

Upcoming priorities for EU securities post-trading

1. Progress made in the EU securities post-trading area

An industry representative considered that significant improvements have been made over the last few years in the post-trading environment thanks to the Central Securities Depositories (CSDR) and the European Market Infrastructure (EMIR) regulations. Considerable progress has also been made on TARGET2 Securities (T2S), which is expected to have significant efficiency and risk mitigation impacts. T2S should help to optimize the use of resources and should also be a continued catalyst for harmonisation, with further developments expected in the future. The industry has also shown a strong commitment to enhancing harmonisation in several post-trading areas, such as corporate actions. Continuing these efforts is essential, although they require tackling many details that are not visible to the wider public.

A Central Bank official noted that T+2 settlement could not have been achieved in Europe without T2S, for example. The industry could nevertheless make even more efficient use of the opportunities presented by T2S, the official felt, and should continue to collaborate with the public authorities on developing it further.

2. Main challenges and issues ahead in the EU post-trading area

2.1. Further harmonisation steps and needs

A Central Bank official stated that the upcoming introduction of the Eurosystem Collateral Management System (ECMS) would bring further harmonisation. ECMS is a joint approach supported by all national eurozone central banks that will foster harmonisation in the collateral management area'. Moreover, settlement discipline, which is part of CSDR, will also provide additional harmonisation incentives. If missing a delivery is expensive, institutions will seek to improve their processes and on the cross-border level, there will be a request to further harmonise procedures and practices.

An industry representative emphasized the need for more efficiency in risk, capital and liquidity management and also in collateral management, an issue which is being addressed by the Collateral Management Harmonisation Task Force (CMH TF): With the introduction of ECMS, collateral will only be accepted on T2S accounts, which is another way of driving further harmonisation. Delivering more operational efficiencies and progressing towards a European capital market however requires the lifting of the so-called Giovannini barriers, which have been updated by the European Post Trade Forum (EPTF). The speaker was hopeful that significant changes could be made in this regard in the coming 5 years. In the area of collateral management for example, it is necessary to be able to manage the possible default of a counterparty on a cross-border basis, which requires adequate securities and insolvency laws to be able to get access to the securities posted as collateral and liquidate them. National laws are unhelpful here, because there are significant differences between them. As harmonising them is too difficult, the solution could be to implement a new European securities law (as an additional 28th or 29th regime). Markets like choice, so it is likely that they will convert to this new option. Finally, withholding tax rules are also a significant hurdle to efficient collateral management. There are operational solutions for managing this with triparty agents not using the collateral when the process moves into corporate action dates, but this is a drain

on liquidity for banks, which requires a solution to be found at the legislative level.

A regulator believed that some of these obstacles on the public side could be overcome. For example, the issue around withholding tax has become a budgetary tax issue for certain tax fraud cases, which could make this a priority. However, the issues related to insolvency and securities law will take much more time to tackle, probably more than 5 years.

2.2. Possible outcome of the European Distribution of Debt Instruments (EDDI) initiative

The prospects of the Eurosystem EDDI initiative, which is currently in consultation, were also discussed. EDDI aims to support integration in the current issuance and initial distribution ecosystem of debt instruments in the EU by providing new choice of location of issuance.

An industry representative stressed the importance of offering choice and maintaining the efficiencies that have been obtained through T2S. It would be helpful to be able to access EDDI through a T2S connection rather than via several local CSDs.

A Central Bank official was still uncertain about what the Eurosystem will make of this project and mentioned that the responses to the EDDI consultation indicate at this stage that the market does not believe there is a need for EDDI. A regulator agreed that the goal of EDDI is still unclear.

Another industry representative felt that EDDI could be a route to further harmonisation in a similar way to T2S. As with many European projects, there are diverging views and controversy to begin with. EDDI might not be a top priority for Europe, but it might prove to be more interesting than expected in the context of further harmonisation and with the common currency. The speaker was moreover confident that the industry could help to drive these changes if progress is made on the public side notably in terms of legal harmonisation.

3. Possible evolutions needed in the post trading area to support the CMU

3.1. Higher post-trading efficiency in the whole of the EU

An industry representative stated that the CMU needs an efficient and safe post-trading. The implementation of CSDR and T2S have delivered a considerable degree of safety that often goes beyond the CPMI-IOSCO principles. These initiatives have also fostered progress in terms of efficiency that is however limited by insufficient legal harmonisation notably regarding the securities law.

A regulator stressed that a third aspect in the perspective of the CMU is the ability of the EU post-trading system to support the distribution of products and services in all EU markets, including in some areas which are not part of the Eurozone and have high growth potential. The goal of the CMU is to bring the benefits of the capital markets to investors throughout the EU and to ensure that all Europeans benefit from growth. Improvements in the post-trading sector should therefore not be limited to the Eurozone because growth in the future is more likely to come from periphery countries. Similarly, if efficiency gains are limited to the larger financial institutions where there is already scale, it will be impossible to build

scale in the smaller jurisdictions and thus to leverage the growth opportunities offered by developing non-Eurozone markets.

3.2. The prospects of further CSD consolidation in the EU

An industry representative emphasised the issue of fragmentation in the European post trading market. There is a multiplicity of CSDs, around 42 of them. Additionally, there is a lack of interoperability among these CSDs and insufficient competition between them. This creates issues for pan European service providers and for issuers and investors, who want to access a functioning pan-European capital market.

Another industry representative felt that the insufficient level of consolidation of CSDs is the main issue. The efforts made to date to lift barriers to cross-border post-trading processes in the EU with the EPTF and T2S, have focused on making cross-border settlement more efficient. The consolidation of CSDs, which is about creating economies of scale would be a step further. However, to make consolidation work and create synergies, it must be possible to build common processing platforms. This is hindered by differences in securities laws and also in the characteristics of domestic ecosystem, notably with variable levels of intermediation between issuers and investors. To integrate different EU markets, there must be a deeper level of harmonisation, and the industry has not yet reached this point. In addition, it is not always possible to legally consolidate CSDs, because many national authorities prefer to have a national CSD to service their domestic market. This can be seen in the framing of the CSDR, which some national authorities have taken advantage of to make CSDs even more local and undo some efforts made to develop efficiencies at cross-border level. The review of the CSDR, which should be launched in 2020, should be an opportunity to further assess the situation and determine a possible way forward.

A regulator explained that national supervisors prefer institutions to exist on a local level because they seek to keep control over local markets. If there is a greater level of consolidation or interoperability between infrastructures, supervisors will need to develop cooperation further. Progress towards more pan-European solutions seems inevitable though, in order to increase economies of scale and the competitiveness of the EU post-trading industry. However it is first necessary to realize all the benefits of T2S, which has not yet been achieved. The current level of cost for local CSDs is higher than it was before T2S. This is because the benefits of the cross-border elements have not yet been realised, as shown by the very low level of cross-border settlement currently observed under T2S. The reasons for this need to be understood. The regulator felt it would be very interesting to read the reports of settlement internalisers in the coming months to identify the share of cross-border volumes that is settled on the books of custodians vs what goes through the CSD, which may help to better evaluate where T2S stands in terms of bringing post-trade across national barriers.

Answering a question about the relative importance of competition vs consolidation for CSDs, the regulator suggested that this is not a binary choice. There can be a common post-trading infrastructure that connects with the trading venues and intermediaries that exist in the local markets, until there is more legal harmonisation. The regulator also highlighted the additional need to understand the competitive dynamics around infrastructure providers. In general, competition in financial services allows to increase choice and reduce costs but it is different for market infrastructures for which creating synergies seems preferable to having an excess of competition between CSDs. Eventually there will be more consolidation as we move forward, the regulator felt.

3.3. Improving the provision of supervisory data

A regulator stated that in the context of further interoperability among market infrastructures, the regulators of CSDs, trading venues and CCPs need to cooperate. This is extremely time-

consuming, and can be difficult due to a lack of adequate data. An industry representative agreed that sharing data between the industry and the public authorities is very important, but was surprised that the regulator was seeking more data, given the amount that regulators are already provided with. The regulator emphasised that they are not requesting more data from the industry. The challenge for them is to optimise the way that data is handled, moving away from a static assessment of data, which requires resource-intensive reporting systems, towards a set up that would allow regulators to have direct access to the books of financial firms. The US is discussing at present the idea of 'regulatory nodes' which would enable regulators to do this. Implementing this type of system however requires a different kind of expertise, and it will be a challenge for regulators to put this in place over the coming years.

4. Potential impact of new technologies in the post-trading area

4.1. Potential changes that can be expected from new technologies

A Central Bank official felt there is a significant potential for technology to change post trading, noting however that the industry is not yet ready to reap all these benefits. In Germany for example, the Deutsche Bundesbank and Deutsche Börse created two prototypes for the delivery versus payment (DVP) settlement of securities using two different types of blockchain technology. This trial suggests that blockchain is suitable for the purpose but not superior to existing systems. However, DLT is still in its infancy. The business case for blockchain looks promising if securities can be created and redeemed on the blockchain, including all other corporate events, rather than in the traditional book entry way. The further step would be to bring cash to the ledger in order to enable DVP on the blockchain; there have been some private and public sector initiatives to move in this direction. Ultimately it should be possible for post-trading infrastructures and T2S to use DLT.

An industry representative suggested that DLT is an area where it will be possible to raise synergies and that should play a major role in providing liquidity to the market. Implementing DLT in the collateral industry requires collateral tokenisation and delivery against delivery rather than delivery versus payment. DLT will also allow the post-trade industry to reengineer its operational processes and reduce its costs by removing duplications and low-value processes such as reconciliations. Another industry representative agreed that technology could have a significant benefit in post trade, although the implementation of new systems is often challenging. While blockchain is now operational, the industry is still establishing practical business cases for uses that may go beyond what is possible with current systems. In addition, it is necessary to ensure that risks can be appropriately controlled on blockchain-based platforms, which might require a review of regulation. The industry is also in the process of realising the benefits of robotic process automation (RPA) and better communication through application programming interfaces (APIs). Using RPA can substantially mitigate operational risk for example. APIs and social network-type infrastructures are also used to facilitate the communication between operators and customers and also among institutional investors, providing customers with direct access to their own data and the possibility to organise their own reporting.

4.2. Regulatory and supervisory implications of the use of technology in post-trading

A Central Bank official noted that the use of DLT and digital technology in general pose new regulatory challenges that need to be addressed in securities regulation. Europe has not been very successful so far in its attempts to regulate platforms. Regulations for participants or instruments are well established, but the platforms themselves 'escape' regulation. If the industry seeks to move DVP settlement to DLT platforms, there must be a specific approach to platform regulation. The way stock exchanges are regulated could

be a source of inspiration. The participants, instruments and the listing are regulated, but so is the exchange, including access of the trading parties and the permissible trades.

An industry representative felt that supervisors remain hesitant about DLT, which is understandable because they want to see it work in practice. In the US, there is already a parallel real-time system for treasury settlement based on DLT and which is currently used for reconciliation. This DLT platform is being used in combination with cloud, big data and machine learning. These technologies, as well as artificial intelligence, are also being used by the industry to improve the efficiency and resilience of existing processes. For example, a settlement fail-prediction service developed by the speaker's company provides early warning indicators to its clients, making it possible to identify in real time when parties behave in unexpected ways. Supervisors should encourage experimentation with new technologies and the parallel use of different technologies. While this is happening in some jurisdictions that are developing new legislation around technologies such as blockchain, others are attempting to squeeze new technologies into existing frameworks, which will not help. The industry representative added that bigtech or large fintech firms will increasingly play a 'quasi infrastructure' function in the market that may need to be regulated as such.

Another industry representative stressed that any changes in law touching post trade (e.g. possible changes regarding the securities law) should also address digital transformation that will develop in the post-trading area. Evolutions due to digitalisation also needs to be addressed in a consistent way in the EU. For example, it will be important to have a harmonised European law on crypto-assets, instead of many national ones.

A third industry representative suggested that some regulatory changes could be needed in relation with fintech. For example rights, obligations and reliefs may need to be adapted to new technologies. In addition, trusted third parties used in the context of digitalised processes, should not be allowed to escape regulation. Cyber-risk is also an important issue that should be tackled at the international level.

A regulator emphasized the intensity of the monitoring that the authorities are performing at the domestic, EU and international levels and which is essential for being able to react to the incredibly fast evolution of technologies. The issue around how to regulate DLT and fintech companies in particular is now high on the agendas of IOSCO and ESMA. ESMA published in February 2017 a report on the potential benefits and risks of DLT that is still valid. The FSB is also tracking developments in fintech and market structure. Ultimately, users of DLT will still need to comply with existing regulatory frameworks such as MiFID, EMIR and CSDR. At this stage, given that technologies are still evolving, ESMA considers it premature to make a specific regulatory response to the changes the technology could potentially lead to.

4.3. Technology neutrality

An industry representative noted that the traditional approach to regulation is technology-neutral, based on the principle that the same risk or activity should be subject to the same regulation. This activity-based approach to regulation is however not easy to apply in all cases. Taking the example of CSDs, it is clear that if a firm undertakes core CSD activities, it needs a CSDR licence. But CSDs also perform many other ancillary services, including

collateral management. This is operated under the CSDR licence, but collateral management is not intrinsically a regulated activity, which shows that some gaps may need closing.

A regulator felt that technology often changes how activities are performed rather than changing what is actually done, which is why regulation needs to be technology neutral and should not change for a given activity. However it is also important to consider disruptive shifts in technology which may fundamentally change certain processes. Regulators consider post-trade as a series of steps, which are then regulated, but technology may change the path of these steps or condense some of them into a single point. This is why regulation cannot be completely technology-agnostic. Even if it is claimed that MiFID and CSDR are technology neutral this will not always be true.

4.4. Possible regulatory approach to fintechs and crypto-assets

A regulator considered that regulatory matters should not only be discussed with incumbent companies but also with fintechs. The challenge however is that fintech entrepreneurs often ignore issues around financial regulation and in some cases eventually discover that their project is not in line with regulatory requirements. Regulators also need to adapt their approach to this change in mindset. This is why EU jurisdictions need sandboxes or 'financial innovation hubs' in order to better understand how to tackle these new developments.

A Central Bank official believed that when fintechs seek to scale, which is often the case, they need to address regulatory issues. Moreover, they realise that they need a licence of their own rather than continuing relying on a licensed partner. Another regulator agreed that sandboxes and hubs are necessary, but felt that they are not always the right answer. Such environments cannot be used for infrastructures for example that process very large volumes; they are more adapted for financial service providers or certain infrastructure processes, rather than the whole system. The regulator further suggested that the current approach to regulation in Europe may need adapting. Currently it is segregated by type of service provider, but technology may lead to changes in the post-trade value chains. It would be better to pause and reconsider this approach now, given the ongoing developments in the market, rather than having to do so further down the line when changes might be much more costly to make.

The first regulator also suggested focusing on the subject of crypto-assets. Tougher regulation would encourage participation in safer crypto-asset markets. At the request of the European Commission, ESMA issued in January 2019 a first advice about crypto-assets. Among other things, that advice clarified the existing EU rules applicable to crypto-assets that qualify as financial instruments (transferable securities or other types of MiFID financial instruments). This implied looking at how to qualify crypto-assets, i.e. analyzing when they should be considered as transferable securities. The advice also assessed whether there is a need for a bespoke regime for those crypto-assets that do not qualify as a MiFID financial instrument. Going forward, there will probably be a need for a bespoke regime for aspects relating to anti money laundering (AML) in particular and for appropriate disclosure requirements. ■

¹ The objective of this project is to merge the national central banks' existing 19 different national collateral management systems (CMS) into a single collateral management system covering the entire Eurosystem.

² The Collateral Management Harmonisation Task Force (CMH-TF) formulates and monitors the implementation of a single rulebook for collateral management, custody/corporate actions and other asset servicing processes. The work done by the CMH-TF includes the development of harmonisation standards for triparty and bilateral collateral management, corporate actions (on stock), billing processes and other collateral management processes. Thus the CMH-TF supports the work of the AMI-SeCo (Advisory Group on Market Infrastructures for Securities and Collateral), the aim of which is to facilitate an active dialogue with market participants on issues related to the clearing and settlement of securities and to collateral management, as part of the governance framework of the T2S initiative. The CMH-TF is composed of representatives from market infrastructures, custodians, market participants and Eurosystem national Central Banks.