

CSDR - one of the New European Post-trade Projects

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New European Post-trade Projects

- **The main new European Post-trade Projects are:**
 1. **EMIR** - Regulation (EU) No 648/2012 on OTC derivatives, central counterparties and trade repositories with the aim to improve transparency in the derivatives market, mitigate systemic risk and protect against market abuse. In general, it was achieved by setting data standards and management of counterparty risk for OTC instruments.
 2. **CSD-R** Regulation (EU) No 909/2014 on improving securities settlement in the European Union and on central securities depositories.
 3. **TARGET2 Securities** - a project launched by the Eurosystem to create a common technical platform to support CSDs in providing borderless securities settlement service in Europe.

Connections and Interdependence of the New Post-trade Projects

- The **CSDR** harmonises legal aspects of securities settlement and the rules for CSDs at European level, allowing T2S to achieve its goals more effectively by harmonised operational aspects of securities settlement.
- **T2S is a platform** capable of receiving settlement instructions, matching them and reaching settlement, finally resulting in the generation of irrevocable booking entries. It will act as a technical platform to which the National Central Securities Depositories (NCSDs) can outsource their settlement process.
- **The CSDR should be seen as complementary to, and consistent with, both the European Market Infrastructure Regulation (EMIR) in respect of CCPs and the T2S project in respect of operational aspects. In respect of trading platforms, the CSDR is complementary and consistent with the Markets in Financial Instruments Directive II (MiFID II).**

The Role of the CSDs on Capital Market and Economy as a Whole

1. **CSDs are the key institutions that operate the infrastructure (so-called securities settlement systems) that enable settlement.** They are the institutions which in the settlement process materialise the transactions concluded on the markets and where the transaction could be either finalised, or failed.
2. **CSDs hold records of securities accounts and transactions.** CSDs also ensure the maintenance of securities accounts that record how many securities have been issued by whom and each change in the holding of those securities. This is made possible by the fact that CSDs intervene on the primary market, by centralising the initial recording of newly issued securities.
3. **CSDs also play a crucial role for the financing of the economy,** as in practice almost all the collateral posted by companies, banks and other institutions to raise funds flows ultimately through securities settlement systems operated by CSDs.

CSDR - What has Driven this Regulation?

- Although CSDs in the EU had performed well during the crisis and were regulated extremely tightly under domestic law and under international standards, **they were not regulated consistently** across the EU.
- The need for a consistent regulatory approach to settlement systems and settlement processes was made even more pressing by the development of the Eurosystem's **TARGET2 Securities (T2S) project**.
- **The main objectives of the CSD Regulation are to:**
 1. **Increase the safety of settlements**, in particular for cross-border transactions, by ensuring that buyers and sellers receive their securities and money on time and without risks;
 2. **Increase the efficiency of settlements**, in particular for cross-border transactions, by introducing a true internal market for the operations of national CSDs; and to
 3. **Increase the safety of CSDs by applying high prudential requirements** in line with international standards.

Level 1 and Level 2 of the CSDR

- **CSDR was published in the Official Journal of the EU on 28 August 2014 and entered into force on 17 September 2014 (Level 1);** its provisions are directly applicable.
- CSDR requires the European Securities and Markets Authority ('ESMA') and the European Banking Authority ('EBA') to submit the draft technical standards.
- The CSDR is in the process of being implemented and, as is common with most EU regulations, the implementation of its provisions will be phased. The vast majority of the CSDR's provisions can only come into force once the relevant Technical Standards and Delegated Acts have been implemented.
- **The standards are published in the Official Journal of the European Union immediately after the 'non-objection' period from the European Parliament and Council has elapsed and will then enter into force on the twentieth day following that of their publication (Level 2).**

CSDR Implementation – the Timeframe

- **5 Aug 2015** ESMA final advice on penalties & substantial importance
- **28 Sept 2015** ESMA submits RTS & ITS on CSD requirements & intern. settlement
- **≈ Nov 2015** EBA submits RTS on CSD capital requirements
- **≈ Dec 2015** ESMA submits RTS on settlement discipline
- **By 28 Dec 2015** EC adopts RTS & ITS on CSD requirements
- **≈ Feb 2016** EC adopts RTS on capital requirements
- **≈ March 2016** EC adopts RTS on settlement discipline
- **≈ May 2016** CSDs have 6 months to apply for authorisation
- **≈ By May 2017** All CSDs are authorised & CSDR-compliant
- **≈ May 2018** Entry into force of settlement discipline rules & intern. settlement
- ** The “objection period” prior to the final publication of the standards into law can last from 1 to 6 months depending on whether the Commission adopts the ESMA & EBA standards with or without amendments on substance.*

Subject Matter and Scope of the CSDR

- **Securities settlement**
 - ✓ Dematerialisation and immobilisation of securities
 - ✓ T+2 settlement
 - ✓ Settlement discipline
 - ✓ Settlement fines
 - ✓ Buy-ins
 - ✓ Internalised settlement
- **Central Securities Depositories**
 - ✓ Authorisation and supervision of CSDs
 - ✓ Requirements for CSDs
 - ✓ Access to CSDs
- **Provision of banking-type ancillary services for CSD participants**
 - ✓ Restrictions on banking business
 - ✓ Prudential requirements
 - ✓ Protection of securities of participants and those of their clients
- **Sanctions**

Dematerialisation and Immobilisation of Securities

- The CSDR requires that any issues of EU transferable securities which are admitted to trading or traded on trading venues should be represented in book entry form through immobilisation or dematerialisation.
- The vast majority of securities in Europe are already issued in such form.
- Settlement model can be implemented by 2023 (for new securities) and 2025 (for existing securities), with minimal implementation effort for those clients who currently hold certificated securities.

T+2 Settlement Cycle

- CSDR requires all transactions in transferable securities executed on trading venues **to be settled on a T+2 basis** (i.e. two business days after trade date rather than three) with effect from January 2015.
- All EU markets (apart from the Spanish equities market) migrated to T+2 on 6 October 2014, well in advance of the deadline set by the CSDR.
- Working groups - to manage the technical details of the transition.
- Although the CSDR gives the market some flexibility not to apply T+2 to transactions that are negotiated privately, members of the T2S have recommended that market participants use T+2 as the default rule for settling over-the-counter (OTC) transactions (including eurobonds), unless the two parties to the transaction have agreed otherwise.

Settlement Discipline

- The CSDR aims to encourage clients to settle their trading obligations on intended settlement date, and requires CSDs and other market infrastructures to take measures to prevent and address settlement fails.
- In effect this means the **mandatory implementation of a buy-in regime and a settlement discipline regime across a wide range of securities.**
- This section of the CSDR will affect all clients of each and every CSD in Europe and will have **a widespread market impact.**
- Although the full details of the regime will only be known once the Regulatory Technical Standards are agreed next year, the CSDR already sets out a number of principles.

Settlement Fines

- CSDs will gather data on settlement fails for provision to the relevant Competent Authorities.
- CSDs must implement **a penalty mechanism for fails which serves as an effective deterrent**. The parameters of this mechanism will be established by the Commission.
- The intention of the CSDR is **to cover fails in all transferable securities, money market instruments, UCITS and emission allowances**.
- A majority of CSDs already have a penalty scheme in place for late settlement, although the type of fees applied varies across markets (e.g. recycling fees vs. penalty fees, with some CSDs charging both). In most cases, the fines are charged to the first party in the chain (i.e. the party that caused the initial fail).
- **CSDR encourages fines to be credited to the non-failing client as compensation; fines should not be a revenue source for the CSD concerned**. The precise mechanism for this complex operation are still subject to discussion with ESMA and the Commission.
- A harmonised settlement discipline regime will cause **adaptation costs in many markets**.

Buy-ins

- The CSDR imposes a **mandatory buy-in process on any financial instrument which has not been delivered within four business days of the intended settlement date**. This period can be increased to seven days for illiquid securities and 15 days for transactions on Small and Medium Enterprise (SME) growth markets.
- CSDs will not execute buy-ins themselves (to protect their risk-profile).
- But the CSDR says that they ‘may’ monitor the execution of buy-ins particularly when there are chains of transactions, to minimise the number of buy-ins executed. It is vital for market efficiency that multiple buying or settlement fines are not applied across a single chain of securities transactions.
- The ability of a CSD, however, to identify accurately such chains (particularly in a cross border context) is extremely limited. The market and the CSDs have been working closely with ESMA to identify whether and how fines could be passed on through complex transaction chains, which are frequently crossborder.

Internalised Settlement

- CSDR requires so-called 'settlement internalisers' to report to their Competent Authorities on a quarterly basis the aggregated volume and value of all securities transactions which they settle outside of CSDs.
- ESMA is drafting technical standards to establish the forms, templates and procedures for the reporting and transmission of this information to the relevant Competent Authorities.
- These provisions do not apply to CSDs themselves since the definition of a settlement internaliser is an institution which executes transfer orders on behalf of clients or on its own account other than through a CSD.

Central Securities Depositories – Authorisation and Supervision

- CSD shall be authorised and supervised by the Competent Authority of its home Member State. CSDs established in a Member State that are currently providing CSD services need **to apply for authorisation under CSDR within six months after the entry into force of the relevant technical standards.**
- CSDs already active in the EU can continue to provide their services during this transitional period subject to any applicable national regimes until they have been authorised under the CSDR.
- Each Member State shall designate the competent authority responsible for carrying out the duties under this Regulation for the authorisation and supervision of CSDs established in its territory and shall inform ESMA thereof.
- Any legal person that falls within the definition of CSD shall obtain an authorisation from the competent authority of the Member State where it is established before commencing its activities.
- Procedure for granting authorisation
- Supervision of the CSDs
- Provision of services in another Member State.

Requirement for CSDs

- **Organisational requirements –**
 - ✓ A CSD shall have robust governance arrangements, which include a clear organisational structure with well-defined, transparent and consistent lines of responsibility, effective processes to identify, manage, monitor and report the risks to which it is or might be exposed, internal control mechanisms, including sound administrative and accounting procedures.
 - ✓ Policies and procedures sufficiently effective so as to ensure compliance with the CSDR.
- **Conduct of business rules**
 - ✓ A CSD shall have clearly defined goals and objectives that are achievable, such as in the areas of minimum service levels, risk-management expectations and business priorities.
 - ✓ A CSD shall have transparent rules for the handling of complaints.
- **Requirement for CSD services**
 - ✓ For each securities settlement system it operates a CSD shall have appropriate rules and procedures, including robust accounting practices and controls, to help ensure the integrity of securities issues, and reduce and manage the risks associated with the safekeeping and settlement.

Protection of Securities of Participants and those of their Clients

- CSDR requires CSDs to keep records that enable a participant to segregate the securities of any of their clients if and when required by that participant.
- However, **there is a new obligation on a CSD's participants to:**
 - **offer their clients at least the choice between omnibus segregation and individual client segregation; and**
 - **inform them of the costs and risks associated with each option.**
- Clients should consider carefully how they can best comply with these requirements.
- There is a specific exception granted for direct holding markets.
- This requirement can only come into effect once a CSD has been authorised under CSDR.

Prudential Requirements

- A CSD shall adopt a sound risk-management framework for comprehensively managing direct or indirect risks, including measures to mitigate fraud and negligence.
 - ✓ Legal risks
 - ✓ General business risk
 - ✓ Operational risks
 - ✓ Investment policy
 - ✓ Capital requirements

The Rules applicable to CSDs – Capital Requirements

- Capital, together with retained earnings and reserves of a CSD, shall be proportional to the risks stemming from the activities of the CSD. It shall be at all times sufficient to:
 - ✓ ensure that the CSD is adequately protected against **operational, legal, custody, investment and business risks** so that the CSD can continue to provide services as a going concern;
 - ✓ ensure an **orderly winding-down or restructuring** of the CSD's activities over an appropriate time span of at least **six months** under a **range of stress scenarios**.

Capital Requirements - Conclusions

- **Conclusions:**
 - ✓ **“Gone concern” and “going concern” capital requirements** (i.e. winding down/restructuring capital and other risks capital requirements) should be additive.
 - ✓ **Investment risk should be ‘risk based’** and cannot be replaced by a fixed amount.
 - ✓ **Operational expenses** should be calculated on a gross basis. Amortisation costs should be deductible from the capital requirements calculations (but not from the prudential floors).
 - ✓ **Custody risk** may be considered as already covered by capital requirements of operational risk.
 - ✓ In principle, however, all the investments that generate market or credit risk should be considered for the calculation of the capital requirements.
 - ✓ **Business risk scenarios** should be designed in a flexible way and agreed with the Competent Authorities.
 - ✓ **A minimum prudential floor is required** to ensure harmonised treatment within the Union.
 - ✓ CSDs should go through all the proposed scenarios; the scenarios with no effect for a particular CSD (in agreement with the Competent Authority) may be set to zero.

Provision of Banking-type Ancillary Services for CSD Participants

- In effect these provisions deliver a legal framework to govern the provision of commercial bank money settlement by CSDs to their participants.
- In summary these provisions achieve the following effects:
 - ✓ Restrictions on banking business
 - ✓ A CSD is permitted to provide commercial bank money services to its participants either:
 - through a credit institution under the Capital Requirements Directive, which is actually the same legal entity as the CSD; or
 - through a separate legal entity, authorised as a credit institution under, which is located either within, or outside, the group of which the CSD is a part.
 - ✓ In either of the above options, the credit institution is subject to very tight restrictions on the banking business which it can undertake, and to a very intensive supervisory regime.

Provision of Banking-type Ancillary Services for CSD Participants (contin.)

- The CSDR effectively creates the new status of a limited purpose bank for all CSD commercial bank money settlements.
- As set down in the CSDR, the credit institution/CSD:
 - ✓ can only undertake certain banking services permitted under CRD IV such as:
 - providing cash accounts and accepting deposits from its participants;
 - providing cash credit for reimbursement no later than the following business day;
 - payment services involving the processing of cash and FX transactions;
 - guarantees and commitments related to securities lending and borrowing;
 - treasury activities involving FX, and securities related to the management of participants long balances;
 - ✓ will be subject to an additional capital surcharge which
 - reflects the risk resulting from its provision of intra-day credit;
 - ✓ must report at least monthly to its Competent Authority on the extent and management of intra-day liquidity risk; and
 - ✓ must have an adequate recovery plan in place to ensure continuity of service in crisis situations.

Thank you for your attention

QUESTIONS?

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