Position paper DACSI **17-1051**

T2S – continuing our journey

DACSI's view on the next steps for the Target 2 Securities project

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DACSI (the Dutch Advisory Committee Securities Industry) is the principal trade association in The Netherlands for firms active in the securities industry. The association represents the interests of its members as users/clients of infrastructure providers in the field of securities, e.g. exchanges, central counterparties, central securities depositories. With 11 members, DACSI represents the vast majority of the banks active in The Netherlands, and positions the Dutch view to the market infrastructure service providers and the regulatory authorities in The Netherlands and the European Union.

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Introduction

Target 2 Securities is now between the implementation of its Wave 4 and its final Wave; the right timing for a high-level evaluation and (re)consideration of the next steps for the project.

DACSI's key message:
defects and left-overs have to be repaired and harmonisation should be boosted maximally – by eliminating exemptions and varieties – before one accepts newcomers, bringing either new markets, countries and/or currencies.

We evaluate the achievements of the T2S project by:
1. reiterating the initial objectives,
2. analysing the extent to which the objectives are met,
3. listing the short-term measures necessary to fill the gap(s) between objectives and (foreseen) achievements and ambitions,

and we:

4. suggest mid-term steps necessary to reach the high-level goals for improvement of the entire securities post-trade infrastructure

1. Objectives of T2S

In the wording of the ECB, the fundamental objective of the T2S project is to integrate and harmonise the highly fragmented securities settlement infrastructure in Europe. It aims to reduce the costs of cross-border securities settlement and increase competition and choice among providers of post-trading services in Europe. It is therefore supposed to be a critical step forward in the creation of a true single market for financial services in the EU.

As one of the largest infrastructure projects launched by the Eurosystem to date, T2S is believed to bring substantial benefits to the European post-trade industry.

- **Cost-reduction**: One of the objectives of T2S is to reduce the cost of securities settlement in Europe, in particular for transactions across EU countries, which can be ten times more expensive than domestic transactions.
  Indirect costs – i.e. other than outright settlement fees – can also be lowered by improved market settlement efficiency and a shortened custody chain.
- **Deepening market integration**: The T2S settlement engine also brings us a step closer to a single market for financial services and deeper financial integration in Europe. Furthermore, T2S should harmonise post-trade practices across Europe.
- **Improving collateral management**: The platform also helps banks optimise their collateral and liquidity management by creating a single pool, essentially ensuring that collateral is not blocked in local markets but can quickly be moved to where it is needed.
  This means that if a bank needs collateral in one market and that same bank only has the securities eligible for such collateral in another market, then only one T2S internal booking needs to be executed to transfer the corresponding securities to where they are needed. Today, with separate settlement systems being involved, this is a lengthy and expensive procedure.

As a result of reduced settlement costs, increased competition and greater harmonisation, T2S is expected to have a positive impact on **European economic growth**. The lower costs of settlement can be passed on to investors. By making it easier and less costly to access securities in other EU countries, investors will be able to hold more diversified bond and equity portfolios. In addition, issuers will have access to a more diversified investor base.

The positive impact of T2S does not end here. The T2S platform may also **increase financial stability** in the long run. In particular, it will reduce the risks that still affect the settlement of cross-border transactions. With its robust business continuity solution and settlement in central bank money, it helps decrease counterparty and settlement agent risk. By fostering greater efficiency and integration of European financial markets, T2S may lead to greater diversification and sharing of risks, adding to the stability of the whole system.

Due to the “lean T2S” concept, which facilitates post-trade activities, banks will be able to streamline their back offices and thus reduce costs. As T2S separates the settlement infrastructure from the services offered by central securities depositories, competition in the provision of these services has increased, and will continue to increase, to the benefit of customers across Europe.

2. To what extent are objectives met?

Reduction of settlement costs

We observe the direct costs of settlement being increased rather than decreased. The main cause is that the introduction of T2S created an additional layer in the settlement chain, requiring additional costs reflected in CSD fees (CSDs recovering their investment costs through participant fees) and in the costs of communication (much more messages have to be exchanged now). Initially, it was expected that a substantial part of the functionality of CSD systems would become redundant, leading to the partly decommissioning of the CSDs’ settlement systems and consequent cost reductions. During the project it turned out that the extent of this redundancy is negligible.

In order to effectively reduce settlement costs, T2S should facilitate the shortening of the custody chain. Many major CSDs have announced that they will establish direct access to one another, which would enable market participants to hold their assets directly with one CSD without maintaining connections with all of them. Instead, they can hold their assets indirectly in T2S via another CSD of their choice, which acts as an investor CSD.
Regretfully, the number of established links is currently insufficient. Hence, the potential for cost reduction for cross-border transactions is small.

So, this objective has not been reached so far.

Deepening market integration

The degree of process harmonisation is not according to expectations; this applies not only to the settlement processes, but also to the structuring and processing of Corporate Actions (CA) and Income.

In principle, T2S has set tight conditions to markets joining T2S, requiring a high/maximum degree of compliance with pre-set standards, including the MSCAP (Market Standards for CA Processing). This promised to be a strong boost for harmonisation and integration, but after four Waves we can only observe that ample harmonisation efforts have been sacrificed to the timely migration and hence have been pushed to the background. On varying grounds, (too) many local practices are kept intact.
In addition, harmonisation of tax within Europe is needed to solve some (tough) problems.

There is still a long way to go before this objective will be reached.

Improving liquidity and collateral management

Investigations suggest that market participants are starting to consider the effects of a pooled cash account in T2S on their balance sheet, but are struggling to quantify the impact. Clearstream SA used their own customer cross-border settlement data to estimate the impact on their own liquidity requirements of using a single central bank cash account in T2S, and concluded that it will reduce, on average, the daily cash or credit consumption during peak settlement periods (usually the overnight cycle) by 15%. Transposing this to the broader settlement volume in the Eurozone, PwC

have calculated that under Basel III rules, this could translate into €33 billion of Tier 1 capital savings for all euro zone banks.
The biggest improvement by far introduced by T2S is the management of liquidity by use of dedicated cash accounts (DCAs) and the concept of payment bank. As an effect, conditions for liquidity management have improved.
Wide-scale implementation of auto-collateralisation is subject to CSDs' choices. As per today, large CSDs like Euroclear (ESES), Monte Titoli and Clearstream made different choices, creating another example of non-harmonisation.

We can say that T2S does offer the infrastructure for improved collateral management; however, the single collateral pool is not there yet.

3. Looking into the future

3.1 What needs to be done first?

The T2S platform needs to be fully standardised and harmonised before one accepts newcomers, bringing either new markets, countries and/or currencies. This is necessary to reduce the actual material complexities stemming from non-compliance with standards. Not giving first priority to standardisation would risk a situation where harmonisation cannot be reached anymore by any means, and – by consequence – where the objectives of cost reduction and deeper market integration remain distant and will not materialise.
(Further) harmonisation will remove the necessity for CSD participants to be connected to multiple CSDs. It would become possible for them to choose between the service offerings of the various CSDs, the latter forced to compete (stronger) against each other. A consolidation of CSDs – a substantial reduction in the actual number of players – could go hand-in-hand with economies of scale and decreasing fees.

The processes for securities settlement in Europe are still fragmented substantially. So, our joint T2S journey should be continued by:

- repairing defects and left-overs,
- eliminating exemptions and varieties by boosting harmonisation,

and prioritising this above the entrance of new markets or currencies.
As an instrument for this harmonisation boost we suggest the development of (market) standards for securities settlement analogous to the Market Standards for Corporate Actions processing, as in place for several years now.

3.2 Next, when harmonisation is realised …

The broadened future scope for T2S

When these first-order goals are reached, T2S can – and actually should – be opened up for:

- other European markets;
- new currencies;
- markets outside Europe.

The deepened future scope for T2S

The high-level objectives of T2S would be stimulated strongly by deepening its scope. Therefore, we should choose the next destination(s) of our journey and define the route to follow.
Extending the centralisation movement started with T2S to the entire post-trade we consider several directions:

- towards clearing:

- a “T2Clearing” is conceptually easy to achieve and will reduce risks and costs; it will enable harmonised processes in the clearing environment and create opportunities for centralising various functions, e.g. CA processing of pending trades.
- how this can be shaped will – amongst others – depend highly on the use of new technology. In one extreme, the technology can be the basis for a new European clearing platform, in another the entire idea may be outrun by the technology itself, making central clearing redundant for cash products.

- towards securities issuance:
    - T2S acting as issuer CSD, hence centralising the notary function, which is perhaps not a competitive one;

- towards asset servicing:
    - if not done, relations/connections with multiple CSDs would remain necessary for asset servicing.

How to accomplish this?

We suggest to mobilise a European harmonisation group with the objective to specify practices, rules and procedures for settlement in a way that harmonisation in the T2S context is maximised. This group can be modelled after the Corporate Actions Joint Working Group (CAJWG) – e.g. “Matching & Settlement Practices Joint Working Group”. Monitoring (the path towards) compliance with the resulting standards could be done by an existing group like the T2S Corporate Actions Steering Group (CASG) or the European Market Implementation Group (E-MIG).