Preparing for change

Sponsored by BNP Paribas Securities Services and Société Générale Securities Services, a panel of experts convened at the Sibos 2013 conference, held in Dubai in September, to discuss the effects of Target2 Securities, the Alternative Investment Fund Managers Directive and predictions for the sub-custody market in the coming year

BNP PARIBAS SECURITIES SERVICES

SOCIETE GENERALE Securities Services

The Panel

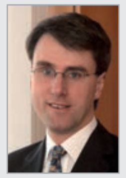
Alan Cameron is responsible for **BNP Paribas Securities Services**' relationships with major brokers and banks. He has more than 30 years of experience of securities services. Alan holds an MA in economic history from the University of Edinburgh and is a chartered banker. He is also a member of the Association for Financial Markets in Europe's post-trade board.

Andy Duffin has been with **Société Générale Securities Services** since 2007 and is head of sales, emerging markets. He has over 25 years' experience in the securities services industry, having started in the custody division of RBS in 1987. A decade later, Andy joined the network management group of Deutsche Bank and headed the Europe, Middle East and Africa team. He joined Clearstream Banking in 2005 as a sales and relationship manager in London.

Isabelle Olivier joined **Swift** 12 years ago as securities business manager before managing the Swift office in Milan as head of southeast Europe. Isabelle now leads the clearing and settlement team responsible for supporting and developing the Swift Securities business in Europe, the Middle East and Africa. She previously spent seven years at Euroclear, covering various operations management functions.

Virginie O'Shea is a senior analyst with **Aite Group**, covering data management and post-trade technology. She has more than nine years' experience tracking financial technology developments in the capital markets sector, with a focus on regulatory developments and standards.

Daniela Peterhoff is a partner in **Oliver Wyman**'s Zurich Office and leads most of the firm's market infrastructure work in Europe and the Middle East, covering a broad range of cash and derivatives exchanges, listed and over-the-counter central clearing counterparties, (international) central security depositories and custodians.



Paul Symons is head of public affairs at **Euroclear**, managing relationships with regulatory and political stakeholders such as the European Commission and the European Central Bank. He is also a board member of the European Central Securities Depositories Association. Previously, Paul spent seven years at the Bank of England.

Alessandro Zignani joined the **London Stock Exchange Group** as general manager of Monte Titoli in 2010, and in 2013 was appointed head of sales for the post trade division. He started at Citibank Securities Services, where he spent 11 years covering different roles. In 2002, he was responsible for the start-up bond platform EuroTLX and has been managing director since 2009..

Custody Risk: **How will the Target2 Securities (T2S) platform help reduce the cost of settling domestic and cross-border trades on the Continent?**
Alan Cameron, BNP Paribas: The T2S headline price was estimated some time ago at €0.15 by the European Central Bank (ECB). It compared this system cost to a fully loaded settlement cost of €3. This has unrealistically raised expectations of cost decreases. For the industry to get cost savings from T2S, we have really got to think more about how we are all going to make the best use of it, not just to accommodate it. T2S won't give us cost savings just by being there. You've got to think not so much about what T2S will do for you, but more about what you can do for T2S.

Andy Duffin, Société Générale Securities Services (SGSS): T2S will deliver benefits, cost-wise, across all transactions. But for domestic transactions we expect to see a lot longer lead time, as the infrastructures recover their costs of the T2S project.

Alessandro Zignani, London Stock Exchange Group: At present, a settlement in Monte Titoli costs €0.50. The investment for the T2S project is significant for a central securities depository (CSD), but the costs will not be passed onto our customers. We have published our pricing principles, which confirm that we will not increase the settlement fees before T2S and that the introduction of T2S will reduce settlement fees and bring the cost of a domestic and cross-border settlement to the same level – that of a domestic settlement.

More generally, the harmonisation process will enable banks to unify their processes and procedures with a reduction in back-office costs. In addition, the opportunity to have one single cash account in central bank money will help to reduce the level of cash and credit lines with a further increase in efficiency in liquidity management.

Daniela Peterhoff, Oliver Wyman: Many parties in the new market structure have not published their fee schedules. We think that, for the parts that are not directly cross-border settlement-related – so, those that need to be offered while connecting to T2S – people will start charging more for value-added elements such as asset servicing, where the reduction in settlement cost will be offset when servicing the local market more specifically. I also agree with the processing and efficiency arguments. If the industry doesn't realise some savings there, the project, as such, will be focused on restructuring the landscape, which cannot be the only outcome.

Isabelle Olivier, Swift: The price challenge is more on the cross-border side, where the benefits will be seen first. It will probably take some time before a reduction is passed on to end-investors, simply because the players making huge investments need to recover their investment one way or another. There is no real harmonisation on what is not considered settlement, and that is unlikely to take place soon, so savings will not come from that side. It may be some years before there is a real reduction of overall costs for the end-investor.

Paul Symons, Euroclear: Cross–border transaction settlement costs in the EU are always higher than for domestic transactions around the globe. Isabelle is right, in Europe, the difference is caused by a lack of common standards and market practices, and a fragmented infrastructure. Following the migration of CSDs onto the platform, cross-border settlement will be largely internalised within T2S. This will

considerably improve collateral mobility and reduce the costs of cross-border settlement, but a technical platform on its own is not enough. The harmonisation of market practices in the area of corporate actions, asset servicing and tax processing is also needed if all intermediaries and their clients are to gain the true benefits of T2S.

Custody Risk: **What are you doing to prepare for T2S?**
Alan Cameron: BNP Paribas settles around 50 million or so transactions a year. Most are in Europe, in fact most are in T2S markets, so T2S is absolutely crucial to us. To get ready, we're working around three different subjects. The first is working with the local markets and with the ECB since the project began to ensure we get a good balance between harmonisation and what can work practically in each market. Second, we're looking to ensure that we give our clients the best and most economic service once T2S goes live. We have to get economies of scale out of the harmonisation of settlement. For us, that means building up our international operations centre in Lisbon. Third, we are exploring new operational set-ups with a very small number of large clients. They are interested in taking more control of their settlements, but they still need an agent bank for the asset servicing. These discussions are, as yet, unresolved because nobody really knows what the pricing from the CSDs will be once T2S goes live.

Andy Duffin: It's very similar at SGSS. We've been an active participant since the project began in 2006, we're represented on the advisory group and all the leading working groups, plus T2S national user groups and sub-committees. We adopted a three-pillar approach to the planning phase. So, firstly, we're looking at the benefits can we deliver to our clients. Secondly, we're looking at our systems and performing system upgrades, mainly around the messaging connectivity to T2S. Thirdly, we're looking at the liquidity requirements of our clients and where we can deliver benefits on the liquidity side.

Alessandro Zignani: As a CSD, we have an institutional role as an infrastructure provider and need to bring the domestic market up to speed and be sure that there is strong awareness and preparation from all participants. From the outset, we have been involved in organising workshop training, helping clients and talking to IT providers in order to minimise the impact for our clients.

Alessandro Zignani and Andy Duffin

Also, as part of the London Stock Exchange Group, we have seen this as an opportunity for our strategy to become more international, hence, our commitment to join as a first-wave participant. Our strategy is to be entirely ready for the settlement side, and offer a point of entry across all T2S markets. We will offer complete asset servicing and have launched a collateral management platform to complete the range of services. We believe that settlement will become increasingly commoditised and it is important to offer additional value-added services.

Isabelle Olivier: We have won one of the two licences to operate as a value-added network operator, for network connectivity to T2S, so we are actively working to make this happen. At the same time, we have developed a set of services and products to support our community in the T2S project, should they decide to connect –directly or indirectly – to the T2S platform. These include consulting services (impact assessment, gap analysis), implementation services and products, and we will soon launch a new testing platform.

Daniela Peterhoff: As a consultant commenting on the different groups we see preparing, I would say some of the large CSDs are already out there with a price schedule and are very much in the marketing phase of acquiring their key participants for the offering. The smaller CSDs are split between those that have decided to go with a very lean solution and get connected themselves, and those that have found it too expensive and are now looking for a solutions provider to do that for them in a cheaper manner, so that they can also be part of it without having to invest at levels that wouldn't be justified. A third group are the custodians discussing whether to go with transmission control protocol or internet protocol, which is still not very clear for many who have not yet detailed their business cases. They are also deciding what add-on services would look like, either stand-alone or through partnerships.

On the partnership side, we see a new dynamic between specific CSDs and custodians linking up their capabilities in the collateral space, and in the asset servicing space more broadly because they may have realised there are synergies in the client flow or synergies with other business units. We see that being a significant area for push, even by those that haven't made an announcement yet. The volumes are pretty much distributed, although there are areas where we think there will be shifts and our clients are thinking about what partnerships they should be looking at to attract some of those shifts towards themselves.

Custody Risk: Under the Alternative Investment Fund Managers Directive (AIFMD) and Ucits V, a fund's depositary assumes increased responsibility for restitution of assets. What impact will this have on sub-custodians?

Andy Duffin: Ucits V is not yet in force, so we can only assume the requirements will be similar to those of AIFMD, or maybe even slightly increased. There is certainly going to be a greater emphasis on the network management function at custodian depository banks. What we are noticing is more in-depth due diligence being performed by clients and additional questions being asked around the legal framework of the local markets. Traditionally, I think depository banks always had to ask these questions, but now it's more prescribed about exactly what they need to do.

Alan Cameron: The French depositories are quite used to all this because they have already been acting under similar stringent rules. Other depositories are really going to have to step up. They will need a review process around the sub-custodians, the local capital markets and, somewhat strangely, the transfer agents. I think the industry is well set-up for doing this for the sub-custodians, but not so much for transfer agents.

Andy Duffin: I think the infrastructure exists at the depository banks, it's just making the process more robust, and there are tools to help. External due diligence can be performed by third-party companies. You can employ system vendors to help manage the data around your network of sub-custodians.

Custody Risk: Do CSDs fall within the scope of AIFMD?

Alan Cameron: I think that debate is very much around whether you can say using CSDs would be categorised as a delegated responsibility or not, and it's apparently not that clear in the written regulation. Our feeling is that rights and obligations of the parties may be determined by the actual functions that you ask the CSD to carry out.

Daniela Peterhoff: I think it would only work if it was mandated by a central bank or some other government body and, if it was quite prescribed, how that would happen? We've heard there is some discussion on that in a European market, but it's not yet final so it would be too early to comment.

Custody Risk: Where are you finding operational efficiencies?

Alan Cameron: Operational efficiencies are all around settlement right now. There is not a great deal happening on the asset servicing side, so that means we're able to build up our international operating centre in Lisbon, mainly for doing settlements. We see asset servicing, such as corporate actions and tax, remaining very local. So we're seeing good progress with one-half of what we do and not so much progress on the other half.

Andy Duffin: Looking at offshoring, what we're noticing from our clients is that the functions of their offshoring are becoming increasingly complex. Previously, it would be very simple reconciliation-type functions that would be offshored. But, as they become more comfortable with offshore locations and the staff there become more experienced, they're starting to move up the value chain into more complex tasks.

Custody Risk: How will relationships between custodians and sub-custodians evolve and how do CSDs fit into the custody equation?

Paul Symons: T2S is not solely about increasing settlement efficiency and lowering costs – it is also about increasing competition between CSDs, and between CSDs and custodians. The future CSD regulation will restrict the activities CSDs can offer, but they will still be very well placed to offer a single access point to eurozone central-bank money settlement across a wide range of markets. Clients will be able to choose whether to centralise their securities positions through a single CSD, through a custodian or through an international CSD. The removal of the Eurosystem's repatriation rule for collateral mobilisation to central banks will enable clients to post collateral from any T2S CSD to any eurozone national central bank. Clients will also need to think about whether they centralise their euro liquidity through a single eurozone national central bank. T2S will have an effect on the sub-custody market as global custodians seek to rationalise their settlement value chains, which may reduce sub-custodian revenues.

Alessandro Zignani: In Europe, 24 CSDs joined T2S. Some of them are large enough to decide to move up the value chain and maybe compete or enter new territories. Some others are small and probably don't have a strong business case. If we look at Monte Titoli, we are the third CSD in Europe and our strategy is to be a more global player and we are completing our product range to become more of an investor CSD. T2S presents a good opportunity for us. We are going to offer T2S as an entry point to cover the whole set of services.

Custodians have developed major strengths in certain areas, as CSDs have in others. Some clients will naturally be more comfortable using a custodian rather than moving to a CSD, and vice versa, but there will be much more competition between CSDs and custodians. The idea of partnership could be another key element to discuss and become something new in the industry.

Alan Cameron: The global custodians and the sub-custodians really need to achieve scale and process simplification. So it is inevitable that there is consolidation. The relationships between them will become even more intense as they remain mutually dependent on each other.

The CSDs are going to be hugely impacted by T2S. They will have outsourced what was a core part of their offering, they are going to be operating in a new market with stiff competition for settlements, but not so much for asset servicing. So what are they going to do? Some think they will rebalance their pricing, settlements will become cheaper and asset servicing will become more expensive. Others think the CSDs will have to launch major new product initiatives, perhaps they will try and become something similar to a global custodian. I would say the world does not need a lot of new global custodians. Europe has been a graveyard for global custodians over the years – those that have tried to build such businesses to service local client groups have mainly failed. It's very important for the industry that not every CSD thinks it can try and do everything, as this will just mean a whole lot of wasted investment, the cost of which will then be passed on to the clients that use the services where the CSDs still have monopolies.

Alessandro Zignani: The world is changing quite dramatically and it is no longer a protected environment. That is something that has been pushed by CSD regulation and T2S to create a level playing field. Don't forget that a new CSD has just been launched by a global custodian. We're considering the whole of Europe – so you either decide to remain a local player, or consider Europe as your new domestic playground, which is the development everybody is probably expecting. The ultimate aims are to further decrease costs for the industry and increase innovation.

We're currently talking to clients about collateral management and we're now talking with treasurers, whereas the back office was usually our main contact. We'll see big changes, probably after T2S, but there definitely will be some consolidation. As an analogy, we will experience similar changes to those in the exchange world following the Markets in Financial Instruments Directive, where new multilateral trading facilities or new exchanges came and competed.

Andy Duffin: It will be interesting to see how sub-custodians react to T2S – how they're going to fill the gap of anticipated loss of settlement income, and how they need to tap into new revenue streams. In particular, the sub-custodians who have traditionally serviced the brokerage community, whose focus is now on low-cost, efficient settlement will be those most impacted. For those servicing the global custodian community, asset servicing is their primary function, so revenue is less likely to be impacted. So, it will be interesting to see how the sub-custodians react and whether there's consolidation as a result.

Daniela Peterhoff: There are specific markets or clusters in Europe where we think there's still room for a sub-custody utility, so we could imagine that would be an outcome in some of those, just because of the market structure and the size. In the Nordics or the Middle East, for example, we could envisage that, given the market structure and the number of banks there. We could well imagine it in some of the regions with smaller CSDs, that is, in most markets where the local custody has been unprofitable.

Isabelle Olivier and Alan Cameron

Alan Cameron: What Andy says may be true, but the jury is very much out. Sub-custodian settlement fees may go down, if there's an economic reason for many of the investment banks that you mentioned to become directly connected parties (DCPs). That's not a given at this point, although it has been looked at.

Andy Duffin: I'm not necessarily referring to settlement cost, I'm saying that maybe the settlement is done directly in T2S by certain clients, so the revenue stream disappears and you service the clients in a different way.

Isabelle Oliver: I think competition is good for the market overall, both from a cost perspective and an innovation perspective. We have seen many more initiatives announced by custodians and CSDs in the last year than we have in probably the last three, or even five, years. This stronger future competition has been an incentive to innovate.

Alan Cameron: But the market may rather have seen CSD pricing come down.

Custody Risk: Harmonisation of the European securities settlement landscape is also gathering pace with the forthcoming CSD regulation, which could impose settlement across Europe no later than two days after the date on which a trade is executed (T+2) and require an electronic audit trail for the trade confirmation process. What is your expectation on timing for T+2, how are you preparing for it and how does it fit with T2S?

Alan Cameron: We expect it to come in by the end of 2014. It sounds quite simple, but the scheduling of this might be a real challenge. You've got to avoid the dividend season, you've got to avoid the annual Swift release in November, the system freezes in December, plus you have the holiday seasons. So you're left with just a few months to get this all done – it's going to be pretty tight.

Paul Symons: It is very clear that T+2 will be mandated by the CSD regulation with effect from January 2015. Many markets are already announcing their transition to T+2 well in an advance of the likely legal deadline. The CSDs of France, Belgium and the Netherlands have been the first to state their plans to migrate to this shorter settlement cycle in October 2014. We expect most other markets to make similar announcements. But this is primarily an issue for the market, and particularly the buy side. There is virually no change for CSDs to make since we can – and do – settle on T+0.

Virginie O'Shea, Alessandro Zignani and Andy Duffin

Andy Duffin: The SGSS view is that the January 2015 deadline is optimistic and probably won't be met in all cases. It certainly won't happen in all markets. Spain has already asked for an extension, and you don't necessarily need the regulation to move to T+2. As Paul says, the Euroclear Settlement of Euronext-zone Securities markets will move to T+2 in October 2014, so you don't need a prescriptive regulation for T+2. The markets could drive the initiative themselves.

Alessandro Zignani: In my view, as a CSD, it's not a big deal to switch to T+2 – it's just a matter of organising and getting all the parties aligned. Of course, there is the involvement of our clients and trading plaforms to agree the proper timing. There is probably another challenge – the big bang approach – where all the markets move to T+2 with no co-ordination and at the same time. It is important that everyone agrees a reasonable framework at a European level, for when all the markets will move to T+2.

Andy Duffin: I tend to agree with you on the CSD. From what we understand, it's not such a big deal for CSDs to move to T+2. The problem comes more with the end-users and the investors. If you've got different markets operating at different settlement cycles and there are, perhaps, some dual-listed securities and you want to move securities between the two, that causes a problem for the end-investor. Where I would slightly disagree is that the migration to T+2 should happen as close as possible across the different markets to bring the end-users and investors the benefits.

Custody Risk: The European Securities and Markets Authority (Esma) believes that, if we have a reduction in the settlement cycle and it is not accompanied by a proper settlement discipline – which should be in the CSD regulation – that reduction of settlement risk would create additional liquidity risk.

Alan Cameron: You're right. What you need is not just a shortening of the settlement cycle, which is a good thing, you need a harmonised settlement cycle with each function within it taking place in accordance with a standard timetable. Although T+2 makes a great deal of sense, the market is for it and it will get shoved up the agenda, and quite rightly so. It is important we retain some exemptions around things such as repos and loans and instruments that are particularly illiquid, so they can't have it for absolutely every trade and for every instrument.

Isabelle Olivier: Some of our customers say T+2 on the settlement side is not an issue, it's just a configuration of the system. T+2 creates more concerns on the asset servicing side. They are asking for help in understanding how to best tackle that issue.

Virginie O'Shea, Aite Group: The buy side is one of the biggest problems, and I think the regulators are quite well aware of it. I attended a meeting at a large domestic regulator and they were fairly well apprised of the facts, because they'd been speaking to a number of big banks to ascertain who might be a laggard and who might need to be fined, and they were wondering how to go about doing that. So I imagine there'll be some fining straight off the bat, to incentivise change.

Paul Symons: We must all ensure that the settlement discipline regime that is mandated in the CSD regulation actually improves efficiency and does not impose unnecessary costs on the industry. I hope we don't end up with a blunt and inflexible regime designed by politicians, rather than a flexible regime based on empirical evidence.

Custody Risk: What else will impact sub-custodians?

Alan Cameron: One of the most interesting areas is the increased interest and awareness about the liquidity that sub-custodians provide. I think regulators across Europe view this as increasingly important. It is not particularly well-measured, nor particularly comprehended across the whole industry. It's a very poorly understood subject and the regulators, at this stage, want a whole lot of information in order to better understand it. I think that is going to be the big topic for the next 12 months or so.

Virginie O'Shea: They're being squeezed, aren't they? Quite painfully. Well, they will be – given the interaction points between various regulations.

Andy Duffin: As a sub-custodian in multiple markets, a lot of what we've spoken about is European-wide regulation, but we also have to follow the individual market regulations and keep our clients abreast of those, which is a challenge for all sub-custodians. In Italy, for example, the law-maker introduced a new tax on banking transactions in March this year. In Spain, they decided not to extend the ban on short-selling. It's not just European-wide regulation the industry is dealing with, it's per-market regulation as well. For our client base, dealing with all those regulatory changes has required a lot of manpower, a lot of resources and a lot of effort.

Daniela Peterhoff: There is not necessarily a full-scope alignment across different regulators of how much these new regulatory demands actually impose on businesses and how difficult that is to implement, even in day-to-day operations. That's where we see many of our clients struggling to reconcile all of that and still have a strategic agenda .

Alan Cameron: There's so much regulatory change going on that it is hard to fully understand its consequences. For example, who would have thought that Esma's interpretation of the European Market Infrastructure Regulation would lead to new CSDs in Europe?

Custody Risk: What are your predictions for the sub-custodian market over the coming 12 months?

Andy Duffin: I don't see too much happening in terms of consolidation over the next 12 months, but we may see something when the banks have to give binding agreements to become DCPs. This is when it is really time to show commitment to the business as you sign the binding agreements.

Alessandro Zignani: I don't think anything will happen in the next 12 months, probably even longer, because all the banks and brokers need to first decide their strategy and take advantage of the new framework, before deciding how and when they want to access T2S.

Daniela Peterhoff

Alan Cameron: Clients absolutely need to simplify processes. They will work closely with any sub-custodian that can help them do this, and there will be a great deal of work around outsourcing various services as a result. On the sub-custody side, I think it is more and more about scale and safety. The banks with scale will stay in the business and be able to invest for it, but those without scale will be leaving the party – perhaps quite quickly.

Virginie O'Shea: Unless they have a particularly good niche.

Alan Cameron: But it's hard to see what these particular good niches are in the sub-custody industry.

Andy Duffin: If you look at the selection criteria that pertains to the sub-custodian network, it has always provisionally been service, price and risk. You could probably put those in any order, whereas now I think, with the different regulation, it is now risk first and foremost, then service and price behind that. Regulation is driving people to look at the risk.

Alan Cameron: I keep saying process simplification is what the clients are looking for. They find that maintaining relationships with multiple sub-custodians is actually becoming more expensive, partly because of increased regulation. The T2S conversion period might be difficult and not all sub-custodians will do equally well in it. So there will be some consolidation prior to that, as it will be easier to go through that journey with fewer partners. There will be some consolidation prior to the conversion period. It makes sense.

Andy Duffin: When we talk about the industry, as a sub-custodian we often look at the international client base, inbound business, and the impact that that will have, but we also need to look at domestic clients. Although we may see some banks retreat from servicing international clients, often they still keep their domestic custodian product for local clients, so consolidation doesn't always follow a loss of business from international clients.