1. Significant evolutions are expected in the post-trading market with the implementation of the CSDR and T2S

A political agreement was reached on the Central Securities Depository Regulation (CSDR) at the end of 2013. The last technical discussions at trilogue level have just been completed and the text is now scheduled to be considered in the plenary session of the Parliament mid-April 2014. The agreed regulation defines the role of the 30 or so CSDs which operate in the European Union (handling the settlement of securities trades and securities registration and safekeeping). It also provides harmonised settlement rules (such as an alignment of settlement cycles on T+2).

Under the CSDR agreement CSDs will face prudential and organizational requirements. A compromise was found among EU policy makers for some pending contentious elements. These include the conditions under which banking services ancillary to settlement may be provided by a CSD: higher capital charges will be imposed and supervisory cooperation will be mandated in authorizing and supervising such banking services. Settlement discipline measures which were another pending issue were also agreed. Participants who fail to deliver securities on the intended settlement date will be subject to penalties and will face mandatory "buy-in" requiring the assets to be bought back in the market at market price and then delivered to the non-defaulting counterpart. A certain degree of flexibility is however foreseen, tailored to the needs of SMEs and specific transactions such as repo agreements, as well as for cleared transactions.

The CSDR level II (regulatory and implementation) standards are due to be defined by ESMA by the end of 2014 and delegated acts will be prepared by the EU Commission[1] so that the regulation may be implemented in 2015. Challenging issues include the definition of appropriate settlement discipline standards and the timing of the implementation of these standards with respect to the schedule of TARGET2-Securities (T2S). Regarding T2S the issues are to avoid differences in rules across CSDs operating in the T2S environment and also to manage the timing between the availability of the CSDR standards and the operational launch of T2S.

The adoption of unified settlement rules with the CSDR should facilitate the implementation of T2S. The objective of T2S is to improve the cost effectiveness of cross-border settlement thanks to a centralization of DVP (Delivery-versus-Payment) settlement in central bank money aimed at facilitating the establishment of links between CSDs. The objective is to foster a reduction of cross-border settlement fees and of the liquidity needs (and related capital requirements) of market participants by a pooling of cash and collateral. The platform is due to be launched by the ECB between June 2015 and February 2017 in 4 successive waves of implementation. For T2S the current challenge is to maximize the volumes on the platform and to expand coverage of instruments / markets. For the moment there will be 24 CSDs and 18 Central Banks participating in the project. The main issue for market participants in the short term is determining how they will connect to T2S either directly (for either cash or securities or both: the so-called Directly Connected Participants or DCP) or indirectly (via a local CSD or intermediary participant), as well as whether they decide to become DCPs, for which markets and at what pace.

The implementation of T2S is expected to transform the environment of CSDs and custodians fostering greater competition. Competition is anticipated to increase between custodian banks on a cross-border and regional basis. There has also been discussion about the expansion of competition between CSDs and custodian banks. At this stage, one global custodian wishing to leverage collateral management and issuer services opportunities has launched a CSD. The main focus of regional / global custodians so far is on enhancing their T2S coverage and offering and on separating settlement services and asset servicing. Some CSDs are pursuing projects to diversify the services they provide in the custody area, in the perspective of the upcoming outsourcing of their settlement services to T2S.

The final outcome of these evolutions is however difficult to anticipate. Despite the positive effects greater competition might provide, some observers are concerned that such changes may trigger more fragmentation among service providers in the short term and potentially blur the delineation between market infrastructures and intermediaries and the scope of application of regulations. Others believe that the CSDR and T2S might not provide sufficient harmonization for cross-border settlement to develop significantly. Indeed, T2S has been focused on settlement harmonization, while the asset servicing areas continue to be highly fragmented on a national basis. Initiatives have however been launched to address the latter issue in the context of T2S (the T2S Corporate action sub-group to deal with corporate actions on flows) and under the aegis of the EBF and AFME (Corporate Action Joint Working Group to deal with corporate actions on stocks). Standards have been produced which are now awaiting implementation. The need for a common framework for securities (the project of an EU Securities Law Legislation) in order to tackle notably conflicts of law is also often cited in this context, however there are no proposals officially tabled so far by the EU Commission.

2. Defining an appropriate recovery and resolution framework for Financial Market Infrastructures (FMIs) is the main forthcoming challenge following the adoption of EMIR and the CSDR

CCPs will concentrate a large part of the risks related to derivatives transactions with the implementation of the clearing obligations of EMIR[2] by the end of 2014. BCBS and IOSCO indeed estimated in a recent impact study that the proportion of centrally cleared OTC derivative trades would rise from 28% to 53% over the coming

[1] The list of CSD ancillary services and the amount of settlement discipline fines will be handled by delegated acts for example.

[2] Derivative products eligible to the EU clearing mandate are currently being defined by ESMA.

years[3]. This will provide many benefits for the market, but also increase the risk of CCPs[4]. The failure of a CCP is a low probability risk but may have extremely high consequences for the market. EMIR already requires many risk mitigation measures[5], designed to ensure that CCPs can survive "extreme but plausible market conditions" and notably the default of the two largest clearing members to which a CCP has exposure. These measures are due to be completed by a recovery and resolution framework providing additional crisis prevention and management tools in order to address cases where the "ordinary" recovery tools required in EMIR have failed and where there is a need to restructure the CCP.

Following a consultation paper published in 2012 by the EU Commission on the recovery and resolution (R&R) of non-banks and proposals made at the global level by CPSS-IOSCO, the Commission is expected to publish a proposal for the R&R of CCPs by the end of 2014. The EU Parliament also adopted a self-initiative report covering the R&R of non-banks at the end of 2013.

In this perspective, several questions remain to be solved regarding CCP R&R: (i) the objective of such a framework (i.e. the extent to which the continuity of services should be ensured vs the benefit of organizing a fast liquidation of positions in some cases); (ii) how to allocate losses between defaulting, non defaulting members and potentially their customers or other investors; (iii) how to take into account the interdependence between a CCP and its clearing members many of which are likely to be GSIFIs (Global Systemically Important Financial Institutions) particularly if many banks choose indirect access to clearing services; (iv) the appropriate toolbox for allocating losses (i.e. cash calls, margin haircuts, tear-ups…) and the way to address different asset classes / market segments within a CCP.

Broader issues also need to be clarified in this context, including (i) the delineation between R&R procedures and ordinary risk management processes (e.g. CCP default waterfalls) as well as between recovery and resolution phases, (ii) the organization and the role of the resolution authorities at the EU and the domestic levels (i.e. whether there should be several authorities for a cross-border FMI or a single EU resolution authority) and (iii) the way to handle the R&R of a cross-border CCP operating in jurisdictions with different rules.

Although CCPs are considered to be the priority, the EU R&R framework is expected to also cover (I)CSDs, possibly in a second stage, due to their critical role in the functioning of EU financial markets. In addition to handling the settlement of securities trades and the safekeeping of securities, CSDs and the ICSDs are indeed expected to play an increasing role in the management of collateral (providing collateral optimization and transformation services) and many CSDs are expected in particular to expand, following the implementation of the CSDR and T2S into new commercial services and offerings some involving risk-taking, which some believe may increase their exposure to systemic risk.

A possible R&R framework for (I)CSDs should complement the CSDR provisions and take into account the specificities of CSDs and ICSDs. CSDs do not have default waterfalls at present, as they are currently not exposed to credit risk[6]. Many observers also point out that several R&R tools cited in the context of CCPs are not applicable to CSDs. These include cash calls and margin haircuts as well as loss allocation mechanisms[7], which may create incentives for CSD participants to become indirect. The specificities of (I)CSDs operating with a banking license and exposed to credit risk will also need to be further assessed. One issue is defining the R&R framework such entities should be subject to (i.e. the banking or the FMI framework or both, and to what extent these frameworks need to be coherent and could complement each other). Another issue is approaching their risks appropriately. Such FMIs indeed stress that the banking activities they perform (that are expected to expand with the implementation of T2S) are limited in their scope, comprising mainly custody services and intra-day credit operations which are normally fully collateralised. Some observers however suggest that distinctions should be made in the R&R framework and possibly capital requirements between core CSD services and ancillary banking services, the latter being exposed to some risk-taking (e.g. in the R&R tools and the way they should be used, depending on whether a defaulting participant is only a participant in core CSD services or also a user of the latter ancillary services).

3. The reporting of data on derivatives transactions to TRs launched in February 2014 needs to be closely monitored

The mandatory reporting in the EU of all on and off-exchange derivative trades to a Trade Repository (TR)[8] by all counterparties[9] in a derivative contract, as well as by the CCP used for clearing the trade, started on 12 February 2014. The objective of this reporting is to enable regulators to identify and analyse potential risks associated with derivative markets. TRs are commercial firms that centrally collect and maintain the records of derivatives contracts reported to them. Six TRs have so far been registered by ESMA in

[3] Source: FSB 2013, Fifth OTC derivatives progress report

[4] Four main benefits of central clearing were identified by B. Coeuré (ECB) in a recent speech (23 January 2014): improved margining and risk management methods; introduction of default and clearing funds in order to mutualise potential losses in a transparent and predictable way; multilateral netting of exposures requiring a reduced amount of collateral for a given level of risk protection; reduction of information asymmetries in the market place. The possible negative side effects of central clearing are also stressed in this speech: growth of risk concentration both nationally and internationally; internationalization of CCPs requiring effective due diligence; risk of crisis propagation owing to greater mutualisation and the greater risks in the event of a participant default which may spread to other participants; regulatory arbitrage and race to the bottom if the rules are not sufficiently consistent

[5] Including prudential requirements, disaster recovery planning and the implementation of a default waterfall and default fund

[6] At present CSDs only face operational and legal contingencies and the non-payment of fees

[7] Mechanisms allocating remaining losses to non-defaulting participants

[8] Lifecycle events such as give-ups or partial termnations also have to be reported. Valuation updates and collateral posted will also have to be reported.

[9] According to EMIR, any EU counterparty which has concluded a derivative contract is covered by the reporting obligation. The following counterparties will therefore have to report their trades to TRs: CCPs, clearing members, MiFID investment firms executing trades on a trading venue and other counterparties to derivative contracts. Clearing members and their clients need to report separately. Reporting of the details of the derivative contract may however be delegated to a firm capable of fulfilling the function e.g. dealer, exchange, CCP, service provider. In case of delegation the compliance responsibility however remains with the delegating firm. Reports have to be made on T or T+1.

the EU and others are expected in the future[10]. The registered TRs will be directly supervised by ESMA and cover all derivative asset classes: commodities, credit, foreign exchange, equity, interest rates and others.

Several issues will need to be closely monitored during the implementation of these TRs. The fragmentation of TRs and the reconciliation and aggregation complexity this may lead to is the main issue stressed. Several TRs located in different jurisdictions may indeed operate for the same asset class and counterparties have a free choice of the TRs they report their transactions to[11]. The FSB is currently evaluating the possible impact and feasibility of different models for aggregating this data, with different degrees of centralization. ESMA is also assessing ways to reconcile the data that will be reported in the EU by both counterparties involved in each trade. The on-going implementation of a system of Legal Entity Identifiers (LEI) should also help to identify the participants in trades. The magnitude of volumes that will be reported and the potential difficulty in keeping track of all the data has also been stressed (the basic information on each contract comprises up to 80 fields including counterparties involved, the product, the price, etc… although not all will be applicable to all reports). Another issue is that the rules have not yet been clearly defined for on-exchange products (ESMA asked for a delay in the implementation of the reporting of on-exchange derivatives which was refused by the EU Commission). The difficulty of aligning the reporting under EMIR with the one under MiFIR[12] has also been pointed out (given the fact that MiFIR implementation standards are not yet defined) as well as the differences between EMIR and Dodd Frank requirements (e.g. only one-sided reporting under Dodd Frank, real-time reporting under Dodd Frank…).

[10] The registration of these TRs means that they can be used by the counterparties to a derivatives transaction to fulfill their trade reporting obligations under EMIR.
[11] Complexity may however be reduced if market players choose to concentrate most of their reporting on one TR, which is what is what some observers expect.
[12] Derivatives traded on EU trading venues are covered by reporting rules under both EMIR and MiFIR. MiFIR covers the actual trading of derivatives, whereas EMIR is about post-trading arrangements.