

2.3 CONSOLIDATION IN THE EUROPEAN SECURITIES SETTLEMENT SYSTEMS ENVIRONMENT

2.3.1 Introduction

For a long period of time it appeared as if the concentration process, already under way in the financial services sector, had stopped short of clearing and settlement agents.

But the launch of a common European currency project and the subsequent harmonisation of ESCB Monetary Policy and Intraday Credit operation practices were to have a significant impact on the clearing and securities settlement industry. In particular, the statutes of the European System of Central Banks and of the European Central Bank stipulate that credit operations with credit institutions and other market participants may be executed only against adequate collateral.¹³

The combination of a) the emergence of a common European currency and b) the requirement for full securities collateralisation of ESCB credit operations, has:

- significantly increased the cross-border use of eligible securities and,
- contributed to the harmonisation and concentration process in the securities clearing and settlement areas.

In order not to hamper the smooth functioning of the market, future developments in the securities clearing and settlement area will have to respect the following cornerstones:

- collateral has to become/remain easily accessible on a cross-border basis;
- collateral has to be moved through faster and more cost-efficient channels;
- the cross-border use of collateral has to obey to the highest security (safety) standards.

To set the framework for all these concerns, the European Monetary Institute adopted in 1998 the "Standards for the use of EU securities settlement systems in ESCB credit operations"¹⁴, the so-called

¹³ See, *Union Européenne, Recueil des traités page 537, Protocol No3 attached to the Treaty establishing the European Union, Chapter IV, Article 18 on Open Market Credit Operations.*

¹⁴ *Standard 1: Legal Soundness*

All securities settlement systems (SSSs) and the links between such systems must have a sound legal basis, ensuring that the settlement of payment and securities transfers is final and must provide for adequate protection of the rights of the NCBs and the ECB in respect of securities held on their accounts in such systems.

Standard 2: Settlement in central bank money

SSSs must use central bank money for the delivery versus payment (DvP) settlement of ESCB credit operations.

Standard 3: No undue custody risk

To limit custody risk as much as possible, SSSs must have a unique and direct relationship with the issuer or a direct link with an SSS which has this relationship. Where use is made of a depository, the SSS which has a direct link with the depository of the global or individual certificates shall be regarded as having a direct and unique relationship with the issuer, provided that there are adequate safeguards against custody risk. Links must have reconciliation procedures for balances at least once a day. All EU SSSs should permit direct access appropriately to all other EU SSSs which meet these standards and other relevant requirements.

Standard 4: Regulation and/or control by competent authorities

An SSS or a linkage between SSSs that is not subject to regulation and/or control by the competent authorities must not be used by NCBs.

Standard 5: Transparency of risks and conditions for participation in a system

SSS operators must provide the NCBs with an insight into potential risks of the settlement of securities (e.g. they must provide timely, orderly and reliable information about the potential risks resulting from participation in the system). Access and exit criteria for participation in the SSS must be objective and public. In this respect, SSSs' full response to the G-10 - IOSCO disclosure framework for SSSs must be readily available.

Standard 6: Risk management procedures

SSSs must adopt risk management measures as appropriate to the individual system, in order to cope with the effects of a default of participants. SSSs must be structured and operate in such a way as to avoid or, if not possible, to minimise any conflict of interest possible arising from their other operations.

Standard 7: Intraday finality of settlement

SSSs must provide facilities to settle certain ESCB operations (those involving intraday and overnight credit) with intraday finality (i.e. settlement that cannot be reversed or unwound). SSSs must not expose NCBs to other sources of settlement risk when they are settling operations with counterparties in an SSS and/or via linked arrangements. SSSs used for the settlement of central bank transactions shall have facilities in place by 2002 to allow the option of intraday DvP settlement in central bank money. This may take the form of real-time gross settlement, or a series of batch processes with intraday finality.

Standard 8: Operating hours and days

The operating hours and opening days of SSSs must be in compliance with NCBs' requirements for the TARGET system and for the cross-border use of eligible securities included in the tier one and two lists.

Standard 9: Operational reliability of technical availability of adequate backup facilities

All SSSs must ensure the operational reliability of technical systems and the availability of backup facilities capable of completing daily processing requirements.

“Lamfalussy standards”. Only those SSSs assessed as compliant with these standards can be used for handling securities eligible for collateralisation of ESCB credit operations.

A milestone in this respect will be January 1, 2002, when Securities Settlement Systems used for the settlement of central bank transactions must have facilities in place to allow the option of intraday finality delivery versus payment settlement in central bank money.

In conclusion, the driving force behind the current consolidation process in the European Securities Settlement Systems’ area can be attributed:

- to the need for SSSs to concentrate and harmonize in order to increase efficiency;
- to the commercial requirement of reducing the current level of operational costs of the European clearing and settlement industry;
- to the obligation to fully comply with ESCB security standards by 2002.

Representing the last link in a chain including stock exchanges, trading platforms and electronic networks, and market practices, clearing and settlement features in the European environment will constitute the main focus of this article in general. In particular, it will highlight both the initiatives of Cedel International/Deutsche Börse Clearing and Euroclear/Sicovam, because they reflect the most important projects for consolidation of the European Securities Settlement System’s infrastructure for the time being.

2.3.2 The merger between Cedel International and the Deutsche Börse Clearing

Clearstream Banking Luxembourg (former Cedelbank)

CEDEL was established in 1970 as a limited liability company under Luxembourg law. Influenced by

the market dominance that Euroclear exercised at that moment in time in the clearing and settlement business of the Eurobond market, 66 financial institutions from 11 different countries constituted CEDEL, the Centrale de Livraison de Valeurs Mobilières. CEDEL was to act as the European counterweight to the Morgan Guarantee operated Euroclear system.

On January 1, 1995, CEDEL obtained a banking licence under Luxembourg law, and the name of the company was changed to Cedel Bank.

In 1998, Cedel Bank’s corporate structure changed significantly.

On May 1, 1998, Cedel Bank, which until then had operated all activities under one roof, was mainly restructured into three different companies:

- a) Cedel Global Services, providing securities as well as IT developments, maintenance and operations services;
- b) Cedelbank, a duly licensed financial institution incorporated under Luxembourg law and thus authorised to effect the complete range of banking activities¹⁵. Cedelbank became the “customer-facing” entity of the new CEDEL Group, offering “clearing, settlement, custody, asset optimisation, communications and reporting”¹⁶.
- c) Cedel International, the parent holding company in charge of administrative, corporate and support services. These include the financing, the strategy, the budgets and the relation with shareholders.

As of today, the (still existing) Cedel International is jointly owned by 92 international banks. Last year Cedelbank processed more than 10 million transactions and the value of securities deposited exceeded 2,000 billion USD.

¹⁵ However, Cedelbank has stipulated in its bylaws that its core business consists of acting as a depository of securities for participants in its securities settlement system and that it provides clearing and settlement services in relation to those securities.

¹⁶ Cedel International, Annual Report, 1998.

Clearstream Banking Frankfurt (former Deutsche Börse Clearing)

The predecessor of the Deutsche Börse Clearing, the Deutsche Kassenverein A.G., was founded in 1989 by the merger of seven German Kassenvereine (Central Securities Depositories) created between 1949 and 1954.

In 1970, the Deutsche Auslandskassenverein A.G., handling non-German securities was set up.

In 1995, both the Deutsche Kassenverein A.G. and the Deutscher Auslandskassenverein A.G. were absorbed as subsidiaries into the Deutsche Börse A.G..

One year later, in 1996, both entities adopted the DKV (Deutsche Kassenverein) as a combined corporate name. Yet another year later, and in order to reflect the fast developing international activities of the Group, DKV was renamed into Deutsche Börse Clearing A.G..

Today, the Deutsche Börse A.G., which holds 100% of the share capital of the Deutsche Börse Clearing, is 81% owned by German and International credit institutions, 9% by stock brokers and 9% by German regional stock markets.

By the end of 1998, the Deutsche Börse Clearing held in custody more than 90% of all bonds traded in Germany and it had a client base of more than 420 customers. Overall deposits exceeded 4,000 billion EURO.

The newly merged Clearstream International

On May 14, 1999 the Deutsche Börse A.G. and Cedel International announced the merger of their clearing, settlement and custody activities. This future integrated European securities settlement system model is called "European Alliance System".

Due to operate under the label of "European Clearing House", this project has subsequently received the shareholder endorsements of both the Deutsche Börse A.G. and Cedel International. Both sides now hold 50% each of Clearstream

International, a Luxembourg holding company regrouping under one roof all former subsidiaries and branches of both Cedel International and Deutsche Börse Clearing A.G..

In addition, a memorandum of understanding was signed between the Deutsche Börse Clearing and Cedel International¹⁷ on the one hand, and Sico-vam on the other hand, stipulating the terms and conditions for future merger talks between both entities. As it appeared, the deadline attached to this memorandum expired at the end of October 1999, and Sico-vam subsequently entered into an alliance with Euroclear.

The "European Clearing House" initiative remains open for other SSSs to participate. Here, various scenarios could apply:

- merging with Clearstream International;
- setting up electronic communication links to Clearstream International;
- outsourcing securities processing services to Clearstream International.

While the current corporate structure of Clearstream International is globally based on the pillars of Clearstream Banking Luxembourg and Clearstream Banking Frankfurt, the challenge for the future will be the timely completion of the step-wise migration of all Frankfurt based IT business onto one integrated real-time settlement platform, called "Creation", in Luxembourg.

During the course of this year, Clearstream will first concentrate over-the-counter (OTC) transactions in Luxembourg, followed by Stock Exchange and remaining OTC transactions.

In 2001, the German domestic bond business will be transferred.

And finally in 2002, Stock Exchange and OTC transactions in German equities will be migrated to the Creation platform.

Due to legal constraints, German account holdings will remain in Germany. And so will the client relationship network.

¹⁷ This memorandum of understanding was signed on May 14, 1999.

For the time being, all existing contracts with the Deutsche Börse Clearing and the CEDEL entities will remain unchanged.

In conclusion, here the main strategy statement issued by the merging parties in May 1999:

“To become the leading European provider of clearing, settlement and custody services. While it will be open for participation by other clearing organisations, the European Clearing House will employ the first mover advantage and will establish European settlement standards”.

2.3.3 THE INTEGRATION OF SICOVAM INTO EUROCLEAR

Euroclear

Euroclear currently holds more than 50% of foreign holdings in European Government bonds. More than 135,000 bonds and equities are settled through its system.

Euroclear Systems was founded, and is currently still operated by Morgan Guarantee Trust Company of New York via its Brussels offices. In September 1999, it was officially announced that the US based systems owners had notified the board of Euroclear of their intention to quit as systems operator.

The investment bank J.P. Morgan will remain as the Euroclear operator for a period of up to 18 months. Starting with the day of retrieval from Euroclear, J.P. Morgan announced that it expected to receive between USD 195 million and USD 295 million per year over a period of three years. Preferably, the new systems owner should become a European bank.

Since 1986, Euroclear is organised under the corporate structure of a “Société coopérative” under Belgian law. Shares were attributed to all system participants. The core IT platform is operated by Morgan Guarantee Brussels under contract with Euroclear. The “Société coopérative” is headed by a Board of 26 Directors which decides on the Euroclear policy guidelines.

Since Euroclear is by far the largest clearing and settlement agent in Europe, both in terms of securities holdings and in terms of the number of transactions, the pressure to merge with or absorb other competitors was less apparent. In addition, Euroclear launched its own real-time settlement platform in September 1999.

As opposed to the European Alliance System, Euroclear promoted a model called “Hub and Spokes” at the beginning of 1999.

According to the original model, Euroclear and Cedel International would have formed the “Hub”. All other SSSs willing to join would have done so as “Spokes”.

This model has the advantage of building on the existing operational IT platforms to settle international transactions, while maintaining decentralised point of entries to affiliated securities settlement systems (the “Spokes”) for settlement of national transactions. So, the latter could continue to input their local market experience, while benefiting from the more cost effective and integrated “Hub” structure.

Euroclear preferred this option for it would have allowed the “Hub and Spokes” model to become operational without too many incisive system adaptations.

As the recent take-over of Sicovam has shown, Euroclear may be able to realise a “Hub and Spokes” infrastructure even though the merger with Cedel International has not occurred.

Sicovam

Sicovam was founded in 1949. Its shareholders are:

- Banque de France (40%);
- Credit institutions (48.72%);
- Paris Bourse S.A. (5.36%);
- the Caisse des Dépôts et Consignations (4.92%);
- Others (1%).

Throughout the last fifty years Sicovam has been the French Central Depository for securities. It has step by step been given the responsibility of hand-

ling registered securities, it has been designated as the organisation authorised to identify the securities holders, and finally it has been designated as the managing agency for French settlement systems (Relit and RGV).

In 1984, the dematerialisation of French securities allowed Sicovam to organise its securities administration more efficiently.

In the aftermath, Relit was launched, France's first automated clearing and settlement system which operates out of batch cycles. It was followed by RGV (Relit Grande Vitesse), the French real-time securities gross settlement system.

Relit settles trades on a delivery versus payment basis.

RGV, the new clearing and settlement system, was launched by Sicovam in February 1998. It operates on a real-time basis and offers immediate finality for settlement in Central Bank money, due to a direct link it operates to France's real-time gross settlement payment system, TDF, operated by the Banque de France.

The link between both systems is that RGV, in addition to cash transfers throughout the day, allows participants to adjust their cash positions with TBF by setting up intra-day repos with the Banque de France.

Due to the real-time settlement finality component of the RGV system, the same collateral may be used several times each day for different purposes.

By the end of 1998, Sicovam held more than 20,000 securities in custody and had a total of 630 customers.

The future structure of Euroclear

Originally, the co-operation framework between Euroclear and Sicovam was designed as an Alliance where each entity would remain independent in its corporate structure and common client interfaces would be developed only where appropriate.

Nevertheless, the current plans for the future point in the direction of Sicovam becoming a subsidiary of Euroclear Brussels, which will control 100% of its

share capital. In order to achieve this transaction, the Banque de France will have to sell its capital stake of 40% in Sicovam to Euroclear.

Under the assumption that this "take-over" will come to a positive conclusion, the 119 shareholders of Euroclear PLC (UK) – the parent company of Euroclear - will be joined during the first quarter of 2001 by the current Sicovam shareholders, which will receive in return 16.67% of the Euroclear PLC share capital.

In addition, Euroclear will acquire a banking licence under Belgium law before the end of 2000. Originally, this bank will have a capital base of 1 billion Euro.

When the corporate restructuring period is due to be finalised (first quarter of 2001), clients of both Euroclear and Sicovam should ideally have the opportunity to access their accounts via a single IT interface platform. Although this single IT interface will not prevent Euroclear and Sicovam accounts to remain effectively separated and visible as such by the clients.

2.3.4 THE DRIVING FORCE BEHIND THE RECENT INITIATIVES

As it has been described, the approach to achieve further concentration and harmonisation in the European securities clearing and settlement environment differs from Clearstream to Euroclear.

Euroclear favours consolidation through common IT interfaces. As such, keeping the "Hub and Spokes" model in mind, this scenario would eventually work towards the creation of an important "Hub" in the centre and many smaller "Spokes" in cross-border jurisdictions.

On the other end, Clearstream International favours consolidation by merger. At the same time, all merged entities should adopt one single IT settlement platform and achieve economies of scale by closing down parallel systems.

Whereas the main obstacles for a faster move to consolidate European Securities Settlement Systems are of political, legal and fiscal nature, the main arguments in favour could probably be summarised in two words: “cost and efficiency”. These will be the driving factors behind future developments.

Finally, it is important to stress that if the market has detailed objectives to attend, so does the Eurosystem. Not only will Securities Settlement Systems have to comply with the “Standards for the use of EU securities settlement systems in ESCB credit operations”, but the Eurosystem will also exercise its duty as overseer in the future. Likewise, National Central Banks, such as the Banque centrale du Luxembourg, with regard to the SSS established in Luxembourg, will have a role to play in the future consolidation of the Securities Settlement industry.