afme/ Post Trade

19 March 2013

CSDR

AFME's position on the issue of separating the provision of CSD core and related services from ancillary banking services in different legal entities

1. Introduction

AFME is a trade association whose members conduct domestic and cross-border securities operations in the EU/EEA area in their capacity as financial institutions, in a wide range of banking activities for their customers and for their own account. AFME's members are securities account providers in the context of European and national regulated activities. The AFME Post Trade Division is the European post trading centre of competence of the Association for Financial Markets in Europe (AFME). Its members are the major users of international securities markets. The Post Trade Division acts as an agent for change, providing and supporting solutions in securities clearing, settlement and custody, to reduce risks and increase efficiency for market participants, representing its members' views towards market infrastructure organisations and public authorities. AFME shares the overriding objective of a single and integrated post trading system in Europe through harmonisation and competition.

Of the broader AFME membership (see www. afme.eu) the following members – investment banks, global custodians and universal banks – actively participate in the Post Trade Division: Banco Santander; Bank of America Merrill Lynch; Barclays; BNP Paribas; BNY Mellon; Citi; Credit Suisse; Deutsche Bank; Goldman Sachs; HSBC; J.P.Morgan; Kas Bank; Morgan Stanley; Nomura; Nordea; RBS; SociétéGénérale; UBS; UniCredit.

2. AFME's position in the EC consultation of March 2011

In its consultation response in March 2011 AFME has put forward the view that

- the stability and resilience of the core functions performed by CSDs need to be maintained and, together with ancillary services that do not attract any other risks than operational risks, should be ring-fenced ('ring-fenced functions');
- the provision of risk-taking ancillary services should not be constrained but be separated functions performed through a separate legal entity;
- only the ring-fenced functions should be in scope of future CSD legislation;
- the separate legal entity offering risk-taking ancillary services, however, should not be subject to limitations in offering ancillary services to allow innovation and competition; for such ancillary services existing authorization, regulation and supervision (e.g. MiFID, CRD, SLD) should apply.

3. Deliberations and considerations upon publication of the EC proposed text

When discussing Art. 52 of the proposed text of the Regulation unanimous agreement among AFME members was instantly achieved in regard of the **overriding objective to achieve a sound balance of safety and efficiency.**

This *excluded* from the outset an *operational separation* of the CSD core and related services (Annex A and B) from banking type ancillary services (Annex C), as this would result in costs that would violate the principle of a sound balance of safety and efficiency in favour of an undue (and in our view unnecessary) emphasis on safety. The only acceptable possibility would thus be a **legal separation** of the two types of services.

In depth discussions revealed significant differences in priorities and interests among AFME members:

- Investment banks prioritise efficiency, e.g. the possibility of making use of highly efficient multi-currency settlement services offered by one service provider, typically an ICSD. Safety considerations in respect of deposited securities are of secondary importance given the usually low volumes of holdings.

- For custodians on the other hand safety aspects are of primary importance and priority, in particular the unhindered and instant access to holdings in securities accounts with CSDs / ICSDs.

4. Risk assessment of the 1+2 model

The 1+2 model, i.e. one authorisation to provide both services, the CSD core and related services and the banking type ancillary services has the effect that

- when compared with the 2+2 model, i.e. separate authorisations for both types of services, the risk profile is significantly changed, as, in addition to operational risk (the only risk dimension for the provision of CSD core and related services) credit, liquidity and potentially market risks are added;

- the *instant* and *unhindered* access to securities deposited in securities accounts may be jeopardised by insolvency proceedings resulting from credit, liquidity and potentially market risks even if such holdings are protected by applicable securities laws.

The consequences of custodians' inability to access holdings deposited in securities accounts instantly and unhindered by insolvency proceedings, if only for a few hours or days could be disastrous (chain reactions) in regard of such holdings being required for

- settlement purposes
- collateral purposes
- securities financing transactions (repo and securities lending transactions)

5. AFME position

Considering the above described diverging interests and priorities as well as the outlined risk assessment, AFME unanimously agreed that:

- CSD core and related services on the one hand and banking type of ancillary services on the other should be provided by two legally separated entities, which may be part of the same group;

- only the legal entity providing the CSD core and related services should be in scope of CSDR;

- the legal entity providing banking type ancillary services should be subject to banking authorisation, regulation and supervision and should be out of scope of CSDR; the two ICSDs would most likely be qualified internationally systemically important financial institutions and thus be sufficiently regulated without any further limitations.

6. Practical effects of implementing the AFME position

In regard of ICSDs (and CSDs) currently offering core services and ancillary banking services within the same legal entity the implementation of the model as per the AFME position would have the following consequences and effect:

- they would have to set up or use existing legal entities ('CSDs') offering exclusively core CSD services and non-banking type of ancillary services of central securities depositories;

- costs incurred by such legal separation appear to be minimal (in spite of repeated requests, no substantiated information in regard of financial consequences was made available by the ICSDs);

- the legal entity offering the ancillary banking services ('Bank') would
  - be subject to banking authorisation, regulation and supervision
  - be outside the scope of CSDR
  - not be limited in its service offerings, including provision of securities accounts; the scope of offered services and associated risk profile would be decided by the Bank's Board of Directors with a view of competitiveness and attractiveness to customers
  - be able to be part of the same group as the CSD
  - be able to act as a designated credit institution for the CSD
  - not be required to separate operationally from the CSD;

- market users would either have the choice a) to use the services (including securities and cash accounts) of the Bank (acting as an intermediary) or b) establish a relationship directly with the CSD for the CSD services (benefiting thus from the respective asset protection in case of failure of the Bank), and the Bank for the banking services. In the specific case of the ICSDs, the newly created (or existing) CSD for Eurobonds could continue to use the existing Bank of settlement in multi-currency commercial bank money.

- in the context of the above described legal (but not operational) separation of the CSD and the Bank and the consequences and effect on the Bank and the market users, the possibility of derogation as per Art. 52.2 would be inopportune; this implies that should

this model prove to be inappropriate to provide a sound balance of safety and efficiency, the possibility of derogation would have to be reconsidered.

7. Conclusion

The CSD Regulation is a much welcomed piece of legislation and one which in the view of AFME is of high importance not simply for its legally binding implications, but also to encourage the vision of a single, integrated, low-risk and low cost post trading system throughout Europe.

In our view the gain of safety will outweigh the (likely minimal) costs of our proposed model and importantly achieve a sound balance of safety and efficiency.