17 April 2009

Report on the outcome of CEBS's call for evidence on custodian banks' internalisation of settlement and CCP-like activities

Introduction

1. Following the delivery of the report on custodian banks to the ECOFIN[1], CEBS committed to undertake further work to assess the materiality of custodian banks' internalising settlement activities or their carrying out of Central Counterparties (CCP)-like activities.
2. The report identified certain gaps with regard to these activities in the currently applicable banking regulations, in comparison to the ESCB-CESR draft Recommendations, which may need to be addressed if such activities were found to be material.
3. A call for evidence to assess the materiality of internalisation of settlement and CCP-like activities was issued on 2 February 2009[2]. CEBS received 33 responses – 17 from members[3] and 16 from market participants[4] representing most major European custodian banks. In addition, CEBS organised a public hearing on 24 March 2009[5] to discuss its preliminary views on the responses received.
4. This report summarises the evidence received both in the written responses and during the public hearing, and draws conclusions on the materiality of such activities from a prudential perspective. Readers of the report should bear in mind that, given the lack of a harmonised definition of internalization, the responses may be based on a heterogenic understanding of this term. For the purposes of CEBS's conclusions, settlement internalisation refers to those settlement activities which would otherwise have been carried out by a Central Securities Depository (CSD).

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[1] http://www.c-ebs.org/getdoc/4aac2440-fa01-436a-a42d-596f27859b8a/CEBS-2008-18-12-Final-response-to-ECOFIN-on-custod.aspx

[2] http://www.c-ebs.org/Aboutus/Key-Dates/2009/CEBS-organises-a-public-hearing-for-custodian-bank.aspx

[3] AT, BE, BG, CY, CZ, DE, ES, FR, HU, IE, IT, LU, PT, RO, SE, SL and the UK.

[4] From which 11 are confidential. All non-confidential responses are published on CEBS website: http://www.c-ebs.org/getdoc/b9209baa-1fbb-48ac-80f4-4b8deca7fc42/Responses-to-CP20.aspx

[5] A summary of the public hearing is published under: http://www.c-ebs.org/Publications/Other-Publications/Others.aspx

Internalisation of Settlement

Omnibus Accounts

5. The omnibus account structure at CSD level[6], a pre-requisite for potential internalisation of settlement, is well established across Member States. From the responses only three countries appear to limit the use of omnibus accounts. The responses received pointed out that even in cases where omnibus account structures are available, clients can request to be held in segregated accounts. Other practices also impact the possibility of internalising settlement – for example some CSDs require a registration number or member registration.

6. Where omnibus accounts are allowed, most custodian banks make full or partial use of these. Most aggregate all their clients, whilst some differentiate between private and institutional clients. When requested, custodian banks in some cases offer segregated accounts and respondents noted that in exceptional cases clients had made use of them. Some markets also prohibit the use of omnibus accounts for safekeeping of securities belonging to domestic investors. It was noted that whilst being aggregated at CSD level, the clients were segregated in the custodian's books. The custodian banks pointed out that all clients would have agreed to the aggregation through an up-front Service Level Agreement (SLA).

Internalisation

7. The percentage of trades that were internalised rather than passed through to the respective CSD varied, although most respondents stated that they did not engage in such activity at all. Of those that did internalise, the percentage of trades was in most cases within the range of 1-3% and only in few cases reached 30%. It should be noted that some recipients did not record whether trades were settled internally thus making the analysis more difficult. One respondent stated that one CSD (no name given) would not execute DVP on trades within the same accounts thus making internalisation inevitable.

8. The answers regarding rules and monitoring procedures varied widely. Amongst those that did internalise, most stated that the same procedures were followed whether a trade was settled internally or via a CSD. Only one respondent noted that it had defined specific rules in its custody system for automatically matching and settling internal trades.

9. Informing the client of the place of settlement was not the norm. Whilst only two custodians specifically inform their clients about the place of settlement, some suggested that clients were indirectly informed by:

[6] The scope of the work only relates to trades that can be settled through a CSD.

- agreeing via an SLA to be held in omnibus accounts (which suggests they agree to the possibility of having their trades settled internally);
- the invoicing structure which informs clients that some trades were settled internally (i.e. CSD fee does not apply); and/or
- through an order routing system, via which clients can trace their trades.

10. The degree of internalisation can depend on the product type, especially for those markets where regulatory practices or market structures limit the possibility of settling internally. For example, for some cleared trades the CCP automatically sends gross settlement instructions to the CSD thus making internalisation impossible for the custodian bank. In some markets, regulatory practice has intervened to make internal settlement for exchange-traded securities impossible. The answers received also indicated that the volumes of internalisation for OTC traded products exceed the exchange traded ones.

11. The responses received from CEBS members showed that settlement internalisation is not viewed as a major risk. Some stated that they were aware of this practice but did not collect data to assess its materiality. Some members noted that the volumes were immaterial. In the light of these responses, it is not surprising that of those members that responded only one had specific reporting requirements for internally settled trades. Most members also believe that the custodian banks in their jurisdiction have procedures in place to ensure orderly settlement.

Conclusion

12. The overall conclusion that can be drawn from the responses received is that the practice of internalisation is not currently widespread across the custodian bank community. However, the answers provided by market participants show great variety on the materiality of internalisation of settlement from the point of view of the institution. It can also be said that internalisation appears more widespread for certain markets/products. Even in these areas though, large differences remain across Member States. These results are in line with those of previous studies where this practice was found to be concentrated in some markets/products.

13. Whilst it was pointed out by many respondents from the industry that an omnibus account structure itself does not qualify a custodian to settle trades internally, the evidence does suggest that it is nevertheless one of the key pre-requisites for internal settlement to take place. In fact, one response pointed out that clients should expect internalisation by virtue of agreeing to be held in an omnibus account at CSD level. The increasing use of omnibus accounts thus potentially makes internalisation more likely, even though, as the industry pointed out, it is not the main driver for the use of omnibus accounts.

14. As of today, there is little evidence that settlement internalisation requires intervention at a European level. This does not imply,

however, that supervisors should not continue to monitor the degree to which such practices are employed by custodian banks. In addition, CEBS will be ready to revisit the issue if there is evidence that internalisation of settlement has become a significant feature of the post-trading market. For that purpose CEBS will continue to rely on close cooperation and cross-fertilisation with overseers and securities regulators[7].

15. For those markets and those custodian banks where the volumes of internalisation reach material levels, CEBS members should require their banks to follow procedures that are in line with those parts of the ESCB-CESR Recommendations for securities settlement systems that CEBS has identified to be relevant and where the gap analysis found that existing banking regulation does not meet the terms of the Recommendation (see Annex 1 for the list of relevant Recommendations).

Materiality of CCP-like activities

16. When carrying out a comparison between the ESCB-CESR draft Recommendations and relevant banking regulations, CEBS also considered the Recommendations for Central Counterparties (CCPs). It became clear that most of the gaps identified related to the risk management recommendations and were only relevant to banks that carried out CCP-like activities[8].

17. The main activity identified as being carried out by custodian banks, which resembles that of a CCP in terms of risk management practices, is where they act as a general clearing member (GCM). Although this was outside the initial scope of the mandate received from the ECOFIN, CEBS decided to include some questions on this topic in its call for evidence. Respondents noted that this activity is not always part of the banks' custody business but is sometimes carried out by other parts of the group. Such activities are also not confined to custodian banks but are common to all institutions acting as general clearing members.

18. Most respondents to the call for evidence answered that they do not take on any counterparty risk, other than in their capacity as GCM, with the exception of two custodian banks who stated that they act in a CCP-like function:

    - in one case by taking on board clearing party responsibilities in the CSD in the absence of a CCP; and
    - in the other case, by having a stand-alone CCP within its group structure.

[7] Joint initiatives in this field aimed at raising awareness of the potential systemic risks inherent in settlement internalisation will be considered by CEBS (e.g. training for supervisors).

[8] In CEBS's report to the ECOFIN, CCP-like activities also included general clearing member (GCM) activity.

19. CEBS has therefore concluded that, from the evidence received, only a few custodian banks, in their role as a custodian, take on a CCP-like activity, other than in their role as GCM.

20. The detail of the responses varied widely with regards to the question of how risks are managed where the custodian bank acts as GCM. Some responses were of a generic nature stating that internal risk measurement, collateral management, limit setting and credit lines are the standard tools used, as well as KYC ('Know Your Customer') checks and financial resources requirements for their clients. Some others were more specific, outlining daily controls of margin requirements vs. collateral posted, and even daily trading volume limits to limit the net settlement risk. Some banks also replicate the CCPs' margining approach with the ability to call intraday collateral from their clients. Where and when necessary, they are even able to go beyond the margin required by the CCP.

21. Most custodian banks acting as GCM only accept clients of a certain nature, usually based on their risk profile. The clearing member activity, in most cases, is limited to equities.

22. Banking supervisors' responses were in line with the view of the industry that, aside from activities as GCM, the custodian banks do not generally act in the role of a CCP by taking on counterparty risk on behalf of their clients

Conclusion

23. The responses to CEBS's call for evidence showed that custodian banks do not commonly engage in any CCP-like activity other than in their role as GCM.

24. The main activities resembling those of a CCP, at least in terms of risk management, are those where a custodian bank acts as a GCM. Whilst the banks' responses in most cases stated that these activities are not significant in terms of revenue generation, the number of banks engaging in these activities nevertheless implies a certain degree of materiality.

25. Some banks pointed out that their GCM activities were not part of their custodian banking business. This point is significant as it illustrates that not every custodian bank acts as a GCM and not every GCM is necessarily also a custodian bank. Any conclusions here would therefore have implications for the wider clearing member community and thus be outside CEBS's initial ECOFIN mandate which was restricted to custodian banks.

26. In the comparison with the RCCPs, CEBS noted that the banking regulations on risk management practices relevant to banks carrying out CCP-like activities[9] were not detailed enough to be considered equivalent to the ESCB-CESR Recommendations. Although CEBS notes that the nature of GCMs is different to that of a CCP, in the light of the

[9] In the CEBS's report to the ECOFIN, CCP-like activities also included general clearing member (GCM) activity

similar risks in managing counterparty exposures on a daily basis, CEBS will nevertheless consider future work in this area and, subject to the priorities set in its work programme, further work could be conducted to understand the different risk management practices amongst GCMs. This would also address the invitation expressed in the draft ESCB-CESR Recommendations for banking regulators to give further consideration to the risks faced by GCMs. Any such work should include not only custodian banks but all banks that act as a GCM.

Overall Conclusion

27. In view of the evidence gathered so far it does not appear that the level of internalisation amongst the custodian bank community would justify any intervention at European level. It would therefore be overly burdensome to impose or issue guidance applicable to the industry as a whole regarding this activity. Those markets and/or those banks where internalization of settlement appears material should follow procedures that are in line with the requirements set out in the relevant recommendations within the ESCB-CESR Recommendations for securities settlement systems and where the gap analysis found that existing banking regulation does not meet the terms of the Recommendation (see Annex 1 for the relevant Recommendations). [10]

28. CEBS has not found evidence that custodian banks commonly engage in CCP-like activity other than in their role as GCMs.

29. Even though GCMs are not replicating the role of CCPs, in the light of the similarity in risk exposures and given the widespread existence of general clearing members and the uncertainty around the risk management practices in use, CEBS will consider the priorities set in its work programme and assess the need to further investigate these aspects. Such an assessment should not be limited to custodian banks, as it will be of relevance to all general clearing members that fall within CEBS members' scope (i.e. all banking institutions).

[10] As mentioned above joint initiatives in this field aimed at raising awareness of the potential systemic risks inherent in settlement internalisation will be considered by CEBS (e.g. training for supervisors).

Annex 1: List of relevant ESCB-CESR draft Recommendations

ESCB-CESR RSSS 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.

1. As a general rule, the rights, liabilities and obligations arising from laws, regulations, rules and procedures, and from generally applicable, non-negotiable contractual provisions governing the operation of securities settlement systems, links (see Recommendation 19) and interoperable systems, should be clearly stated, understandable, public and accessible.

2. The legal framework should demonstrate a high degree of legal assurance for each aspect of the clearing and settlement process, including legally valid and enforceable arrangements for netting and collateral.

3. The rules and contractual arrangements related to the operation of the securities settlement systems and the entitlement to securities should be valid and enforceable, even in the event of the insolvency of a system participant, a participant in a linked or interoperable system, or the operator of the system or operators of linked or interoperable systems.

4. The operators should identify the relevant jurisdictions for each aspect of the clearing and settlement process, and should address any conflict of law issues for cross-border systems.

5. All eligible CSDs governed by the law of an EEA Member State should apply to have their securities settlement systems designated under the European Directive 98/26/EC on settlement finality in payment and securities settlement systems, as amended (hereinafter referred to as the Settlement Finality Directive). The relevant authorities should actually designate the systems that meet the criteria of the Settlement Finality Directive

6. For systemic risk purposes, the relevant public authorities should support the harmonisation of rules so as to minimise any discrepancies stemming from different national rules and legal frameworks

ESCB-CESR RSSS 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 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.

1. Confirmation of trades between direct market participants should occur as soon as possible after trade execution, but no later than T+0.

2. When confirmation/affirmation of trades by indirect market participants is required by regulators, clearing systems or market participants, it should occur as soon as possible after trade execution, preferably on T+0, but no later than T+1.

3. Settlement instructions should be matched prior to settlement and no later than the day before the specified settlement date for settlement cycles longer than T+0. This does not apply to free-of-payment transfers in those systems where matching is not required.

ESCB-CESR RSSS 7 – Delivery versus Payment (DvP)

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

1. The technical, legal and contractual framework should ensure DVP.

2. All securities transactions against cash between direct participants of the CSD should be settled on a DVP basis.

3. The length of time between the blocking of the securities and/or cash payment and the moment when deliveries become final should be minimised.

ESCB-CESR RSSS 8 - Timing of settlement finality

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

1. The timing of settlement finality has to be clearly defined in the rules of the systems, which require transfer orders and deliveries of securities and payment to be irrevocable, enforceable and supported by the legal framework.

2. Settlement finality should be provided in real time and/or by multiple-batch processing during the settlement day. Where multiple-batch processing is used, there should be a sufficient number of batches distributed across the settlement day so as to allow interoperability across systems in the EU and to allow securities transferred through links to be used during the same settlement day by the receiver.

3. The settlement system and its participants should execute the transactions without undue delay as soon as securities and cash are available.

4. The rules of the system should prohibit the unilateral revocation of unsettled transfer instructions late in the settlement day.

ESCB-CESR RSSS 10 – Cash Settlement 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

1. For transactions denominated in the currency of the country where the settlement takes place, CSDs should settle cash payments in central bank money whenever practicable and feasible. For this reason, central banks may need to enhance the operational mechanisms used for the provision of central bank money.

2. If central bank money is not used as asset to settle obligations in a currency, steps must be taken to protect participants from potential losses and liquidity pressures arising from the failure of the cash settlement agent whose assets are used for that purpose. Where both central and commercial bank money facilities are offered, the choice to use commercial bank money should be at the sole discretion of the participant.

3. Only regulated financial institutions with robust legal, financial and technical capacity, in accordance with EU prudential (or equivalent) regulation, should be allowed to act as cash settlement agents. When central bank money is not used, the CSD acting as cash settlement agent should put in place adequate risk measures as described in Recommendation 9 in order to protect participants from potential losses and liquidity pressures. There should be sufficient information for market participants to identify and evaluate the risks and costs associated with these services.

4. The proceeds of securities settlements should be available for recipients to use as soon as possible on an intraday basis, or at least on a same-day basis.

5. The payment systems used for interbank transfers among settlement banks should observe the Core Principles for Systemically Important Payment Systems (CPSIPS).

ESCB-CESR RSSS 16 – Communication Procedures, Messaging Standards and Straight-Through Processing

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.

For this recommendation to be effective, it also needs to be applied either directly or indirectly by other providers of securities communication services, such as messaging services and network providers.

1. International communication procedures and standards relating to securities messages, securities identification processes and counterparty identification should be applied.