

POST-TRADING PRIORITIES



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Post trading efficiency: halfway through the journey

Europe is still enduring the Covid crisis, which called for exceptional measures in order to cushion its potentially devastating effects on the economy. Contrary to the 2008 financial crisis, not only the ECB reacted vigorously but also both the EU and its Member States. This testing crisis is therefore a unique opportunity to pave the way for further European integration. After emergency measures in 2020, Europe must now build a solid economic union for which a genuine Capital Markets Union (CMU) is a key enabler.

The second CMU action plan published by the Commission in September 2020 was an important step to operationalise progress on issues identified as priorities over the last few years, some of which relate to post-trading and to more fluid capital flows across the EU. Despite significant progress made through the European Post Trade Forum, fragmentation along national borders remains. The need for concrete actions and an active monitoring of their implementation is still acute.

To that end, the Eurosystem has stepped up its contribution in the field of collateral harmonisation. The Eurosystem Collateral Management System (ECMS) project is on track, and will help improve circulation of cash, securities and collateral across Europe as from end 2023 onwards; it will be complemented with the implementation of the Single Collateral Management Rulebook. Nevertheless, a long journey remains ahead of us before achieving full harmonisation, as barriers still exist on accounts of structural constraints and market practices, especially in areas such as tax. Tax processes have been identified as one of the top ten priorities by the Eurosystem AMI-SeCo[1], which could eventually lead to the elaboration of new market standards.

As regards securities settlement, the first review of the Regulation on improving securities settlement in the EU and on central securities depositories (CSDR) will be a cornerstone to support the CMU objectives related to cross-border market integration. Although still under discussion, CSDR Refit is expected to ease passporting. A single supervision would also help remove potential unnecessary barriers.

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A single supervision does not call for a single supervisor though: national authorities remain indeed vital contributors to effective and efficient European supervisory mechanisms grounded in a deep understanding and close monitoring of markets. A legislative proposal by early 2022 would be welcome, all the more since the review of two fundamental directives, namely the Settlement Finality Directive (SFD) and the Financial Collateral Directive (FCD), closely interplays with CSDR Refit.

In particular, reshuffling the SFD appears necessary in order to update it along recent market and regulatory changes, for instance regarding the extension of participation to payment systems.

The Commission's proposal for a Regulation on a Pilot Regime is also welcome. It will help grasp which requirements of the current regulation will need to be adjusted and how, to safely support technological innovation. In the meantime, it will provide legal certainty for market players to operate a DLT market infrastructure, on an experimental basis, with alleviated regulatory requirements compared with historical players. The pilot regime will also be the opportunity to measure industry's appetite for DLT in general, and for different technologies and segments in particular.

In a fast-moving technological environment, settlement in central bank money remains a critical principle: it avoids introducing counterparty or liquidity risk, and helps contain market fragmentation. If sound guiding principles are forgotten in the frenzy for new technologies, regression rather than progress can be feared in the end. Central banks support technological innovation in a market-neutral way. They can also have a direct role to play: the Banque de France has successfully performed experiments on a central bank digital currency in 2020 and 2021, focused notably on the different ways to "put central bank money on the ledger" for securities settlement[2]. The Eurosystem recently decided to launch the investigation phase of a digital euro project[3]. As technological innovations are dawning on a still fragmented post-trading landscape, it is of utmost importance that all stakeholders strive for market integration.

[1] Advisory Group on Market Infrastructures for Securities and Collateral. See <https://www.ecb.europa.eu/paym/integration/collateral/html/index.en.html>

[2] As an example: <https://www.banque-france.fr/en/communique-de-presse/banque-de-france-conducts-new-central-bank-digital-currency-experiment>

[3] <https://www.ecb.europa.eu/press/pr/date/2021/html/ecb.pr210714~d99198ea23.en.html>



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Advancing post-trade services

A well-functioning financial market is essential for the European economy. Since the introduction of the euro, substantive progress towards financial integration has been achieved. TARGET Services have been crucial in standardising the settlement of payments and securities, with essential harmonisation achieved through the T2S project and the Regulation on securities settlement and central securities depositories (CSDR), which provides the legal framework for CSDs operating securities settlement systems across the EU. Nonetheless, national non-harmonised solutions still prevail in parts of the financial market such as the issuance and distribution of debt, and for collateral management-related processes. In this article I will look at how the ECB helps drive forward further financial integration.

One of the basic tasks of the Eurosystem is to ensure the smooth functioning of payment systems. As operator we run three TARGET settlement services – TARGET2, T2S and TIPS – and, as of November 2023, a new service is scheduled to go live, namely the Eurosystem Collateral Management

System (ECMS). The service will ensure that a single system based on harmonised procedures and processes will allow counterparties and the Eurosystem to better manage the assets used as collateral in Eurosystem credit operations for all euro area countries. The ECMS will remove the current fragmentation and ensure a level playing field for Eurosystem counterparties.

Coinciding with the ECMS project, the financial industry asked the Eurosystem to initiate work on a Single Collateral Management Rulebook for Europe (SCoRE) including the United Kingdom and Switzerland. The Advisory Group on Market Infrastructures for Securities and Collateral (AMI-SeCO) has led the work which, together with the ECMS project, has brought about substantial harmonisation in the field of collateral management processes. So far, harmonisation standards have been agreed in the areas of billing, corporate action handling and triparty services, establishing a single triparty model for Europe. SCoRE will increase efficiency, lower costs and risks and increase interoperability and reach across Europe. Agreed SCoRE standards are now being implemented and compliance is monitored. For more see our interactive map.

The ECB will continue to work for deeper integration of financial markets in Europe.

Despite the extensive progress, fragmentation is still visible in the area of issuance and initial distribution of debt securities in Europe. Access to capital is subject to legacy standards, conditions and market practices at national level. As a result, issuers are unable to reach European investors in a neutral and standardised way. To address this problem, a market consultation was launched in July 2019. The consultation resulted in the set-up of a market contact group with industry professionals involved in euro area primary debt markets. The group's objective is to: 1) identify issues that prevent further improvements in efficiency and integration; and 2) investigate how these issues may be addressed. Work is progressing well, and the group is scheduled to publish its report in autumn 2021.

As mentioned, the post-trade market has advanced extensively over the past decade. However, with a dynamic market that is continuously evolving, there

is a need to assess if adjustments are required and the ongoing review of the CSDR launched by the EU Commission in June 2020 offers an opportunity to consider potential adjustments. The Commission recently published a report which identifies areas where further action may be required in order to achieve the objectives of the CSDR in a more effective and efficient manner.

The European System of Central Banks (ESCB) has made several proposals for the review based on the experience gained by central banks acting as relevant authorities under the CSDR. More specifically, the ESCB proposed that the cooperation among authorities is enhanced, for example through establishing cooperative arrangements, in particular for CSDs belonging to the same capital group, that are of substantial importance for other Member States or which outsource core services to other CSDs.

As concerns the provision of banking services, the current rules may impede the expansion of settlement activity in foreign currencies for CSDs without a banking licence. A review of the current threshold under which cash settlement can be conducted via credit institutions could therefore be considered, provided that any increase is accompanied by adequate risk-mitigating requirements.

In its area of direct responsibility, the ECB will continue to work for deeper integration of financial markets in Europe and support various initiatives in the areas of payments, securities settlement and collateral management.



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Post-trade harmonisation: status quo and looking beyond

The efficient functioning and resilience of securities markets as an integral part of the financial system is of utmost importance to the EU economy. Harmonising the legal and regulatory framework across Member States as well as avoiding fragmentation on the technical side play a key role in achieving the goal of a truly integrated EU capital market. While much welcome progress has been achieved in recent years, complex issues remain – especially for the Member States. However, tearing down existing barriers is only one side of the coin. The other is not to erect new ones when it comes to challenges such as Distributed Ledger Technology (DLT) and green finance.

Looking back, we can state that, on the regulatory side, the CSDR contributed considerably to shaping European securities markets and enhancing their efficiency and safety. Another cornerstone, the Shareholder Rights Directive II, will add to this. Retail investors, who can now exercise their shareholder rights across borders, will also feel its impact. The ongoing CSDR review is likely to clarify and simplify rules for CSD passporting and further intensify competition in the European post-trading sector.

On the infrastructural side, the Eurosystem platform TARGET2-Securities for

the centralised settlement of securities in central bank money drove harmonisation in the past. The Eurosystem's "Vision 2020" projects aim at further safeguarding and deepening the integration of EU financial markets. In this regard, collateral management plays a crucial role as it contributes to the stability and integrity of the financial markets. With the Eurosystem Collateral Management System (ECMS) as one of these projects, the Eurosystem is set to replace the existing 19 different national collateral management systems with a single one for the entire Eurosystem. Of course, such an undertaking goes hand in hand with harmonising underlying processes and national procedures. Thus, ECMS and the related work on the standards of the Single Collateral Management Rulebook for Europe are key for pushing further ahead with harmonisation.

This work covers not only processes, workflows and messages on the NCB side, but diverse market practices. The first step is to harmonise the processing of corporate actions and billing based on ISO 20022 formats and enable a single triparty collateral management model. Further areas of harmonisation will follow. This should benefit not only the Eurosystem, but the whole EU securities market, inter alia by further facilitating cross-CSD market activity.

Further promoting CMU requires harmonising the existing and timely setting standards for the future.

Despite the progress already made, some challenges still stand in the way of a fully harmonised and integrated EU capital market. Some of these are the result of new developments and external factors, others stem from the EU's set-up. Unlike the US, the EU is a political and economic union made up of independent Member States. Diverging national withholding tax procedures as well as varied securities and insolvency laws are still serious obstacles to cross-border investments. However, the EU has limited competence in these fields as they chiefly fall under the responsibility of the Member States, and harmonisation proves to be complex.

The Commission's plan to propose a common EU-wide system for withholding tax relief and to foster convergence of national insolvency laws with an initiative for minimum harmonisation will be important elements for dismantling

these barriers. Yet its success will hinge on the willingness of and a strong commitment from the Member States.

Looking to the not too distant future, regulating DLT and encouraging green finance in a harmonised way will help reap their benefits. The Commission made the first steps with a proposal for a pilot regime for market infrastructures based on DLT, providing also new opportunities for smaller-sized issuers, and the Markets in Crypto-assets Regulation on the one hand, and the EU Taxonomy and the European Green Bonds Regulation on the other. Directly applicable regulations instead of directives are the right way to guarantee a level playing field. However, besides the regulatory framework, it is now also important to prevent technological barriers, especially when it comes to DLT.

Standardisation and interoperability on a technical level will be crucial to avoid fragmentation driven by different technologies. Integrated capital markets require both the harmonisation of existing frameworks and keeping pace with new developments and technological progress to set standards right from the beginning.



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The post-trading sector: turning challenges into opportunities

Since the launch of the first Capital Markets Union (CMU) action plan by the European Commission (EC) in 2015, significant progress has been made in implementing several of the plan's building blocks to support an integrated, safe and efficient EU capital market. A key role has been played by actions targeting the financial market infrastructures (FMIs), including central securities depositories (CSDs). The implementation of the CSD Regulation (CSDR) has ensured the harmonization of regulatory and supervisory requirements across the EU. From an operational perspective, T2S provides significant support for the integration of securities settlement in central bank money. During the recent COVID crisis, CSDs services have proved to be resilient.

Nevertheless, the post-trading landscape in the EU is still characterized by some national features. The EC is aware of this and has identified the main outstanding issues. A targeted revision of the CSDR will play a key role. Among other things, it will include easier access to the CSD passport in the EU and improved

supervisory convergence. Further initiatives include revisions of the Settlement Finality Directive and of the Financial Collateral Directive to ensure their effectiveness and consistency across legislative frameworks.

Looking ahead, another major challenge facing the post-trading sector is innovation in technologies and business models. Distributed ledger technologies (DLTs) have the potential to profoundly change the business of post-trading and further enhance the efficiency and integration of EU capital markets. In this respect, the CMU and the EC's digital finance strategy, including a proposed Pilot Regime, are mutually reinforcing.

New technologies have already made inroads into the financial system and the time is ripe to ensure that the post-trading sector can take advantage of the new opportunities. The focus should be on a few key issues, namely (i) whether there are barriers limiting the adoption of technological innovation by CSDs, (ii) what would be the impact on risks if they were removed, and (iii) what measures could be taken to preserve the resilience and stability of the financial system. Nor can it be overlooked that new technologies themselves face considerable challenges. Infrastructures based on new models will have to enter markets served by incumbents, be competitive in their offerings to customers and interact with counterparts whose services and systems are based on traditional technologies.

A major challenge facing the post-trading sector is innovation in technologies and business models.

The proposed Pilot Regime establishes the approach to start addressing these points. The Pilot's intrinsic logic is to allow temporary exemptions from existing requirements to facilitate the uptake of new technologies by both CSDs and multilateral trading facilities (MTFs). In doing so, it will make it possible to introduce highly innovative aspects into the traditional value chain of a financial transaction. These aspects include the possible concentration of trading and post-trading services within a single DLT market infrastructure, the potential disintermediation of access to MTFs and CSDs, and the use of so-called 'settlement coins', including e-money tokens (as defined in MiCAR).

Exemption from certain requirements should be counterbalanced with imposing additional conditions on the infrastructure to continue to properly protect against the relevant risks. For regulators and supervisors, the licensing of new initiatives and their ongoing monitoring will be two key tools to allow market infrastructures to exploit the potential of the new technologies while ensuring a level playing field and their safety and resilience.

Moreover, while the Pilot allows different cash assets to be used for securities settlement, which solution will gain traction among DLT infrastructures? For a central bank, it is crucial that the settlement of securities and cash remain safe and efficient. In performing their roles, central banks may contribute to finding solutions supporting resilience in the new context.

Preparing Europe for the digital era is not something accomplished from scratch. EU-wide projects may be supported by complementary initiatives at national level. As an example, in Italy a regulatory sandbox was recently introduced to encourage experimentation with digital technologies in the financial sector. This initiative, undertaken with the support and close involvement of all the relevant Italian authorities, including Banca d'Italia, has the twofold objective of allowing experimentation while preventing and limiting the potential spread of risks.

As with any challenging objective, the construction of a truly integrated post-trading market at European level requires the collaboration of all the actors involved.



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Reforming post-trade in Europe – an activist and co-ordinated approach

In July 2021, the European Central Bank published a fascinating book giving an overview of post-trade market infrastructure developments over the past twenty years.

The book conveys two powerful images. One is of Alberto Giovannini, while preparing the reports of the Giovannini Group, carefully deciding whether a specific post-trade barrier should be eliminated in two years, or in two years and three months.

The other is of the comparison, subsequently made by Alberto Giovannini, between work on post-trade barriers, and the construction of the metro in Rome. As soon as you dig and make progress, you make new archeological discoveries and have to stop digging.

The first image tells us very clearly that work on post-trade issues requires both an activist and a co-ordinated approach.

The second image tells us that for an approach to succeed it has to deal with the fundamentals of a problem, and not just the surface layers.

In the twenty years since the first Giovannini report identified 15 barriers to cross-border clearing and settlement in Europe, we have seen some significant progress, but the core problem of unharmonised post-trade processes in Europe remains.

We need an activist, indeed voluntarist, approach because there are many factors – difficulties inherent in trying to modify complex and arcane national fiscal and legal rules – that drive us to passivity.

We need a co-ordinated approach because post-trade processes have three dimensions, fiscal, legal and operational, and changing the rules in one dimension creates risks, as well as the potential for synergies, in the other dimensions.

The European Commission's Capital Markets Union Action Plan includes three major actions relating to post-trade – Action 10 (on withholding tax), Action 12 (on shareholder rights), and Action 13 (on CSDs).

These Actions all have a common feature, in trying to strengthen the custody chain – ensuring that end investors are taxed at the right rate, ensuring that end investors have the ability to exercise the rights associated with ownership of securities, and improving the supervision of cross-border custody chains involving CSDs.

The core problem of unharmonised post-trade processes in Europe remains.

Successful delivery of these Actions will require alignment between fiscal, legal and operational processes, and, in particular, common definitions so as to ensure that the answers to the questions of which entity is entitled to receive the proceeds from a corporate action, which entity should be taxed on those proceeds, which entity should be entitled to vote, and which entity should be identified as the legal owner, are, or can be, the same.

In today's world, a lack of alignment between these processes, and different answers to these questions, have concrete operational impacts. They create cost and risk, and they lead, for example, to investors being incorrectly debited for withholding tax, and to rejected voting instructions.

One very positive outcome of the work on the Giovannini barriers is that

Europe has developed world-leading sets of market standards that describe how the end-to-end communication and processing in the custody chain between issuers and investors should take place.

In short, we know how the operational processes should work, and thanks to the work of many stakeholders, including industry associations and the European Central Bank, we have in some areas taken significant steps towards implementing these processes. The key outstanding gaps relate largely to fiscal and legal rules and requirements.

Delivering improved fiscal and legal processes should be based on three core insights.

The first is that the ambition set out in Action 10 of the CMU Action Plan for a common, standardised, EU-wide system for withholding tax relief at source should be based on the OECD's TRACE framework. This is because TRACE has a structure that increases the integrity of the custody chain, while minimising redundant transfers of data and documents, and requirements to maintain duplicative information at different points in the custody chain.

The second is that the introduction of an EU-wide, harmonised definition of 'shareholder' as end investor is a necessary part of Action 12 of the CMU Action Plan. Differences in definition, and any definition in which a party other than the end investor is treated as the legal owner of securities, necessitate complex and idiosyncratic work-arounds to try and ensure that an end investor can exercise the rights associated with its holdings.

The third is that the SRD2 mechanism for shareholder identification – currently handicapped by different national definitions of shareholder – has the potential to be a powerful tool for delivering increased transparency throughout the custody chain for the benefit of fiscal, legal and operational processes.

A famous 19th century journalist once wrote that the tradition of all dead generations weighs like a nightmare on the brains of the living.

Let us take action to reduce this weight.



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CSDR review – A value-add for CMU?

CSDs have worked intensively over the last years to meet the highest possible standards prescribed in the CSD Regulation (“CSDR”) and to adapt to harmonisation efforts linked to T2S, or in the context of ECMS. CSDR is also making CSDs more competitive. For example, it gives issuers choice of which CSD to use for their securities issuance.

How then to deal with the upcoming CSDR review? CSDR is still relatively new, and, an important piece – the Settlement Discipline Regime – is yet to be implemented.

We believe the CSDR policy objectives in terms of financial stability and resilience have largely been achieved. This has been confirmed by the resilience CSDs have demonstrated in the COVID-19 crisis. The financial stability aspects of CSDR need to be protected in any CSDR review.

Yet, the ambition the EU has in frame of its single market objectives - to have greater competition and market integration within the EU - is only partially realised for the moment. Further efforts are needed to address some of the more politically difficult areas of harmonisation as highlighted in the CMU Action Plan. And some targeted changes to CSDR seem warranted.

A detailed and full legislative review of CSDR would come too soon and in our view would need to be conducted in the

context of a more fundamental analysis on how the whole securities value chain (trading, clearing and settlement) is evolving following introduction of MiFID, EMIR and CSDR.

For a targeted CSDR review, we see three main priorities. First, to focus on targeted corrections, simplifications or clarifications where there is a disproportionate burden or even potentially new barriers which impact the CSDs’ and EU’s competitiveness. Three examples: the CSDR passporting requirements, the Review and Evaluation process and the Mandatory Buy-In Regime:

- While CSDR has harmonised the conditions for conducting CSD business, amongst others with a view to opening up for competition, the CSDR passporting requirements have - unfortunately and unintentionally - made it more complex, costly and long to accept foreign securities compared to the process before CSDR.
- The Review and Evaluation process: This is a yearly process by which National Competent Authorities (NCA) need to review and evaluate any significant changes which have been made since the initial CSDR filing or the previous Review and Evaluation. We have noted that this process gives rise to different approaches and expectations amongst NCAs, hence creating an important recurrent cost for both CSDs and NCAs as well as unequal level playing field amongst CSDs.
- For the Mandatory Buy-in Regime, there significant market concerns related to impact of the implementation of the regime. While included in CSDR, the effect of this regime will be felt on EU27 capital markets, not only at the post-trade infrastructure layer. We therefore welcome the Commission’s and ESMA’s openness to look for a suitable solution to the challenges posed by those CSDR rules. We need an urgent steer on the way forward.

Second, we would welcome more supervisory convergence in the practical implementation of CSDR. Settlement and safekeeping of securities remain to a large extent domestic industries, and therefore a homogeneous application and supervision of the new regime is a precondition to the development of cross-border services; services that are efficient and truly competitive (both within the EU and globally).

Third, we believe that clarifications to CSDR are needed to ensure CSDs can use DLT to settle crypto-assets within the existing regulatory framework. CSDs could service crypto-assets considered as MiFID financial instruments by

using a permissioned DLT platform with a centralised validation model. Although we believe that there would be no immediate need for level 1 changes in CSDR, certain clarifications seem required to provide legal certainty to the industry and drive market adoption. We are happy to see that the recent ESMA report supports this point. The Pilot Regime for DLT Market Infrastructures that is currently under negotiation between Council and Parliament is a welcome additional route to innovation. We hope that the negotiators on this file will stick to the principle of “same activity, same risk, same rules”.

A targeted review of CSDR will benefit the CMU and the EU competitiveness.

A targeted review of CSDR will benefit the CMU and the EU competitiveness as it should remove unintended and detrimental consequences from the CSDR implementation on capital markets, thereby removing rather than creating barriers. At the same time, clarifications to CSDR to make it “fit for digital” which will allow CSDs to provide a safe infrastructure layer for crypto-assets.