no credit or liquidity risk. If central bank money is not used, steps must be taken to protect the participants in the system from potential losses and liquidity pressures arising from the failure of the cash settlement agent whose assets are used for that purpose.

The DACSI refers to the general remarks made. Considering their central role to the market, CSDs should not be allowed to take credit risks and liquidity risk and the use of central bank money should be generalized.

Recommendation 11: Operational Risk

Sources of operational risk arising in the clearing and settlement process should be identified, monitored and regularly assessed. This risk should be minimized through the development of appropriate systems and effective controls and procedures. Systems and related functions should (I) be reliable and secure (II) be based on sound technical solutions, (III) be developed and maintained in accordance with proven procedures, (IV) have adequate, scalable capacity, (V) have appropriate business continuity and disaster recovery plans that allow for the timely recovery of operations, and (VI) be subject to frequent and independent audits.

Although the recommendation is referring to operational risk, the text is also referring to IT-risk. The DACSI is of the opinion that an integrated risk policy should be developed and used.

As mentioned in our general remarks DACSI strongly supports that all systems used by CCPs and CSDs are audited by an independent external auditor.

Recommendation 12: Protection of customers securities

Entities holding securities in custody should employ accounting practices and safekeeping procedures that fully protect customers' securities. It is essential that customers' securities be protected against the claims of the creditors of all entities involved in the custody chain.

The DACSI agrees with this recommendation and supports the separation of proprietary and client positions. We strongly support that the ways of holding a customer's securities, which are determined by the local jurisdiction and/or the governing law of the respective intermediary, should be harmonized.

Recommendation 13: Governance

Governance arrangements for CSDs should be designed to fulfill public interest requirements and to promote the objectives of owners and market participants.

Market participants should be represented, in particular, through a consultation mechanism. If the CSD is user owned it should also be user governed. If there is sufficient competition between CSDs, a market representative in the Board is needed less, as the market forces will influence the strategy and policy of that CSD.

B6. "The Board should approve the limits on the total credit exposure to participants". The DACSI feels that a CSD should not have any exposure towards their clients as risks should be as low as possible.

Recommendation 14: Access

CSDs should have objective and publicly disclosed criteria for participation that permit fair and open access. Rules and requirements that restrict access should be aimed at controlling risk.

DACSI agrees with this recommendation.

Recommendation 15: Efficiency

While maintaining safe and secure operations, securities settlement systems should be cost-effective in meeting the requirements of users.

The DACSI is of the opinion that the SSS should not only be cost-effective but also safe, sound and secure. The role of the CCP in physical settlements is not clear to us.

Recommendation 16: Communication procedures, messaging standards, STP

CSDs and participants in their systems, should use or accommodate the relevant international communication procedures and standards for messaging and reference data in order to facilitate efficient clearing and settlement across systems. This will promote straight-through processing (STP) across the entire securities transaction flow.

The DACSI is of the opinion that all processes should be harmonized while using ISO-standards, not only between the CSD and their participants but in the whole chain of Issuers, CSDs and participants.

Recommendation 17: Transparency

CSDs should provide market participants with sufficient information for them to identify and accurately evaluate the risks and costs associated with securities clearing and settlement services.

The DACSI supports this recommendation but does not see how publication of the balance sheet can lead to reduction of operational risks or improve transparency.

Recommendation 18: Regulation, Supervision and Oversight

CSDs and securities settlement systems should be subject to transparent, consistent and effective regulation, supervision and oversight. In both a national and a cross border context, central banks and securities regulators should cooperate with each other and with other relevant authorities regarding the CSD and the securities

settlement systems it operates. Central banks and securities regulators should also ensure a consistent implementation of the recommendations.

The DACSI supports this recommendation but is of the opinion that this recommendation should be equal for CSDs and CCPs. Therefore we would suggest a set of (general) recommendations that apply to both CSDs and CCPs and a separate set of recommendations that are more specific for CSDs or CCPs.

Recommendation 19: Risks in cross-system link or interoperable systems

CSDs that establish links to settle cross-system trades should design and operate such links so that they effectively reduce the risks associated with cross-system settlements. They should evaluate and mitigate the potential sources of risks that can arise from the linked CSDs and from the link itself.

The DACSI is of the opinion that cross-links can only exist between CSD's as direct links and not as relayed links as this would increase risk significantly.

Part II

Recommendation 1: Legal Risk

CCPs, linked or interoperable CCPs should have a well-founded, transparent and enforceable legal framework for each aspect of their activities in all relevant jurisdictions.

The DACSI agrees with this recommendation

Recommendation 2: Participation requirements

A CCP should require participants to have sufficient financial resources and robust operational capacity to meet obligations arising from participation in the CCP. A CCP should have procedures in place to monitor that participation requirements are met on an ongoing basis. A CCP's participation requirements should be objective, publicly disclosed, and permit fair and open access. Rules and requirements that restrict access should be aimed at controlling risk.

The DACSI agrees with this recommendation.

Recommendation 3: Measurement and management of credit exposures

A CCP should measure its credit exposures to its participants at least once a day. Through margin requirements and other risk control mechanisms, a CCP should limit its exposures to potential losses from defaults by its participants so that operations of the CCP would not be disrupted and non-defaulting participants would not be exposed to losses that they cannot anticipate or control.

B1: We agree but are not sure whether the term 'participants' is including cross-link CCPs. We suggest the following sentence: "A CCP should measure its credit exposures to its participants, including other cross-link CCPs, at least once a day".

C2: "the CCP should elaborate a model on the basis of the theoretical value of the financial instrument concerned."

This model, based on a theoretical value has to be disclosed to the members of the CCP.

Recommendation 4: Margin Requirements

A CCP should to the greatest extent feasible impose margin requirements to limit its credit exposures to participants. These requirements should be sufficient to cover potential exposures that the CCP estimates to occur until the liquidation of the relevant positions. The models and parameters used in settling margin requirements should be risk-based and reviewed regularly.

The DACSI is of the opinion that the risk management method of CCPs should be standardized in such a way that they should not compete with other CCPs on margin requirements.

Recommendation 5: Other risk controls

A CCP should maintain sufficient available financial resources to cover potential losses that exceed the losses to be covered by margin requirements. For this purpose, the CCP should develop plausible scenarios and conduct stress tests accordingly. At a minimum, a CCP should be able to withstand a default by the participant to which it has the largest exposure in extreme but plausible market conditions.

The DACSI would suggest that "other risk control mechanisms" are specified such as establishing a clearing fund and having insurance for potential losses".

B1.states: "The stress testing assumptions that a CCP uses in reaching a judgment about the adequacy of its resources should be disclosed to participants and authorities. A CCP should have a clear policy on the actions it would take in the event tests indicate resources are not likely to be adequate; either its exposure should be reduced or its resources should be enhanced."

The DACSI feels that information can only be shared with participants if anonymity can be assured; as it could possible disclose confidential information.

B3: The assessment should be made to identify cost for credit lines against the time to ensure the CCP can meet liquidity needs.

Recommendation 6: Default Procedures

A CCP's default procedures should be clearly stated, and they should ensure that the CCP can take timely action to contain losses and liquidity pressures and to continue meeting its obligations. Key aspects of the default procedures should be publicly available and tested regularly.

The actions described are related to the default of clearing members. The DACSI feels that special attention should be given to the actions to be taken if a default of a General Clearing Member of another CCP (Interoperability CoC) takes place. This will have a huge impact and should be addressed separately.

The default procedures should not only be clearly stated but also be non-negotiable.

Recommendation 7: Custody and investment risks

A CCP should hold assets in a manner whereby risk of loss or of delay in its access to them is minimized. Assets invested by a CCP should be held in instruments with minimal credit, market and liquidity risks.

The DACSI refers to the remarks made under point 3 of the General remarks.

Recommendation 8: Operational Risk

A CCP should identify sources of operational risk, monitor and regularly assess them. The CCP should minimize these risks through the development of appropriate systems, and effective controls and procedures. Systems and related functions should be (i) reliable and secure, (ii) based on sound technical solutions, (iii) developed and maintained in accordance with proven procedures and (iv) have adequate, scalable capacity. The CCP should have appropriate business continuity and disaster recovery plans that allow for timely recovery of operations and fulfillment of a CCP's obligations. Systems should be subject to frequent and independent audits.

The DACSI agrees that systems should be subject to frequent and independent audits at least once a year. We assume that existing international regulation that imposes measurements to reduce operational risk are imposed to CCPs as well.

Recommendation 9: Money settlements

A CCP should employ money settlement arrangements that eliminate or strictly limit credit and liquidity risks. If central bank money is not used, steps must be taken to strictly limit cash settlement risks, that is, credit and liquidity risks stemming from the use of banks by a CCP to effect money settlements with its participants. Funds transfers to a CCP should be final when effected and rely on efficient and safe payment systems.

We favor settlement in Central Bank Money as this eliminates most of the risks. Exceptions can be made for multi-currency settlements that settle with more than one private settlement party. A CCP should take any measurements that it could resist the largest outstanding risk towards its members.

It is not all clear what is expected from the various parties.

Recommendation 10: Physical deliveries

A CCP should clearly state its obligations with respect to physical deliveries. The risks from these obligations should be identified and managed.

The role of the CCP is not clear with regard to physical deliveries. The DACSI would have expected this recommendation in relation to the CSDs.

Recommendation 11: Risks in links between CCPs

CCPs that establish links either cross-border or domestically to clear trades should design and operate such links so that they effectively reduce the risks associated with the link. It should evaluate the potential sources of risks that can be arising from the linked CCP and from the link itself. It should ensure that the risks are managed prudently on an ongoing basis. There should be a framework for co-operation and co-ordination between the relevant regulators and overseers.

The DACSI is of the opinion that a CCP should be considered as a 'normal client' and should comply with the regular standards and regulations.

Recommendation 12: Efficiency

While maintaining safe and secure operations, CCPs should be cost-effective in meeting the requirements of participants.

The DACSI agrees with this recommendation.

Recommendation 13: Governance

Governance arrangements for a CCP should be clear and transparent to fulfill public interest requirements and to support the objectives of owners and participants. In particular, they should promote the effectiveness of a CCP's risk management procedures.

Market participants should be represented, in particular, through a consultation mechanism. If the CSD is user owned it should also be user governed. If there is sufficient competition between CSDs, a market representative in the Board is needed less, as the market forces will influence the strategy and policy of that CSD.

Recommendation 14: Transparency

A CCP should provide market participants with sufficient information for them to identify and evaluate accurately the risks and costs associated with using its services.

Key issues 2 and 3 are repeated, not explained. We do not think that this is correct.

Recommendation 15: Regulation, supervision and oversight

A CCP should be subject to transparent, effective and consistent regulation, supervision and oversight. In both a national and a cross borders context, central banks and securities regulators should cooperate with each other and with other relevant authorities regarding the CCP. Such cooperation should also ensure a consistent implementation of the recommendations.

DACSI agrees with this recommendation.