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LSEG Response to the European Banking Authority's consultation:

Draft Regulatory Technical Standards on Prudential Requirements for CSDs

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### **Background Information**

The London Stock Exchange Group plc (LSEG) is a financial market infrastructure provider, headquartered in London, with significant operations in Europe and North America. LSEG welcomes the opportunity to respond to the EBA's Consultation Paper on draft regulatory technical standards on prudential requirements for CSDs.

LSEG operates a range of international equity, fixed income and derivatives markets, including: London Stock Exchange; Borsa Italiana; MTS Group and Turquoise; post-trade and risk management, including Cassa di Compensa/zione e Garanzia (CC&G), the EMIR authorised CCP; Monte Titoli, the Italian CSD; and globeSettle, a new CSD based in Luxembourg; and is majority owner of the multi-asset global CCP, LCH.Clearnet Group serving major international exchanges and platforms, as well as a range of OTC markets (with EMIR authorised CCPs in France and the UK). LSEG operates the EMIR authorised trade repository UnaVista, and offers a range of real-time and reference data products, as well as access to international equity, bond and alternative asset class indices, through the leading index providers, FTSE International Ltd and Frank Russell Company.

As a general comment, we note that the draft regulatory technical standards are influenced to a significant extent by both existing banking capital requirement standards and those for CCPs under EMIR. While there may be areas where consistency between different types of standards is helpful, regulatory capital is meant to address risks specific to the institution in question, so these standards should be tailored to the actual risks of CCPs and mitigants specific to their operating models.

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## RESPONSE TO QUESTIONS

### 1) What are the practical impediments of calculating capital requirements for custody risk as set out in this Article?

Before considering the “practical impediments” for calculating capital requirements for custody risk, we would like to highlight certain issues in respect of the assumptions related to the EBA proposal under article 5 of RTS.

In this regard we note that the EBA’s explanatory note states that custody risk is included in the operational risk charge<sup>1</sup>.

We believe this approach is fully backed by CSD-R level I and CPSS-IOSCO Principle 16 for financial market infrastructures related to custody risk. Indeed, CPSS-IOSCO Principle 16 takes into account custody risk only where an FMI uses a custodian that could not ensure the same resiliency in terms of asset protection as another FMI. This also reflected within EMIR whereby securities settlement systems (“SSS”) are considered as safest mechanism to deposit CCPs’ and clearing members’ asset as SSS are able to ensure the full protection of those assets. However, the draft RTS, both in recital 10 and article 5, require CSDs to calculate an additional buffer of capital to cover custody risk related to participants’ assets held in custody by another CSDs. We believe the proposed requirement is too burdensome if compared to the effective custody risk posed by CSDs’ activities. These, in our view, should not be seen as a source of systemic concerns. Furthermore, we believe this requirement seriously jeopardises non-bank CSDs’ cross border business development.

Currently, even in the absence of an harmonised insolvency regime, CSDs operates both their domestic and cross-border custody services in a safe and resilient environment in which custody risk, if any, is considered low and properly managed through operational and legal arrangements which ensures that those assets are “bankruptcy remote” meaning that could they not be claimed by CSDs creditors and are returned immediately to participants in case of CSD default. For such purpose it is good practice, and often accepted as a result of bilateral agreements, that CSDs remove reciprocal liens or rights of retention on assets held by investor CSDs in their books, further mitigating any potential custody risk.

This framework will be even sounder after CSD-R is fully implemented. Taking into account the requirements in terms of recording of securities in dematerialised form, automatic reconciliations procedures, accounting practices and all other asset protection/segregation arrangements provided, custody risk with reference to participants asset is almost null.

In this context it is worth to recall that under CSD-R:

- CSDs have to keep records and accounts that *“enables them, at any point in time and without delay, to segregate in the accounts with the CSD the securities of a participant from those of*

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<sup>1</sup> Page 6 of the Consultation paper.



*any other participant and, if applicable, from CSDs' own assets*", thus eliminating the risk of commingling of assets.

- CSDs are not allowed to use participant securities and in particular with reference to links those securities are kept only for settlement purposes.
- CSDs are required to establish, implement and maintain adequate procedures ensuring the timely and orderly settlement and transfer of participants' asset to another CSD in the event of withdrawal of authorisation.
- CSD link arrangements shall ensure adequate protection of linked CSDs and of their participants.

Requiring CSDs to hold an additional buffer of capital for custody risk compared to other custodian banks or intermediaries which are not subject to similar requirements under the CRR suggests the EBA considers that CSDs are more exposed to this risk than other institutions. However, there is no evidence to support this position – on the contrary, CSD-R requirements will ensure full protection of asset and mitigation of custody risk also in the context of a CSD link. Therefore, we would suggest that, like the requirements under the CRR such risk is fully covered by capital requirements for operational risk.

It should also be recalled that the migration of CSDs systems to T2S will further harmonise the operational functioning of CSDs' cross-border activities and improve the soundness of CSD links, with a view to the better provision of cross-border settlement. Imposing additional custody risk requirements run counter to this concept and could have a negative impact on market integration by dis-incentivising CSDs to maintain links with other CSDs thus resulting in a negative outcome from a capital market union perspective.

In respect of "practical impediments" to calculating custody risk, first, we note that costs and revenues related to custody services used to calculate the capital charge for the operational risk by means of the basic indicator approach are already double-counted when applying the standardised approach for custody risk.

Further, activities of non-bank CSDs do not coincide with the list of business lines of a credit institution provided under the "Standardized Approach" (TSA) in the CRR. Even the so-called "payment services" and "agency services" provided by financial institutions are not comparable to CSD custody services from a risk perspective.

For all the reasons outlined above we believe that recital 10 and article 5 should be removed and custody risk should be considered as a component of capital requirements calculated under article 4.

Just in case EBA would keep its approach on custody risk, for consistency, it should clarify at least that income accounted for under the TSA should only be the one relating to cross border custody services provided within in a link and not to the overall income relating to "payments and services" and "agency services" business lines. This would at least mitigate the double counting of those income which are already is included in the operational risk calculation.



**2) Is the level of capital requirements as proposed in these draft RTS adequate to capture all the risks arising from the activities of a CSD? Are they proportionate for all CSDs' business models?**

**General comments**

We understand by making direct reference to CRR requirements, the EBA wants to ensure consistency among different pieces of legislation that might be applicable to bank and non-bank CSDs respectively (i.e. CRD / CRR and CSD-R), as well as with relevant legislation of other market infrastructure (i.e. EMIR).

However, we are very concerned about this “one-size fits all” approach that could affect the economics of non-bank CSD businesses and hamper their future development. In this context, we point out that non-bank CSDs perform their services with a risk profile that is:

- mainly focused on operational risk; and
- more segregated from systemic contagion than CCPs, banks and ICSDs.

These characteristics should be properly reflected by capital requirements for non-bank CSDs and be calibrated to address the specific risks posed by such entities. Therefore, we request that the EBA reconsider how the “weight” of each risk has been reflected in the calculation of regulatory capital in order to avoid an overcapitalisation compared to the overall non-bank CSDs risk profile. Inappropriate weighting risks altering the current business model and placing non-bank CSDs in a competitive disadvantage compared to banking CSDs and custodian that have different risk profiles. In this regard it should be considered that non bank CSDs are basically an “engine” infrastructure facilitating post-trading activities for which they do not need prompt access liquidity to cover their risk exposure that is operational by nature rather than financial.

In this context it should be noted that the migration to the T2S platform will further reduce non-bank CSDs' risk profiles, in particular with reference to cross-border services. We urge the EBA to conduct a further quantitative analysis in this perspective to better determine appropriate weightings of contingent investment undertaken by CSDs in relation to the T2S project. Considering the resources invested in this project, the financial impact of those investment plus the economic impact of CSD-R capital requirements could put undue stress on CSD capital structures by the time of re-authorisation.

Furthermore, it is worth recalling that the most common domestic regulatory practices allow CSDs to cover their risk exposure through insurance or similar arrangements. Such arrangements could be taken into account when calculating capital requirements. This approach would be consistent also with ESMA RTS whereby insurance coverage is expressly mentioned as measure to mitigate operational risk (see article 26, page 226 of ESMA's Consultation Paper).

With reference to specific capital requirements Going in further details we would like to point out the following comments on capital requirements for (a) general business risk; (b) capital requirements for winding down and restructuring; and (c) investment risk.

**(a) General Business Risk (Annex II)**



With reference to article 7(2), we believe that the definition of annual gross operational expenses should be recalibrated on the basis of the following consideration:

- costs related to tangible and intangible amortisation and depreciation should be excluded as those costs are not actual costs related to the running CSD business but rather bookkeeping losses from an accounting perspective. This approach would be also in line with CPSS-IOSCO principle 15 on general business risk (see footnote 137);
- intragroup expenses should be excluded, where applicable, to avoid a double counting of those costs where there are two CSDs in the same group; and
- only those costs which are ongoing in their nature should be included, with non-recurring costs excluded.

As regard the scenario based approach, we believe that CSDs in particular non-bank CSDs should retain the possibility to define the relevant event according to their own corporate and business structures. Therefore, we suggest that the detailed description of scenarios provided in Annex II of RTS should be removed.

By retaining such scenario testing there will be analyses of situations that will not be relevant for non-bank CSDs and some other scenarios could put them in a competitive disadvantage compared to banking CSDs whose business models are more diversified.

In particular we would like to point out that:

- reference to ratings should be removed in view of international and European initiatives calling for a progressive removal of references to ratings included in legislation. Furthermore, most CSDs are not required to have ratings by CSD-R;
- percentages should be removed in order to avoid automatic triggers, these should be set by CSDs according to their own financial structures;
- reference to pension plans could not be relevant according to a CSD's domestic jurisdiction;
- as regard references to unexpected reduction of clients' balances, as we understand, it is not relevant for non-bank CSDs that do not have exposure towards their participant, we would ask EBA to confirm this.

## **(b) Winding down and restructuring**

The EBA's proposed requirements for wind-down capital suggest that the winding-down costs of a CSD would be the same (or reasonably approximated) by its previous gross operating expenses calibrated to the estimated time for winding-down.

However, using gross operational costs as a basis for wind-down requirements is not proportionate to the risks run by CSD in wind-down which is catered for suitably by its business risk capital. Therefore, it does not seem proportionate that such aspects of business risk capital are repeated when essentially they are covering the same needs.



Moreover, certain aspects of operational expenses are not appropriate for the calculations of wind-down capital as per our comments under point (a) (i.e. depreciation, amortisation and intragroup costs)<sup>2</sup>. We believe that for the purpose of winding down and restructuring only actual cash costs which are ongoing should be considered.

In addition CSDs should have the possibility to remove other expenses from gross expenses, in particular:

- intragroup expenses, where applicable, to avoid a double counting of those costs where there are two CSDs in the same group;
- cost of sales, which are not relevant in a winding-down situation, e.g. because they can be cancelled promptly from the moment the CSD enters into winding down;

With reference to winding down and restructuring scenarios included in **Annex I**, as recognised in paragraph 4, we believe that that *"the scenarios shall be commensurate with the nature of the business of the CSD"* therefore non-bank CSDs which have different business models and lower risk profiles than banking CSDs should not be required to develop scenarios based on the "idiosyncratic events" and "systemic-wide events" listed in Annex I paragraph 5, 6 and 7. This approach would be in line also with CPSS-IOSCO principles on recovery and resolution for market infrastructure which suggests that "scenarios should take into account the various risks to which the FMI is exposed, which will vary across different types of FMIs and **even across FMIs of the same type**".<sup>3</sup>

For example, the "failure of significant counterparties" referred to in point (a) will not necessarily lead to a restructuring or winding-down of a CSD, since non-bank CSDs are not exposed to counterparty credit risk in relation to their participants.

In light of the above, we suggest the EBA remove the events listed in Annex I and include only a generic reference to "idiosyncratic events" and "systemic-wide" events should be maintained in line with EMIR and CPSS-IOSCO principles.

### **(c) Investment risk**

As regard method for calculation of investment risk, we would like EBA to clarify how it should be calculated in particular when CSDs hold their own asset fully in cash and market risk need not be taken into account.

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<sup>2</sup> We note that the EBA dismissed the idea that depreciation/amortisation could be excluded from the wind-down capital requirement for CCPs under EMIR; at the time the EBA suggested these expenses had to be included because they "do not fulfil the capital eligibility criteria set out in EMIR". However, excluding these costs from the basis of calculation of the wind-down capital requirement is not the same as including these as eligible capital holdings. Rather, the nature of article 47 of the CSD-R and article 8 of the draft RTS explains that the numerical value of the calculation is the required capital amount, but that capital amount should be held by the required capital instruments as set out in article 2 of the draft RTS. Not including depreciation/amortisation in the calculation of wind-down capital cost does not mean that these become capital instruments, but rather that whatever the ultimate calculation is, that amount would need to be met with holdings of eligible capital instruments.

<sup>3</sup> CPMI-IOSCO – Recovery of financial market infrastructures – October 2014, paragraph 2.4.5, <http://www.bis.org/cpmi/publ/d121.pdf>.