ECSDA
European Central Securities Depositories Association

Friday 3 July 2015

CSD Regulation "Level 2": A delayed adoption for better standards

European Central Securities Depositories (CSDs) have actively contributed to the public consultations launched by ESMA and the EBA with regards toLevel 2 technical standards under the CSD Regulation (EU Regulation 909/2014 or "CSDR").

In its letter of 18 June 2015, ESMA notified the European Commission that the CSDR technical standards would be submitted with a slight delay, i.e. in September instead of June 2015. We assume that the EBA will follow a similar timeline, the two sets of standards being closely linked. We understand that the delay is partly due to the "early legal review" procedure enabling ESMA to take into account the advice of the Commission's Legal Service prior to finalising the standards. We believe that having recourse to such a procedure can be beneficial if it contributes to enhance the quality of the standards as well as their review against the mandates contained in the Level 1 regulation.

Seizing the opportunity of this delay, ECSDA would like to stress some key considerations in view of the finalisation of the CSDR technical standards:

1. **Impact assessment reports should be shared and discussed with the market.**

ESMA and the EBA are required to prepare an impact assessment to accompany their technical standards. ECSDA was disappointed by the lack of impact assessment in the ESMA Consultation of December 2014, especially with regard to the future settlement discipline framework which is expected to have a market-wide effect. We believe that the delayed publication of the technical standards provides an opportunity for ESMA and the EBA to share their draft impact assessment with the industry prior to sending the technical standards for adoption by the European Commission. Such disclosure would make the impact assessment process more transparent and would allow regulatory authorities to obtain feedback from industry experts on their cost-benefit analysis and on possible ways to mitigate a potential negative market impact of the standards.

2. **The EBA regulatory technical standards on CSD capital requirements will only be workable and proportionate if they take CSD specificities into account.**

Capital requirements should reflect the fact that the vast majority of EU CSDs do not provide cash credit and are thus not exposed to counterparty credit risk in relation to their participants. As stressed in the ECSDA response to the EBA consultation (27 April 2015), this involves:

(a) Recalibrating provisions coming from the framework in place for banks and/or CCPs to take into account the many instances where such provisions are irrelevant in a CSD context, especially for non-bank CSDs. Examples of such provisions include mentions of client "long and short balances" in Annex 2 and references to business lines of banks in article 5 of the of the draft EBA RTS;

(b) Treating custody risk in a consistent way, as a risk faced by the CSD itself, not by its participants, to avoid duplicate requirements (this will require a redrafting of article 5 of the draft EBA RTS);

(c) Requiring CSDs to set aside capital for winding-down or restructuring their activities to the extent that this does not overlap with capital requirements for business risk, thereby avoiding the imposition of strict cumulative requirements exceeding international standards in article 3 of the draft EBA RTS;

(d) Recalibrating some requirements to reflect the low risk profile of CSDs. For example, CSDs' specific insurance arrangements and/or guarantee schemes should be taken into account in article 4 of the draft EBA RTS for determining the ratio to be applied for operational and legal risks;

(e) Replacing the predefined business risk and winding-down scenarios mentioned in articles 7 and 8 of the draft EBA RTS (and detailed in Annexes 1 and 2) by a more flexible approach allowing CSDs to define reasonably foreseeable adverse scenarios relevant to their business model, subject to the approval of the competent authority.

3. **Standards on settlement discipline should maintain CSDs' low risk profile and foresee a phased implementation of 24 months.**

ECSDA supports the new approach adopted by ESMA in its Consultation Paper of 30 June recognising that buy-ins should be executed at the trading level rather than at the settlement level and that the introduction of mandatory buy-ins should not require CSDs to perform new tasks which could have a detrimental impact on their risk profiles such as appointing a buy-in agent or performing “consistency tests” on the instructions they receive in order to prevent multiple buy-ins, as initially suggested in article 11 of the draft ESMA RTS on settlement discipline. Besides, if CSDs are expected to report on the execution of buy-ins, it should be clear that CSDs are not in a position to control the accuracy of the information provided to them by market participants whenever this relates to instructions processed outside the CSD's settlement system.

4. **Level 2 standards should not impose specific technical functionalities of CSD systems.**

Mandating compulsory matching fields and technical functionalities of CSD systems such as the number and duration of settlement batches is unnecessary and inappropriate for binding Level 2 legislation. CSDs are convinced that a high level of settlement efficiency can better be achieved by allowing each CSD to decide on the most appropriate tools and technical solutions, based on the specific characteristics of the market in which it operates. Article 3 of the draft ESMA RTS on settlement discipline should thus be reconsidered.

ESMA should also not underestimate the importance of harmonising market practices prior to imposing the use of certain harmonised standards. Imposing mandatory matching fields by law might not only create obstacles to future adaptations, it could also increase the number of settlement fails and create systemic risk if market practices have not been harmonised beforehand.

5. **CSDs should be given sufficient time to adapt their records to international standards.**

Based on articles 8 to 13 of the draft ESMA RTS on CSD requirements, we expect the Level 2 rules for record keeping to be far-reaching and to require a transition period of at least 24 months before they can be implemented. To allow regulators to control compliance with the CSDR in a cost efficient way, these records should allow for ISO compatibility but should not be applied retroactively. The use of Legal Entity Identifiers (LEI) for all issuers and CSD clients cannot be implemented by imposing a requirement on CSDs alone. CSDs have no means to force the obligation on third parties such as non-EU issuers, and the upcoming standards must take these constraints into account.

6. **The CSD authorisation framework should not endanger the reconciliation process.**

To avoid negative consequences on financial stability, technical standards on reconciliation at CSD level should not require the automatic suspension of settlement in a financial instrument in case of discrepancies. Article 17 of the draft ESMA RTS on CSD requirements should include an element of proportionality to ensure that the damage caused by the suspension is not greater than that caused by the reconciliation error. It should also include situations in which the decision should be taken by the competent authority and not by the CSD.

Besides, requirements on daily reconciliation (article 16 of the same draft RTS) should only apply to cases where the CSD provides central maintenance services for a financial instrument. In other cases, including in the case of offshore investment funds for which a transfer agent provides the notary and central maintenance services, the CSD is not in a position to impose daily reconciliation to the third party transfer agent.

7. The CSD authorisation framework should not hamper links with non-EU CSDs.

European CSDs must be allowed to continue to maintain links with non-EU CSDs. Article 4 of the draft ESMA RTS on CSD links suggest that CSDs or intermediaries established in non-EU jurisdictions should be subject to a comparable regulatory regime as that in place in the EU in order for links to be allowed. This is simply not realistic, given that European rules are among the strictest in the world. It is also not justified from a risk perspective since CSD links do not expose the linked CSDs to credit or liquidity risk. Forcing European CSDs to discontinue existing links with non-EU CSDs would be detrimental to market integration and would not in any way enhance the safety of cross-border settlements, since transactions would have to occur outside the network of existing infrastructures. This could also put EU CSDs at a competitive disadvantage compared to non-EU CSDs.