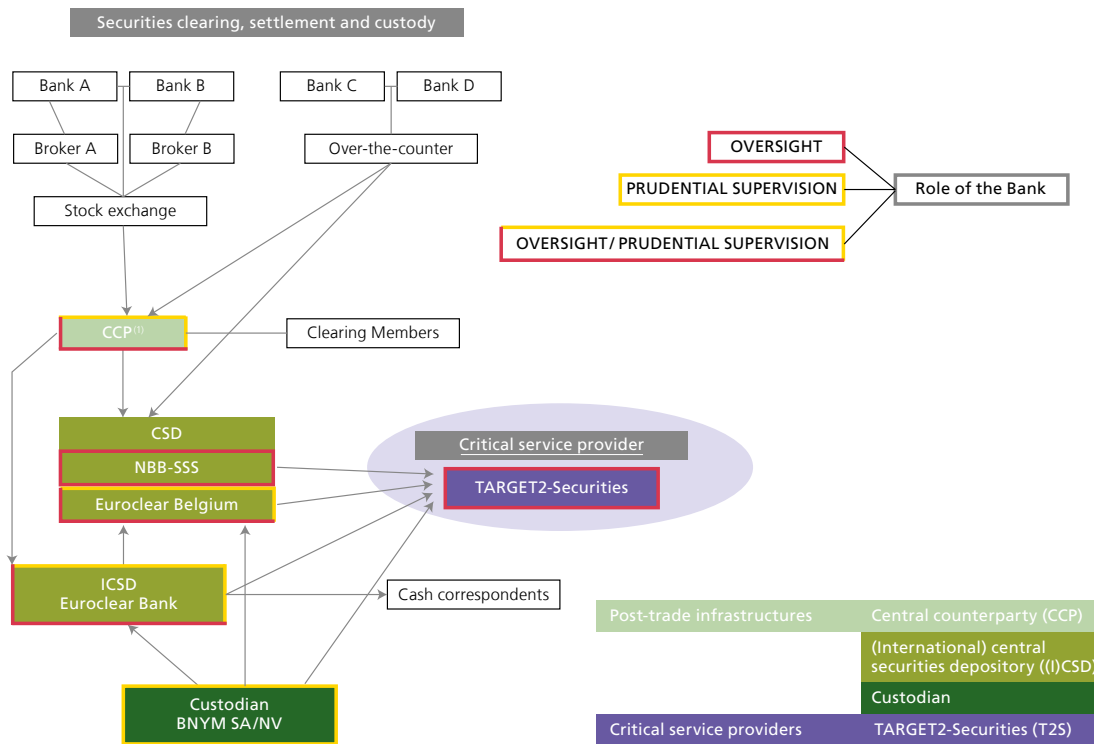


## 2. Securities clearing, settlement and custody

FMI and financial institutions that provide securities clearing, settlement and custody services are considered part of the post-trade securities landscape. Systems that clear trades conducted on a stock exchange or are concluded between counterparties on the OTC market, as well as the systems that settle the obligations of the buyer and seller of a trade are subject to oversight. The institutions that operate these systems are subject to supervision. Chart 2 depicts the scope of the Bank's oversight and supervision role in this area. Section 2.1 covers CCPs which systemic relevance has grown after new regulation made central clearing for standardised OTC derivatives mandatory. While there is no CCP established in Belgium, the Bank takes part in seven EMIR CCP regulatory colleges as supervisor of (I)CSDs to which the CCP is linked or as supervisor of Belgian Clearing Members providing large contributions to the CCP's default fund. (I)CSDs, responsible for the last stage in the post-trade chain, are dealt with in Section 2.2. Among the (I)CSDs hosted by the country, Euroclear Bank and Euroclear Belgium are subject to both prudential supervision and oversight, while NBB-SSS is subject to oversight only. The only (I)CSD with banking status is Euroclear Bank. It falls under the prudential authority of the European Central Bank (ECB). However, as Euroclear Bank has been qualified as a less significant institution (LSI) under the SSM, it remains under the direct prudential supervision of the Bank as national competent authority. Finally, Section 2.3 covers institutions whose single business line is the provision of custody services (i.e. providing securities safekeeping, settlement and investor services to their clients) with a focus on BNYM SA/NV which is a global custodian established in Belgium with links to multiple (I)CSDs allowing its clients to hold securities issued in markets worldwide. BNYM SA/NV is supervised by the ECB under the framework of the SSM as a significant credit institution (SI).

CHART 2

SCOPE OF THE BANK'S OVERSIGHT AND PRUDENTIAL SUPERVISION ROLE IN POST-TRADE SECURITIES LANDSCAPE



(1) LCH.Clearnet Ltd (UK), ICE Clear Europe (UK), LCH.Clearnet SA (FR), Eurex Clearing AG (DE), EuroCCP (NL), Keler CCP (HU), CC&G (IT).

### 2.3 Custodians

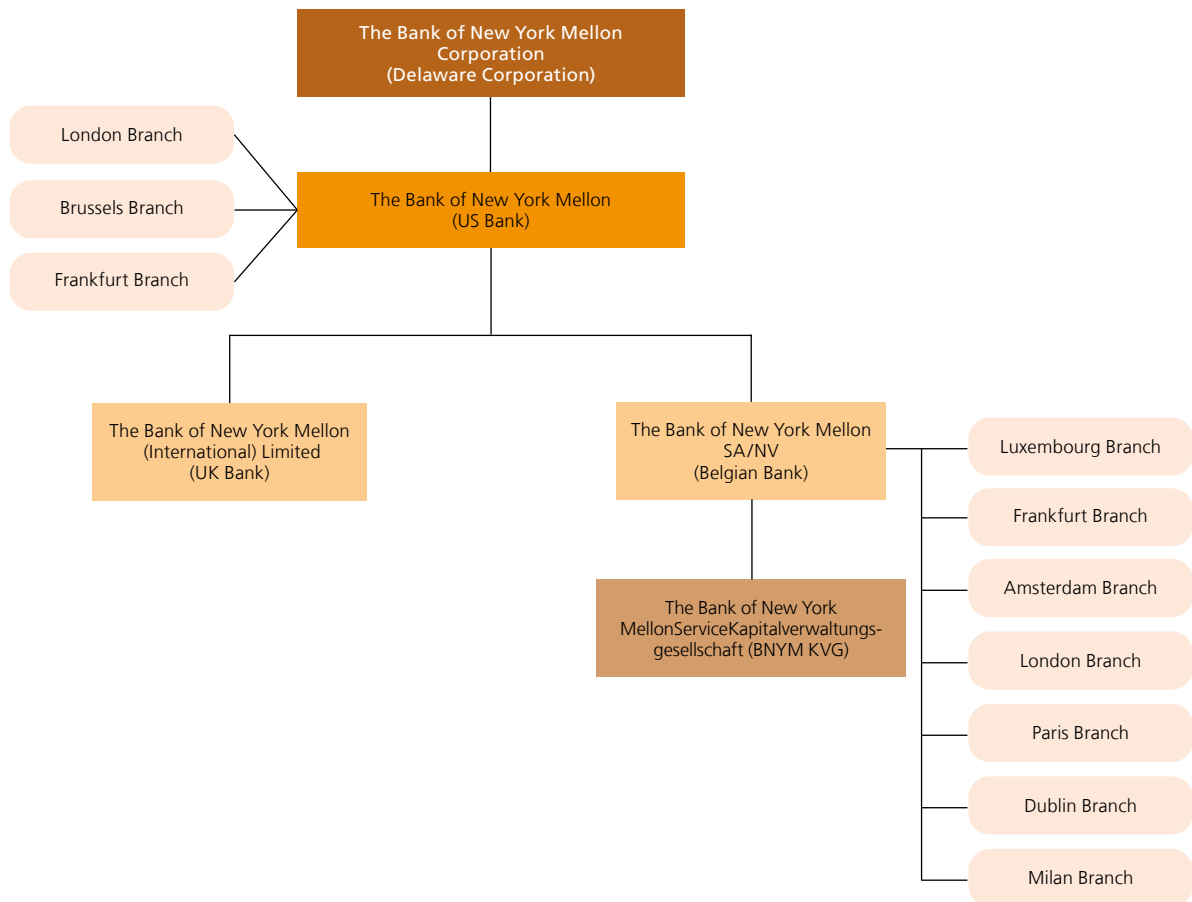
Custodians facilitate access to the securities investment market by providing securities investment related services (e.g. custody, asset administration, tax and foreign exchange services, collateral management, securities financing) to institutional investors or financial service providers in the investment chain. Custodian banks have a distinct risk profile from other financial institutions as their business lines all relate to the investment servicing activity for professional counterparties. They do not engage in retail banking, in significant maturity transformation activities, nor in proprietary trading. As such, they are considered as part of the payment, clearing and settlement ecosystem. This is explained in more detail in box 4.

The Bank of New York-Mellon SA/NV (BNYM SA/NV), established in Belgium, is the European subsidiary of BNY Mellon, a US based global systemic bank, which in turn is a subsidiary of the US holding company BNY Mellon Corporation (BNYM Group). BNYM SA/NV is the global custodian of the group (i.e. providing investment services on 100+ markets outside the US) and its European gateway to the euro area markets and payment infrastructures. As shown in chart 10, BNYM SA/NV has a non-bank subsidiary in Germany and branches in Luxembourg, Germany, the Netherlands, the UK, France and Ireland, through which it operates in the local markets. This is the result of the BNYM Group's strategy to consolidate its legal entity structure into the so-called "Three Bank Model" (i.e. US/UK/EU), initiated before the US resolvability enhancement requirements were issued, and has recently been completed by integrating a Luxembourg subsidiary and Italian branch of the group in BNYM SA/NV.

The BNYM Group is also present in Belgium through a branch of the US parent company and through a CSD which is also a subsidiary of the parent company<sup>(1)</sup>. The Brussels branch has outsourced all its operational activities to BNYM SA/NV (the Brussels branch essentially hosts the cash and securities accounts of clients that cannot be deposited in a non-US bank).

(1) Not shown in chart 10. BNYM SA/NV has indicated that BNYM CSD will not file for a licence under the CSD Regulation.

**CHART 10** BNYM GROUP STRUCTURE AND BNYM SA/NV POSITION  
(simplified diagram)



### Box 4 – Specific risk profile of a custodian

A custodian's core services are to hold and safekeep securities for investors, provide record keeping services, receive interest, dividend and redemption payments, withholding tax on behalf of its clients. Assets held under custody are recorded off balance sheet and therefore the failure of a custodian would not result in the loss of customers' securities.

Apart from these core services, custodians may offer complementary services in order to facilitate clients' investment in securities and portfolio management as, for example, foreign exchange services, collateral management as well as



securities lending. In those activities, the custodian acts upon its clients' instructions. Custodians may also allow short term cash overdrafts to ensure timely settlement of securities purchases in case of operational delays in client funding.

Credit institutions typically take short-term deposits and use them to fund long term loans. Net interest income is the bulk of a credit institution's income. Unlike credit institutions, custodians do not engage in significant maturity transformation activities. Their earnings are therefore not generated primarily from net interest income but rather from service fee revenues.

Custodians face market risk, operational risk, as well as credit and liquidity risk. The extent to which custodians face each of these risks varies significantly from typical credit institutions. Market risk is limited (as custodians' assets held under custody are recorded off balance sheet and belong to their clients). Operational risk, on the contrary, is high because of – among other factors – the dependence on sophisticated IT systems to process large volumes of transactions and operational tasks. In terms of credit risk, notwithstanding potential lower level and shorter-term risks, it can be observed that custodians are usually holding relatively higher levels of capital against their counterparties' exposures, in particular to cover for potential concentrations on systematically important counterparties. While they also face liquidity risk like other credit institutions, it has to be managed by custodians on an intraday basis maintaining sizeable portfolios of highly liquid assets.

In its capacity as supervisor, the Bank adopts a pragmatic and risk-based approach that fits the specific risk profile of these types of financial institutions.

## CHANGES IN REGULATORY FRAMEWORK

As a bank, every change in banking regulation (Capital Requirements Directive, Capital Requirements Regulation, EBA guidelines, Bank Recovery and Resolution Directive, etc.) is applicable to BNYM SA/NV. Moreover, as its clients are exclusively institutional counterparties, BNYM SA/NV offers services and accompanying solutions to ensure compliance of its clients with the regulations that they themselves have to comply with (e.g. AIFMD<sup>(1)</sup>, UCITS<sup>(2)</sup>, Collateral Directive<sup>(3)</sup>, etc.).

## BUSINESS ACTIVITY

At group level, BNYM US is the largest custodian bank in the world with assets under custody worth about \$ 30.5 trillion<sup>(4)</sup>. Acting as a global custodian for the group, BNYM SA/NV holds assets on behalf of other BNYM Group entities through worldwide relationships with 100+ sub-custodians or (I)CSDs. BNYM SA/NV facilitates the expansion of BNYM into other EU countries through the establishment of a network of branches or passporting of services (further detailed below).

By the end of 2016, BNYM SA/NV counted 1 840 clients which are all institutional counterparties ranging from traditional buy-side investors (insurance companies, pension funds, mutual funds, etc.) to investment banks, broker-dealers and hedge funds. Due to its role as the global custodian of the group, BNYM SA/NV clients' base, served

(1) EU regulation applicable to hedge funds, private equity funds and real estate funds for investor protection purposes. Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010, OJ. 1 July 2011, L 174/1, 1-73. (<http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32011L0061&from=EN>).

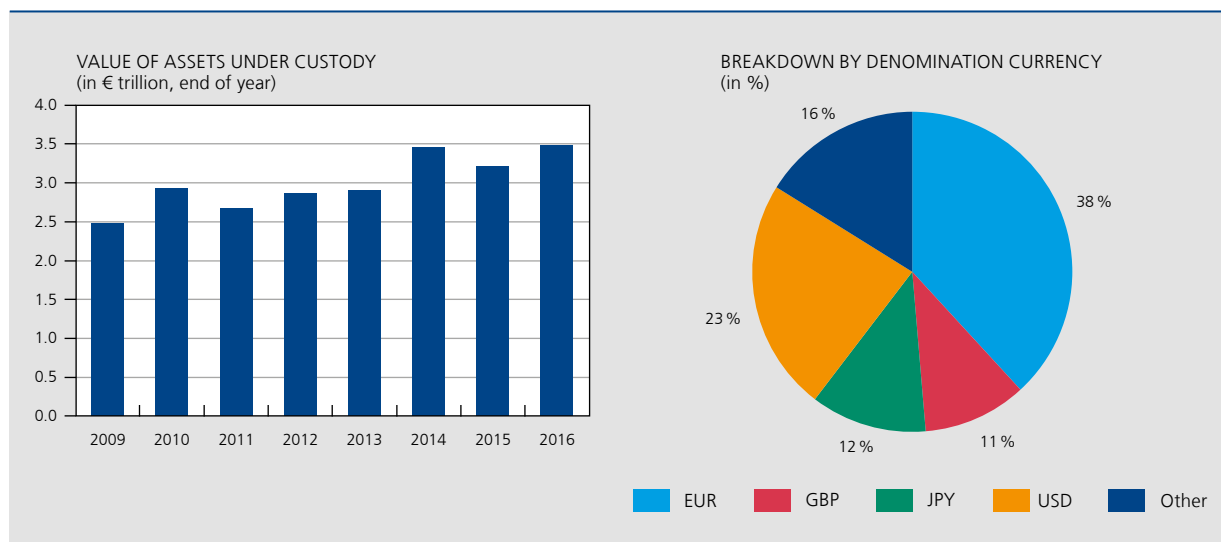
(2) EU regulation for the management and sale of mutual funds. Directive 2014/91/EU of the European Parliament and of the Council of 23 July 2014 amending Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) as regards depositary functions, remuneration policies and sanctions, OJ. 28 April 2014, L 257/186, 1-28. (<http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0091&from=EN>).

(3) Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements, OJ. 27 June 2002, L 168/43, 1-8 (<http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32002L0047&from=EN>).

(4) At global level, the BNYM Group offers pre-trade, trade & post-trade services including investment management and investment servicing (including custody & asset servicing, funds administration). BNYM US has a key role of (duopolistic) US Treasury Bills Clearer with JP Morgan Chase (JPMC) to bring the US Treasury Securities to the market. About 85 % of that activity flows through BNYM US and 15 % through JPMC. The latter announced in July 2016 that it would withdraw from this business, which will result in a de facto monopoly of BNYM US. The operational implementation of JPMC's decision will take several months. BNYM is rated between AA- and AA+ by four credit-rating agencies.

directly or indirectly (i.e. through a group affiliate), is not only European but global. Chart 11 shows that BNYM SA/NV held close to €3.5 trillion assets under custody on behalf of its international clients. An increase of 8.1 % compared to previous year (€3.2 trillion). The main part of these assets is denominated in EUR (38 %), followed by USD (23 %), JPY (12 %) and GBP (11 %).

**CHART 11** VALUE OF ASSETS UNDER CUSTODY HELD BY BNYM SA/NV



Source: BNYM.

In general, the main drivers impacting the strategy of custodians concentrate along three main axes. Firstly, changes in regulation and increased regulatory focus result in de-risking complex banking and IT structures and deleveraging banking entities. Custodians also have to focus on client asset protection measures and the resilience and resolvability of legal entities, as well as on enhancing the operational continuity and sustainability of the supervised entities.

Secondly, custodians need to meet changing clients' behaviour and demands. Traditional clients of custodians have stepped up their focus on risk-adjusted returns and are increasingly interested in the Big Data of *inter alia* their transactions and collateral portfolio. They also require more advisory services to assist them to comply with new regulations. In order to extract, process and provide access to value added data for its clients, custodian banks are intensively exploring a vast array of FinTech solutions.

Thirdly, custodian banks need to modernise their IT landscape to cut costs (and thus increase returns) as demanded by shareholders and other investors. Business opportunities related to clients' requests for more data analysis on their transactions, be it due to new regulatory requirements or from an efficiency and profitability gains perspective, also require changes in custodians' legacy IT systems which are often designed for processing transactions and not for extracting related information. Moreover, like most other banking institutions in a low interest rate environment, custodians – even if their profits are generated more largely from fee income activities – have to maintain profitability, be it only for raising of bail-inable capital purposes as requested by the resolution regulations.

The precise nature of the impact of Brexit on carrying custody activities is not precisely clear yet, as it depends on the content of the arrangements to be concluded between the EU and UK and their impact not only on the custodians but also on the custodians' clients, which are for the moment still unknown. However, experience has shown that diverging regulations (e.g. Dodd-Frank versus EMIR) have had an impact on the location of activities of custodian groups.

## PRUDENTIAL APPROACH

The BNYM Group has been designated as a global systemically important financial institution (G-SIFI) by the Financial Stability Board (FSB). BNYM SA/NV is the only material entity of the group within the euro area and is labelled as domestic systemically important financial institution (D-SIFI) following the BCBS criteria or, based on the related EBA guidelines, as Other Systemically Important Institution (O-SII)<sup>(1)</sup>. BNYM SA/NV is supervised by the ECB under the SSM as a significant credit institution<sup>(2)</sup>. The Bank is still the sole supervisor of BNYM Brussels Branch.

There are currently three supervisory colleges for the BNYM Group: the European (EEA) College, the US (FSB) College and the Crisis Management Group (CMG), also set up according to the guidelines of the FSB. As a material entity within the group, BNYM SA/NV is included in the scope of the three colleges and therefore the Bank is a member of these three colleges, alongside the ECB and the UK Prudential Regulation Authority. The US regulatory authorities (the Federal Reserve Bank of New York and the Federal Deposit Insurance Corporation) chair the FSB and CMG Colleges.

Moreover, the Bank has direct supervision competence for BNYM SA/NV as a so-called “assimilated settlement institution”<sup>(2)</sup>. This specific Belgian status has been developed to ensure adequate supervision of entities that provide core services to (I)CSDs.

The main developments that have driven recent prudential supervisory activities can be grouped around three main axes. A first axis is the upgrading of BNYM SA/NV’s organisation, management and risk and control framework in order to bring it into line with its supervisory status of a licensed credit institution when it was transformed from a branch to a subsidiary in 2009. Secondly, the establishment of BNYM SA/NV’s appropriate autonomy level in a group context and direct oversight by the parent company. A third axis is the reduction in operational complexity and establishment of effective and robust oversight of intragroup outsourcing.

## SUPERVISORY PRIORITIES IN 2017

Like other global custodians, the BNYM Group is engaged in the process of reducing its global footprint (i.e. decreasing the complexity of its group structure), partly to cope with regulatory pressures to reduce operational risks and enhance resolvability, but also to increase sustainability and profitability. In that regard, the BNYM Group was an early mover that has positioned itself very clearly from the outset in simplifying its structure, notably through the merger of its euro area’s legacy entities into one single entity called BNYM SA/NV.

Another challenge closely followed up by the Bank includes the modernisation of legacy IT systems to allow for the development of new applications and functionalities as well as enhanced data gathering and processing for internal management information systems, risk management and business development purposes for custodians to comply with new regulatory requirements applicable to them or their clients.

Recovery and resolution planning (RRP) at global custodians presents some specificities due precisely to the global coverage of these groups as well as the intricacies of their operational platforms and applications. In this context, the following topics are of particular relevance: legal entity, operational processes and IT systems rationalisation, the setting up and location of so-called “intermediate holding companies” or “intermediate parent undertakings” (i.e. potential requirement to bring sub-entities of third country G-SIFIs established in the euro area under a common entity located in the euro area<sup>(3)</sup>), the relevance, consistency and effectiveness of measurement of the RRP indicators throughout the crisis continuum, the conditions for continued access to FMI as well as the communication flows between the different global stakeholders.

(1) For BNYM SA/NV, the final O-SII buffer has been set at 0.75 % by the Bank.

(2) The status of “Assimilated Settlement Institution” has been introduced in Art. 23 § 7 of the Law of 2 August 2002 on the supervision of the financial sector and financial services and in the Royal Decree of 26 September 2005 on the legal status of settlement institutions and assimilated institutions.

(3) Proposal for a Directive of the European Parliament and of the Council amending Directive 2013/36/EU as regards exempted entities, financial holding companies, mixed financial holding companies, remuneration, supervisory measures and powers and capital conservation measures, 2016/0364 (COD) (<https://ec.europa.eu/transparency/regdoc/rep/1/2016/EN/COM-2016-854-F1-EN-MAIN.PDF>).