The quiet revolution that is transforming post-trade securities services in Europe

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The European financial market infrastructures of 2021 will look like radically different from their predecessors of today. But what is driving that transformation is not the widely anticipated wave of mergers and acquisitions of central securities depositories (CSDs). Instead, say Nadine Limbourg, Senior Market Manager, Market Infrastructures at SWIFT, and Isabelle Olivier, Head of Securities Initiatives and Payment Market Infrastructures at SWIFT, the securities market infrastructure of Europe is being re-built spontaneously by CSDs and custodians in pursuit of practical solutions to the new challenges created by regulations and transformative projects such as T2S.

There is grandstanding in business as well as politics. CEOs like to make grand strategic gestures. Investment bankers work hard to find the businesses to merge or sell or buy that enable them to do so. Journalists, eager to inject personality and drama into the intrinsically dull routines of corporate money-making, populate the business pages with deals and rumours of deals.

In reality, industries are transformed not by great events but by hard work, which occurs unseen. This is certainly true of the central securities depositories (CSDs) that serve the European securities industry. A long-anticipated wave of mergers and acquisitions between CSDs has failed so far to materialise, but an operational revolution is nevertheless in train.

Regulation is the driver of change

What has sparked this revolution is the conjunction of several regulatory and harmonisation initiatives. Some have had a direct impact on CSDs. TARGET2-Securities (T2S), the pan-eurozone settlement platform, and the accompanying Central Securities Depositary Regulation (CSDR) are gradually harmonising and centralising the settlement activities and revenues of the CSDs.

The CSDR has already shifted European markets on to a common settlement timetable of trade date plus two days (T+2) as part of the preparations for the transition to T2S. The T2S project is now migrating the majority of euro-zone countries - and some non-euro markets, in the shape of Denmark, Hungary, Romania and Switzerland – on to a single settlement platform.

Importantly, the CSDR also invites CSDs to choose what services they will offer, and where.

Other regulations have also created new opportunities for CSDs. The Alternative Investment Fund Managers Directive (AIFMD), the European Market Infrastructure Regulation (EMIR) and the upcoming revisions to the 2007 Markets in Financial Instruments Directive (MiFID II) are creating a new line of work for infrastructures and custodians: regulatory report services and storage.

CSDs are positioning themselves to defeat the threats and exploit the opportunities created by T2S and other regulatory initiatives. Yet they must also maintain their existing settlement, custody, issuance, asset servicing and - in some cases – banking services. This has created a tension between business-as-usual, mandatory adaptations to regulations, and long-term strategic decision-making.

After all, every CSD must continue to service existing accounts. Almost all CSDs in the eurozone are transitioning to T2S, necessitating technical decisions over integration technologies and connectivity. Even CSDs outside the euro-zone and T2S are bound by CSDR. Its penalisation of late settlement, and insistence that CSDs allow users to choose account structures, also need implementation.

To impose late settlement penalties, CSDs have to devise and build systems to collect buy-in data from users, source market prices to calculate and charge the correct amount, and isolate and communicate exemptions. Since T2S insists on omnibus accounts, while CSDR demands that clients be offered segregated as well as omnibus accounts, CSD systems must offer both.

CSDs need to make choices

But there are strategic, as well as technological, choices to be made. T2S truncates the core settlement revenues of CSDs, so a change of business model is involuntary. CSDR recognises this. Its CSD licensing system effectively invites CSDs to decide if they wish to offer services in other member-states of the EU, seek the business of non-domestic issuers, or acquire a banking licence.

The ability to settle in central or commercial bank money, offer services or open branches in third countries, and solicit foreign issuer business, is rich in opportunities for European CSDs. Any CSD prepared to seize them has the chance to turn itself into a pan-European, regional or sub-regional investor or issuer CSD - or both - in, say, the Nordic or central and eastern European markets.

The choices of CSDs will be conditioned by multiple factors. Chief among them is the confidence of the management in their ability to shift from a domestic to a broader canvas. They will also have to upgrade systems and procedures to adapt to the price and fee disclosure, additional capital, liquidity monitoring, governance and recovery and resolution requirements set by the regulators.

The competitive environment will also influence the strategies of CSDs. After all, their most valuable clients (the sub-custodians) and the clients of their most valuable clients (the global custodians and global investment banks) are also assessing their strategic options, not just in terms of extending their services into new markets and asset classes, but in terms of mergers and acquisitions.

CSDs and custodians experiment in collateral management services

Some global custodians have considered investing in CSDs of their own, though these initiatives are now on hold. Initially, their interest was sparked mainly by the requirement under EMIR for central counterparty clearing houses (CCPs), whose importance as a source of demand for collateral was being greatly expanded by the mandatory clearing of OTC derivatives, to hold collateral posted by clearing brokers at a CSD.

Anticipation of an EMIR-driven increase in demand for CCP-eligible collateral was also a major factor behind the tri-party collateral management alliances formed between leading sub-custodian networks in Europe (such as BNP Paribas and Citi) and the international CSDs (Clearstream and Euroclear). They enable broker-dealers to access as collateral assets held in domestic markets.

The lack of links to transfer collateral across borders is a longstanding criticism of the market infrastructure of Europe. Even the Correspondent Central Bank Model (CCBM), introduced at the advent of the euro to help central banks advance credit against collateral held elsewhere, was long undermined by a requirement to transfer assets to the CSD into which they were first issued.

This chronic difficulty in moving assets between domestic markets forces payments and custodian banks to maintain collateral "buffers" in domestic CSDs to access credit from national central banks. T2S promises to solve this problem by allowing banks and tri-party agents to settle collateral trades on its 20-market settlement platform, effectively creating a single European pool of collateral.[1]

1 See Marc Bayle, "The future of collateral management in Europe and beyond," MI Forum magazine, issue 2, 2014, pages 142-7.

Co-operation more common than competition or consolidation

Partnerships of this kind between banks and infrastructures indicate co-operation is as probable a response to the threats and opportunities created by regulation as competition or consolidation. In fact, Clearstream has formed partnerships with BNP Paribas, BBVA, Citi, Erste Bank and Intesa San Paolo, in which it will settle trades, and the sub-custodians service the assets.

A similar arrangement is in place between Northern Trust (as global custodian), Euroclear France (as the CSD able to settle trades in T2S) and Deutsche Bank (as account operator and asset servicing agent in domestic markets). In both the Clearstream and Northern Trust cases, the specialists – CSD, sub-custodian and global custodian – have decided not to stray beyond their core capabilities.

The chief rationale for these partnerships is that they combine efficiency (a reduced need for local liquidity) with service (proximity to the local market), but it is highly significant that they also allow specialists to play to their strengths. This is a somewhat unanticipated outcome of T2S, which was originally expected to reduce the reliance of global custodians and investment banks on CSDs and sub-custodians.

The rise of the specialist service provider

The hierarchical settlement and custody model of the past (global custodian, sub-custodian, CSD) is giving way to a new division of labour. It is one in which banks and CSDs combine best-of-breed skills to deliver to buy- and sell-side clients bespoke blends of settlement, collateral management and liquidity management, and asset servicing. Even specialist providers of compliance or regulatory reporting are no longer unthinkable.

To realise this prospect, however, specialist providers must be able to inter-operate efficiently. If the transactions costs of inter-operability are too high, the vertical integration of specialist skills will become unavoidable. New technologies (such as distributed ledgers) may eventually play some part in reducing transactions costs, but the real key to efficient networks is standardisation.

The importance of standards

Here, there are potential obstacles. A first example is that both CSDR and EMIR favour Legal Entity Identifiers (LEIs) over Business Identifier Codes (BICs) as the best way to identify counterparties, but CSD and custodian bank systems have yet to complete a conversion from BICs to LEIs. Similarly, although T2S uses ISO 20022 messages, the European securities industry still uses ISO 15022 or even proprietary messages to exchange information.

Custodian banks can insulate their clients from non-compliance with these standards for a time, but not forever. If CSDs and custodians are to exchange the richer information required by CSDR, let alone to grow their businesses, adoption of a common version of ISO 20022 messages is essential. This is one reason why SWIFT is encouraging CSDs to sign the ISO 20022 harmonisation charter.[2]

2 See Andrew White, "Everybody benefits from standardising the ISO 20022 standard," MI Forum magazine, Issue 3, 2015, pages 104-115.

These changes will take time to implement, and their outcome is hard to predict. It is not yet clear whether the manoeuvres and adaptations now taking place represent the beginning, the middle or the end of the transformation of the securities markets of Europe. Work needs to be done to complete the current process, let alone address challenges that have yet to disclose themselves.

But it is already obvious that the moves initiated by regulations and harmonisation measures such as T2S are transforming the post-trade architecture of the European securities industry more profoundly than the regulations themselves. That is because they are between them delivering an infrastructure off which new and existing businesses can provide genuinely innovative services.

"EU securities markets transformation - is the glass half empty or half full?" at Sibos

Monday 26 September 2016
09.00 – 10.00
Workshop A