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Executive Summary

to the Impact assessment accompanying the

Proposal for a

DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL

amending the Directive 98/26/EC on settlement finality in payment and securities settlement systems and Directive 2002/47/EC on financial collateral arrangements as regards linked systems and credit claims

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EXECUTIVE SUMMARY

Over the past three decades, the European financial sector has evolved and grown with incredible speed, spurred principally by four forces: globalisation, European integration, financial innovation and technological innovation. Due to the combined action of these four forces, the European financial sector witnessed a tremendous increase in cross-border financial flows, the creation of ever more complex financial products and the adoption of increasingly sophisticated designs by both payment and securities settlement systems.

These developments have had a profound impact on the way the various market players conduct their business. For instance, market infrastructures, which had been designed principally to meet the needs of domestic markets, have needed to adjust to the challenges posed by an increasingly cross-border reality. Similarly, players who decided to expand their activities beyond their domestic markets have been faced with the challenge of having to do business in different jurisdictions. Moreover, market participants faced with an increasingly complex operational environment have needed to put a stronger emphasis on risk management and collateralisation.

The Financial Collateral Arrangements Directive ("the FCD") and the Settlement Finality Directive ("the SFD") represent two Community-level legislative measures that were adopted in response to some of the challenges highlighted above. Recent evaluations have concluded that both Directives are functioning well. Still, according to many of the responses received from the various stakeholders, both could be improved in order to take into account the market developments that have occurred since the time of their implementation.

Based on the above, this impact assessment focused on market developments in three major areas: collateral, payment and securities settlement systems, and conflict-of-laws rules.

Collateral

In the area of financial collateral arrangements, the growing use of collateralisation for the purpose of securing financial transactions has led to an increase in the demand for assets suitable to be used as collateral. This has triggered a search for possible ways to enlarge the current pool of eligible assets for collateral use. One asset class considered in this respect were credit claims. Their main attractiveness lied in their abundance and in the fact that they have few, if any, alternative uses. In fact, some Member States, and most recently the Eurosystem, have decided to accept certain credit claims as eligible collateral.

The use of credit claims raises a number of practical questions, first and foremost about the protection extended to credit claims when they are used as collateral. Only in some of the abovementioned Member States the protection enjoyed by existing types of financial collateral (i.e. cash and securities) was extended to cover credit claims. Even in those cases, the protection does not cover the cross-border dimension. As a consequence, credit claims are currently used as collateral almost exclusively in domestic transactions. Second, even within the domestic setting there are indications that certain formal requirements hamper the use of credit claims for collateral purposes, which means that there is ample room for improvement even at the domestic level. Finally, when including credit claims in the pool of eligible assets for collateral use, a decision needs to be made as to which credit claims to include.

Payment and securities settlement systems

Substantial developments have taken place in the area of (payment and securities) settlement systems as well. Most notably, links between various settlement systems have become much more common than was the case a decade ago. In addition, initiatives such as the Market in Financial Instruments Directive ("the MiFID") and the Code of Conduct on clearing and settlement are likely to encourage the establishment of new links and the more intensive use of existing ones. Night-time settlement has also become a rather widespread solution offered by settlement systems in the last ten years. Last, but not least, in recent years new types of institutions have emerged in the payments area that were not there a decade ago (e.g. electronic money institutions or ELMIs).

In light of the above, a legitimate question that needs to be answered is whether the current protection enjoyed by the various settlement systems adequately covers the new technical solutions they have adopted. Given the crucial role settlement systems play in the financial markets and hence the economy as a whole, it needs to be made sure that is indeed the case. Thus, in the context of linked systems, one issue that needs to be addressed is that of the risk of contagion between systems. Furthermore, for what concerns night-time settlement, it needs to be verified whether the introduction of this solution and consequently of business days that do not necessarily coincide with calendar days has any implications in terms of the protection granted to settlement systems. Another important question is whether the existing protection needs to be adapted to take into account the new types of institutions mentioned above.

Conflict-of-laws rules

Nowadays, the great majority of securities are held in electronic book-entry form in securities accounts with intermediaries, rather than directly in physical form held by the investors. Due to the increasing internationalisation of the financial markets, these intermediaries may be located in different jurisdictions with the result that - depending on the length of the intermediation chain - two, three or more jurisdictions may be involved.

Market participants therefore need a clear and uniform conflict-of-laws rule to determine in advance with certainty the law (and thus relevant jurisdiction) applicable to their securities, because (e.g. in case a participant goes bankrupt) depending on the applicable law, they may either be the "owner" of these securities or not. The question here is whether the current conflict-of-laws rule, based on the location of the account, provides enough certainty in this respect.

The objectives

The goal of this impact assessment is to investigate the possibility of finding Community-level solutions to the issues outlined above. The possible solutions need to achieve three specific objectives, namely (i) facilitating the use of credit claims as collateral (both in domestic and cross-border setting), (ii) ensuring the stability of settlement systems, and (iii) enhancing legal certainty. As these objectives are still rather broad, more operational objectives need to be defined:

(1) harmonise the treatment of credit claims (across Member States) when they are used as collateral;

(2) remove obstacles that hamper the use of credit claims as collateral;

(3) adapt existing protection to the solutions adopted by settlement systems in response to recent market and regulatory developments;

(4) extend protection applied to existing participants in settlement systems to relevant new types of institutions;

(5) establish a clear conflict-of-laws regime for book-entry securities.

As some of the above objectives share certain common characteristics, they are divided in three separate groups in order to facilitate the formulation of the possible policy options and the impact analysis: the first group (credit claims) contains objectives 1 and 2, the second (settlement systems) objectives 3 and 4, and the third (conflict-of-laws regime) objective 5.

Preferred policy instruments and policy options

For the first two groups of objectives, of all available policy instruments, an amending Directive is chosen as the most suitable one to achieve the desired objectives. This solution is deemed to provide the right balance between harmonisation and flexibility in terms of implementation.

The impacts of each possible policy option to be contained by such a Directive is then analysed and compared with a baseline "do nothing" scenario to determine the most appropriate course of action. Following this analysis, it is concluded that, within the scope of the first two groups of objectives, the largest net benefits would be achieved through the adoption of a Directive that would:

(1) extend the scope of the FCD and the SFD to include credit claims eligible for central bank operations;

(2) relax, through the FCD, certain formal requirements linked to the mobilisation of credit claims (i.e. ex-ante notification and registration) and give debtors the possibility to waive some of their rights (the right of set-off and banking secrecy);

(3) adapt the SFD to take into account the technical solutions adopted by settlement systems in recent years, namely by making it clear that in case of interoperable systems, one system's own rules on the moment of entry/revocability shall not be affected by any rules of the other systems with which it is interoperable, and by extending the protection of transfer orders to the business day and not the calendar day;

(4) expand the SFD's scope to include ELMIs.

For what regards the third group objective - taking also into account the ongoing discussions on this topic - it is deemed that the situation is not yet mature for proposing any changes to the current conflict-of-laws rule. Therefore, the "do nothing" option is selected as the preferred option.