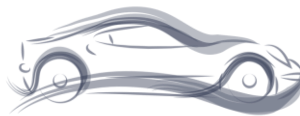
DACSI

FLASH UPDATE ON SECURITIES POST-TRADE

A link to our 2020 whitepaper and 2021 report



7 July 2022

DACSI is the principal trade association in The Netherlands for the securities industry. Our aim is to promote and improve the smooth functioning of "securities post-trade": we strive for an efficient and effective infrastructure for the securities and derivatives markets. We do so by coordinating between providers and users of the securities infrastructure and by advocating the Dutch interests with relevant institutions, including the domestic and European legislators and supervisors.

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1 Introduction

In July 2020, we published our whitepaper A NEW CAR FOR POST-TRADE? Our main question: "What could the world of securities post-trade in Europe look like in 2025?". Since then, a lot has happened. In 2021, we wrote an update report providing a refreshed view of the four scenarios defined in the whitepaper.

We think that our scenarios are still valid. Without evaluating our scenario analysis in full, we describe in this flash update what we consider to be the most striking recent developments in some particular areas:

- the use of DLT in securities post-trade,
- the evolution of the Capital Markets Union,
- the increasing importance of ESG,
- geopolitics,
- the Brexit file(s).

2 DLT: a pause for reflection

In our 2021 update report we wrote:

New or innovative technologies cover a wide area of applications in post-trade. Whilst cloud computing and Robotic Process Automation (RPA) are increasingly accepted in post-trade, there is more uncertainty about where and how DLT can be applied in combination with the tokenisation of bonds or equities. Many initiatives have not resulted in widespread adoption. It becomes increasingly clear that the successful use of tokenised assets is part of solving a larger jigsaw puzzle and cannot be treated as a purely technical question.

Issues like interoperability with existing (legacy) platforms, regulatory compliance, and market practices must be solved. In addition, the whole industry has to move in sync to reap the network effects of DLT and tokenised assets. More promising are recent initiatives of incumbent (post-trade) players like Deutsche Börse Group, DTCC and SIX Group making serious inroads in using tokenisation of assets, whereas the EIB uses a public blockchain for bond issuance in a limited set-up for the first time. We have also seen increased attention for Central Bank Digital Currency (CBDC), which could ultimately be used as a settlement coin for tokenised assets. Despite these initiatives, it is still early days.

On the legal side, the EU's DLT Pilot Regime is a meaningful step towards the possible use of this promising technology, although this regime will be applied step-by-step, and with limitations in scope. Regulatory initiatives on crypto-assets (MiCAR) are examples of adapting regulation to the use of new technology.

Since the summer of 2021, we see a continued interest in the application of new technology with a clear focus on tokenisation in connection with DLT. Moreover, a multitude of central banks is experimenting with CBDC.

In securities post-trade however, we have not yet seen a clear turning point showing mass adoption of this new technology combined with the tokenising of assets (or using native assets for that matter). Some observations are widely shared in related studies and are in sync with our observations.

To summarise our main findings/observations:

- It is important to keep a clear focus on the problem(s) we are trying to solve. The current infrastructure – although complex in nature – has proven to be robust and resilient and is geared towards the current market infrastructure (e.g. the advantages of netting). Any new technical structure needs to be fit for its purpose. It should also be mentioned that the whole securities chain is closely connected from IPO to trading, clearing, settlement and asset servicing. This complex chain of events needs closely interconnected systems and processes.
- Rebuilding the current infrastructure with the use of new (DLT) technology will be an extremely expensive exercise and will probably not deliver a solid business case. A full overhaul of the complete infrastructure is not realistic for many years to come. Using this new technology in specific areas like withholding tax procedures, automated processing of corporate actions, or identifying shareholders could however still prove to be fruitful. Anyway, further investigations in these specific use cases should be welcomed. We will keep a sharp eye on any developments in this field and we will liaise with regulators or other industry associations where appropriate.
- With the introduction of new technology we run the risk of ending up with a myriad of incompatible standards and protocols. Work is underway to solve this, but without proper standardisation and harmonisation success will become even more illusory. Furthermore, we believe that there will be a long period of coexistence of the legacy environment and the brave new world of modern technology. Evolution seems far more likely than a revolution.
- The financial services industry is highly regulated, and for good reasons. Any new technology would have to fit in the current regulatory environment. So, apart from possible fragmentation and interoperability issues, possible legal issues would have to be examined closely and solved. A few examples are the legal validity of a token, the construct of DVP and finality issues.
- We will need an effective and coordinated, or even centralised, governance on possible DLT solutions, including the use of smart contracts.
- There is a broad appeal for a common technology-neutral taxonomy also in terms of the regulatory framework.

There are predictions that the next generation of securities won't just be digital representations of existing securities like security tokens, but instead will be programmable securities that are digital natives on the blockchain. These native digital securities will then be a legally accepted primary record of securities created on a distributed ledger. Tokenisation in whatever shape or form will not change the current ecosystem overnight since that system has proven to be resilient, robust and fit for purpose. Nevertheless, the combination of tokenised securities (or native tokens) with a wholesale CDBC could be promising.

We believe this development will be evolutionary and may well take more than five years, but we have interesting times ahead of us.

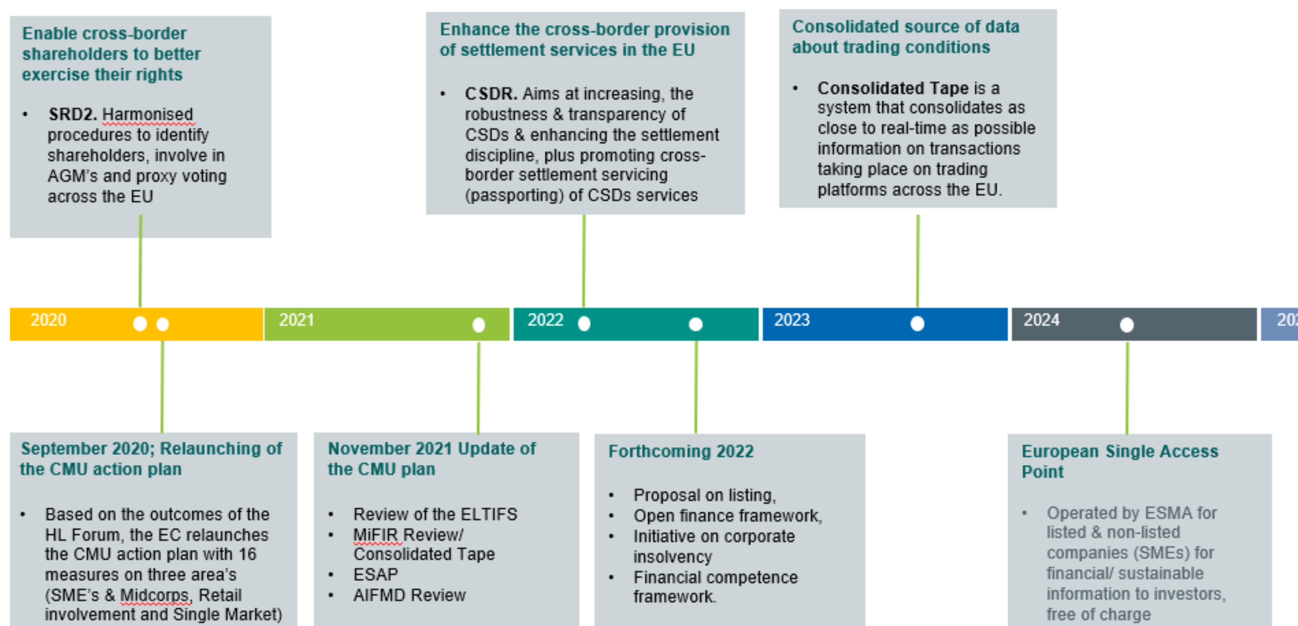
All in all, it is fair to say that the impact of new technology in the short run is often overestimated whereas that same impact, in the long run, is underestimated.

3 The Capital Markets Union revisited: slow but steady progress

In our previous report, we briefed you on the CMU project, which aims to develop “deep and liquid” capital markets in the EU by removing (information, legal and regulatory) barriers between EU member states to make cross-border investment more appealing. Also, the revival of securitisation to boost funding to SMEs is high on the CMU agenda, as well as other measures to create a single market for financial services. After relaunching the CMU "flagship" project with sixteen proposals in September 2020, the European Commission updated its plan one year later by bringing four initiatives forward:

- **review of the European Long-Term Investment Funds (ELTIFs),**
- **MiFIR Review and the consolidated tape,**
- **European Single Access Point (ESAP),**
- **review of the Alternative Investment Fund Managers Directive (AIFMD).**

The consolidated tape and the ESAP – currently high on the Commission’s agenda – aim to improve investors' transparency to break down information barriers, but from different angles. In brief, the consolidated tape provides (near) real-time prices, volume and timing of transactions for 500 execution platforms for all asset classes in the EU, starting with bonds.
On the other hand, the ESAP is a shared information platform operated by ESMA for listed and non-listed companies to make financial and sustainability-related information available to investors free of charge. The ESAP is expected to be operational in 2024.
After a delay, the final pieces of the CSDR were implemented in February 2022 with the penalty regime in place, while the Commission stated that – after hearing the concerns from the market – the mandatory buy-in regime would be reconsidered and possibly targeted in those cases where it could work.
Other CMU initiatives made less progress: a new consultation was launched for harmonising Withholding Tax Procedures (WHT) to simplify tax refunds procedures for dividends in the EU. Also, many years on the agenda are the harmonisation of insolvency procedures to make them more predictable for investors. The Commission proposes an initiative to harmonise targeted aspects of the framework in Q3 of this year.
The below picture captures recent progress and initiatives for the coming years:



Source: ABN AMRO Bank

Despite the urgency to complete the CMU, progress has been slow for several reasons. First, the CMU often requires structural changes in capital markets, while the benefits are often long-term. This makes it difficult to muster the essential political support to make the necessary change in the member states. Second, some measures of the CMU made little progress due to vested interests defending their positions. An example is the creation of the Consolidated Tape in the EU. Third, capital markets are more heterogeneous than banks, so it is not always clear what barriers need to be lifted. This makes the CMU a challenging yet still a very important project moving from "nice to have" to "must-have".

CMU: all parts of the value chain are affected

Source: Deutsche Bank

However, this might change in the coming years as governments realise that financing the green transition requires immense investment; such would need a fundamental shift in thinking. As the UK left the EU in 2021, access to one of the largest capital markets has become more limited for the EU. With financial centres emerging (Paris, Amsterdam, Frankfurt, Dublin), the call for more "sovereignty" in the EU has become louder to cater for our own financing needs. Combined with countering the economic effects of the war in Ukraine, the EU may become ready to integrate its capital markets into a genuine single market.

4 Environment, Social and Governance (ESG)

In our previous report we briefly touched upon ESG, on which we wrote the following:

We also looked at the impact of new developments like changing investor behaviour, new types of investment opportunities and increased attention for ESG. Based on today's insight, we are not (yet) convinced whether or how they can impact the post-trade value chain, and decided not to include attention for ESG as an additional trend in our analysis.

In this update however, we enter into the topic with a somewhat broader view. Climate change, the most recent social crises, and the ever-increasing political pressure to achieve demanding environmental goals brought a more significant momentum to the ESG spectrum. The spotlight points towards transparency, scrutiny, liability, and the fight against greenwashing – it has been, so far, mostly a data-centric story.

The EU has set up ambitious targets to become the first climate-neutral continent by 2050 and to reduce at least 55% of its net greenhouse emissions by 2030. To reach the 2030's carbon emission benchmarks, the EU needs to invest € 350 billion more every year during the decade 2021-30 than it did during the previous decade. It is not enough for the public sector to sustain this flux alone. The ambition is now placed on the vital role that the financial industry can play.

How we see the market evolving:

- To support a swift transition, the EU has been at the forefront of regulation proposition and implementation compared to the rest of the world. As time goes by, the dossier gets more complex and more prominent. We do not expect this trend to slow down in the short or medium term.
- The regulation drafting exercise focuses on three main pillars, which are ultimately related to data: (i) common definition of sustainable economic activities; (ii) harmonised sustainable asset standards to allow investors to make informed investment decisions, and (iii) sustainability reporting regimes to raise transparency on companies' behaviour.

  Some of the key European ESG initiatives are: ESAP (European Single Access Point), EUGBS (EU Green Bond Standards), EU Taxonomy, SFDR (ESG Disclosure Requirements for Asset Managers), CSRD (Corporate Sustainability Reporting Directive), Corporate Due Diligence Directive and Gender Balance on Boards.
- In parallel, investors' demand for sustainable securities is picturesque of a market segment that will continue to grow exponentially in the near future. Issuers experienced, over the last years, higher oversubscription for GSS (Green, Social and Sustainability) bonds when compared to their plain-vanilla counterparts[1].

However, despite impressive recent growth, the sustainable finance market has a long road to maturity. While there is a proliferation of sustainable finance initiatives, many obstacles remain that prevent the effective scaling up of the market for sustainable finance. Specific estimations support that by 2026, over 50% of EU new bond issuance will be sustainable[1].

Nonetheless, the post-trade industry will have to:

- remain vigilant and follow the market developments closely to promptly and efficiently assess possible implications. Considering the proliferation of ESG regulations, there is a possibility that the post-trade industry could play an important role in simplifying taxonomies (both at the EU and international level), and aiding market players to fulfil their disclosure and regulatory requirements. Closer collaboration with RegTech may be necessary for this effect. European start-ups like Greenomy, focusing on supporting the market players on their regulatory obligations, will become more and more relevant to support post-trade.
- tailor market solutions that will support the need (from issuers to investors) for more transparent, fast, reliable, and detailed ESG data. We believe that the market will expect the post-trade industry to be capable of processing ESG information flows, including ESG metrics, disclosure, and assurance.

The central and neutral positioning of FMIs within the financial ecosystem offers three important opportunities for FMIs to further support the scaling of the sustainable finance market. Cross-border FMIs in particular have a coveted reach across financial markets connecting developed, emerging and frontier markets, and are in a prime position to:

1. encourage greater sustainable finance issuance, through reducing infrastructure, regulatory and informational barriers to issuance,
2. improve the processing of ESG information flows including ESG metrics, disclosure and assurance, and
3. expand the market to more asset classes and participants[2].

[1] PwC – ESG Transformation of the Fixed Income Market (pwc.lu)

[2] Scaling the sustainable finance market, a cross-border financial market infrastructure-driven approach. strategy& (part of the PwC network) in collaboration with Euroclear, September 2021

5 Geopolitical developments

We are still in the process of recovering from the Covid-19 crisis which has affected many sectors of the European economy. Covid-19 was a health crisis with severe economic consequences and was a real test of European cooperation and resilience. It is broadly believed that the way Europe has handled this crisis has strengthened the confidence in the European project. This belief has been severely tested after the UK decided to leave the EU in January 2020.

In terms of EU decision-making, the decisive moment to fight the economic fallout from the pandemic was the July 2020 EU Council decision which put in place a new fiscal and governance framework. The European project has proved its worth by putting together a framework that for the first time allowed for direct transfers to countries, in addition to loans, and on proposals by the Commission to finance such combined grants and loans by borrowing in markets and temporarily lifting the 'own resources' EU ceiling. An example of swift decision-making and a tribute to the saying "never waste a good crisis".

The resulting recovery plan (NextGenerationEU) involves raising more than € 800 billion on financial markets in 2021-2024, in addition to the reinforced Multiannual Financial Framework (2021-2027) of over € 1.200 billion. Together, these are aimed at assisting member states to recover and 'build back better', by aligning public and private investment with broader EU goals – notably its green and digital agenda. Recovering from a health crisis and the economic fallout had hardly started when the next black swan occurred.

Before the Russian invasion of Ukraine in February 2022, most key global macroeconomic variables were seen as returning to normality over 2022-2023 following the Covid-19 pandemic. The general belief was that in time we could head towards a more prosperous period in which the economy would pick up the pace.

But the unthinkable happened: we are confronted with a war in Europe. The most important consequence of the war in Ukraine is the lives lost and the humanitarian crisis associated with the huge numbers of people affected, either "at home" or as a refugee. In addition, there are numerous significant economic implications. Europe reacted swiftly to the outbreak and implemented a full set of sanctions, which seem to become stricter as time goes by. We believe these events will have major economic and possibly radical geopolitical changes. Obviously, there are a large number of Ukrainian refugees who have sought refuge in Western Europe. It remains to be seen how many will return to their country.

The impending energy crisis has resulted in a spike in energy prices and has also severely influenced consumer confidence. On a general note, supply chains for products like grain and certain minerals have been influenced largely. Price spikes have caused high inflation rates and have once again tested the limits of European resilience. It has been a wake-up call and has raised serious questions about our dependence on Russia and other global players for that matter. It may not be the end of globalisation, but it has certainly opened our eyes to the vulnerabilities of the current economic world order. So far, the ECB and the FED have reacted by raising interest rates, which may cause political tension, especially in Europe where diverging economies may face difficulties.

The direct impact on post-trade is evident, sanctions and SWIFT bans seem to be implemented without great difficulty although constant attention to new sanction packages and the possible impact on financial services is necessary. Europe will once again have to show its resilience and its will to cooperate without giving in to nationalistic tendencies.

The indirect relationship between geopolitics and post-trade is at least as interesting:

1. Brexit resulted in a realignment between the UK and other financial centres, while the position of London as a financial centre is challenged. It is still unclear what the realignment means for the CMU or whether it would lead to more fragmentation.
2. The war in Ukraine reinforced the political cooperation between EU member states and NATO, but it is too early to say whether the political and military cooperation accelerates economic integration in Europe, from which post-trade could benefit.
3. The changing geopolitical developments between the US, China and Russia have reinforced the call for more sovereignty with efficient and integrated capital markets, taking matters into their hand. Overall, the political will to take the next steps remains to be seen, but the benefits could be significant.

6 Brexit and CCP equivalence

In our 2020 and 2021 reports we qualified Brexit as a significant source of uncertainty, also for our post-trade environment. In particular, we addressed the potential for regulatory divergence in several fields and its paralysing effect on the CMU.

With today's knowledge, we can state that:

- other – previously unforeseen – forces are strengthening EU cooperation in general (see par 5 on geopolitics);
- a certain degree of regulatory divergence is inevitable, but we do not see signals indicating a material effect on post-trade.

This brings us to the file "CCP equivalence". Following Brexit, the EU's recognition of the UK regulation re and oversight of CCPs was no longer evident. More than the equivalence of CCP regimes in other third countries and/or the regimes for other financial services, the assessment of the UK regime has a political dimension. The European Commission and the ECB believe there are significant risks of being dependent on a third country for the clearing of euro-denominated derivatives transactions. Hence, the Commission has a strong ambition to move away from UK CCPs.
After some temporary earlier decisions, the European Commission has now declared the UK regime equivalent until 2025 with the firm message that this qualification will not be prolonged, and – in addition to hints at possible "incentives" like extra capital demands – is planning legislative proposals later this year.

The EU post-trade industry will have to monitor:

- how current CCP(s) in the EU will prepare to step in and offer clearing services for euro-denominated (interest rate) derivatives on a large scale;
- how competition between (existing and new) CCPs will evolve;
- if/how existing contracts will be transferred from UK CCPs towards EU CCPs;
- the effect of the proposed incentives/disincentives on European clearing members and their clients.

On the other hand, we cannot exclude the possibility of a changing attitude at the level of the European Commission. Any stance has to be seen in the context of overall political dynamics; in that respect, uncertainty remains.

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7 Conclusions

DLT/tokenisation: We do not see a widespread use in securities post-trade yet. The claims of more efficiency, less data redundancy etc. are imminent, but we are not yet convinced that (the application of) DLT will solve most of the problems our industry is struggling with (like the EPTF barriers).
Application of DLT for sub-processes can be useful, but will not necessarily require or lead to a redesign of the entire infrastructural chain. Current processes for bulk are robust and resilient; rebuilding them is not an attractive business case.
On the other hand, using DLT in combination with tokenisation and/or wholesale CDBC may be an interesting mid-term development.

CMU: This flagship project of the European Union includes elements relevant for post-trade; we see that steps taken are primarily selected on (political) feasibility, but these are not always the most relevant/urgent/ profitable. Dossiers like withholding tax simplification or shareholder engagement have a very long lead time.

ESG: The financial sector is required to contribute substantially to this major development, and FMIs may even play a pivotal role from their unique (central/neutral) position. There is large potential, but substantial time and money will be required, while the relevant – complex en detailed – legislation is still in development.

Geopolitics: Recent developments illustrate that “the unexpected” can always happen and that we may not be prepared adequately. We need to be aware that a next crisis is not likely to resemble the current or previous ones. It will help to organise ourselves in a manner that shortens our time to react and adapt (nimbleness).

CCP equivalence: The primary dimension of granting the label “equivalent” seems political, rather than an assessment of adequate legislation and oversight. It is to be seen how the EC will incentivise moving volume towards the continent, and whether the UK will take countermeasures.