TARGET-2 SECURITIES: THE TRANSFORMATION OF EUROPE’S POST TRADE LANDSCAPE

Market experts at the 2014 thought leadership roundtable on TARGET 2 SECURITIES (T2S)

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INTRODUCTION

TARGET-2 SECURITIES (T2S) is at the core of the European harmonisation project. In Frankfurt, in mid-March last year, European Central Bank president Mario Draghi, noted: “Greater financial integration is a key part of building the single market and something that improves the functioning of national financial systems. Financial integration leads to better risk-sharing and diversification, it makes markets deeper and more liquid, and it encourages competition, which in turn reduces the costs of intermediation. In addition, financial integration fosters more efficient allocation of capital, higher productivity, and stronger and more sustainable non-inflationary economic growth.”

By and large, the view of banks is that T2S will lead to consolidation in which efficiency and scale play a vital part, particularly given the phalanx of regulations around risk, capital and Basel III, which now play an important part in the strategic decisions of the global financial institutions. T2S is perhaps even overdue in terms of harmonising and bringing together the European capital markets and it is abundantly clear that banks and investment institutions will want to make the best use of it.

According to the European central bank, in terms of infrastructure, T2S is a “necessary platform” for setting up a single European market for securities services. In terms of benefits for Europe, T2S will make the post-trade environment safer and more efficient. It will reduce the cost of settling securities transactions and bring about significant collateral savings for market participants. “These collateral savings are particularly valuable at a time when demand for high-quality collateral continues to increase, as a result of both the crisis and new regulatory developments,” says Draghi. Even so, he notes: “reaping the full benefits from the launch of T2S requires that it is complemented by the provisions laid out in the CSD Regulation proposed by the Commission. Both initiatives are supported by the harmonisation agenda which has been advanced by the Eurosystem and other European fora”.

CSD Regulation then is critical to post-trade harmonisation efforts in Europe, and it is hoped that it will enhance the legal and operational conditions for cross-border settlement in the EU in general and in T2S in particular. In this respect, the ECB has recommended that the regulation and the corresponding implementing acts are adopted prior to the launch of T2S. Work is also in progress in the eurosystem to improve the possibilities for the cross-border use of collateral for eurosystem credit operations, which will increase efficiency. Further benefits are expected from market-led initiatives to enhance the interoperability of tri-party services in Europe.

Clearly then, the T2S project has implications for both securities services providers, for CSDs, sell side brokers-dealers and buy side traders. With so much in flux, we have brought together some of the key market thinkers and players to highlight the key trends and implications on business of the project.

OPENING GAMBITS: WHAT T2S MEANS TO YOU

JO VAN DE VELDE, HEAD OF PRODUCT MANAGEMENT, EUROCLEAR: In Euroclear’s business mix we operate six CSDs serving seven European markets, as well as one ICSD, and we have a large number of assets and securities trading volumes that settle with us. For us, Target2-Securities is a major undertaking. In fact, it is one of our two strategic pillars, the other is collateral management. We see T2S both technically and strategically: technically because we have a number of CSD entities, Euroclear Belgium, Euroclear France and Euroclear Nederland collectively known as ESES and Euroclear Finland that will connect to T2S. Right across our business domains we are making substantive changes, both in terms of outsourcing settlement and adding new functionality, for example. Moreover, not only do we participate in all the groups in and around T2S but also, more importantly, around European market harmonisation—particularly from the technical side.

Strategically, there are clear implications in that we have now to adapt our asset services and collateral management offering to suit new market conditions. Clearly, we anticipate more service unbundling taking place going forward. Our focus is on our clients and how we can support them. In terms of T2S, in many ways it has to be said that it is coming into play at the wrong time for clients, not least because firms are grappling lowering cost right now. This is an opportunity for us to alleviate the testing consequences of T2S on our clients simply by providing a unique service offering independently of where clients want to settle and hold their assets.

TOM CASTELEYN, MANAGING DIRECTOR, BNY MELLON: The bank regards T2S as a very fundamental change in the European landscape. It is changing the entire post trade value chain, and it is a catalyst for us to change our business model. At the end of T2S implementation, on the one hand BNY Mellon will have a global custodian that’s fully and directly connected to the T2S platform, and on the other, we also will have a CSD that has signed the T2S framework agreement and will be an integral part of T2S. We think that the combination of these elements is powerful and will enable us to serve our clients better. At the same time is helps us respond effectively to the challenges resulting from incoming regulation, such as enhanced collateral obligations under the European Market Infrastructure Regulation (EMIR).

ALAIN POCHET, HEAD OF CLEARING CUSTODY & CORPORATE TRUST SERVICES, BNP PARIBAS SECURITIES SERVICES: T2S is a very, very important step for Europe. For more than 20 years I have consistently heard that Europe is a fragmented market. T2S is a big step towards European market harmonisation. Frankly, not everything will be solved by T2S, but it is a big, important, first step. The market will be more harmonised. That means it is more efficient, less risky because investors now have the opportunity to manage their European wide risk in a single location,
than 60 markets. In EMEA, we have the largest direct proprietary custody network in the world, spanning more

RICHARD SCAVETTA, T2S PROGRAMME DIRECTOR, CITI: Rather like my counterpart around the table, not only as a technical change in the market, but also as a strategic catalyst for change, it is probably the biggest thing in the European landscape, especially in settlement and custody. We are looking at T2S from an overall bank’s perspective, although there are many different lines of business within the same bank, whether it is prime brokerage, custody, equity capital markets, fixed income capital markets or collateral management, and custody. Each of those constituent lines of business are different points of interest with us, but, overall, it is a trigger for all of these constituent parts to look at ways to access the European markets more efficiently, which is a core part of our business. Given the size of the firm as well, we feel we are in a position to actually drive part of this strategy. Our view on T2S is that it will lead to consolidation in which efficiency and scale play a vital part. Regulation has been mentioned; and it is those particular regulations around risk, capital and Basel III, which now play an important part in our strategic decisions. This is not a short term project; it is a long term project. As a firm, we have been since the start a big fan of T2S because we think it is long overdue in terms of harmonising and bringing together the European capital markets. We want to make the best use of it.

ERIC DE NEXON, HEAD OF STRATEGY FOR MARKET INFRASTRUCTURES, SOCIETE GENERALE SECURITIES SERVICES: We have been one of the initial supporters of the project, in fact we have been involved since 2006. Our team remains totally focused and involved and committed to the project. I will not go over ground already covered, but I will emphasise the fact that T2S is only one of many initiatives that will lead, within the next decade, to a much more integrated financial market landscape is immense. We can pass cost savings directly on to clients; it will help stimulate competition across Europe and it will help grow the trading front and middle offices. All this will work to the competitive advantage of Europe and the people that trade within it.

ALEX DOCKX, EXECUTIVE DIRECTOR, PRODUCT STRATEGY, REGULATIONS AND MARKET INFRASTRUCTURES, CORPORATE AND INVESTMENT BANKING, JP MORGAN: Rather like my counterpart around the table, not only as a technical change in the market, but also as a strategic catalyst for change, it is probably the biggest thing in the European landscape, especially in settlement and custody. We are looking at T2S from an overall bank’s perspective, although there are many different lines of business within the same bank, whether it is prime brokerage, custody, equity capital markets, fixed income capital markets or collateral management, and custody. Each of those constituent lines of business are different points of interest with us, but, overall, it is a trigger for all of these constituent parts to look at ways to access the European markets more efficiently, which is a core part of our business. Given the size of the firm as well, we feel we are in a position to actually drive part of this strategy. Our view on T2S is that it will lead to consolidation in which efficiency and scale play a vital part. Regulation has been mentioned; and it is those particular regulations around risk, capital and Basel III, which now play an important part in our strategic decisions. This is not a short term project; it is a long term project. As a firm, we have been since the start a big fan of T2S because we think it is long overdue in terms of harmonising and bringing together the European capital markets. We want to make the best use of it.

RICHARD SCAVETTA, T2S PROGRAMME DIRECTOR, CITI: Citi’s direct custody and clearing business is the largest proprietary custody network in the world, spanning more than 60 markets. In EMEA, we have the largest direct presence in the T2S scope markets. This is a business that’s core to our DNA at Citi and this is a project that’s mission-critical to the success of our franchise. We see T2S as an opportunity, and have done right from the start.

Our T2S strategy is built upon existing services currently offered globally and leveraging our local presence in all of the material T2S markets. Our clients take comfort in the fact that our T2S solutions are ‘tried & tested’ solutions offered by Citi, which we are now extending to the full scope of T2S markets. Our T2S offering should be described as modular and flexible where clients can pick and choose from the various options depending on the underlying needs of their business in a specific market.

Graham Ray, Director, Global Product Management, Direct Securities Services, Deutsche Bank. I work within the Direct Securities Services business, which is part of our global transactional banking group. We are one of the large custodians, and local custodians in the T2S region. Our level of commitment to the programme and the project has been, from initiation to where we are today, consistent and we believe the market gains from this initiative. We service many different client segments, both in the international space as well as the local space. Their understanding and their partnership approach to how they will manage the implementation of T2S are very different.

I can condense these differences into a few points around what T2S means for Deutsche Bank. The first is the opportunity to continue to be a directly connected participant of the market infrastructure (T2S), providing custodial services to our clients. The second is the ability to utilise the benefits of the functionality that T2S can bring and pass them on to our clients. Third, T2S gives us the opportunity to look at our own business model and evaluate the components that are going to be value-add to the many different client segments that we support. Then it becomes how we facilitate that our clients benefit in turn from T2S, particularly around unbundled components, such as liquidity, collateral and distribution that can come from such an offering.
CHI BONO? WHO WINS AND WHO LOSES IN THE T2S LANDSCAPE?

FRANCESCA CARNEVALE: Clearly, the executives around this table see T2S as an opportunity. I understand their viewpoint; but it is one that is coloured by the fact that they are almost all leading players in the T2S and investment services space. Is it also the case for Tier II or Tier III players, where the cost of implementing T2S is prohibitive? Might these firms see themselves being (potentially) pushed out of the market by the larger players around the table? In that regard, is T2S creating a divided, not a harmonised landscape?

AXEL PIERRON, HEAD OF CAPITAL MARKETS, CELENT: T2S doesn’t solve all the issues around post-trade costs in Europe, and especially cross border settlement costs. T2S is just a settlement platform. In post-trade, a lot of the costs are all driven by asset servicing, and the reality is that you still have many peculiarities and discrepancies between European countries that will prevent, at this point in the drive towards harmonisation, any economies of scale in the asset servicing business.

There is another consideration: T2S solves the cost of cross border settlement. The big question for me though is how T2S will foster growth in the volume of cross border transactions and hence cross border settlement? We need to remember that in terms of trading you need to have a home-based kind of environment. The vast majority of securities, which are listed in Europe are very likely to be traded locally and not on a cross-border basis.

I also want to say something here about the nature of regulation in Europe which is driving market change. There seems to be a multiplicity of approaches. MiFID, for instance, was a directive; the Code of Conduct is a self-regulatory structure around clearing, which in reality has not driven very much. T2S meanwhile is a separate kind of initiative which has essentially emanated from the European Central Bank. Which vehicle for change is the most effective? I don’t have a firm answer right now.

ALAIN POCHET: Axel is right. In terms of saving money MiFID was an important project, and T2S will be as well. The big difference is that MiFID effected significant decreases in prices while T2S will try to decrease costs. I doubt the market has noticed a big difference in the way that it interacts with the trading infrastructure, there is just more competition around providing prices. T2S, on the other hand is not so much about fostering competition as a route to market efficiency, it is about harmonisation of processes. However, each time that you kill a piece of fragmentation, particularly as a global player, in reality you are bringing something less to your client.

Let’s focus on costs for a minute. In Europe over the last 30 years, every eight years or so the market has invested something like €100m and €400m just to change the settlement system. And I can tell you that the Euroclear system is very good, the Monte Titoli system is good, the Spanish one is good, the German one is good, and they are doing exactly the same thing. In that regard, I think that T2S will ultimately mean that we will eventually save all these investments in iterations of settlement systems every five years or so.

T2S also redefines what we mean by cross border settlement. Cross border means you have German shares in Germany, and Italian ones in Italy, and you need to make a bridge between both. T2S cancels that need, you will simply put either an Italian or German or whatever security into the system or platform and it will settle, just as it would in the domestic market. In that regard, it must deliver a saving to the end investor.

It is the combination of these elements, I believe, that will ultimately make the European market more competitive.

TOM CASTELEYN: Various headline numbers have been mentioned, 15 cents per settlement, for example. Pricing is sometimes misunderstood. We don’t know what the final price of a trade on T2S will be because there are messaging costs involved, there are account maintenance costs involved, and there are CSD add-on costs to the settlement transaction. As Alain explains, eventually cost efficiencies will appear all the way up the value chain for market participants. Right now however the project continues to involve significant investment from all of us to ensure we are compliant with T2S. This spend will have to be recouped. Settlement costs cannot come down until the industry has recouped its investment; that goes for both global, sub custodians and CSDs.

GRAHAM RAY: In identifying where the costs lie, that may mean you have to look a lot deeper into T2S and away from just the settlement component and towards liquidity, collateral and some of the underlying variables that drive the cost benefits and the cost savings. The solutions around these issues do not solely lie around volume and scale. Instead it will force a reassessment of the overall operating models in the post-trade segment, in the middle and back offices, to identify the new service requirements and ultimate benefits that will eventually ensure you are a winner in a post T2S landscape.

FRANCESCA CARNEVALE: Graham raises interesting points around the impact that T2S will have on the nuts and bolts of sub custodian services. Richard, the people around...
this table are well positioned to benefit from T2S. How are you selling that to some of your clients? Particularly those smaller sub-custodians that have much to fear from T2S.

RICHARD SCAVETTA: That’s a good question. Clearly, this is a scale business, and obviously that plays well into our hands. In this environment you really have to question the single market sub custodian model and how or will it survive in a T2S environment. There are sub custodians out there with a good track record in their domestic market, but how viable is their business model going forward?

MACRO CONSIDERATIONS: FINGS AINT WOT THEY USED TO BE

FRANCESCA CARNEVALE: T2S has been brought in at a time when markets, and certainly equity trading, are still at depressed levels compared with 2007. Moreover, in de-risking portfolios investors have reduced their overall allocations to equities. Can a more rigorous post trade infrastructure start to pave the way for a return to equities?

ALEX DOCKX: The answer revolves around how much settlement and settlement related costs drive volumes. In other words, the bigger the cost, the bigger the spread needs to be in order to do a trade. Obviously, if there is a decrease in cost, and it will eventually come after the amortisation of investments, that’s a positive for investors who want to do trades, whether they are long term investors or people who just arbitrage. Will that happen over a short space of time? We all agree, T2S requires a substantial period of phasing in; investors don’t work on this timescale and therefore it is unlikely to support higher volumes.

On the other hand, the reality is T2S is not just about settlement, it is about removing barriers. Removing barriers not just for competition, but removing barriers between markets. Where probably the pick-up will come, without having a crystal ball, is the ability to invest much more on a cross border basis, and much more on a pooled basis, without recourse to some of the instruments which have been devised in the past to overcome those hurdles.

JO VAN DE VELDE: If you look at the markets today, you see a lot of financing moving away from banks, and banks that are heavily deleveraging. Corporations are looking for direct access to markets and, the more you can do that on a pan-European scale, the more you can reach an investor base to lower the cost of funding to that specific capital market. T2S can help in terms of extending that Pan-European investor base but, this is not just about T2S; this requires a free flow and a free access across all of the different markets. Such free flow and access requires, first of all, harmonisation. Today you still have stock exchanges that force all the volume through one CSD, tomorrow people will want to have open access to different CSDs.

I also want to point out that the financial transaction tax (FTT) if implemented across Europe will definitely have the opposite effect than initially intended. A recent study noted a decline of between 10% and 15% in equity trading volumes on the French market in the first six months after the introduction of the French transaction tax. T2S should certainly help restore confidence in trading volumes, but I caution that there is more to do and of course there are external factors that can work against it.

ERIC DE NEXON: I like to say that T2S is a gift for the next generation. Perhaps we will not be even still working when we will start seeing the real benefits of T2S. That’s the first remark. You can also benefit from T2S independently of cost considerations; I am talking about improved liquidity and easier transfers of collateral, for instance. These are much more important benefits. Finally, I believe T2S will, as Graham mentioned earlier, force us all to review our existing business models and become leaner, meaner, have vastly improved IT platforms and everyone in the market will benefit from that business restructuring. Actually, it is a very exciting time.

T2S & EFFECTIVE LIQUIDITY MANAGEMENT

TOM CASTELEYN: It is intuitively logical that T2S will improve your liquidity position. It will reduce your intraday need for liquidity. Today, if people settle in European markets, they might have accounts with three or four national central banks and a few commercial banks. Clearly, having all your liquidity in one place is beneficial and there are studies out that that have quantified that benefit. I assume they are directionally correct, but whether in the absolute they are correct, I do not know. Certainly, there is a liquidity benefit and it should be obvious. And at BNY Mellon we think that benefit is important enough for us to directly participate in the central bank money space and to become our own cash clearer in euro as a result. That’s certainly an important benefit.

RICHARD SCAVETTA: We see effective liquidity management as the single largest opportunity for the market in T2S. I say the ‘market’ as it is not only an opportunity for us as sub custody providers who will benefit from the pooling of liquidity across markets, but it is also an opportunity for more market participants to gain access to central bank money. If you think about the model today, most market par-
participants rely on agent banks to provide them with intraday liquidity, which is not necessarily reflected in today’s settlement fees. We expect there to be an inevitable shift in this space, as more market participants look to insource the funding of their settlement activity, as Tom has just alluded to.

GRAHAM RAY: T2S introduces an opportunity to understand how you can benefit from pooled liquidity across the European region, both on the cash and the stock side. As Richard says, who is actually utilising that liquidity on an intraday basis? More importantly though, T2S, CSDR regulation, liquidity and collateral allow market participants to reassess what service offering will be available post T2S. For example: there will be an opportunity to set up your account structures in many different ways to benefit from the value added functionalities being offered. Understanding the complexity and the resultant account structures and account models will provide investment service providers with a new business opportunity. Let me give you an example. As Deutsche Bank is a local payment bank, a local sub custody provider, the pure benefit of the pooling of the cash and securities and then providing that transparency to a client, is a paramount change in our model and can actually be seen through the organisational structure and the financial benefits our clients achieve.

T2S & THE VELOCITY OF COLLATERAL

FRANCESCA CARNEVALE: How does T2S encourage or discourage efficient use of collateral? If at all.

JO VAN DE VELDE: T2S can add a lot of value in regard to the mobilisation and optimisation of securities collateral. Upcoming regulations around the mandatory clearing for OTC derivatives will require the utilisation of more collateral and because collateral is a scarce resource, naturally firms will be looking to optimise and mobilise that collateral from where it is to where it is needed in the most efficient way. The T2S infrastructure can help; it provides us with a virtual view on all of the assets that are held across Europe. Euroclear has its own Collateral Highway, where we build such a view for our clients on a global scale so as to help them fulfil their collateral needs. Progressively, we are putting together positions irrespective if those assets are held in Euroclear or in a CSD or an agent bank. Once we have created a view on the assets that our clients have; they can consider them as one virtual pool from which they can then source, optimise and mobilise assets to cover their funding exposures.

Connectivity to T2S is for us an additional source of collateral assets in this regard. We can plug our Collateral Highway onto T2S and facilitate the optimisation of collateral management across Europe. This however is just on the European scale. Of course, collateral management is bigger than that and is more and more done at a global scale, but certainly T2S can help.

AXEL PIERRON: When we talk about collateral management, we need to think on a global scale, just thinking around the European border is clearly insufficient, particularly as investors tend to invest globally these day. Obviously T2S is a great infrastructural solution and helps at the European level, but it is not sufficient to really optimise and mobilise collateral on the necessary global scale.

Clearly T2S will drive consolidation and that is a clear benefit for the market. The question to me is, was it necessary to create T2S to achieve these things? Consolidation and market harmonisation; do they really require T2S? Will the market drive these trends in any case? I feel the ECB jumped in to force this initiative because it is the only way to really deal with it the barriers in today’s market. But is it really the answer we want? I look at the US market, for instance, and very little is settled at the CSD level. For most of the securities, there is a pre-settlement meeting done at the custodian level. The irony is, if T2S were to be genuinely successful then, eventually, we will end up in a situation where T2S will handle very little volume itself.

ALAIN POCHET: This is a competitive field. That means that in order to stay in business, one needs to look at all the options. The options which JPMorgan has taken, which is slightly different from some of the other banks around the table, is to say we don’t want to become a market infrastructure, but for reasons that are mainly in the CCP clearing space, we want to forge alliances with existing CSD providers; in this case, the London Stock Exchange, to provide collateral services and to offer our clients the opportunity to comply with EMIR. That is one way of approaching the issue. Other banks have different views on that. On the other hand, there is a blurring of who is who, at the end of the day, in terms of services being provided and also in terms of positioning. Now, this is really being driven is by two things. First of all, what the regulations say, whether it is Basel, whether it is EMIR, whether it is CSD Regulation, because clearly, depending on the label one carries, there is a different regulatory treatment and impact. The second piece is that we should remember why banks are in this business. It is because they have big balance sheets, which is absolutely necessary to do the kind of liquidity intensive activity that we do.

TOM CASTELEYN: There are two points to be made. One is that, clearly, the regulator has made a few statements where it is become clear that they’ve started to prefer market infrastructure over commercial banks, and they’ve started to prefer central bank money over commercial bank money. EMIR has gone that way, AIFMD is that way inclined as well. EMIR and AIFMD are clearly two pieces of regulation that drove us to the decision to establish a CSD. It is certainly not the only reason, but it is part of the reason. If we want to continue what we are doing in the collateral management space, we need to also be a CSD. Then you get the other side of the coin, and that is that T2S is clearly a catalyst. If you look at the traditional value chain between the global custodian, sub custodian and the CSD, you see that T2S is making it a lot easier for global custodians to directly access a settlement system. It is questioning a part of what used to be in the sub custodian value chain, which...
is the settlement part. I’m not saying it would do that for the portfolio servicing part.

T2S is clearly helping us in achieving our CSD ambition. It certainly would be a lot harder if we had to build a CSD without T2S, because T2S is automatically giving you the linkages to all the other CSDs that will be joining T2S. We would also have a direct market strategy if T2S wasn’t there, because we currently are already direct in a few markets, but it is very hard to connect to each market individually and deal with all the idiosyncrasies of each market. Again, T2S is changing the landscape for us, and once you’re connected to T2S, you’re automatically connected to all the markets.

ALAIN POCHET: T2S is not only a platform project but also a very important catalyst in terms of harmonisation, but we have seen that people have started to work in corporate events just because of T2S, knowing that T2S has nothing to do with corporate events. I am going back to one point, which is the fact that, in the market, the only way to do something in terms of harmonisation is a rather big project. We have done ten times more when we have decided to manage three markets in one single platform, than during the previous 20 years. With T2S it will be the same. If you want several countries, several players going in the same direction, you need to have a bigger project. That’s very important.

Secondly, all or most of the players that are concerned by T2S have become more serious about themselves during the last three or four years. Before T2S, every CSD was supposed to become a global custodian or an ICSD. I just want to say that if you are an issuer CSD, you are covering 12 or 15 markets. Very nice. The only thing is that the buy-side is asking us to have at least 110 markets for 15 equities, listed derivatives, OTCC, cash transfers, things like that. We are very far from having somebody able to manage all the asset classes and instruments available around the world, just because you have an issuer CSD and T2S. It is the same for harmonisation. People are more honest with themselves when there is this kind of big project.

GRAHAM RAY: As Alain intimates, large institutions are very aware of T2S and very aware of how T2S integrates into the ultimate regulatory landscape that is changing in Europe. However, as you move down that institutional scale, there probably isn’t as great a depth of understanding of the collateral opportunities within T2S around the region. Obviously, one of our functions is to try and help provide that partnership, towards the market client base, to ultimately find out what collateral solutions they will need in future. One thing that can’t be also missed in all of this, whether it is regulation or whether it is T2S, is there is always going to be an element of cultural knowledge, as well as expertise that is going to still be required. And if we can recognise as market participants, what expertise it is that we are offering to clients, then we will provide the appropriate collateral solutions. The understanding of T2S, settlement and maybe the commodity, lesser value of such a component is absolutely true and recognised around the table by colleagues today. But again it is the catalyst to start many functions and services around asset servicing, around tax and collateral management that maybe has an expertise sitting in a particular location today that needs to continue in a post T2S world.

RICHARD SCAVETTA: To answer the original question, T2S as a platform should clearly increase the velocity of collateral movement around Europe, which helps. As previously stated by my fellow panelists though, collateral management is a global challenge where T2S does not contain all the answers.

ALEX DOCKX: On the topic of transparency, one of the benefits T2S brings is a much clearer view on who is providing which service to whom, on a much more unbundled basis than it used to be before. It is an important benefit because it used to be all bundled and all packaged, and it wasn’t always very clear what a given service at a given cost included, but the basis costs are now becoming very transparent.

One of the objectives of firms like ourselves and others around the table is to, first of all, understand what all of these moving parts mean because there are a lot of moving parts. Then, secondly, help our customers in figuring out what the best combination is for themselves. That is different for each and every client. Not all clients have the time or the appetite to spend a lot of time on it, but deep down they know this is important for them. They rely on the services of the providers, to tell them how they should navigate in this landscape.

EXPORTING T2S: A NEW OUTLOOK?

FRANCESCA CARNEVALE: T2S will redefine a European market place, but there’s been a lot of interest from entities outside of Europe in the T2S project. You’re all global players. Japan has expressed interest in being involved in T2S. Does it have wider application and recognition? Can it be a template that can be exported elsewhere?

JO VAN DE VELDE: Well, if I look at it from a pure market infrastructure point of view, looking at the rest of the world, there is one big market called the US, but the US for me today is already a single market. It has one single infra-
structure. It has one legal structure, it has one single currency. The US has the scale and there is no obvious reason to change anything there. Then you come to other regions like Asia, where you have a lot of fragmentation and a lot of post-trade ecosystems. You mentioned Japan. Could T2S be a solution or something to bring into those regions? For sure, T2S is an example of how you can link different markets with a single platform, but let’s not forget that the magic is not in T2S. The magic is about harmonisation, about overturning existing legal and fiscal barriers, and that is the crux of the issue. Other markets will look at T2S, but for the moment they will just wait and see what the success of T2S will be.

**RICHARD SCAVETTA:** To be blunt, T2S should probably concentrate on getting the rest of Europe into T2S before it starts any Asian adventures. Let’s remember that you’ve got two Euro denominated markets that are not in T2S, you’ve got five countries that are in T2S where the Euro isn’t the domestic currency and the domestic currency isn’t in T2S. Today we are sitting in one of the larger capital markets in Europe (the UK) that isn’t in T2S. There are many opportunities right on the doorstep for T2S without having to venture to Asia, in my opinion.

**FRANCESCA CARNEVALE:** Is it a problem for T2S that the markets such as the UK are not part of it? Denmark, for example, which is also not part of the eurozone has been happy to join the T2S project. What are the implications for those countries in Europe outside the T2S infrastructure; is eurozone membership important for T2S to work?

**ALEX DOCKX:** I would say yes. When the UK decided not to join T2S, it became something of a problem and was probably first felt by Euroclear. It means they have a big piece of their business which is on T2S, and a big piece of their business which is not on T2S, and in terms of platforms it is probably not easy to manage. In this regard, I don’t want to be in their shoes. T2S has been built for the eurozone, it has been arranged because it supports the single currency. Look, I think it is a terrific achievement. We fight in Europe, but it has achieved a single currency, it is achieving market harmonisation and T2S and a single cash system. I can understand people who say: Okay, I want to wait a bit to see how it will run before I join. I am sure that it is probably the position of very intelligent people that we have in London and Sweden, for instance. That’s very simple. You have one half of the Nordics which are in, one half which are out. If the T2S starts well, I am sure that the other European country will be happy to join. Denmark’s involvement is particularly pleasing as it will show that T2S can encompass currencies other than the euro.

**JO VAN DE VELDE:** UK not joining T2S can be seen as an issue, if you refer to the T2S business case and the ultimate cost of settlement on T2S as the UK represents large business volumes within Europe.

However, if you look at it from the UK market perspective there was no cost incentive and there is no incentive either from a liquidity point of view. With sterling you already have a single liquidity pool. As Alain says, there are a number of countries that have decided not to join T2S now. I wouldn’t exclude them over time. I still see that T2S will become a success because T2S is not only about a single platform, it is also around market practice harmonisation. There is a clear benefit for the industry to have a more streamlined, single operating models for accessing different markets, but of course the proof is in the pudding and we need to wait to see how T2S will act as a catalyst for all of these barriers to be removed.

**AXEL PIERRON:** Despite what we said about T2S is European. For me something that has been very interesting is the fact that T2S, going forward has pushed the DTCC in the United States to reconsider selling on T+2. It means that globally there are market standards that are being driven entirely by T2S. I think it is a very positive trend.

**ALAIN POCHET:** We spoke about T2S as an efficient model to settle trades, and a very efficient model in order to have less risk to manage. All the securities are in the main engine. The purchasing power, meaning the cash power the securities brought are in the same engine. At least in Europe we will have made the world safer, though we have also made the world safer by having OTC derivatives clear in CCPs. The best for T2S could be if one day if the final private bank of the final guy investing in the market will be happy to invest because he knows that he is not investing in Spain, Italy or Germany but he is investing in a single European market. That is what all the regulation will bring about.

**CSD REGULATION & T2S: A HAPPY MARRIAGE?**

**FRANCESCA CARNEVALE:** It has often been said by market commentators that CSD Regulation and T+2 need to be absolutely in place before T2S. These initiatives seem to cut to the core of European passporting and the status of CSDs, and of course Giovannini barrier nine. Are the European Central Bank and market commentators over-stating the case, or is it a genuine requirement.

**GRAHAM RAY:** From a regulatory perspective, you get the other side of the coin with regards to managing all reg-
ulations in line with T2S. I wouldn’t say all regulations are completely coordinated towards T2S or its facilitation. CSDR obviously works completely in parallel and needs to occur in time before T2S actually does roll out. We have seen a lot more of a positive move towards that occurring. Again it comes down to ensuring that both T2S and CSD Regulation are viewed, analysed and understood in parallel for the client segment that you are working with. It can be a very simple, maybe a buzzword around safety and account segregation, but when you get down to the granularity it really brings, from a provider perspective, the need to have the flexibility and optionality into providing the solutions that fit an account operator model or maybe a segregated account to a certain client segment, in a harmonised manner. The key element is being transparent to the solution that you’re providing and ensuring that the solution has the benefit of a value added service within it, it is very key. But understanding all of the regulations and how that impacts your choice around the facilitation of the T2S platform is critical in the decision that we make for or make with our clients.

ALEX DOCKX: We shouldn’t over estimate how CSD Regulation and T+2 and all these things need to be absolutely in place before T2S. The risk with all of this is that we rush towards the finish with a half-baked product, and that should not be the case. But to answer your question; a couple of things that spring to mind is the harmonisation of settlement cycle T+2. It cuts to the core of European passporting and the status of what are CSDs and what they can do as. It is also cuts to the famous Giovannini barrier nine, with regards to freedom to issue in other countries, and it is also the one single piece of the overall jigsaw that the ECB is concerned about. Pressure around these issues are based around considerations of responsibility, liabilities and outsourcing arrangements. You can’t look at a piece of infrastructure without looking at the regulation at the same time on price tariffs.

RICHARD SCAVETTA: It will be a welcome development to have a common set of set of rules in place prior to the implementation of T2S. The freedom to issue in other countries, for example, should bring welcome competition to the issuance space. From our side the drive towards a harmonised T+2 settlement cycle across Europe, even in advance of the adoption of CSD Regulation, is a welcomed harmonisation development.

JO VAN DE VELDE: T2S is a system, it is a platform, and the biggest risk is that we end up with European passporting and all CSDs outsourcing their settlement to T2S and that is it. CSD Regulations a necessity for T2S to become successful because, in the end, if we want to reduce costs, we need to have more standardisation, more straight through processing, and more competition, which will then lead to more consolidation. That’s the only way you can eliminate costs. If costs don’t change, the price in the end is not going to change. A proper regulatory framework for CSDs will ultimately create the kind of competition and consolidation which is conducive for costs decreases.

TOM CASTELEYN: CSD Regulation is probably a useful piece of legislation to have at the point of inception of T2S, because it puts a few rules down that are very important. There are two points out of CSD Regulation that I’d just like to highlight. One, I’m not sure that it needs to be as detailed about settlement discipline as it currently is. It is important that settlement discipline is harmonised, but it maybe shouldn’t be as prescriptive since it is part of a European regulation. The second point relates to the role of a bank within a CSD. Whether or not we agree on the fact that a bank can be part of a CSD or a bank should be split from the CSD, I don’t think that is the most important point. The key consideration is whether we are really going to be safer if we have single purpose banks that are either also a CSD or provide services to a CSD? One thing is clear, that it is going to be very hard, using Basel III rules that are coming down the pipe, to have a single purpose banks that can have both big balance sheets and actually make sense from an economic point of view. Things like leverage ratios will be a killer to these single purpose banks, and we should think really hard about what kind of banks do we really want to provide services to our CSDs. I don’t think the single purpose bank that can just service a CSD and can do nothing else is really a solution here.

BLURRING THE LINES: BETWEEN INSTITUTIONS/BETWEEN ASSETS

JO VAN DE VELDE: Our post-trade industry is an industry which operates according to economics of scale. I think some of the smaller CSDs and some of the smaller local custodians could struggle, because they lack scale. Ultimately, I see more consolidation in our industry. The winners will be some of the largest CSDs that have the capacity to become investor CSDs and to provide a pan-European service offering. I also agree that the lines between CSDs and custodians will blur. You will see some of the larger custodians possibly becoming a CSD, there will be new kinds of ecosystems that I can see that will grow around T2S. Where differences will remain is in the definition of services, Euroclear, for instance will continue to focus on infrastructure service. However, the world will be very different in ten to fifteen years’ time and
some of that difference will be tracked back to what is happening now.

ERIC DE NEXON: Most players will benefit from T2S and from the new world that will emerge, in terms again of safety, ability to invest cross border and to transfer and move collateral. There will also be some losers; but all in all, winners will outpace the losers.

T2S, in combination with CSDR, seems to stretch the frontier between infrastructures and their participants. Every global custodian will think about perhaps becoming or not a CSD. Some CSDs intend to become global custodians or develop their current franchise, as it has to be clear that an investor CSD is nothing else than a global custodian. Then comes the question: what becomes of the ICSD? When we look at the way the CSD Regulation is evolving, it appears clearly that ICSDs will be encompassed in this directive and will become CSDs while remaining global custodians. And it is a fact that we have an issue with this situation, not only as global custodians, but more specifically as trustee and depositary for funds. Depositories for funds have seen in recent years their liability increasing dramatically with regards the assets they held in custody. They remain totally responsible vis à vis the funds, even when the custody has been delegated to a third party: it means that a depository has to refund the client or to give back the securities to the fund in case of loss with very few exemptions. Some seems to consider that certain regulations would have potentially introduced an exception to this principle based on the recourse to a CSD or an operator of SSS: in such a case, the CSD or the operator of SSS would not be considered as a sub-custodian which would exempt the depository from its liability vis à vis its clients. I such a case, ICSDs and investor CSDs would benefit from a competitive advantage with regards the global custodians. To what extent is this interpretation of the legal framework admissible? Is, in fact, the intention of the regulator to only target issuer CSDs as they are the ones which hold the accounts at the highest tier level and guarantee the integrity of the issue? That is really a tricky question we have to answer right now, and continue to discuss it and its implications with the authorities (especially with ESMA). Because if that is what they want to do we are facing a totally un-level playing field.

GRAHAM RAY: I don't want to use the word power shift, but what we are seeing in the industry is that whoever is committed to Europe as a landscape and whoever is committed to providing benefits of T2S and regulation, are obviously committed to being in a post-T2S world. At the end of the day, it is that recognition and identifying that T2S is a technical platform that’s allowing us to gain harmonised benefits in partnership with regulation.

However, there is still a key element, resources. As I mentioned earlier, the people element means there is knowledge. You cannot buy a platform to replace that knowledge. We have to recognise or identify that the shift is to the committed market participants, who identify the value they add to their clients, and then recognise where they want to change their own business model or adapt their business model to expand their integration of solutions, understanding that at the same time you’ll always need the skill of the people and the local expertise of the people to continue to provide post-settlement activities in a post T2S world!

FRANCESCA CARNEVALE: T2S, was initially designed around the equity markets. Will it roll out and play out across all asset classes?

ALAIN POCHET: T2S will not only be a settlement system only for equities and fixed income, it will also be a settlement system for funds. And I can tell you that on the fund business side there is a lot to achieve in terms of efficiency.

FRANCESCA CARNEVALE: Axel. A post-T2S world: ultimately a huge benefit or an expensive exercise?

AXEL PIERRON: I’m a fan of consolidation, in a scale business it helps. Another question is: how far will consolidation go? That will really depend on other elements, we mentioned harmonisation and the reduction of some of the barriers, such as tax and fiscal issues. Depending on the ultimate level of harmonisation of harmonisation achieved in Europe, we could end up with a very, very consolidated market.

T2S IMPLEMENTATION: THE NEXT STEPS

TOM CASTELEYN: Generally, I believe the industry is on track. T2S software has been developed and testing seems to be going well. CSDs are preparing well, and it looks like the first wave in mid-2015 is all going in the right direction. Clearly, apart from the platform itself and the CSDs, you also need all the players to adapt to new circumstances. There are two things there. One is if you look at the list of DCP participants that have shown their intention to sign up, there are some names on there that you wouldn’t necessarily expect. T2S preparation goes well for the people in this room but it remains to be seen, market by market, how well, for instance, all the smaller Italian banks, because they are all on wave one, will be adapting to the new platform. The second point is whether everybody is going to go to Swift 20022 and how well
that adaptation goes. So, there may still be some questions out there as to whether everybody will really be ready.

RICHARD SCAVETTA: A welcome development is the National Bank of Belgium’s plans to introduce most of its T2S functionality in its system upgrade in the fourth quarter of 2014. That will give us six months of live period to test some of the functionality before the first migration wave in June 2015. Tom touched on a good point—the big players will be ready, certainly. So will the CSDs, by and large. I guess we should remember that some market participants still have the status quo option, which is to continue to leverage the services of an agent bank. Hopefully, that’s a strong enough fall-back plan.

JO VAN DE VELDE: Integration testing is easy. It is once you start to test with all the different CSDs, the participants, the central banks that it will become especially complex. Don’t forget there are 24 markets involved in T2S, with 24 central banks, 24 CSDs and so on. It is a big orchestra that needs careful conducting. That’s the connectivity issue. The other point I would like to make is that we should look at institutions such as Monte Titoli, which is in the first wave, as being very brave. I think people underestimate the complexity and nuance within T2S. Today’s market is straightforward: you have a CSD, you have the securities of that CSD, and you have the clients of that CSD and it is very much identifiable who is where and what sits where. If tomorrow you have investor CSDs, like Euroclear, Clearstream, and Monte Titoli, it can become quite messy. Where is my counterparty? You have securities sitting in different places. Eventually it will settle down; and in the end it might all happen in a much more systematic way than we think right now.

ALEX DOCKX: It will be a fairly busy year and a half. Wave one will be a crucial testing point. Most of the people around the table have been grizzled in battle over past consolidation exercises as well. From the market participants’ side, it will be wise to have a Plan B. That means that, as Alain mentioned, before you jump too far, you need to make sure that you can actually be in business on July 1st 2016. Consistency and resilience is at the forefront. There is something to be said for a phased approach, where you don’t go from zero to 100 hours in one go. Instead you get there gradually, which allows you to adapt to the way markets will inevitably change. That is a viable option for almost all users of CSD settlement services. It is not a viable option for the CSDs themselves because they are the market infrastructure.

The biggest CSDs have put in a lot of time and programming into it, some of the smaller CSDs haven’t even come up with their service descriptions, which is worrying for users. How will we adapt ourselves if we don’t know what the service will be. There is a great deal of clarity and information that is needed and a great deal of honesty about everyone’s state of readiness as well.

GRAHAM RAY: T2S isn’t about 2015; it is about wave one and a number of CSDs that are participating in the decision to be first movers. This is about a period of time that still has an extension to run following wave 1 and some CSDs will have to face up to their preparedness to migrate to T2S. The other point to make is that is very critical, if we are going to achieve the benefits of T2S, whether those benefits become tangible in a defined framework. It will be interesting to see whether participants decide to utilise T2S or the region for their own strategies going forward. We can all buy a car, which we could say was a platform, but I’m sure we’ll all drive it very differently and it’ll be interesting to see how the platform is actually utilised by the market participants as we move forward in a post-T2S landscape.

ERIC DE NEXON: What is important is the ability of the programme board to coordinate all the different players. This coordination will be centralised at the level of the ECB, but it also has to be centralised in each market. We have to consider the situation market by market. Self-reporting done by each market should be as transparent as possible. In God we trust but in the markets we may have some doubts from time to time, especially in some small markets. The reality is that some CSDs or markets could not be ready to migrate in time, and would have to consider postponing their migration in order not to put at risk the other participants in their wave. Moreover, the third wave is potentially problematic, because of timing issues. The fine detail has still to be finalised in that wave; but we have to ask difficult questions about the ability of some institutions to migrate to T2S in a defined timeframe.

ALAIN POCHET: In terms of risk when we had done the euro conversion in most of the markets, we had some very, very strong audits done for all participants. When migration to T2S is well underway, it will be better perhaps to replace audit capacity for the level of preparedness of all the CSDs and just a declaration. Actually, I am less anxious about the level of preparedness of the very, very big infrastructure, such as Belgium One or Luxor or Frankfurt One. But don’t forget that they are bringing more than 60% of the volume. If we have an issue of preparedness with a Second Tier or Third Tier market, it could be a problem but basically they can stay out for a further month and come back later on. If one of the big ones is not 100% prepared, then we have a big risk because they are coming with something like 60% of the volume.