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**REPORT FROM THE COMMISSION**

**Evaluation report on the Settlement Finality Directive 98/26/EC  
(EU 25)**

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### **Evaluation report on the Settlement Finality Directive 98/26/EC (EU 25)**

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## Summary

The Settlement Finality Directive 1998/26/EC, in the following the SFD, entered into force on December 11<sup>th</sup>, 1999 for the EU 15 Member States and for the 10 new EU Member States on May 1<sup>st</sup>, 2004. The SFD is also applied by the EEA states: Norway, Iceland and Liechtenstein. According to Article 12 of the SFD, “---the Commission shall present a report to the European Parliament and the Council on the application of this Directive, accompanied with, where appropriate, proposals for its revision.” A report should have been presented to the European Parliament and the Council on December 11<sup>th</sup>, 2002 the latest.

One such report was indeed commissioned by the Commission and drawn up concerning EU15. This report was finalised on February 19, 2003:

[http://europa.eu.int/comm/internal\\_market/payments/docs/transposition-dir-9826/main\\_en.pdf](http://europa.eu.int/comm/internal_market/payments/docs/transposition-dir-9826/main_en.pdf)). In view of the forthcoming enlargement, that report was not presented to the Council and the European Parliament. This evaluation report is intended to cover the whole of EU 25.

To prepare the present report, the Commission asked Member States to reply to an extensive questionnaire regarding the implementation and application of the SFD. 24 Member States have done so: Cyprus, which did not, has explained that there was not yet sufficient practical experience of the application of the SFD to reply to the questionnaire.

## The Settlement Finality Directive – Rationale and Description

The SFD was the Community legislator’s response to the concerns identified by the Committee on Payment and Securities Systems (CPSS) under the auspices of the Bank for International Settlements regarding systemic risk. With the start of stage II of the Economic and Monetary Union (EMU) in 1994, it became evident that there was a need for a stable and efficient payment infrastructure to assist cross-border payments, to support the future single monetary policy and to minimise systemic risk especially in view of the increasing cross-border aspects.

As a response to the need to minimise systemic risk and to ensure the stability of payment and securities settlement systems, the SFD provides that transfer orders entered into such systems cannot be revoked or otherwise invalidated. Such protection is created by stipulating the irrevocability and finality of transfer orders and of netting of transfer orders entered into a qualifying system, even in the event of insolvency proceedings against a domestic or foreign system participant. It should be noted, however, that such protection did exist in many Member States, but in different forms, also before the introduction of the SFD.

The SFD contains 14 articles and is relatively short. This brevity is counterbalanced by the high complexity of the text.

The mechanism of the SFD is to establish a class of systems that benefit from its protection, being those that fall within its operational definition of a ‘system’ and that have accordingly been so designated by the competent MS authority and notified by them to the Commission. In this report, ‘system’ is used to refer to a member of this class. Overall, the SFD has established a pan-European class of systems, membership of which is said anecdotally to be of commercial, as well as systemic, value. The Commission maintains list of notified systems at [http://www.europa.eu.int/comm/internal\\_market/financial-markets/settlement/dir-98-26-art10-national\\_en.htm](http://www.europa.eu.int/comm/internal_market/financial-markets/settlement/dir-98-26-art10-national_en.htm).

The SFD sets out its scope by defining several core components, such as “system”, “participant” and “insolvency proceedings”. As soon as, under the rules of a system, a payment transfer order or a securities settlement order has been entered into a system, it is protected against third party claims, even in the event of a bankruptcy of one or more participants in the system. This protective effect occurs if a transfer order has been entered into a system before opening of insolvency proceedings, or, on the same day after the opening of such proceedings, provided the concerned parties can prove that they were not aware or should not have been aware of those proceedings. Further to this protection, no law, regulation, rule or practice on the setting aside of contracts and transactions concluded before the opening of insolvency proceedings shall lead to the unwinding of a netting of transfer orders. The crucial moment of entry of a transfer order is determined by the rules of each system. Furthermore, the SFD requires the disapplication of all retroactive effects of insolvency proceedings on transfer orders or netting.

If a decision is taken in a Member State to open insolvency proceedings against a participant in a system, this shall immediately be communicated to a central authority, appointed in each Member State, which then notifies the central authorities of all other Member States. This is to ensure that a rapid alarm can be given.

The applicable law that governs a system is decided in each system’s rules. The SFD allows for the national law of any Member State to govern a system, as long as one of the participants in the system has its head-office in that State where the law chosen is applicable.

As for securities provided as collateral to participants in connection with systems or central banks, the law applicable to the collateralisation is the law of the Member State where the register, account or depository where they are legally recorded is located.

### **Designation of Payment- and Securities Settlement Systems**

According to articles 6 and 10 of the SFD, Member States must notify to the Commission which systems they have designated and which national authorities are in charge of notification,. The Commission holds two registers with this information, which are available on the internet. They are up-dated whenever Member States send new information to the Commission.

The information concerning which authorities Member States have designated for notifications of opening of insolvency proceedings (Article 6 of the SFD) contains the official name of the authorities in charge and the contact details (responsible persons, telephone numbers etc.). 11 Member States have designated their National Central Banks as responsible authorities (At, Bel, Cyp, Gr, Hu, Irl, It, Lt, Mt, Nl, Pl); 7 others have designated their Financial Supervisory Authorities (Dk, Ee, Fr, D, Lv, Lu, S) and 6 have designated both (Czech Rep, Pt, Si, Sp, Sk, Uk (6 Member States). One MS has designated a ministry (Fi), (1 Member State) ([http://www.europa.eu.int/comm/internal\\_market/financial-markets/settlement/dir-98-26-art06-insolvency\\_en.htm](http://www.europa.eu.int/comm/internal_market/financial-markets/settlement/dir-98-26-art06-insolvency_en.htm))

As to the designated payment and securities settlement systems (Article 10 of the SFD), there is also information about the full names of the systems and contact details. Member States notify this information to the Commission with a varying degree of detail. The Commission will consider making the details Member States supply uniform. This however, should not necessitate legislation, but rather an informal agreement with Member States.

There are a total of 107 systems designated and notified to the Commission. Of those, 49 are payment systems and 58 are securities settlement systems. There is a clear trend that more and more systems want to be designated by the relevant Member States as this provides a double benefit: they gain the SFD's "quality-label", and its trust-building informal "passport" for doing cross-border business. When a system has been designated and notified, market operators can rely on the legal quality of the providers of services and the legal framework in which they will operate. Foreign courts and authorities must respect the protection granted under the SFD to those systems.

## **1. OBJECTIVES OF THE EVALUATION**

The main objectives of this evaluation report are: (i) to analyze the process by which the SFD has been implemented and (ii) to identify a list of potentially problematic issues that could be subject of a future revision of the Directive.

The evaluation has been carried out on the basis of information collected from Member States and the European Central Bank. As for the first objective, Member States have responded to an extensive questionnaire from the Commission (see section 1) on the application of the SFD. The material that the Commission has at its disposal is voluminous and cannot be reproduced in detail. In consequence, where this evaluation is silent on an issue, there is seen to be no problem and no need consider any revision. The interested reader may however consult each Member State's replies on the Commission Web-Page (address to be provided) for full details.

As for the second object given, several Member States and the ECB have expressed an opinion on what they see as potentially problematic issues. In this evaluation report, the Commission has identified the key issues to be further analyzed (section 4). This is not a formal proposal for "the revision of the directive", in the terms of Art.12 of the SFD. Any proposal for amendments to the directive would of course be accompanied by a full impact assessment.

## 2. IMPLEMENTATION OF THE SETTLEMENT FINALITY DIRECTIVE

### Analysis of the process by which the SFD has been implemented.

There seems to be consensus among Member States that the SFD provides a very important tool to ensure increased protection against systemic risk in European payment and securities settlement systems and that it provides and increases legal certainty and predictability among participants from different Member States. The SFD is seen to have had its intended effect and to work well. To illustrate this: one reply to the questionnaire states “We are quite satisfied with the SFD which offers a comprehensive (almost perfect) legal protection for systems with international participation. The SFD does not require any fundamental changes. Yet, we could imagine some minor improvements”.

Based on the answers to the questionnaire, there are a few issues concerning the implementation that could to be highlighted. This section will not deal with problematic issues; this is dealt with under section 4.

- **Article 1(a):** Concerning the choice of law governing the rules of a system (any Member State law) - if there are systems that are registered, located in and/or notified by one Member State that are governed by the laws of another Member State, all but one Member State replied in the negative to this question. To the reversed question, if Member States know if their laws are used by a system that is registered, located and/or notified in/by another Member State, two Member States replied in the positive. These replies do not allow a straightforward conclusion. However, it suggests that payment and securities settlement systems could still have a preference to operate in a domestic set-up, despite the intention to create an Internal Market also for these services. It implies that there are no, or very few, systems that are truly pan-European.
- **Article 2 (c) (d) (e):** There is uniform treatment of central counterparties, settlement agents and clearing houses, in that all Member States allow such entities to be “participants” under the SFD.
- **Article 2 (g):** Concerning the use of the concept of “indirect participants”, the picture is more divided. On the question whether there are cases where “indirect participants” or other undertakings have been considered as “participant”, 9 Member States reply in the affirmative. The other Member States’ legal systems either do not recognise the concept or have not admitted any indirect participants yet, even though it is considered possible in some cases. All Member States have chosen not to expand the circle of participants beyond what is foreseen in the SFD.
- **Article 3:** The SFD minimises systemic risk by providing irrevocability, enforceability, and that they should be binding on third parties, of payment orders and securities settlement orders that are entered into a system. Systemic risk reduction requires amongst other things the possibility to act in a timely manner should there be an insolvency of a participant in a system. In this context, it is important that market participants as well as courts and competent authorities have immediate and full access to information, decisions and rulings regarding insolvencies. In 18 Member States, such decisions are made public and available on different media with different delays. Some Member States use the internet to notify immediately about insolvencies whereas other Member States only publish the information with a few or up to 8 days delay in a national “Gazette” or

“Official Journal”. Some Member States make decisions public only after they have gained full legal force and some Member States leave the option to judges to order more extensive advertising of a decision in local and national newspapers for example. Five Member States do not make insolvency decisions public, even if they have an extensive reporting duty in place where Courts must immediately notify for example the National Central Bank, the government and the Company register

- **Art 5:** None of the 24 Member States that replied to the questionnaire has any legislation to define the “moment of entry” of a payment order or a securities settlement transfer; all Member States refer this to be decided by the agreed rules of each system, in line with the provisions of the SFD. This is to be welcomed as it means that no participant must fear that national legislation would override the systems’ arrangements on this point.
- On the general question, whether Member States have or have had problems with the implementation of the SFD, all replied in the negative. Very few Member States had a delayed implementation, but this was said to be due to other factors than the content of the SFD itself.

The Commission concludes that the SFD has been transposed in all Member States in a very satisfactory manner, except in the cases mentioned in section 4.

### 3. MAIN PROBLEMS DETECTED AND RISKS ENVISAGED

This section provides an overview of areas where problems with the correct transposition or application of the SFD are perceived on the basis of the replies and suggestions from the Member States and the ECB. It identifies the key potentially problematic issues that could be subject of a future revision of the Directive.

There is also a range of lesser, more technical issues, that will need to be fully examined in any future work on revising the SFD, but which do not seem at this stage to qualify as headlines issues.

1. **Article 1(a)** One issue which seems to be supported by some 7 Member States is the introduction of an option to have more than one Member State’s law govern a particular system, or different parts of it.

It appears that 6 (perhaps 7, one has not provided a clear answer) Member States may not, explicitly, allow the free choice of which law should govern a system. This is, potentially, a problem that cannot be disregarded and might lead to infringement proceedings.

2. **Article 2(a)** of the SFD should make it clear that an “arrangement” between system participants can be established either by contract or by legislation.
3. The range of institutions defined in **Article 2 (b)** includes credit institutions. There is some debate as to whether this includes electronic money institutions (ELMIS), as defined in Directive 2000/46/EC. For 13 Member States and the ECB it does; for 11, it does not. The ECB is concerned about this and has suggested that, for stability reasons, ELMIS, should enjoy the same protection as other “credit institutions”, in particular with regard to the operation of the TARGET system.

4. The definitions in **Article 2 (f) and (g)** of “participant” and “indirect participant” have attracted some attention.

First, according to the ECB; there is no consensus across the Union whether settlement agents, clearing houses, and central counterparties fall within these definitions; although all Member States uniformly consider, in their replies to the questionnaire, that such entities can also act as participants.

Secondly, the protections afforded by the SFD do not extend to participants outside the EU. Some 10 Member States argue that some sort of extension should be arranged and another 4 Member States are cautiously positive to this idea. Specifically, protection is sought, in the light of integrating financial markets, for participation of third country participants in EU based systems and of EU participants in non-EU systems. This is already possible on a case-by-case bilateral basis, but such arrangements carry a not negligible risk to legal foreseeability and potentially to the systems as such. Obviously, there is no EU-competence to extend the validity of the SFD outside the territory of the Union, but it could be imagined that participation of third country participants or systems in EU based systems and EU participants participation in non-EU systems could be regulated in greater detail. Such arrangement could provide further financial stability.

5. **Article 2 (i)** Some Member States would also like the SFD to clarify when a transfer order should be considered to be entered into a system, when several systems are inter-connected. This is to ensure that the definition of “transfer order” or “payment order” covers all kinds of payment instruments.
6. The definition of “insolvency proceedings” in **Article 2 (j)** of the SFD does not clearly cover all types of national insolvency-like proceedings. Some Member States seek further expansion of the definition to ring-fence against insolvency incursion. Regulatory moratoria, for example, not being identical to insolvency proceedings, may not be covered, although “insolvency-like proceedings” of that type can have the same effects on payment and securities settlement systems as insolvency proceedings proper. One suggestion is that orders should be protected with a strict “24 hour rule” (transactions within this time will count as made before bankruptcy) without a “good faith” requirement. This problematic extends to Art 7 of the SFD to also include protection against so called cherry-picking (claw back rules) after other procedures than pure insolvency procedures.
7. National definitions of “collateral security” **Article 2 (m)** do not seem to have caused compatibility problems although they differ quite substantially. The ECB has stated that although at present there is no immediate problem, difficulties may arise in view of the planned changes to the eligibility of collateral, which will include for instance bank loans.
8. **Article 3.** A further problematic issue is that some 8 Member States do not foresee an obligation by Courts and administrative authorities to indicate the exact time of the day when an insolvency decision is taken. The exact time when insolvency decisions are taken is indicated in 15 Member States. Some of those Member States have very exact requirements that oblige judges and courts to indicate hour and minute of a decision and others also publish this information together with the decision on for example the internet. This issue may have less importance for



publicity reasons but all the more important when deciding the effects of an insolvency decision concerning a participant in system, especially considering the amounts transferred in the systems and their irrevocability under Article 3.1.

9. It is said that clarity as to the moment of entry into the system is also needed (See point 5) under **Article 5** for the rules of some RTGS payment systems, and in circumstances where several systems are inter-connected and for the purpose of **Article 6(2)** (insolvency notification). Article 6(2) foresees no to notify directly the ECB or the Commission. Considering their respective roles as overseer and system operator and as holder of the Community register of systems, such an obligation should probably be introduced. The Commission could possibly assume a rapid-reaction mechanism to ensure that information about a possible insolvency is transmitted to all relevant parties immediately
10. **Article 8** applies the law of a system to “[...] the rights and obligations arising from, or in connection with, participation in that system”, in the insolvency of a participant. Clarity is suggested as to a possible collision of insolvency laws, where the law of system is different from the law of the Member State where the system is located.

#### 4. OBJECTIVES, RESULTS AND IMPACT OF THE SETTLEMENT FINALITY SFD

To summarise the findings from the information provided by Member States, a number of key questions should be answered. These main evaluation questions as to the effects of the SFD are:

##### 1. *How have the different Member States transposed the SFD?*

As outlined above, Member States have transposed the SFD in a very satisfactory manner. However, there are some problematic issues and, concerning a few Member States, the implementation of the article on the choice of law for systems, which may lead to that the Commission will consider infringement cases.

##### 2. *How has new legislation been enforced?*

It appears that enforcement of the SFDs rules, through Member States laws, is efficient. The designation and supervision of systems seems to work without any particular problems.

##### 3. *Have there been important delays?*

No, there were no important delays in the implementation of the SFD. All new Member States to the EU, as from May 1, 2004 state to have also implemented the SFD in a proper and well functioning way.

##### 4. *Has legal clarity been achieved as to the consequences of an insolvency of a system participant?*

The SFD has, as intended, provided a two-fold legal clarity/certainty; in that each system can choose which Member State law it wants to apply and follow; and in that all Member States laws have made payment transfer and securities settlement orders irrevocable, binding and effective once they are entered into a system (with the exceptions outlined in the SFD) and in accordance with the system’s rules.

5. *Can the market be assured that payment transfers and securities settlement orders cannot be revoked after entry into a “system”?*

Yes, there are however a small number of factors that should be considered, such as the definition of “insolvency proceedings” in the SFD that may be insufficiently clear to cover all types of relevant proceedings that could, theoretically, put in question the irrevocability, binding effect and enforceability. Furthermore, the moment of “entry” into a system could be difficult to establish where two or more systems, designated as single systems, in reality work together.

6. *Has the SFD reduced systemic risk to payment- and securities settlement systems and the financial markets as a whole?*

Systemic risk associated with legal issues cannot be quantified. It is therefore appropriate to rely on circumstantial evidence that the SFD has reduced systemic risk. In addition to the implications to this effect from the Member States’ replies, affirmation may be found in the views of central banks charged with responsibility for contributing to the stability of the financial system. Thus, the ECB has said, “... *investor protection and systemic stability are based on a stable legal environment that supports investors’ rights and the integrity of systems, of which one example is the Settlement Finality SFD*” (2004). And the Bank of England has said, “... *Designation [of the type provided by the SFD] can promote financial stability by providing protection for a system’s default rules from insolvency laws in EEA countries in the event of default of a system member* (Financial Stability Review, Dec 2002).

7. *Have there been any costs due to the implementation of the SFD?*

No costs are known to the Commission besides the obvious man-power used in the Member States to actually transpose the SFD and administrate record of systems etc. As anecdotal evidence, a report by the Austrian Chamber of Commerce (October 2005) does not include the SFD among Directives considered costly for the banking sector.

8. *Have there been any unexpected results or effects of the SFD?*

No Member State has reported such problems.

9. *Is there any evidence of bankruptcy having impact on a system?*

Member States have replied with different degrees of precision to the question whether participants to payment and/or securities settlement systems have been involved in insolvency proceedings (“bankruptcies”) (since the entry into force of the SFD). Member States have reported that 12 bankruptcies have occurred since the SFD entered into force. However, the effective number might be much higher than this. The reported bankruptcies seem not to have done any systemic harm; neither to the system the insolvent participant was involved in, nor to financial stability, at any measurable level.

## **5. CONCLUSIONS**

The European Commission draws the following conclusions.

1. The SFD is functioning well. Member States are overall satisfied with it.
2. There is some need and space for clarifications, improvements, better definitions and possibly simplification, as specified above.
3. As a consequence of the above, the Commission will propose to revert to the Member States and the ECB during 2006, for instance in the framework of the European Securities Committee (ESC) to start a dialogue to establish how far the issues identified for improvement, and/or other issues, should be subject to amendments to the SFD.

This dialogue should take into account that in the area of payment and securities settlement systems, some important changes may be underway which could have an influence on the SFD. The Commission may propose legal instruments to increase the efficiency and safety of clearing and settlement services during 2006. Moreover, the outcome of the discussion of the proposal for the Community to sign the Hague Securities Convention may also have to be taken into account.

## ANNEX

### Logframe for the evaluation of Settlement Finality Directive

	Description	Evaluation questions	Evidences	Indicators
<b>Assumptions</b>	<ul style="list-style-type: none"> <li>The insolvency of a participant in a Clearing and Settlement system may have systemic implications.</li> </ul>		<ul style="list-style-type: none"> <li>Potential consequences of the failure of a participant in a system for the system as a whole or even to other systems as evidenced e.g. by the relevant studies of CPPS-IOSCO.</li> </ul>	<ul style="list-style-type: none"> <li>Potential risk of unwinding and losses for participants</li> <li>Regulatory and capital adequacy treatment</li> </ul>
<b>Actions</b>	<ul style="list-style-type: none"> <li>Settlement Finality Directive.</li> </ul>	<ul style="list-style-type: none"> <li>How have the different Member States transposed the SFD?</li> <li>How has new legislation been applied and/or enforced?</li> <li>Have there been important delays or shortcomings?</li> </ul>	<ul style="list-style-type: none"> <li>National laws.</li> <li>System rules.</li> </ul>	<ul style="list-style-type: none"> <li>Transposition indicators.</li> <li>Transposition delays.</li> </ul>
<b>Results</b>	<ul style="list-style-type: none"> <li>Ensure legal certainty, bindingness and enforceability of payment transfers- and securities settlement orders entered into a system as defined by the SFD.</li> </ul>	<ul style="list-style-type: none"> <li>Has legal certainty increased?</li> <li>Can the market rely on the bindingness and enforceability of payment transfers and securities settlement orders after entry into a “system”?</li> </ul>	<ul style="list-style-type: none"> <li>National laws.</li> <li>Insolvency cases.</li> <li>Responses to questionnaire</li> </ul>	<ul style="list-style-type: none"> <li>Treatment and impact of insolvency cases. [the number will stay unaffected, it’s the effects that count]</li> <li>Problems reported by Member States.</li> </ul>
<b>Impacts</b>	<ul style="list-style-type: none"> <li>Reduction of systemic risk inherent in payment systems.</li> <li>Contribute to the cost-effective operation of cross-border payment and securities settlement arrangements in the EU.</li> </ul>	<ul style="list-style-type: none"> <li>Is there any implementation cost due to the SFD?</li> <li>Are other costs reduced?</li> <li>Are there any unexpected impacts?</li> <li>Is there any evidence of bankruptcy having impact on a system?</li> </ul>	<ul style="list-style-type: none"> <li>Insolvency cases.</li> <li>Contagion risk/effects due to insolvency cases.</li> <li>Responses to questionnaire.</li> <li>Information provided by the Member States</li> </ul>	<ul style="list-style-type: none"> <li>Reduced impact of insolvency cases.</li> <li>Reduced risk of contagion cases.</li> </ul>