European CSDs are still authors of their own destiny

T2S, the single securities settlement platform for Europe launched successfully this year, with the admission of the Greek, Italian, Maltese, Romanian and Swiss depositories. They are the first of four waves of CSDs in 21 European countries to join T2S over the next two years, in a process expected to trigger a major realignment of the market infrastructures of Europe. Isabelle Olivier, T2S programme director at SWIFT, finds that it is up to CSDs to decide if they are victims or victors in a post-T2S environment.

TARGET2-Securities (T2S) is changing the competitive landscape of the securities market infrastructures of Europe. By creating a pan-European processing platform, T2S is precipitating fierce competition for survival between CSDs and custodians. It is forcing CSDs to change their strategies.

Meaningful competitive re-positioning – including further consolidation of CSDs in Europe, where so far only the three Baltic CSDs are in the process of merging into one - is not expected before the end of the T2S migration in 2017. As T2S board member Paul Bodart observes, the current tendency is to focus on “short term T2S readiness and smooth delivery of this critical market infrastructure in Europe. Longer term, one may expect from CSDs strategic positioning, involving collaboration, co-operation and the transformation into real commercial entities with marketing functions.”

In delaying significant strategic decisions, CSDs also gain time to understand how a potential significant driver of structural change – the right of issuers to choose the CSD into which they issue securities, under the Regulation on settlement and Central Securities Depositories (CSDR) –

will materialize in practice.

The environment in which CSDs must make decisions is also fluid. Global custodians, sub-custodians and global investment banks are re-thinking their own approaches to European securities services. In particular, T2S has accelerated a long competitive battle between CSDs and custodians over responsibility for settlement, safekeeping and asset servicing.

However, two developments are evident already. One is that the international CSDs (ICSDs), which have long competed with custodians, are extending ICSD services to customers of the domestic CSDs they own. The other is that some CSDs are looking to expand their services into areas previously controlled by custodians, and developing more sophisticated offerings in areas such as asset servicing and collateral management across multiple countries.

Opportunities as well as threats for CSDS

No wonder Paul Bodart believes that T2S is having a "huge impact on CSDs, which are emerging from a sort of monopolistic world." Philippe Leblanc, T2S project director for the 4CB (Deutsche Bundesbank, Banca d'Italia, Banco de Espana and Banque de France) and operational director for European market infrastructures at the Banque de France, agrees. CSDs, he says, have not only to connect to T2S but work out how to exploit the opportunities created by T2S.

"T2S brings new functionality to CSDs that they did not always have before, such as harmonized matching and settlement rules, a single settlement window, settlement optimization algorithms, centralized liquidity management and a central pool of collateral," explains Leblanc. "All these new services will replace those currently offered by CSDs for settlement. But T2S is not a CSD, and will not replace CSDs, which remain in charge of issuer services, notary services, and asset servicing. T2S triggers harmonization and centralization of the settlement process, but does not make CSDs disappear."

The opportunity for CSDs with ageing systems, explains Leblanc, is to offer new services without investing in a new platform. "The opportunity of T2S is not limited

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- Philippe Leblanc, Banque de France

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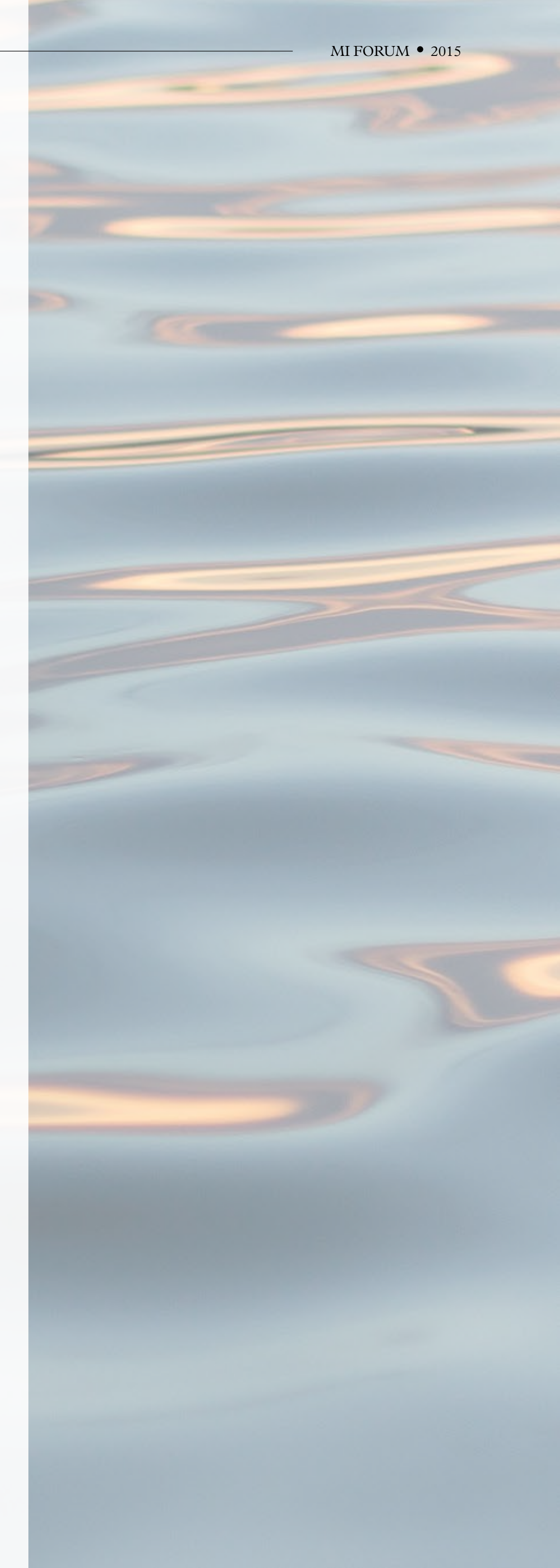
- Indars Ascucks, Nasdaq Baltic

to large CSDs,” he says. “Smaller CSDs will be able to benefit from these services, provided they adapt their current platform and make the necessary efforts to customize their services to deliver a relevant offer to their client base. Each CSD, according to its history, its size and its client base, needs to construct its own business development project and define a strategy that fits the needs of its clients, without necessarily looking to compare and compete with bigger CSDs.”

Philippe Leblanc adds that the critical determinants of a successful competitive response by a CSD are timeliness and cost. “T2S services are quite complex and represent a big jump for some CSDs, especially the smaller ones, some of which have started to realize only now what T2S is offering, and hence may not have identified yet how to take full advantage of the platform and what new services they can develop and offer to their own clients,” he says. “In addition, CSDs’ capacity to attract new business - and their pricing policies - will be linked to the adaptation cost to T2S.”

Indars Ascucks, associate vice president and chairman of the management board of Nasdaq Baltic, the Latvian CSD, agrees that cost control is critical to survival. “In my view, to be successful as a CSD going forward, you need to be either big or beautiful – by which I mean excelling as a specialist, and being highly efficient,” he says. “Revenues will be eroded, making cost control critical. IT is one of the biggest cost drivers we have, and the importance of IT in enabling CSDs to be competitive, to offer straight-through-processing, to underpin excellent corporate actions processing, will be very high.”

Alex Dockx, an executive director in custody product strategy and the T2S programme director at J.P. Morgan in London, points to an unavoidable T2S connection cost, which applies irrespective of the size of the CSD. “There is a one-off adaptation cost for projects like these which is not related to volumes,” he says. “It is a threshold cost. The bigger the volumes you can process, the more you can spread that cost, which is not linear. This gives you a pricing advantage, but size and scale alone will not make a CSD or an institution successful. You still have to adapt



your business to the new environment and evolving customer needs."

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Banks are confident they can compete with CSDs

Meeting evolving customer needs inevitably pits CSDs against custodians large and small. Luca Terzaghi, head of banking solutions and services at Istituto Centrale delle Banche Popolari Italiane (ICBPI), acknowledges the competitive threat but is confident that directly connected banks such as his own can meet it. "The competition with CSDs is getting fiercer, but they cannot develop in a short time-frame all the services that custodians have been offering for years, especially with all the effort they need to make to have their own and their clients' processes adapted to T2S," he says. "Clients value smaller custodians for the customized services we can offer. Even if the competitive landscape is changing, T2S represents an opportunity for banks like ICBPI."

The perspective of a large bank is similar. At BNY Mellon, which recently put plans to build a CSD of its own on hold, Tom Casteleyn, managing director and head of T2S and market

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infrastructures, highlights differences of culture and reach between CSDs and custodians. “Their perspectives are fundamentally different, as is the scope of their respective services,” he says. “CSDs usually offer settlement and basic portfolio services on a limited set of assets. Banks offer a wide range of services beyond settlement, including certain aspects of liability and credit which CSDs just cannot offer. Custodians can also offer bespoke service levels, while CSDs offer one service level for all clients. These differentiators will remain.”

Alex Dockx, who endorses the view that commercial banks have a different service proposition from CSDs focused on cutting cost and risk, argues that there are CSDs who are pro-actively looking to compete with each other and with banks in certain areas, though their core service proposals – especially on the provision of banking services – remain fundamentally different. “It is a good thing, as long as it happens on a level playing field,” he says. “And this is debatable when you are looking at totally different regulatory frameworks applicable to banks and to CSDs.”

T2S is only one part of a long process of integration

T2S alone cannot deliver that level playing field. It also requires at least the full implementation of CSDR. The settlement period agreed in CSDR is already harmonized on trade date plus two days (T+2) in all countries except Spain, but the buy-in discipline to enforce it, and open access and common operating rules for all CSDs, have yet to be implemented. In addition, Europe needs harmonization of all the post-trade activities itemized in the Giovaninni reports of 2001 and 2003.

The failure to harmonize areas such as corporate actions and collateral management provides continuing scope for competitive differentiation. But it also creates room for markets and market participants to protect themselves from competition, so further harmonization is important to generate effective rivalry between service providers.

Bodart sees ample potential for the industry to further leverage T2S to achieve higher levels of harmonization. “As soon as stability of the platform is achieved, with a critical mass of settlement activity, further developments could be elaborated with the market,” he says. “The Eurosystem could do more, based on its ability to deliver huge projects on time and within budget.”

Alex Dockx believes that harmonization needs to be pursued actively and should remain a core axis of infrastructural reform. Other areas of expansion are interesting, he notes, but the key objective remains a successful roll-out of the four waves of CSDs affected by T2S. “Given how large the changes are in every market, that must be the primary focus,” he says.

Philippe Leblanc adds that full harmonization will be easier to achieve once T2S is delivering the benefits it was designed to achieve, especially in releasing liquidity currently trapped in national markets to support settlement processes. A 2014 study by Oliver Wyman, commissioned by Clearstream, suggested brokers, asset managers and banks could save between €30 and €70 million a year through consolidating their cross-border flows across the major T2S markets alone, even before taking account of potential savings on domestic transactions.

"We may challenge the figures, but there are still strong arguments that demonstrate tangible benefits, especially in the liquidity management area," says Leblanc. "Some CSDs, in waves one and two, have focused on developing their interface with T2S. It is unlikely that they will be offering all the services they had in mind as of day one of their go-live. The benefits to the market will depend on how capable and quick the CSDs prove to be in offering these services."

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If Philippe Leblanc is right, the impact of T2S will accelerate over time, and the speed of that impact depends on the ability of the CSDs to realize the benefits of T2S. It is a message somewhat at odds with the widespread belief that T2S will, by reducing the settlement revenues of European CSDs, result in a far-reaching consolidation of market infrastructures. But it certainly does not contradict it. The future shape of the infrastructure which will service the securities markets of Europe will be determined by the CSDs themselves, as well as T2S and the custodians, over the next two years.

"A future for CSDs?" at Sibos

Monday 12 October 2015
15:30-17:00 p.m.
Conference room 4

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