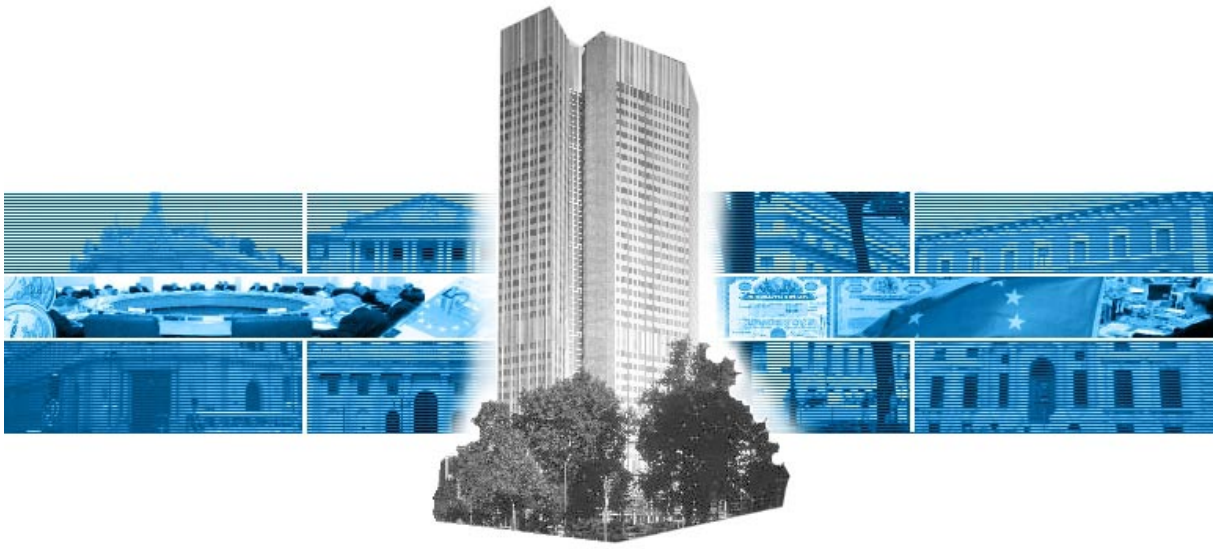
European cross border clearing & settlement 2005-2007



A Thought Leadership Paper from BTA Consulting

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bta Consulting

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Preface

1 PREFACE

1.1 THANKS

BTA Consulting Limited (BTA) would like to sincerely thank all those eminent individuals from a broad cross section of stakeholder institutions who gave up their time and openly shared their unique thoughts with us. We certainly appreciated all contributions - without which, we would not have been able to produce this document.

1.2 STRUCTURE OF DOCUMENT

This report begins with an Executive Summary of key conclusions. This is followed by a more detailed report, which sets out the background methodology and the key messages derived from the research. This section is supported by Appendix I that provides a summary of the responses to the 20 topics that were covered during interviews.

All sections represent the views of interviewees.

1.3 AUDIENCE

This report primarily addresses audiences within Europe.

Executive Summary

2 EXECUTIVE SUMMARY

2.1 INTRODUCTION

Throughout the interviews with 40 organisations across Europe, BTA clearly identified significant enthusiasm and commitment to resolve European cross border clearing and settlement challenges. However, interviewees stressed that it is doubtful whether the current collective efforts will enable cross border European clearing and settlement to make the requisite and necessary contribution to achieving the goals of the Lisbon Agenda[1]. Indeed, interviewees were unsure as to whether low cost efficient cross border clearing and settlement will materialise before 2010.

2.2 2005 – 2007

This research captures recommendations from interviewees to help the industry. If these recommendations are not taken on board, interviewees concluded there was a grave risk that:

> *"clearing and settlement may continue to adversely affect the cost of capital and market efficiency in Europe between 2005 – 2007".*

Interviewees believed that 2005 to 2007 will lay foundations for the period beyond 2007.

2.3 WHICH MODEL?

The structural model for cross border European clearing and settlement has yet to emerge and will continue to be fluid, given Europe's model is driven by commercial providers and not mutually owned utilities. The majority of interviewees recognised that the "for profit" governance methodology used by clearing and settlement infrastructure providers is not synonymous with cheap, efficient and competitive cross border clearing and settlement. Cheap processing is not an outcome of such governance because:

- the power of institutional investors. These organisations seek shareholder returns from the clearing and settlement businesses that are now the cash cows for many exchanges; and
- market forces do not currently operate within the cross border clearing and settlement space.

The presence of truly operating competition is now essential for low cost cross border efficient clearing and settlement. This has never been the case historically.

[1] In March 2000, the EU Heads of States and Governments agreed to make the EU "the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion." This is the so-called Lisbon Agenda.

Under either a mutual or Government owned clearing and settlement utility structure, competition in the operation of systemically important systems has historically been unnecessary. With the paradigm shift to the "for profit" governance model, competition and market forces are critical success factors.

Ironically, market forces in the cross border clearing and settlement space are not anticipated to be capable of operating for at least another 5 years. During this period some 75% of respondents believed that:

> *"consolidation would be the way forward, in response to shareholder demands".*

The result will be cross border natural monopolies with the obvious risk of tariff increases (rather than decreases). Such an outcome is a concern, particularly in the absence of other moderating influences. Full consolidation is however not expected. Ironically interviewees believe that:

> *"commercial interests stand in the way of full consolidation with regional players retaining their domestic focus."*

Most interviewees believed that interoperability is not expected to be a major contributor to the cross border clearing and settlement market because it is flawed on the grounds of cost benefit and risk portability.

Europe is pioneering the use of the "for profit" governance methodology. Accordingly, interviewees consider other critical success factors need to be in place to make the cross border clearing and settlement efficient. These include greater unanimity and co-operation, a full support for legal reform using a European Union (EU) Directive or Convention for clearing and settlement, and greater strategic direction and leadership. In addition, this research identifies some further barriers that need to be addressed, additional to and complimentary to the so called "Giovannini barriers".

2.4 WHO BENEFITS?

The next three years will see continuous benefits for intermediaries:

- as users of the cross border clearing and settlement systems; and
- on the buy side as investors in the infrastructure organisations.

In the cross border clearing and settlement debate intermediaries are likened to "turkeys" – "they don't vote for Christmas."

End consumers however will suffer. In particular, issuers and retail investors who have no consumer power to drive down or even identify transaction tariffs will simply have to absorb costs, directly or indirectly.

2.5 OPEN ISSUES

This research left interviewees with many unanswered questions:

- Can cross border clearing and settlement make its requisite contribution to achieving the Lisbon Agenda in time for 2010? Will delays in cross border clearing and settlement reform pose an unacceptable level of risk to the Lisbon Agenda?
- If the EU embarks on a programme to implement a Settlement Directive / Convention will it be implemented as National Law before 2010? If not, can it be fast tracked to significantly improve the balance of cost and benefits of such legislation and to avoid further post FSAP regulatory fatigue?
- How can market forces be injected into the cross border clearing and settlement space when shareholders seek value for themselves?
- How will low cost cheap cross border clearing and settlement actually be achieved? What will be the catalyst? Should tariffing be bundled or unbundled? What level of tariff reduction is realistic?
- Will the public sector Giovannini barriers be implemented?

2.6 NEXT STEPS

This research raises some significant and new conclusions. Consequently, BTA would very much welcome the opportunity to participate in the process to discuss these findings and to facilitate a quantum leap in progress in the European cross border clearing and settlement arena. In this way, the investment of all parties in this research will contribute to the achievement of the Lisbon Agenda.

The remainder of this report considers this complex issue.

Methodology & Background

3 METHODOLOGY & BACKGROUND

3.1 OBJECTIVE

This research was undertaken to review and analyse the future of European cross border clearing and settlement over the next three years (2005-2007).

3.2 METHODOLOGY

The approach solicited the views and opinions of some 40 selected interviewees representing a range of key European industry stakeholders, including brokers, custodians, exchanges, clearing houses, central depositories, regulators, legislators and industry representative bodies. A healthy balance between Anglo-Saxon and mainland European interviewees was achieved. A full list is provided in Table 1 - Matrix of organisations interviewed and their stakeholder groups on page 13.

The research is a unique insight into the topic of European cross border clearing and settlement, as interviews were conducted on a one-to-one basis, in the form of a discussion based on 20 key questions (please see section 6 - Appendix I – Summary of Interviews on page 36 for the questions and a summary of the responses). A key feature of this research was that no one has been attributed. Total anonymity enabled participants to be reflective and at the same time focus on the questions that they believed were of most interest and importance to their own stakeholders. The research also avoided a committee approach, providing a very healthy basis to the analysis.

A three-year horizon was established to ensure that research solicited and focused on matters of practical interest, recognising that views beyond this time horizon tend to be more philosophical in nature.

3.3 TIMING

This research has been conducted at a time when the European Securities Markets are working extremely hard to achieve the creation of a pan European Financial Services Market in the context of an overall goal for Europe set by the Lisbon Agenda. The European capital markets have embarked upon a programme to achieve a set of reforms, intended to promote the functioning on an integrated basis as a Single Market. Clearing and settlement is now viewed as one of the most significant obstacles impeding this goal according to most commentators. This opinion is accepted in Brussels.

3.4 EUROPEAN CLEARING AND SETTLEMENT EMBRYO

European cross border clearing and settlement is a tool for cross border securities transactions. Since the advent of the Euro, institutional asset allocations in equity markets have been organised on a European and sector level rather than a national or security level. In the bond markets, the European Monetary Union (EMU) has brought about institutional investment on an EMU wide basis with zero friction costs across borders. There is however little cross border retail investment.

Pan European cross border clearing and settlement is non-existent as an infrastructure. However, some cross border components exist. Accordingly, to respond to the investment patterns that have emerged post Euro, intermediaries have glued together national infrastructures to offer a Pan European clearing and settlement service. The result is that cross border settlements are expensive when compared to their domestic equivalents because:

- Each market uses a different methodology, the main influencer being the national legal system. The UK model is based on Common Law, whilst the mainland European models are based on the Napoleonic Code;
- The infrastructures have created a significant divide between the issuer and the investor; and
- Practices are archaic. There is little harmonisation. Standards are not embraced or enforced.

Five years ago, the EU inaugurated the Financial Services Action Plan (FSAP), known as the Lamfalussy Process. Some 42 initiatives were created. Clearing and settlement was not included. Re-organising European clearing and settlement has often been regarded as "too difficult" and any change should be driven by the private sector, reflecting the governance models of the infrastructure providers. More recently however, the balance between private and public sector involvement has been steadily changing. Whilst the consensus is that there will not be a second phase of the FSAP process, this study shows that legislative changes if implemented across Europe would inevitably help drive change in clearing and settlement.

The European Commission (EC) formulated the "Giovannini Group" to conduct a consultative process. This group analysed the barriers to efficient cross border European clearing and settlement. This body made recommendations, set time frames and assigned responsibilities for removal of these barriers. It is believed that the private sector has made great progress in the intellectual analysis of the issues, with particular encouragement from the public sector. The European Central Bank (ECB) has in the interim sought to regulate a specific aspect of the clearing and settlement process – namely "systemically important systems." These are entities that are gaining seemingly monopolistic custody and settlement positions within the European landscape. In addition, the EC has now commissioned an Impact Assessment on the Integration of EU Clearing and Settlement. This assessment is a pre-requisite of any legislative programme.

What can be learned from the above is that there is both significant change underway and an open playing field of opportunity. Enthusiasm is also high. To that extent, many consolidation processes are materialising at a cross-border European level:

- Euroclear has bought Crest;
- The London Clearing House (LCH) has merged with Clearnet;
- NCSD has been created in Scandinavia (the merger of the OMX-owned Finnish Central Securities Depository (APK) and VPC); and
- Intermediaries have merged to dominate the custody business.

At the time or writing, the London Stock Exchange has been engaging in possible merger discussions with the other major European Stock Exchanges, Deutsche Börse and Euronext. The power of institutional investors in that process is immense and should not be forgotten when considering the conclusions of this research.

While merger activity is in the limelight at a pan European level, there are also many focused thought leadership concepts being pioneered across different dimensions of the end-to-end clearing and settlement process. Intellectual analysis is being applied to a range of functions designed to bring greater efficiency and more cost effective cross border clearing and settlement. These include "securities account certainty", reference data (especially legal entity identifiers), standing settlement instructions and Straight Through Process (STP) messaging.

All of the above shows that is recognition that clearing and settlement are fundamental functions that underpin an efficient capital market. The European cross border clearing and settlement environment is about to undergo significant change and can best be described as an embryo that is evolving into an unknown form.

3.5 RESULTS

This research presents the thoughts and opinions of industry stakeholders, examining developments over the next three years. What is shown in this report is that the interviewees or stakeholder groups do not know how the European clearing and settlement landscape may unfold (see section 5.1 on page 33 for the main areas of consensus), not because they vehemently disagree but mainly because:

- the destiny for cross border clearing and settlement has not been defined and agreed; and therefore
- the path to the future is very unclear.

In the absence of consensus at such a strategic level, this report distils the results of the 40 interviews.

The following section summarises the key findings from our interviews.

Table 1 - Matrix of organisations interviewed and their stakeholder groups

Sectors	Institutions	Regu-Lator	Central Bank / Market	Interme-diaries	Other	Industry Body
Belgium	Euroclear		■			
	Fortis Bank			■		
France	The Autorité des Marchés Financiers	■				
	Citibank			■		
	The Committee of European Securities Regulators "CESR" France	■				
Germany	BVI Bundesverband Investment und Asset Management					■
	Norton Rose				■	
Netherlands	Aldires N.V.				■	
	Kas Bank			■		
Switzerland	CLS Holdings / CLS Bank International		■			
	CSFB			■		
	Sega Intersettle "SIS Group"		■			
	SWX Schweizer Borse virt-x		■			
	The European Central Securities Depositories Association "ECSDA"					■
	UBS, Switzerland			■		
UK	Association of Private Clients and Investment Managers "APCIMS"					■
	Bank of England, Financial Stability Forum		■			
	Barclays Capital			■		
	Citigroup			■		
	CRESTCo Ltd, Euroclear		■			
	Dresdner Kleinwort Wasserstein			■		
	Financial Services Authority "FSA"	■				
	HSBC Securities Services			■		
	Investment Managers Association					■
	JPMorganFleming Asset Management			■		
	London Clearing House Clearnet Ltd		■			
	State Street Bank			■		
Other Markets	Iberia - Iberclear		■			
	VPC, Sweden		■			
	Malta Stock Exchange		■			
	KDPW, Poland – National Depository for Securities		■			
Supra-national	European Central Bank "ECB"		■			
	European Commission	■				
	European Securities Forum "ESF"					■
	Federation of European Securities Exchanges "FESE"					■
	International Securities Association for Institutional Trade Communication - International Operations Association					■
	SWIFT, S.C				■	
	The Giovannini Group					■
	World Federation of Stock Exchanges					■

Interviews were not possible with the largest exchanges in Europe due to the merger activity. BTA Consulting will be happy to meet with them in the future.

Key Findings

4 KEY FINDINGS

4.1 INTRODUCTION

Over the past five years European clearing and settlement providers have undergone a paradigm shift in their governance models. This research is the first to uncover the implications of moving to the "for profit" model in an environment where market forces do not operate. Interviewees consistently demonstrated that Europe has yet to formulate a consistent and comprehensive approach to deal with the implications. Suffice to say, interviewees were optimistic identifying some key critical success factors (CSFs) that will help to create a true pan European cross border clearing and settlement infrastructure.

4.2 "FOR PROFIT" GOVERNANCE & MARKET FORCES

The "for profit" governance model is prevalent in European clearing and settlement organisations today.

The majority of cross border clearing and settlement transactions are processed through infrastructure providers who use a "for profit" governance model. Furthermore, these providers deliver services in non-competitive markets where market forces do not operate. This route has been adopted over the last 5 years. However to our knowledge, it has never been previously tested or proven elsewhere in the global securities market. Interviewees were unable to explain how "for profit" natural monopolies would deliver low cost efficient and innovative clearing and settlement services. As early adopters of the "for profit" methodology, 74% of interviewees highlighted other CSFs need to be implemented in order to kick start market forces. If such CSFs are adopted a lower cost pan European clearing and settlement landscape may materialise. If ignored, tariff increases are expected.

4.3 MARKET FORCES

Europe is heavily reliant on market forces to make cross border clearing and settlement as low cost and efficient as domestic clearing and settlement. Interviewees left us with no evidence to believe that market forces will achieve the required result.

For market forces to operate, a range of factors need to exist, including inter alia:

1. Products and services must be relatively homogeneous and capable of migrating;
2. Competition; and
3. Consumers are empowered.

In markets where these factors exist, then the outcome is cost reduction and improved services. In the cross border European clearing and settlement landscape, it is fair to say that none of these factors really exist, as we explain:

1. **Products and services must be relatively homogeneous and be capable of migrating:** Clearing and settlement products/services are not homogeneous. From the point of access to the point of settlement they vary considerably anchoring the products and services via national law or national service provider policies. Today the cross border clearing and settlement services are nationally constrained and cannot be transported cross-border.

   This means that new entrants or service providers have significant barriers to entry. For this reason alone, Europe needs the Settlement Directive and the ESCB-CESR regulations to release the products and services from their historic borders and service providers.

2. **Competition:** Interviewees believed that creating a competitive pan European clearing and settlement environment is unlikely before 2007. This is a legacy of the mutualised structures of the 20th century combined with the fact that the functional approach to regulation has yet to ignite competition. Conventionally, it has been possible to argue that competition should not apply to systemically important systems such as clearing and settlement infrastructures. That argument holds true, where the service is delivered under a utility governance models. However, where the service is delivered by profit driven entities, market forces and competition must be allowed to operate otherwise monopolistic tendencies will occur. For the foreseeable future, national natural monopolies are expected to continue to exist, at least until cross border mergers or acquisitions take place. Tariffs may rise unless other moderating influences are put in place. Yet it should be highlighting that some 50% of respondents were sceptical about the benefit of any competition enquiry that may ensue.

3. **Consumers are empowered:** In the cross border clearing and settlement market, consumers (the issuer and investor) are outside the process. Prima facie, this is no different to any other capital market – except that the European infrastructure providers are run as profit driven entities. Consumers have little power to drive down tariffs, in contrast to other industries. Consequently, consumers have no choice but to absorb high costs, particularly given that interviewees believed that any cost savings achieved or negotiated bi-laterally by intermediaries would not be passed on to consumers. Visibility of costs would be a key tool that could ignite market forces in the short term.

The above three factors show that in the European cross border clearing and settlement environment. Consequently market forces do not operate. Instead a number of CCPs and (I)CSDs are now owned directly or indirectly by institutional shareholders whose primary objective is an investment return for themselves and their underlying clients. Essentially the power of the institutional investor reinforces the current status quo. Does this mean that the governance model needs changing or do other factors need addressing? We now discuss how interviewees responded to this issue.

4.4 GOVERNANCE MODELS

"For profit" governance is here to stay as the clearing and settlement providers are the new cash cows for central market institutions.

The past decade has seen a significantly changing role for clearing and settlement. It was aptly described by one respondent as:

> *"the clearing house and CSD used to be the back door of an exchange. In the for profit governance model, they are now the front door of an exchange".*

Clearing houses and CSDs are the economic engines of exchanges and consequently represent a significant driver of their governance models. In this context, interviewees felt two governance models could emerge as winners while two governance models had no future in the cross border European market:

THE FUTURE OF CROSS BORDER C&S:

1. Private sector natural monopoly(ies).
2. Utility for selective services.

NO FUTURE IN CROSS BORDER C&S:

3. Public sector utility.
4. "Not for profit" mutualised model.

4.4.1 PRIVATE SECTOR NATURAL MONOPOLY(IES)

80% of interviewees believed that it is conceivable that one or more private sector natural monopolies may emerge as pan European cross border clearing and settlement providers, but probably not before 2007.

However, when these institutions emerge, interviewees stressed that it was unclear how they would become synonymous with low cost cross border clearing and settlement for several reasons:

1. **Economies of scale:** The evidence so far was that economies of scale were very hard to achieve on a cross border basis. Legal reform to harmonise underlying practices was an essential precursor of significant cross border efficiency. Therefore a step change in cross border cost reduction was unlikely to occur before 2010 (on current timetables).
2. **Market forces:** Many interviewees believed that commercially driven natural monopolies will drive up clearing and settlement transaction costs, for reasons explained earlier. Indeed there was already reported evidence that price increases are starting.
3. **Tariff control:** In the absence of market forces, it was discussed whether natural monopolies overseen by an external pricing regulator was a likely outcome. It was universally viewed as inconceivable. Almost 100% of interviewees believed that an external pricing regulator is undesirable, impractical and a distraction because it would consume excessive scarce resources. It would be a huge overhead to the industry to embark on a programme of end-to-end fee unbundling. In particular, while there are no commonly agreed and enforceable definitions of clearing and settlement products and services, a regulator would be ineffective. However, it is worth pointing out some interviewee considerations on this issue:
    - the view was expressed that the presence of such a regulator would help to quickly resolve many of the issues that are currently viewed as unpalatable by the private sector;
    - a fee regulator would not materialise in advance of the Settlement Directive, as tariff control will be dependent upon the content of the Directive. However, in the interim, competition authorities may authorise cross border mergers of key central market institutions if some "drilling of some holes" into tariff policies was conceded.

Overall interviewees were left with a dilemma. The "for profit" natural monopolies are expected to emerge as the dominant service providers but without offering low cost efficient services.

4.4.2 UTILITY FOR SELECTIVE SERVICES

One interviewee summed up the views of many by saying

> *"it is not envisaged that the next three years will see major changes in cross border clearing and settlement. However, the principle of free access to each of the steps in the securities transaction processing chain should be established."*

Functions that are capable of being migrated into a utility could include a single access mechanism to the private sector clearing and settlement organisations. The access mechanism would need to overcome most weaknesses the industry experiences associated with the lack of standards (see section 4.7.2 on page 26). Furthermore, a single access mechanism is an essential pre-requisite for deriving the benefits that can be achieved from the proposed Directive as passporting of clearing and settlement services (in the absence of standards) will multiply the access requirements rather than streamline them.

The benefits of an access mechanism would include:

- Cost reduction providing a single mandatory technology mechanism to communicate with market infrastructures (versus 40+ forms of technology mechanisms today);
- A low tariff as it would be delivered as a utility;
- Harmonisation particularly with markets that choose not to consolidate into the pan European structure but elect for interoperability;
- Greater access to more assets, including collateral;
- No conflict with core revenue streams of existing (I)CSDs; and
- Competition for underlying settlement services as users of CCPs and (I)CSDs would not be obliged to use one particular infrastructure because of location.

This simple solution offers significant benefits and needs to be explored further by the industry.

4.4.3 PUBLIC SECTOR UTILITY

Interviewees universally agreed that it was not an option to create a low cost pan European clearing and settlement utility financed by tax payers from EU nation states. It was felt that the threats of public intervention from European politicians would not go this far, as interviewees believed that the immense efforts currently underway in the private sector are sufficient to prevent such radical intervention. It was felt that market forces could be relied upon to achieve the goal and the barriers to entry for any such utility are too significant.

4.4.4 "NOT FOR PROFIT" MUTUALISED MODEL

Now that clearing and settlement in the larger European markets is recognised as a cash cow for profit making private sector providers, none of the intermediaries interviewed believed that a not for profit mutualised model could re-emerge in the most liquid markets in the foreseeable future, let alone before 2007. It was believed that:

"there was no room for a "not for profit mutualised model" in the pan European clearing and settlement market."

Regional markets may continue to use this model but only to the extent that they facilitate clearing and settlement access to their largely domestic markets.

4.4.5 GOVERNANCE MODELS – A SUMMARY:

When intermediaries voted to convert market utilities into profit making and sometimes public enterprises, sometimes as publicly listed companies, they probably did not fully consider or analyse the trade off between short term capital gain versus long term structural cost challenges. The lack of opportunity for market forces to prevail means that clearing and settlement will not make its requisite contribution to the goals of the Lisbon Agenda. One interviewee summarised the combined issues around market forces and governance by saying:

"logically it is difficult to see how costs will be controlled if at all."

Paradoxically, interviewees believed that governance will be the barrier that prevents full consolidation. This is explained in the next section.

4.5 CONSOLIDATION

Commercial interests stand in the way of full consolidation.

More than 70% of interviewees believed that the future of European clearing and settlement is in the hands of independent commercial providers, who are likely to evolve through organic expansion, mergers and acquisitions, towards consolidating market and customer bases within Europe. Between 2005 to 2007 itself interviewees predict limited consolidation. However, the commercial governance model is in itself a barrier to full consolidation as the industry fears monopolistic tariffing from a single natural monopoly.

Inter-operability linkages are unlikely to survive long-term. Neither the industry nor the regulators have a solution to this issue today. While 80% of respondents believe that both linkages and consolidation would over time (not necessarily the next three years) erode national and market differences in clearing and settlement processes, several interviewees believed that the linkage process is flawed. Linkages do not transfer risk. This may not be a problem for low volume low value traffic outbound from regional players, but is a significant and unacceptable risk for global investment banks and custodians. This issue was summarised by one interviewee:

"Proponents of interoperability underestimate the capital required for cross border business; the structures to support interoperability are extremely expensive to build and maintain. It cannot be justified without massive volume. Interoperability will only work for the domestic markets where local intermediaries seek to preserve their local identity and franchises."

Additionally, there was some considerable concern that the consolidation and linkage process would not remove all barriers, either through lack of commitment, or in order to protect domestic markets, as one industry spokesperson explained:

"Domestic users will slow down the process of consolidation, but at the end of the day unless they adapt they will not survive. By implication this means the international model will overtake the domestic model."

It would appear consolidation will occur at some point in the future. If this creates monopolistic behaviour, some other form of anti-competitive control will be essential. The form and substance of control is unidentified and unknown today, but suffice to say consolidation is not synonymous with competition.

We tested whether the fear of monopolistic behaviour would "kick start" fragmentation with competition arising from a functional rather than entity approach. It would appear that strategies have not yet been devised to test this issue. Tariff pressure is insufficient today while intermediaries can pass on their costs in a bundled manner. Furthermore, the regulatory basis is unclear.

Currently the development of pan European cross border clearing and settlement lies principally in the hands of independent commercial providers of the European clearing and settlement, who are likely to evolve through organic expansion, mergers and acquisitions, thereby consolidating market and customer bases within Europe.

4.6 CRITICAL SUCCESS FACTORS (CSF)

Three positive and one negative critical success factors accounted for 74% of responses to question around critical success factors for the future of European clearing and settlement.

Europe has embarked upon a route for clearing and settlement that has never been tested or proven, to our knowledge. Infrastructure providers are profit driven entities who work in non-competitive markets. Recognising the position Europe finds itself and in order to achieve the goal of the Lisbon Agenda, at the conclusion of each interview we asked:

"what is the single most important critical success factor to achieving a low cost Pan European clearing and settlement infrastructure?"

As early adopters of the market driven governance approach, 74% of interviewees highlighted other CSFs need to be implemented to achieve the Lisbon Agenda (which by definition implies a low cost pan European clearing and settlement landscape). The key CSFs were (and the associated percentage of responses):

1. Unanimity and co-operation (20%)
2. Legal and regulatory reform (20%)
3. Strategic direction and leadership (20%)
4. A significant market correction / technical failure (14%)

Additional responses included:

5. Consolidation through M&A activity (6%)
6. Interoperability (6%)
7. Competition (6%)
8. A utility (4%)
9. Cost transparency (4%)

These factors are self-explanatory and have been referenced elsewhere in the report. It is hoped that the private and public sectors implement CSFs 1 to 3 above in order to bridge the gap between the current structure and the goal. It is of course the industry's hope that CSF 4 above – a significant market correction or technical failure is not required to achieve the strategic goal of the Lisbon Agenda. CSFs 1 to 3 are discussed below.

4.6.1 UNANIMITY AND CO-OPERATION

The ultimate goal for cross border European clearing and settlement is not clear today. Key stakeholders are not consistent in their thoughts as revenue drivers within their own businesses are creating dissention. Short term commercial imperatives preclude the adoption of a clearing and settlement blueprint for the future. 95% of stakeholders believed a blueprint is unnecessary and unachievable.

It was implicit from responses that the nearest substitutes for a blueprint are therefore:

- The removal of the Giovannini barriers;
- ESCB-CESR recommendations; and in the future
- A Directive / Convention (which is unlikely to be operational before 2010).

Even though these guidelines seek to contribute to the delivery of a pan European clearing and settlement infrastructure, not all stakeholders are embracing them as they contradict some traditional business models in certain areas. This dichotomy will continue to represent a barrier to progress. It is difficult to conceive how this barrier can be overcome, but interviewees proposed public intervention in the form of legal and regulatory reform and leadership as catalysts. These are considered overleaf.

4.6.2 LEGAL REFORM

Without pre-empting the results of the EU's Impact Analysis, interviewees believed that it is highly likely that the EU Settlement Directive / Convention ("Directive") would move ahead. Not one interviewee voiced an objection to a proposed Directive on clearing and settlement. Indeed, some 70% of interviewees offered positive support for a Directive by offering comment on points which the Directive should contain, believing that the European clearing and settlement landscape would benefit significantly from the inclusion of:

- Key definitions of clearing and settlement functions;
- Standardising the representation of a security;
- Facilitating competition through passporting and a functional approach; and
- Certain aspects of corporate actions processing.

Almost 100% of interviewees support the concept of remote access to securities via accredited third parties within the EU. Some 40% of interviewees did make some observation and criticism concerning the time line for implementation of the Directive. Specifically, there was concern that the Impact Analysis, drafting, approval and eventual implementation as national law would not be completed until about 2010. This end-to-end process creates regulatory fatigue. As some interviewees highlighted:

> *"this timescale is inconsistent with both the Giovannini barrier removal plans and the Lisbon Agenda."*

The Directive is a precursor to achieving other successes in the Single Market. It's conclusion is likely to be coterminous with the timetable for the Lisbon Agenda. It is recommended that a Directive's implementation timetable should be re-examined (and a fast tracked version be implemented).

4.6.3 STRATEGIC DIRECTION AND LEADERSHIP

Throughout all interviews, there was discussion and enthusiasm to create a pan European clearing and settlement infrastructure uninhibited by barriers. It would offer users significant reductions compared to current tariffs. Interviewees believed that to achieve this goal strategic direction and leadership was required and recommended a range of complimentary solutions:

- A private sector appointed and funded European leader of clearing and settlement, an individual or institution, the so-called "Mr or Ms Clearing and Settlement;"
- A more authoritative approach from the ECB to support key aspects of the Euro denominated markets; and
- Greater political will to implement change to eliminate public sector barriers.

Today, no single individual, committee or organisation in Europe is charged with creating consensus or with delivering the pan European cross border clearing and settlement infrastructure. Perhaps this is the reason why clearing and settlement continues to represent a barrier to achieving the Lisbon Agenda. This gap contrasts with economies where clearing and settlement is delivered by mutualised or governmental organisations. It also contrasts with how the FSAP was delivered.

4.7 NEW BARRIERS

Market reform programmes have ignored clearing and settlement until recently. This research highlights that barriers are very entrenched. A more formalised private – public partnership is essential.

The Giovannini group has identified a range of barriers to cross border European clearing and settlement. This research uncovered the following additional barriers within the intellectual approach to European clearing and settlement reform:

1. Tariffs
2. Standards and the lack of an enforcement authority
3. Custodians
4. Authoritative approach
5. Leadership
6. Political desire

Interviewees believe these barriers need to be addressed to minimise the effect of a potential divergence between the ambition of the Single Market and the reality of progress. If addressed the Lisbon Agenda has an improved chance of being achieved. Each is discussed below.

4.7.1 TARIFFS

The EU internal market goal is that there is no discernible difference in tariffs for EU national domestic transactions and equivalent cross border transactions. In theory this means efficiency must be similar at both a domestic and a cross border level. The benefit will be further investment in European markets.

At the time of this research it was found that intermediaries are not sufficiently in control of third party tariffs. Indeed such control was **not** found to be a primary driver for two reasons:

- intermediaries now find themselves powerless to manage tariffs at a market level in the context of profit driven CCP/(I)CSDs; and
- tariffs may still be relatively high, but their absolute levels do not currently cause significant dissatisfaction within the market (because they are passed on to consumers). Indeed, one interviewee summed up by saying:

  "there is currently little sensitivity to transaction costs because most are agreed as a package of services. Transaction cost may fall but it was difficult to see how these reductions would be separately and distinctly recognised and evidenced as being passed on to the end investor."

Interviewees were consistent in their beliefs that pan European cross border clearing and settlement manifests itself as a complicated, inefficient and expensive process. The interviewees identified six key barriers that prevent tariff reductions:

1. **The power of the buy side as institutional investors:** European clearing and settlement services are delivered by profit driven private sector entities wherein institutional investors hold significant investments, shareholder returns are expected. This return conflicts with the requirement for low tariff transaction processing;
2. **Governance:** Costs of the central infrastructures in particular, are no longer controllable because they are no longer delivered by "not for profit mutually owned" entities. This in turn means there is no longer industry consultation over the tariff for service upgrades;
3. **Market structure:** Consumers (issuers and investors) are one step removed from the profit driven private sector entities delivering the infrastructure and have no ability to drive down tariffs;
4. **Profit from inefficiency:** It is not palatable for intermediaries involved in the delivery of many post trade services to reduce their fees particularly where they are able to profit from inefficient services. In the short term, they may respond to bi-lateral negotiations with individual customers;

5. **Unbundling and transparency:** Unbundling of services to create transparency of tariffs is unlikely to occur if no legal support for such activities exists;
6. **Lack of enforced standardisation:** Assuming the Directive achieves the objective to standardise the representation of a security it will allow the settlement function to be passported across any EU nation state. National monopolies will be challenged. However to reduce costs, access to clearing and settlement will also need to be standardised, using a common enforced messaging protocol.

Resolving items 1 to 5 above to achieve cost and associated tariff reductions remains a very significant open and unanswered question. Item 6 can be resolved through the Giovannini process, while implementing some of the detailed recommendations within this paper.

Consequently, interviewees believed that tariff reduction (and associated cost reduction) will only influence the shape of cross border clearing and settlement at the fringes, by encouraging the smaller providers to adopt different strategies. These include:

- Exiting the business;
- Linking with other cross border providers; or
- Seeking mergers or acquisitions, preferably on a cross border basis to avoid domestic competition challenges.

In sum, the private sector has no solution today to deal with high cross border clearing and settlement tariffs.

4.7.2 STANDARDS AND THE LACK OF AN ENFORCEMENT AUTHORITY

Today there are no harmonised technical standards applied to system access and interfaces to clearing and settlement systems. Furthermore, it was also recognised that technical standards vary. Standards today do not cover the universe of transaction types, they are slow to be created, and lack an enforcement body. This issue has been highlighted and is known as Giovannini Barrier 1. This research uncovered that there is now a growing desire for one access method using one set of messaging standards for the pan European clearing and settlement environment. Ironically, there are currently significant multiples.

100% of interviewees agreed that if standards existed and were enforced this would contribute to a reduction in costs and an increase in efficiency. At a central infrastructure level, the lack of standards is a barrier to cross border clearing and settlement. What is more alarming is that most stakeholders interviewed saw the status quo prevailing. This is such an important issue, that today's ambivalent attitude needs to be replaced by a clear agenda to achieve the end-to-end implementation and enforcement of standards, particularly in advance of any Directive. If

standardisation of IT interfaces and messages is not achieved in advance of a Directive that unlocks a security from its national clearing and settlement boundary, one only has to think about the mathematics, each intermediary would have to add 26 additional message formats to an individual CCP or CSD access format to process a unified security. Standardisation of representation is not enough without enforced standardisation of access and messaging.

4.7.3 CUSTODIANS

It was evident from interviews that the functional approach to clearing and settlement is going to allow intermediaries and major custodian banks to develop value added services based on their clearing and settlement capabilities. These new services would compete head on with CCPs and (I)CSDs. In Europe competition on functional grounds is a driver of change, working hand in hand with the new Markets in Financial Instruments Directive ("MIFID"). However, today it is too early to tell whether opportunities will be realised.

Interviewees reported that custodians have the potential to create and heighten the level of systemic risk possibilities by fragmenting the services of infrastructure providers and effectively novating transactions, be they market trades or corporate actions. Effectively such organisations have the opportunity to modify settlement at an (I)CSD into a settlement within an intermediary without the direct use of central bank monies. Over time this will become a greater concern of the ECB and other central banks.

The risk models, by which systemic risk is managed and controlled, have to satisfy the financial services regulators.

To what extent the Central Banks will permit these to operate within commercial banking and financial institutional conglomerates remains to be seen. How central bank money is made available to obviate any systemic risks in extreme situations also remains an open question. This area of uncertainty further enforces the lack of competition and the inability of market forces to truly have their effect.

4.7.4 AUTHORITATIVE APPROACH

The ECB together with the national central banks have been highly authoritative in implementing national payment systems. Trans-European Automated Real-time Gross Settlement Express Transfer System (Target) was highly specified from end to end:

- At the highest levels the inter-bank requirements, the systemic risk management, market stability requirements were identified; and
- At the lowest levels – IT standards and messaging requirements were defined.

These systems work and are cost effective. They are simpler than securities settlement systems but not significantly. It may be recollected that the project to enhance the efficiency of central Clearing and Settlement within the UK was conducted under the guidance and leadership of the Bank of England following the failure of a previous initiative from the London Stock Exchange.

This authoritative approach was successful and some interviewees with a particular interest in these issues now recommended that the approach needs to be channelled into a number of other directions:

1. A pan European Capital Market with a pan European clearing and settlement infrastructure for collateral integrated with Target, is important for the credibility of the Euro and to support the encouragement of investment in Euro financial assets not only from the internal market but also from investors globally; and
2. Harmonisation of securities settlement and Target rules in order to ensure there are no systemic risk "black holes" arising from timing differences and rule inconsistencies.

4.7.5 LEADERSHIP

The FSAP is viewed as successful. Its success has been led by many factors:

- The initial master minding and leadership came from an eminent individual M Alexandre Lamfalussy and the Committee of Wise Men;
- The follow up with implementation co-ordination from the Council of European Securities Regulators ("CESR");
- The EU and the passing of Directives.

In sum, comprehensive leadership and management were in evidence.

The irony in the case of clearing and settlement is that, having recognised that it represents a major impediment to creating a Single Market, equivalent leadership is lacking. Interviewees universally agreed that Mr Alberto Giovannini in his role as head of the Giovannini Group fulfils a leadership role but no individual in Europe today has the mandate to deliver or encourage the delivery of the European clearing and settlement infrastructure. Many eminent individuals own other parts of a highly complex jigsaw. The Clearing and Settlement Advisory and Monitoring Expert Group (CESAME) is seeking to bring these interests together.

Indeed, some 70% of interviewees stated that overall leadership was essential to future success. Leadership in this case is a broad concept. Analysis of this statistic reveals:

1. Some 60% of that 70% adopted a specific approach. They indicated leadership was required or was lacking in specific areas for example in setting and enforcing standards or ensuring improvement in administrative procedures to address corporate standards.
2. Some 40% of that 70% referred to the need for someone or some institution to provide overall leadership and direction for European clearing and settlement. Of this constituency 80% were in favour of an industry leader as opposed to leadership provided by a governmental/regulatory body. The group recognised that this appointment would be difficult. Appointing a leader is insufficient as key stakeholders will need to be in agreement, including a willingness to make compromises for a common good. Such issues would need to be taken into account in the terms of reference.

Without the various components of leadership, the structural impediments arising from the European clearing and settlement landscape are unlikely to be removed to a level that will deliver the goals of the Lisbon Agenda.

4.7.6 POLITICAL DESIRE

Supporters of a more integrated EU have a strong political desire to ensure that there is a successful pan European Financial Market. The EU and its legislative and administrative organs (including the EC and the European Parliament), have been disappointed that the introduction of the Euro was not in itself a sufficiently strong catalyst for markets forces to deliver a pan European Financial Market. As the Lamfalussy Report states "the European Union has no divine right to the benefits of an integrated financial market. It has to capture those benefits by building an integrated European market - in many cases from a very low level. If it does not succeed, economic growth, employment and prosperity will be lower, and competitive advantage will be lost to those outside the European Union."

A pan European Financial Market is seen is essential for the Euro as the EU's currency. The research highlights those barriers, which obstruct the achievement of an efficient, operational and cost efficient equity market including legal, regulatory and taxation issues. These cannot be removed as part of an industry effort, however cohesive that may be. The political will to introduce legislation both at a supra-national and national level may drive these changes. The political will to overcome these barriers is seen as important to accelerate the changes, which would in normal events be left to market forces. This political will needs to be evidenced with results.

The barriers above exist for a range of reasons. Responsibility should be allocated to eliminate them in order to realise low cost efficient cross border clearing and settlement.

4.8 WHO BENEFITS?

Essentially intermediaries.

Throughout all our research stakeholders consistently highlighted in their interviews that during the period 2005 – 2007, prime beneficiaries of any improvements to the European clearing and settlement infrastructure (cross border or otherwise) would appear to be intermediaries.

They benefit in two ways, either as:

1. Institutional investors in clearing and settlement service providers; or
2. Intermediaries by:
   - Passing on costs of inefficient clearing and settlement to institutional and retail investors;
   - Internalising economies of scale through organic expansion and mergers and acquisitions;
   - Cross-subsidisation.

4.9 WHO SUFFERS?

Issuers and retail investors.

Throughout our research stakeholders consistently highlighted that issuers and retail investors are dependent upon intermediaries for access to the clearing and settlement infrastructure. Under the governance structures of infrastructure providers, they are neither considering cost nor tariff reduction as a driver, nor are they contemplating cost or tariff transparency or unbundling. They will entertain bi-lateral tariff negotiations but it was believed by more than 50% of interviewees that intermediaries are not intent on passing benefits on to investors. Issuers and retail investors are powerless to force down tariffs and have no choice of access to services. They therefore have to absorb the costs of inefficiency.

4.10 CONCLUSION

The market view on how clearing and settlement will evolve between 2005 and 2007.

As we highlight at the beginning of this section "the pan European clearing and settlement landscape today is best described as an embryo that will evolve into an unknown outcome." As an embryo it is at a critical stage of life.

Today, private sector clearing and settlement providers dominate the market structure operating as natural monopolists with no real competition. The intermediaries who use these infrastructures see the friction costs of changing provider to be too significant – settlement liquidity is totally sticky. The key question is whether the drivers such as the Lisbon Agenda, the Euro, systemic risk considerations and others, can be a catalyst of change or whether the power of the providers and their shareholders is greater.

Most interviewees remained sceptical, believing there is sufficient evidence that in the next three years, clearing and settlement will become more expensive and will not evolve sufficiently to facilitate the goals of the Lisbon Agenda.

Specifically, between 2005 and 2007, most of the stakeholders interviewed believed that there would not be significant structural change, because most of the energy being driven into clearing and settlement would most likely focus on the intellectual development of the infrastructure through the Giovannini Group, the Directive and the ESCB-CESR standards. Structural change may happen after 2007.

Taking this further, interviewees did not believe that any new settlement models would emerge over the ensuing three years. Different models were explored, with competition on functional grounds being the driver of change, working hand in hand with the new Markets in Financial Instruments Directive ("MIFID"). However, today it is too early to tell.

The only exception to this conclusion related to the possible impact of mergers and acquisition activity amongst infrastructure providers and global players. Even then, most interviewees were sceptical about whether additional mergers would take place in this period, other than in Scandinavia. It was thought by and large that other regions and the Accession Countries would continue to exist as stand alone domestic markets. These markets would integrate rather than consolidate using improved inter-operability infrastructures, in the main for out-bound traffic rather than in-bound traffic.

Many options are still open and the balance of market forces versus regulatory intervention will ultimately determine the shape of the landscape. The shape may become clearer if many of the barriers and critical success factors presented within this section are addressed. While this evolutionary process continues, the necessary contribution that cross border clearing and settlement needs to make to the goals of the Lisbon Agenda will be substantially delayed.

This process of extracting, collating and analysing interviewee responses leaves a number of issues "in the air" but also provided significant collateral for on-going discussion within the industry. Accordingly, the next section provides an hypothesis, that it is hoped will help move the industry forward.

Conclusions

5 CONCLUSIONS

5.1 AREAS OF CONSENSUS

This research identified the following as the main areas of consensus amongst interviewees:

- The market and market forces should determine and drive changes in cross-border clearing and settlement.
- Competition in clearing and settlement is to be encouraged.
- Europe is an early adopter of market forces as a methodology to deliver clearing and settlement services. It is a new methodology and it has not been tested elsewhere. Interviewees believe other CSFs need to be implemented to ignite true market forces.
- Commercial providers of clearing and settlement services should be regulated on a functional basis.
- Cross-border clearing and settlement tariffs and costs were too high and should be reduced over time, however tariffs and costs were uncontrollable over the period.
- The necessity for technical and administrative standards.
- Greater leadership through a range of channels.

5.2 AREAS OF DIVERGENCE

The research identified the following areas of divergence amongst interviewees:

- The time frame and the pace of change in cross border clearing and settlement.
- The commercial appetite for competition in all areas of clearing and settlement.
- The method and form of consolidation of clearing and settlement services.
- The degree and impact of internalisation of securities trading, clearing and settlement services.
- Methods for implementation and enforcement of standards for the processing and administration of corporate actions.
- Current inefficiencies in European infrastructures are being preserved by profit motives of key stakeholders.
- The role of harmonisation and interoperability. Regional markets are reliant on interoperability preserving domestic markets, while others observe significant flaws in the business model around inter-operability.
- The benefits of unbundling services and tariffs.

5.3 HOW WILL IT UNFOLD?

2005 – 2007 will lay the foundations, for the period beyond 2007 when market forces tempered by some level of regulatory control will help to achieve consolidation but not necessarily around one Pan European clearing and settlement provider. The model has yet to emerge and will continue to be fluid given Europe's model is driven by commercial providers and not mutually owned utilities.

Appendix 1

6 APPENDIX I – SUMMARY OF INTERVIEWS

6.1 SUMMARY RESPONSE

6.1.1 SHOULD EUROPEAN CROSS-BORDER CLEARING & SETTLEMENT DEVELOPMENT BE MARKET DRIVEN OR SUPRA NATIONAL OR STATE REGULATOR DRIVEN?

Over 70% of interviewees support the need for market led initiatives to improve the efficiency and reduce the costs of European Cross-border Clearing and Settlement.

Some 74% of interviewees specified other CSFs need to be in place for the market driven methodology to truly succeed.

Almost 100% of respondents agree that some of the mechanics to enable improvements in the efficiency and reduction in costs may be put in place over the next three years. Over 70% are sceptical about the degree of impact of changes in the next three years. Also there is a similar level of scepticism about the public sectors contribution to the removal of the Giovannini barriers – in particular the tax collection procedures.

6.1.2 DO YOU SEE EUROPEAN CROSS-BORDER CLEARING & SETTLEMENT DEVELOPING THROUGH CENTRALISATION AND CONCENTRATION OF SERVICES OR LINKAGE?

The majority of interviewees (over 75%) see consolidation and concentration of clearing and settlement services as the way forward. There is a considerable dissent on both the time frame in which this may be achieved and the route this will take. 70% believe this will be achieved through mergers and acquisition activity rather than linkage in the next three years. Some 20% believe that extensive linkages will conclude with consolidation in the much longer term.

6.1.3 TO WHAT EXTENT SHOULD COMPETITION BE ENCOURAGED TO INCREASE EFFICIENCY AND REDUCE COSTS OF EUROPEAN CROSS-BORDER CLEARING & SETTLEMENT?

Over 50% of the respondents shared the belief in principle that the creation of a competitive environment should encourage efficiency and reduce cost in the medium to longer term. A similar percentage of respondents thought that the prospective EU Directive on Clearing and Settlement should encourage transparency and competition through definition of core clearing and settlement functions. Some were sceptical about the extent to which competition could be forced or created in national markets, where there was insufficient market liquidity and volumes of transactions. 50% of respondents were sceptical about the benefit of competition in low volume markets. The process of any competition enquiry is seen by almost 50% of respondents as a distraction, an impediment or even of irrelevance to the industry.

6.1.4 SHOULD ENTERPRISES CONDUCTING CROSS-BORDER CLEARING & SETTLEMENT BE REGULATED ON A FUNCTION AND ENTITY BASIS?

Without exception all those interviewed recognised that the largest financial institutions provided a range of services including clearing and settlement for their clients. The regulation of such business should be conducted on a functional basis not on a legal entity basis. In other words they should be regulated as clearing and settlement businesses just as separately constituted clearing and settlement businesses, once there is an agreed definition of clearing and settlement (and their component functions), which it is anticipated the prospective Directive will provide. This would ensure that the large financial institutions do not suffer duplication or excessive regulation arising from the added value services such as credit and securities lending and borrowing provided as a component of their clearing and settlement service.

Over 80% agreed that there should be a level playing field to ensure that there can be effective competition between the different types of clearing and settlement service providers. There is some embarrassment over the form of the debate and the extent to which the major custodian banks seem to compare the scope of regulation of their services with those of the single entity clearing and settlement enterprises.

6.1.5 TO WHAT EXTENT ARE FINANCIAL INSTITUTIONS INTERNALISING THEIR CLEARING AND SETTLEMENT SERVICES WITHIN ENTITY AND FUNCTION AND WHAT IMPACT DOES EUROPEAN CROSS-BORDER CLEARING & SETTLEMENT HAVE IN THIS?

There was universal acknowledgement that the largest institutions were able to internalise all processes in the life of a securities transaction from trade execution through to clearing and settlement.

This would result in an increasing number of transactions not being executed on exchanges with arguably, a consequent deterioration in the price discovery process. The volume and value of transaction did enable those institutions to create internal clearing and settlement businesses and in effect become CCPs and CSDs, which may become systemically important systems. The current extent or motivation for growth in this trend was the subject of scepticism by many interviewees due to the current lack of clarity and direction in regulations governing "these systemically important systems."

6.1.6 TO WHAT EXTENT WILL EUROPEAN CROSS BORDER CLEARING & SETTLEMENT IMPACT TRANSACTION COSTS AND CURRENT KNOWN INVESTMENT?

Increased efficiency is probably a greater driver at the moment compared to cost reduction. There is no vocal demand for deep and radical cost reduction, in part, a result of the cost reductions and cost restructuring of internal operations over the past 4/5 years.

Most enterprises would be content with gradual cost reductions.

There is a complete fragmentation of view on who should benefit from cost reductions. Doubt was expressed by over 50% of respondents as to whether the end investor would benefit perceptibly or even whether the benefit could be demonstrated or measured under current pricing structures for end investors.

6.1.7 SHOULD REGULATION BE IN VANGUARD /REARGUARD OF EUROPEAN CROSS-BORDER CLEARING & SETTLEMENT REGULATION?

Regulatory intrusion is needed to ensure some of the barriers are removed but broadly seen as bringing up the rear. The recent developments at the EU were seen to be very positive, in particular recruiting specialists, undertaking an Impact Assessment and facilitating the CESAME process. Competition regulators however were viewed to be ineffective in this space.

6.1.8 SHOULD THE DEVELOPMENT OF EUROPEAN CROSS-BORDER CLEARING |& SETTLEMENT BRING RESTRICTIONS REQUIRING USE OF SPECIFIC SYSTEMS OR ACCESS AND CHOICE / IT STANDARDS AND INTERFACES?

100% of interviewees agreed that technical and procedural standards should increase efficiency and reduce costs. Misunderstanding exists over the term "standards." Over 50% of interviewees see standards as a broad term encompassing variations in form, access and means of access. The observation is made that there is no enterprise in Europe vested with the authority to enforce standards and there is a general antipathy towards regulatory enforcement of standards, which many feel should be left to the market. There is some desire (by some 30% of respondents) for increased "accreditation (regulation)" of technologies, which provide services for clearing and settlement, particularly where they are perceived as systemically important.

6.1.9 SHOULD INVESTOR BE ABLE TO REMOTELY ACCESS THEIR SECURITIES ON A EUROPEAN CROSS BORDER BASIS?

Almost 100% of intermediaries support the concept of remote access of securities via accredited third parties within the EU.

6.1.10 WILL PROVISION OF A LEGAL DEFINITION OF "OWNERSHIP" OF SECURITIES HELP OVERCOME THE CURRENT BARRIERS TO EUROPEAN CROSS-BORDER CLEARING & SETTLEMENT?

Over 80% of interviewees considered a clearer and consistent definition of "final settlement" would be helpful. Over 50% highlighted the difficulty arising from conflict of law establishing a legal definition of "ownership"; which would satisfy the Continental European legal systems deriving from Roman Law and the UK Common Law enhanced by Equity Law.

6.1.11 WILL THERE BE ANY CHANGES IN SETTLEMENT PERIODS INCLUDING OPERATING HOURS, SETTLEMENT DEADLINES INCLUDING INTRA-DAY FINALITY BETWEEN SYSTEMS?

Over 80% of respondents thought that both linkage and consolidation would over time (not necessarily the next three years) erode these national and market differences. There was some concern that national authorities would not remove the barriers, either through lack of commitment, or in order to maintain artificial barriers.

6.1.12 WHAT DEVELOPMENTS WILL THERE BE IN OUTSOURCING (INTRA EU AND EXTRA EU) AS A CONSEQUENCE OF DEVELOPMENTS OF EUROPEAN CROSS-BORDER CLEARING & SETTLEMENT?

Outsourcing is not seen as a major enabler to reduce costs. In some instances the nature of the activities are not considered appropriate for outsourcing.

There was some opportunity for outsourcing intra-EU but it was not high on the agendas of interviewees.

6.1.13 WHAT STEPS WILL THERE BE TOWARDS HARMONISATION OF SECURITIES LAWS WITHIN EU (& SOME ELEMENTS OF COMPANY LAW)?

With a handful of significant exceptions (15%) there was no belief that this would occur but not yet highlighted as a major obstacle.

6.1.14 WHAT STEPS WILL TAKE PLACE TO BRING REGULATORY HARMONISATION IN EUROPEAN CROSS BORDER CLEARING & SETTLEMENT?

There is almost no belief that this would happen to any extent: but, again, it was neither highlighted as an obstacle nor as a benefit.

6.1.15 WHAT IMPROVEMENTS WILL OCCUR TO IMPROVE THE ADMINISTRATION OF CORPORATE ACTIONS?

It was universally agreed that the inadequacies of processing and administration of corporate actions is a growing area of risk and exposure for custodians, agents and clients. There is a very strong requirement for additional procedural and technical standards and their enforcement, with further consideration required in respect of capital adequacy issues. However, it was generally unclear who will drive these issues?

6.1.16 WILL THERE BE ANY STEPS TO IMPROVE HARMONISATION OF TAXATION PROCEDURES GOVERNING INVESTMENT INCOME WITHIN THE EUROPEAN UNION?

There was almost complete agreement that the focus should be on harmonisation of tax collection and reporting procedures for investment income. This would have the added benefit of contributing to improvement in the processing and administration of corporate actions deriving from investment income events, payment of interest and dividends.

6.1.17 HOW WILL THE DEVELOPMENT OF EUROPEAN CROSS-BORDER CLEARING & SETTLEMENT INFLUENCE GOVERNANCE AND SHAREHOLDER RIGHTS?

Everyone agreed that corporate governance of "for profit" clearing and settlement organisations, particularly those with national monopolies and with demutualised status, presents a dichotomy. In many instances the shareholders no longer constitute the users of the services. The interests of shareholders and users are sometimes juxtaposed. The shareholders seek an investment return and increasing commercial performance from their investment. These do not necessarily align with the interests of the users and the longer-term development requirements of the industry.

6.1.18 WILL INVESTOR PROTECTION REQUIRE STRENGTHENING AS A RESULT OF DEVELOPMENT OF EUROPEAN CROSS-BORDER CLEARING & SETTLEMENT?

There was very little reference to the requirements to improve investor protection or the impact of developments in clearing and settlement on investor protection except in the context of systemic risk and risk and exposure to investors arising from the current corporate actions processing and administrative inefficiencies

6.1.19 WILL THE ACCESSION STATES BE AN ACCELERATOR OR INHIBITOR TO THE DEVELOPMENT OF CROSS BORDER CLEARING & SETTLEMENT IN EUROPE?

It was thought that there would be some linkage/sub-consolidation: small markets (low volumes/ thin liquidity). The Accession process was viewed to have no impact on the volume or value of cross-border flow. The increase in the number of nation states within the EU from 16 to 25 may slow down decision making and implementation of proposals to reduce the barriers to European cross border clearing and settlement.

6.1.20 WHAT IS THE SINGLE MOST IMPORTANT CRITICAL SUCCESS FACTOR FOR THE DEVELOPMENT OF CLEARING AND SETTLEMENT IN EUROPE?

As early adopters of the market driven governance approach, 74% of interviewees highlighted other CSFs need to be implemented to achieve the Lisbon Agenda (which by definition implies a low cost pan European clearing and settlement landscape). The key CSFs were (and the associated percentage of responses):

1. Unanimity and co-operation (20%)
2. Legal and regulatory reform (20%)
3. Strategic direction and leadership (20%)

A significant market correction / technical failure (14%). These are fully discussed and reviewed in section 4.6 on page 21.

Appendix II

7 APPENDIX II – AUTHORS

7.1 BRIAN TAYLOR, BA (HONS), ACA

Brian is Managing Director of BTA Consulting Limited - a niche financial markets consultancy group, which Brian set up in 1991.

Brian has provided consulting and interim executive management services to more than 40 mature and emerging markets across a broad range of financial services disciplines. Currently Brian is Interim Head of Finance, for the investment and banking arm of a UK Government department. Previous interim management roles include CEO of the Bahamas International Securities Exchange.

Brian qualified as a Chartered Accountant with Arthur Andersen & Co. London, in 1984 and has a First Class Honours Degree in Geography from the Victoria University of Manchester. He has held Directorships at Price Waterhouse and Merrill Lynch Europe Limited.

7.2 BOB MCDOWALL, BA (HONS)

Bob McDowall is a strategic advisor with BTA Consulting concentrating on a number of areas including financial regulation.

Bob has worked in the financial sector for the past 25 years, primarily in the City of London, for most of his career in a variety of management and consultancy roles for organisations as diverse as Merrill Lynch, Pru-Bache, Singer & Freidlander and Syntegra, the systems integration division of British Telecommunications. He is a member of a French Monetary "think-tank", "Le Centre Jouffroy". Bob has an interest in a small technology business and writes periodically for financial sector press and professional publications on a range of current and topical issues concerning the financial services markets.

Bob has an honours degree (LLB) in law from University College London.

Appendix III

8 APPENDIX III – CONTACT DETAILS

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