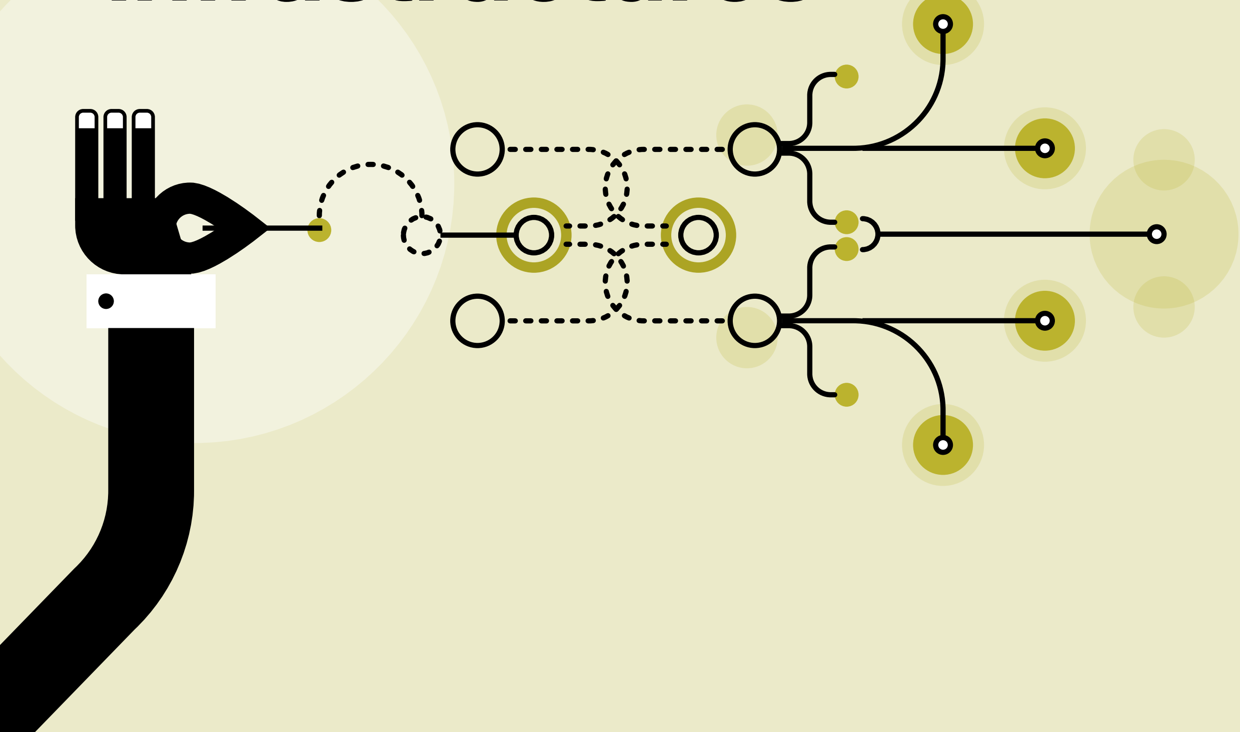
MI FORUM *SESSIONS*

Ask not what infrastructures can do for their users but what users can do for infrastructures



It is natural to think of banks and financial market infrastructures (FMIs) as occupying separate categories in the financial system. It is why regulators look to FMIs to reduce the systemic risk created by banks, and banks look to FMIs to provide the platforms from which they can launch services. In the face of the mounting challenge of regulatory compliance, and a range of competitive threats from new entrants, Frank Van Driessche, senior business manager, market infrastructures at SWIFT, argues that it is time for users of FMIs to stop thinking in terms of institutional categories and start thinking in terms of networks.

It is simplistic to ask whether financial market infrastructures (FMIs) are meeting the needs of their users. In reality, FMIs not only serve their members, but evolve in line with shifts in the marketplace to create new service possibilities for users. In custody, for example, network managers have long monitored the ability of sub-custodian banks to keep up with the service innovations of central securities depositories (CSDs). In a similar way, by developing real-time retail payment systems (RT-RPS), payments market infrastructures (PMIs) are providing payment banks with opportunities to develop innovative services.

But the role of the FMI is not confined to operating reliable platforms on which banks can develop competitive new services. They can also help their users to access new markets, as they are doing in European payments and securities markets already. Inevitably, however, they might also be drawn into competition with their users as their services develop to the point at which they displace their members from a

“Relationships between FMIs and their users are never one-dimensional. They are multi-layered, complex, dynamic, and evolve over time.”

- Frank Van Driessche, SWIFT

market altogether, especially where this can be shown to cut costs. And they can create openings for new entrants, as they are by developing RT-RPS services. So relationships between FMIs and their users are never one-dimensional. They are multi-layered, complex, dynamic, and evolve over time.

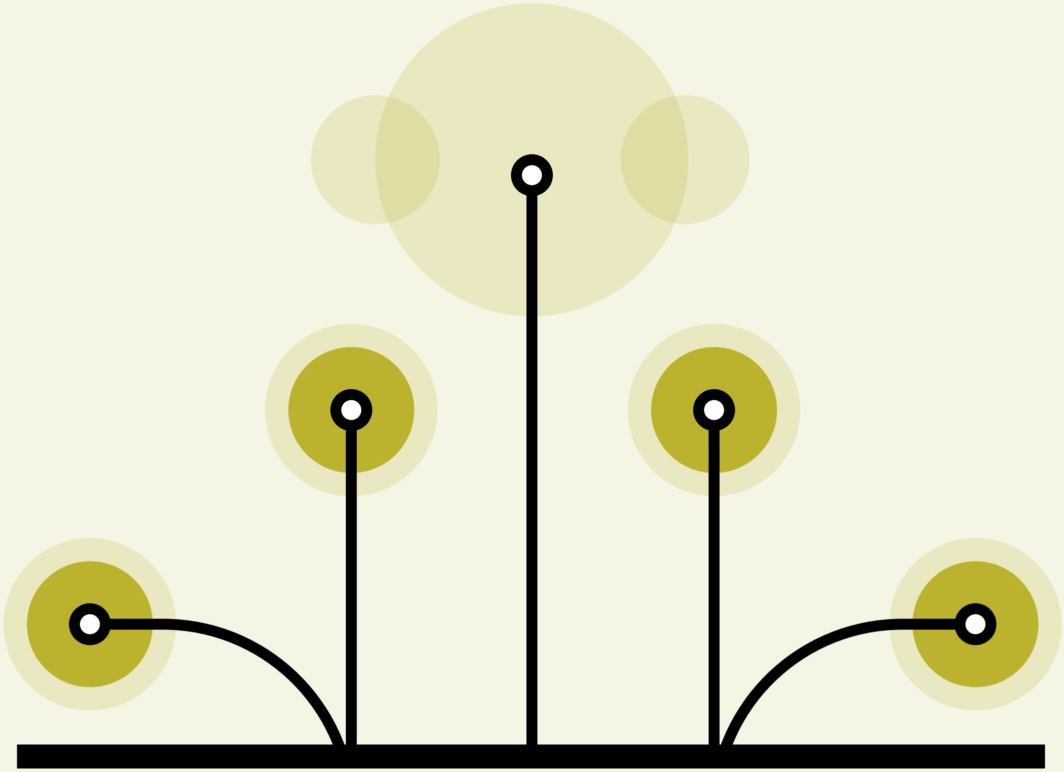
FMIs are crossing borders, but only at the tempo set by transaction flows

In an increasingly global marketplace, FMIs are also developing cross-border services, and entirely new FMIs are emerging to meet cross-border needs. TARGET2 and TARGET2-Securities (T2S) are instances of infrastructural adaptation to growing cross-border traffic. The international CSDs (ICSDs) have long serviced both international and domestic market participants and asset classes. The real-time gross settlement (RTGS) systems that support currencies widely traded outside their domestic markets, such as the U.S. dollar, have extended opening hours to cover multiple time-zones. In a world in which currency barriers remain intact, CLS was built specifically to eliminate

> **“But in the long term it is a natural development for FMIs to establish links that make it easier and cheaper for their domestic constituencies to transact business across borders.”**
>
> **- Frank Van Driessche, SWIFT**

the settlement risk of cross-currency transactions. When any domestic FMI is built or refurbished, consideration is always given to how cross-border transactions can best be supported, especially through adoption of international message standards.

Yet participants in both the securities and payment markets are nevertheless operating in a context in which cross-border links are incomplete. The majority of RTGS systems exist primarily to support domestic constituencies, and automated clearing houses (ACHs) have made little impression beyond their domestic market, albeit largely because cross-border flows have yet to rise to the level which would encourage them to do so. Providing a robust and secure service to domestic market participants is a natural priority. This is why even the pioneering New Payments Platform (NPP) in Australia is aiming to provide no more than a purely domestic RT-RPS initially, with cross-border payments continuing to be intermediated by the existing correspondent networks that provide the gateways into purely domestic infrastructures. But in the long term it is an equally natural development for FMIs to establish links that make it easier and cheaper for their domestic



constituencies to transact business across borders.

In the securities markets even the most internationally-minded investor still accesses domestic markets in a comparable way. Stocks and shares are bought and sold remotely via a link to the local stock exchange, or through a seat a global broker retains on the local stock exchange, or by a local broker approached either directly or via a global broker. Trades still clear and settle locally too, through the sub-custodian bank of a global custodian, between accounts at the local central securities depository (CSD).

These patterns imbue FMIs with an understandable focus on servicing domestic clients, transactions and asset classes. The settlement of payments and trades remains for the most part restricted to local market opening hours, at least in markets other than the major internationally traded currencies. This makes cross-border settlements relatively cumbersome. They require high levels of intermediation in both payments (two correspondent banks adjacent to the relevant PMIs) and securities (a global broker, a local broker, “It is not just liquidity that ensures trading and investment activity remains primarily local: there is an infrastructural reason for it too. ”

- Frank Van Driessche, SWIFT

a global custodian, a sub-custodian and a CSD, and perhaps also a local central counterparty clearing house, or CCP, as well). They also tie up cash in local markets as transactions await settlement, or require the provision of credit at the local level.

The internationalization of infrastructure has begun

In other words, it is not just liquidity that ensures trading and investment activity remains primarily local: there is an infrastructural reason for it too. FMIs have yet to provide the underpinning for a genuinely seamless cross-border transaction settlement service that operates 24/7/365. Unaided, infrastructure cannot displace local markets as the ultimate source of liquidity, but it is possible to foresee a time when infrastructure can contribute to the widening of pools of liquidity. In fact, there are several portents of such a future already. One is TARGET2-Securities (T2S) in Europe. Its principal aim is to increase the size and liquidity of European capital markets by bringing the cost of settling securities transactions across European borders down to the same level as domestic transactions.

In effect, T2S can be seen as the securities market equivalent of the Single Euro Payments Area (SEPA), which was designed to bring the cost of cross-border cash movements within a single currency area down to domestic levels, in line with the broader vision of an integrated European payments market. In the short term, T2S is likely to add costs as custodian banks pass on the price of the additional services, but it will eventually lead to cost reductions, as it did with SEPA, even if it took some time. Transaction costs will fall as banks make savings on liquidity and the domestic securities market infrastructures are linked (and later consolidated) in the same way as their payments counterparts. In payments, the next step is already visible: the European Central Bank (ECB) has started work on defining its vision for an integrated pan-European real-time payments system.

A similar pattern is emerging in Asia, where the Financial Integration Framework (AFIF) developed by the Association of Southeast Asian Nations (ASEAN) aims to cut costs and foster liquidity by making the links between FMIs more efficient. Similarly, the Stock Connect link between the Shanghai and Hong Kong stock exchanges eroded restrictions that have long divided the Chinese stock market between shares open to local investors and those available to international investors. Tellingly, once it became clear that the settlement process was an obstacle to trading activity via Stock Connect, Hong Kong Exchanges and Clearing Limited (HKEx) modified its Central Clearing and Settlement System (CCASS) to eliminate the problem.

Standards are not enough: operational infrastructure and practices have to change

The Stock Connect experience is a reminder that links between trading infrastructures must be supported by equally effective links between clearing and settlement infrastructures if the goals of tighter integration, lower costs and greater liquidity are to be met. It proves that the adoption of international message standards such as ISO 20022 is not enough. While they reduce an important part of the friction inherent to linking domestic FMIs, changes in operational practices will also be required. This need is especially acute when FMIs are required to support links between trading platforms across time-zones. In these circumstances, FMIs have to change the way they work to ensure that market participants are not faced with an unenviable choice between settling trades within an exceptionally narrow window of opportunity or assuming the risk of leaving a transaction unsettled overnight.

Regulation as a catalyst of change

Another hurdle FMIs can help their users surmount is regulatory obstacles to cross-border flows. Though many FMIs do not regard compliance support as part of their remit, stock exchanges have long fulfilled regulatory duties on behalf of their members, and regulatory trade reporting and repository services are supplied almost entirely by market infrastructures.

An obvious new opportunity in this area for FMIs is to help their users meet Know Your Customer (KYC), Anti-Money Laundering (AML) and sanctions screening obligations. A repository of KYC, AML and sanctions screening data, coupled with a service offering unique digital identifiers, is natural territory for FMIs, because such a service would benefit everybody while

> **“FMIs are not the passive instruments of either users or regulators, but active agents of change.”**
>
> **- Frank Van Driessche, SWIFT**

advantaging nobody. Fraud detection and resolution is another opportunity of a similar kind.

FMIs have already shown that they are prepared to be adventurous, by exploring opportunities to inter-operate across borders, provided this does not compromise their primary duty of building and maintaining robust and scalable transaction processing infrastructures. They are not the passive instruments of either their users or the regulators, but active agents of change in both the payments and securities industries.

They provide services which meet regulatory goals (such as trade reporting), create new opportunities for users (such as servicing cross-border trading and investment) and prompt users to find innovative solutions to competitive threats (such as overlay services in RT-RPS). The boundaries between FMIs and their users are not blurring. They are ceasing to exist. FMIs and banks, and the broker-dealers, fund managers, investors, and corporates that are their clients, are component parts of a boundary-less network of mutually dependent market participants.

Want to find out more?

Market infrastructures forum opening

Monday 12 October 2015

09.00-09.50 a.m.
Conference room 1

Moderator:

Dominic Hobson
Founder, COOConnect

Panelists:

Ian Banks
Head of Securities Services APAC, HSBC

A.P. Hota
Managing Director & CEO, National Payments Corporation of India

Paul LaHiff
Chairman, New Payments Platform (NPP), Australia

Calvin Tai
Head of Global Clearing Asia, Hong Kong Exchanges & Clearing Ltd

MI FORUM

making real world change

making real-time payments really work

a real-time payments system that's secure, reliable and peer-to-peer

swift.com/realworldchange

@swiftcommunity
#realworldchange #fintech

SWIFT