

# POST-TRADING: PROGRESS MADE AND PRIORITIES FOR SUPPORTING THE CMU

## 1. Progress made in the post-trading area in terms of efficiency and integration

### 1.1 State of play and main achievements

A Central Bank official stated that 'the glass is neither completely full nor completely empty' with regard to post trading. Much progress has been made with the Central Securities Depositories Regulation (CSDR) and TARGET2 Securities (T2S). 10 years ago, it would have seemed unbelievable that 10 of the 15 original Giovannini barriers would be solved with a settlement efficiency of 94%, including overnight settlement. However, post trading is similar to 'a jigsaw'. There are many pieces to assemble to achieve sufficient harmonisation and integration and it will be challenging to put together the remaining 20 or 25 pieces. In addition, there is still a low level of cross border settlement in the EU. Only 13% of T2S transactions are cross CSD, although certain CSDs provide cross border services which are not included within this statistic.

A second Central Bank official agreed that both T2S and CSDR have contributed substantially to integrating securities settlement across Europe. T2S harmonisation was promoted by the Eurosystem, but the fact that it was embraced by the market has made the difference. A considerable amount has been achieved since its launch, particularly in the areas of messaging, operating hours and settlement finality. There has also been progress on corporate actions, even if the issue is not entirely solved. Prior to the implementation of T2S, market practice varied widely across Europe. The obstacles to achieving integration and the smooth functioning of financial markets were well known, having been identified by the Giovannini group and several reports by the European Commission, but little progress had been made. The fact that the drive for harmonisation was channelled into a single securities platform and a concrete settlement solution with T2S, has enabled the realisation of tangible benefits for all actors in the market. In other words, T2S provided a concrete action plan to address the harmonisation challenges in the market and to advance integration.

A third Central Bank official concurred that there have been achievements both in terms of the harmonisation of rules and operational integration with T2S and CSDR, which are complementary and mutually reinforcing initiatives. There have been several key achievements in relation to harmonisation. First, the common authorisation process means that CSDs are subject to a single set of safeguards at EU level. Furthermore, CSDR introduced a framework for increased cooperation between the authorities concerned. Each authorisation process is managed by a national competent authority (NCA) with the close involvement of other relevant authorities, including the central bank of issue (CBI). This introduces a horizontal perspective on the common points of

attention in the process which has fostered more convergence among the authorities. Secondly, T2S has been a key driver of regulatory harmonisation because it supported the introduction of a single regulatory framework at EU level, the CSDR, which replaced national settlement regimes. The progress made is attested by the performance of post trading during the COVID crisis and demonstrates that Europe is moving in the right direction in this area.

An industry speaker agreed with the remarks made by the previous panellists on achievements in the post-trading space and emphasised the resilience and seamless performance demonstrated by Central Securities Depositories (CSDs) during the pandemic. While there are still obstacles to cross-border settlement, a considerable degree of resilience has been built into the system. However, there are differences between equity and fixed income markets. For fixed income, there has been more and easier integration than for equity. In respect of bonds, the European Commission has started Next Generation EU (NGEU) issuance. €45 billion was issued seamlessly and there were no problems raising the money, indicating that the settlement system is working correctly.

Another industry representative also highlighted the differences between the wholesale and retail markets in terms of cross-border integration within the EU. In the wholesale market, there has been substantial progress in terms of cross border trade. A key example is the repo market. During the COVID crisis, there was a large amount of cross border activity and the migration of the euro repo market from LCH Ltd to LCH SA is also positive. However, in the retail market there has been practically no improvement, with no cross border activity happening within the EU. The only significant cross-border trading at present happens with the US. This is due in part to the excessive cost of cross border post trade within Europe, which is a major inefficiency. Improving the situation does not seem to be part of the objectives of European regulators, although a focus has been put in the Capital Markets Union (CMU) action plan on the growth of retail investment. The EU has a very efficient market infrastructure, but it is mainly functioning on a domestic basis at present. Hopefully, the ongoing consolidation of European stock exchanges around Euronext will contribute to a further integration of post trading.

### 1.2 Pending issues and obstacles to integration

A Central Bank official agreed with previous speakers that, despite significant efforts and initiatives from all stakeholders in terms of regulation, supervision and operations, the level of cross border settlements remains quite low in Europe. This means that there are further improvements to make on the harmonisation of settlement services and rules, and that significant barriers remain to be tackled. A second Central Bank official was not pessimistic. Only around 10% of the T2S harmonisation agenda remains to be fulfilled, which

means that work remains to be done, but these are very complex issues which will take time to address, and have been slowed down by COVID. Progress is being made in different areas. One is currencies. The Danish krone has been integrated into T2S alongside the euro, and other currencies will potentially also soon be available. The further integration of CSDs is a second area where progress is underway. There is some integration of CSDs at the EU level, the interaction between international CSDs (ICSDs) and CSDs settling in T2S is likely to improve and the Finnish market will also soon join T2S. However, futureproofing should be a key consideration in the post-trading area, because it is important to determine regularly whether the right priorities are being pursued. It could take more than five years to address insolvency law fragmentation, for example, which is heavily rooted in national laws.

A third Central Bank official acknowledged that harmonisation is not an 'easy effort'. The T2S harmonisation process started many years ago and is still not finished. The European Central Bank (ECB) published its 11th progress report in January, which recorded 90% compliance with the T2S harmonisation standards, meaning that 10% is still outstanding, as mentioned by a previous speaker. However, the degree of progress has slowed down over the last few years, which is natural because the outstanding elements are necessarily the 'stickiest issues'. There remains work to do on corporate actions in particular, but much has already been achieved.

An industry speaker was less optimistic, however. Using the metaphor of the glass of water, the glass is 'slightly half empty' in the speaker's view due to the amount of work still outstanding, especially in respect of the continuing fiscal and legal barriers. From an external perspective, there are still 27 different markets in Europe and it is essential that work continues on further integrating post-trading in the EU. The discussion started with the work of the Giovannini Group in 1996 and their report in 2001. Some of the Giovanni barriers are still relevant today, such as barrier 3 on corporate actions and barrier 11 on domestic withholding tax regulations. CMU could provide the political momentum needed to tackle these issues, because the CMU will not exist if there are 27 different approaches to insolvency law or processing withholding tax, which disadvantages foreign intermediaries in particular. The CMU action plan, which introduces tangible actions, such as action 10 on withholding tax or action 12 on shareholder rights is an opportunity to overcome some of the key legal and fiscal barriers which hinder cross-border capital markets in the EU. It is essential to push the agenda forward here and pass the necessary legislation. The progress made over the last 20 years in the trading space, in areas such as trade execution and execution modes, thanks to MiFID I and MiFID II proves that this should be feasible.

A second industry speaker noted that the post trade space has been discussing 'barriers' for the last 20 years, but this is too strong a word for what remains to be done, which is closer to tackling frictions or inefficiencies. This constant reference to barriers tends to discredit the progress that has been made over the years, which is significant. There are inefficiencies which create extra costs, but it is still possible to conduct post-trading activities on a cross-border basis. Withholding tax procedures is a topic that has been discussed for a very long time. Hopefully digitalisation can help to solve this issue, making the process more efficient even without broad harmonisation, if national tax authorities progressively digitalise their processes. Additionally, it is surprising that securities law harmonisation does not feature in the CMU action plan as it is a major element of friction at the cross-border level.

A third industry representative noted that there is no harmonisation of insolvency law and of the legal status of bonds and shares in the wholesale market. In the retail market, there is also no fiscal harmonisation and there are some specificities in different markets that create fragmentation. France, for example, has the Service de Règlement Différé (SRD), which is part of a Euronext specificity called the Règlement Mensuel. The SRD allows clients to purchase shares on credit and pay at the end of the month, which is very efficient. This is only one of many specificities demonstrating the fragmentation that exists in post trade. The fact that such barriers have been discussed for many years possibly indicates that achieving full harmonisation in these areas may be 'wishful thinking', however it is essential to address the retail cross-border market as a priority in any future post-trading initiatives in order to increase retail participation in capital markets.

## 2. Ongoing policy initiatives and additional actions needed

### 2.1 Ongoing Eurosystem initiatives

A Central Bank official emphasized that a substantial amount of work has been achieved around TARGET Services<sup>1</sup>, even if some pending issues remain. The ECB is continuing its efforts in this area, working on a consolidation of TARGET Services and the introduction of a new Eurosystem Collateral Management System (ECMS), which will facilitate even more efficient, harmonised and widespread use of central bank money settlement in euros. TARGET Services consolidation, which is scheduled for November 2022, will bring an enhanced set of tools, a consolidated view of balances and holdings for market participants and higher overall efficiency in euro liquidity management across wholesale services on the TARGET side, as well as securities settlement in T2S and instant payments. Like T2S, ECMS will advance harmonisation, making collateral management more efficient for counterparties who participate in ECB

1. TARGET Services are a set of services developed and operated by the Eurosystem which ensure the free flow of cash, securities and collateral across Europe. These financial market infrastructure services include: TARGET2 for settling payments; T2S for settling securities; TIPS, which is a service for instant payments; and ECMS, which is a service for collateral management. All of the services settle in central bank money. The Eurosystem also engages in a number of initiatives which aim to promote efficiency and innovation and ultimately achieve greater integration in financial markets in Europe. In line with this strategy, the Eurosystem is investigating ways to enhance its financial market infrastructure to continue to meet the needs of the market, to stay ahead of cybersecurity challenges and to keep up with the latest technological developments.

credit operations. Debt issuance and distribution is a further important topic for the ECB. The ECB established a Debt Issuance Market Contact Group (DIMCG) last year, which is working on identifying issues, finding ways to improve efficiency in primary markets for debt instruments and seeking to achieve a better integration between pre issuance and post trade services. The DIMCG will conclude its work by the end of 2021 and it will then be taken forward by the ECB.

Another Central Bank official described the current level of fragmentation of the post-trading market with 27 markets, 37 CSDs, eight third party agents and over 200 custodians. This means it is essential to be realistic about the improvement objectives. ECMS is designed mainly for the Eurosystem, but it will have far reaching effects beyond the Eurosystem. ECMS will not only allow the consolidation of 19 back office applications into one, it is also an opportunity for market participants such as large banking groups to have access to several central banks in a central place, which will foster harmonisation. However, to further enhance harmonisation, more than regulation is needed because a number of the remaining T2S barriers that need addressing are outside the remit of central banks, in particular those that relate to corporate actions and withholding tax. T2S and ECMS are a demonstration that public involvement is beneficial in this area, but there is also a need to involve market players at an early stage because ultimately the new standards will be implemented by the market, which means that their commitment is needed as well as a monitoring of the progress. Triparty services is a further area where greater harmonisation could have a substantial impact. For the time being, there is a focus on corporate actions, collateral and the billing process in the efforts being made to harmonise triparty services, but there are other areas to address, such as taxation and margin calls. This is more applicable to the wholesale market than the retail market, however.

An industry representative highlighted the importance of creating a euro benchmark to compete against other existing benchmarks. With the Commission issuing a substantial amount of debt, there is a need to make progress on insolvency law, which is different across EU countries. The European Distribution of Debt Instruments (EDDI) initiative could be a solution in this regard.

## 2.2 The ongoing CSDR review

An industry speaker explained that the forthcoming CSDR review, which will be a refit, will aim at correcting the main elements that are causing friction, rather than attempting a major policy overhaul. The requirement for CSDs to obtain a passport in order to provide services to foreign issuers should be amended for example, because it is lengthy and to some extent unnecessary process. Additionally, after having a licence for a year, there is a requirement for CSDs to complete a quasi new application to demonstrate continuing compliance with CSDR. This is too cumbersome and should be revised to a more proportionate level. The problems have been identified and it seems likely that these issues will be addressed in the CSDR review.

Another important area of focus is the long-debated settlement discipline regime, the industry speaker added. At present, the implementation date for the settlement discipline regime is February 2022, which is only 6 months away. Much has been said about the negative effects of the mandatory buy in regime, and CSDs are quite worried about it. There is a market impact, but there are also level playing field issues for CSDs, because non EU CSDs are not subject to such a buy in regime. There has been some political agreement on the need to address this. The buy in regime could become voluntary rather than mandatory, but this would create a timing problem as a result of the February 2022 implementation date. This date should be changed, and many players in the market have been calling for quick feedback from the Commission on this point for several months. The possibility of a delay must be enacted in law, but this would also raise doubts as to whether the entire settlement discipline regime will be delayed. There is no need for delaying all settlement penalties, the speaker believed. These should be implemented, but the buy in regime should be put in place later and in a different form. Ultimately, this will require changes at Level 1 also, where these rules are defined.

An industry representative agreed on the need to solve the timing issues regarding the implementation date for the buy-in regime. The public authorities and the private sector are working very hard on this issue. A solution should eventually be possible, but this is a tricky subject.

Another industry speaker stated that there are some other areas that require further thought in the context of the CSDR review. First, there is currently no depositary passport across the 27 EU member states. At present, offering depositary services entails acquiring a licence in every member state, which seems incompatible with the objectives of the CMU. Secondly, there is a risk of moving backwards in terms of integration if legislative initiatives in contradiction to CMU are introduced in CSDR. This is true of the mandatory buy in regime in particular, which is in total contradiction with the goal of building integrated, deep and liquid European capital markets. The mandatory buy in regime will drive even more players out of the European markets, which cannot be the intention.

A Central Bank official agreed with the need for clarity on the settlement discipline regime and possibly for reconsidering the requirements. Another Central Bank official emphasized that the review of CSDR is important, because it addresses areas that are relevant for the CMU. In this respect, passporting is a key element. There are at present some complexities in the requirements concerning the assessment of member states' national laws, which will be considered in the context of the CSDR review. Another important area within the scope of the review is the provision of banking services. The CSDR has introduced a strict set of requirements to limit settlement risk in commercial bank money. However, the market did not develop services in this area. A review is needed here but it should not endanger the final purpose of the rules, which is to limit settlement risk when commercial bank money is used. Finally settlement discipline, which

has emerged as a somewhat controversial point, is a complex set of rules, in part due to the large number of actors involved and the actions needed to implement it. The result of the public consultation points to a lack of clarity and to some disproportionality between the rules and the objectives. The review should provide the opportunity to tackle these two issues.

### **2.3 The implications of digitalisation and digital assets in post trade**

An industry speaker emphasised the need to take digitalisation into account, as it is now a reality in post trading and has the potential to transform the sector. This means that EU legislation such as CSDR and SFD must be adapted to the digital world. There is however sometimes a naïve belief that digitalisation will remove the barriers that post trade is facing in the EU, but digitalisation will necessarily integrate the existing fragmentation of rules, such as withholding tax, for example. The need for enhancing harmonisation will therefore not stop in the digital world. A Central Bank official suggested that the DLT pilot regime will enable supervisors and relevant stakeholders to understand better how innovation and technology can impact CSDs in particular and whether rules need to be adjusted or completed.

A second industry speaker also highlighted the risk of fragmentation in the crypto space, as European national markets are currently designing different laws on digital assets. This is reproducing the same error as in the post trade space, potentially creating new barriers, and should be avoided. Other industry speakers on the panel concurred that Europe is repeating the same mistakes in the digital space, which will create problems in the future. A Central Bank official agreed that avoiding fragmentation in the developing cryptoasset space in particular should be a priority.

### **2.4 Supervisory convergence**

An industry representative raised the question of the possible evolution towards a common supervision of CSDs in the EU. CSDR is a major step forward, but this identical law should be applied in the same way everywhere in order to enhance harmonisation, which requires supervisory convergence and possibly a common supervision of CSDs. One example is around payment for order flow for which, on the retail side, Germany is more flexible than France. Another industry speaker suggested that the question around whether CSD supervision should become more unified at EU level is mainly a political debate.

A Central Bank official explained that the supervision of CSDs is a topic that has been discussed at the ESCB (European System of Central Banks) with Eurozone central banks in the context of the CSDR review. The ECB feels that while a more consistent application of CSDR rules is needed notably to ensure a level playing field, there are other ways to achieve this objective than moving towards a single supervision of CSDs. Supervisory convergence and cooperation could be further enhanced. There are many tools available to facilitate supervisory convergence, such as Q&As and voluntary colleges, which have not yet seen much use. The current arrangements, including the CSDR toolbox for achieving supervisory convergence,

should also be further taken advantage of with a more proactive identification of interpretation issues and a timelier tackling of divergent supervisory practices. Cooperation between authorities could also be enhanced, including with the ECB as central bank of issue and other authorities with legitimate interests in non domestic CSDs. More intensive dialogue supported by assessments and input can help to achieve a clear understanding of most issues in the post-trading space. While central banks have been very much involved in the authorisation, review and evaluation processes, they must now play a more meaningful role. The contribution of central banks to the supervisory process should have a more binding character. Hopefully, this will be achieved in the revisions that arise from the CSDR refit process.