IN CONVERSATION WITH LIEVE MOSTREY AND MARC BAYLE DE JESSÉ

The momentum towards a single European capital market may be unstoppable, but it is proceeding less rapidly than its original prospectus forecast, and there remains a great deal to accomplish before Europe can truly be said to own a market large and liquid enough to compete with the United States. In their conversation at Sibos in Toronto in October, Marc Bayle de Jessé, director-general at the European Central Bank (ECB) in charge of market infrastructures, and Lieve Mostrey, CEO of Euroclear, nevertheless thought European market integration will not only survive unhelpful geopolitical developments and rapidly mutating cyber-threats but deliver a single infrastructure for the euro-zone, with or without the assistance of DLT and AI.

"We are swimming in the middle of the river on a number of issues," warned Lieve Mostrey, chief executive officer at Euroclear. "That is very dangerous because it is not sustainable. In the end, you have to go to one bank or to the other." But this candid assessment of the current state of market integration in Europe was not unhopeful. "It is very important that we, as European markets together, achieve the necessary level of harmonisation and integration to attain the economies of scale and skill across Europe," she said. "That is the big challenge going forward, but I would hope to see it happen in my lifetime in business."

A single CSD for the euro-zone is in prospect

Marc Bayle de Jessé, head of the directorate general, market infrastructure and payments, at the European Central Bank (ECB), was even more optimistic. He thinks a single domestic market infrastructure for the euro-zone - as opposed to the entire European Union (EU) - is eminently achievable within the span of his own career. "When do you retire?" asked Lieve Mostrey, much to the amusement of the audience.

Bayle elaborated. He predicted the single domestic infrastructure would be virtual in nature, with multiple providers experimenting with different levels of service. "You can have different service providers, but they should follow the same fully harmonised and standardised process," said Bayle. "Users will then choose whether it is better to be with one service provider or another, because they offer different services or additional features."

Mostrey was less confident. "I am not convinced that today, in Europe, even within the euro-zone, the thinking is already that a central securities depository (CSD) can be somewhere in the cloud, not related to one country within Europe, and serving the whole of the environment," she said. Nevertheless, she argued that a single European CSD is the natural culmination of present trends.

"A single CSD for Europe is the result of a number of things," said Mostrey. "It is not an action in and of itself. If we continue on the path that we are on, together, when we have arrived at sufficient harmonisation, combined with sufficient political will to share things rather than each and every country having its own infrastructure, the result will easily be one CSD. One CSD could be achieved easily, if the environment truly wants it."

Bayle agreed that a single European CSD was not likely to be achieved in the short term. "Politically, it is not possible to do it, otherwise we would have done it," he said. Mostrey countered that, despite the disappointment of the early optimism about the speed of market integration, the single European capital market now has an unstoppable momentum. "It is our true belief that the direction of travel we have taken is irreversible," she said. "I think that it is very important, and that it is very important we state it, and that all market actors state it together."

Integration of European markets is still a work-in-progress

As she pointed out, the European Post Trade Forum (EPTF), established in 2016 by the European Commission as part of its Capital Markets Union (CMU) programme, is looking afresh at how the remaining barriers to integration identified by the Giovannini Group – whose twin reports now date back to November 2001 and April 2003 – can be cleared.

In its report of May 2017, the EPTF pointed out that some of the barriers had now changed their form, and new barriers had also emerged. "Beyond the technical tools, and the infrastructure that we have put in place, more is needed around harmonisation in order to make sure that integration can happen," said Mostrey.

Marc Bayle agreed that there was still much to do before even the euro-zone could be described as a truly single, domestic capital market. "It is no time to be complacent," he said. "We can do more." But he did not want the existing achievements to be forgotten. Chief among them is TARGET2-Securities (T2S), which is now settling an average of 550,000 transactions a day in central bank money across almost all parts of the euro area.

"The fact that we have the same tools, the fact that we have defined the same standards together, and the way to implement those standards and harmonise them together, is established," said Bayle. "But we have not yet fully integrated the euro-zone. We cannot say it is natural to trade from one place in Europe to another one completely and fluidly, because the links between the markets are not yet fully operational, or do not deliver, because the levels of integration in all the layers of the market are not yet completely achieved."

"It is not a domestic euro area market, and we need this. We need a solution that enables an issuer to say, `I want to be able to tap the euro domestic market"

- Marc Bayle de Jessé, head of the directorate general, market infrastructure and payments, at the European Central Bank (ECB)

Collateral mobility and optimisation are priorities

His priority now is to maximise liquidity through the integration of the collateral, securities and cash payments market infrastructures. The Eurosystem has a series of projects in hand to deliver this. Most importantly, T2S is being integrated with the TARGET system for high value cash payments.

The Eurosystem Collateral Management System (ECMS) is simultaneously introducing a single process for receiving collateral. "This is in good complementarity with the services provided by the financial market infrastructures (FMIs) to deliver value to the market, so the banks can have mobility of collateral," explained Bayle.

Mostrey agreed that efficient collateral management was vital to the banks, and would become even more valuable as quantitative easing (QE) was reversed, and pre-2008 forms of liquidity stress re-emerged. "It is an environment in which market infrastructures are very complementary," she said.

Mostrey added that Euroclear was already working with both Clearstream and the Depository Trust and Clearing Corporation (DTCC) to make it easier for banks to move collateral across the Atlantic as well as across borders in Europe. "I call it the industry just-in-time supply chain approach," she said. "Just in time and just the right quality collateral for all the needs that clients have."

Bayle said the collateral mobility arrangements between Euroclear and the DTCC were "interesting," but the ECB was naturally focused on the integration of the European market infrastructure, and creating a single capital market for issuers would be an important step towards that goal.

"Today an issuer who wants to issue debt or equity instruments in Europe has to choose a domestic place of issuance, at the national level," he said. "It is not a domestic euro area market, and we need this. We need a solution that enables an issuer to say, `I want to be able to tap the euro domestic market.' We need to work on this with the FMIs of Europe, and especially the CSDs, to deliver a solution to those issuers who want to be domestic pan-European."

"I consider cyber-risk the risk of today and tomorrow."

- Lieve Mostrey, chief executive officer at Euroclear

Geo-political developments are unhelpful to integration

Mostrey agreed with this objective, but thought progress towards tighter integration of European markets was bound to be slowed down by what she called "geopolitics." Brexit, for example, undermined the efficiency with which Euroclear managed its own CSD servicing Ireland as well as the United Kingdom.

"It is an unfortunate demonstration of how geopolitics can gain the upper hand over economies of scale and skill, which is our raison d'être in the marketplace" she said. "We will be unwinding some of those economies to be able to continue servicing the Irish market."

Mostrey added that Brexit, because it was not widely anticipated, had occasioned adjustments to the long-term technology investment budgets of banks as well as FMIs. Since the eventual outcome of Brexit is unknown, it was unclear to market participants how to invest most efficiently to cope with it. "One reason we do not see quick progress in the take-up of T2S is related to that," said Mostrey. "It is diverting IT resources to the Brexit agenda. It is a bit sad."

Bayle agreed Brexit was unfortunate, but counselled against excessive gloom. "If you are faced with a big challenge, you should try to get the best out of it," he said. One option was for both Ireland and the United Kingdom to join T2S. As he pointed out, Switzerland – which is not a member-state of the European Union – is already connected to T2S.

Lieve Mostrey thought this offer a sensible and generous one, which proved that FMIs can respond more quickly and sensibly than politicians. "I would not try to build a model which would in the end hide the reality of Brexit," concluded Bayle. "But we should try to extract a benefit from the new framework as much as we can."

Cyber-security now the risk most in need of management and mitigation

If geopolitical risk has increased, classic forms of risk - market, credit, liquidity and operational - have certainly not disappeared. But Lieve Mostrey said it is cyber-risk that worries her most. "I consider cyber-risk the risk of today and tomorrow," she said.

Marc Bayle agreed. "My main challenge in the coming months and years is cyber-resilience," he said. "It is to tackle this dossier completely, and to be able to increase cyber-resilience in Europe, for all of us, not only the ECB, but the whole eco-system. This risk is not specific to FMIs. It threatens the whole eco-system, and beyond. Eventually, our entire economies are at stake."

Bayle argued that the best way for FMIs to mitigate cyber-risk was by sharing information about the threats they encounter, and developing plans to resume operations promptly after a successful cyber-attack. He urged FMIs also to share information with public administrators, the intelligence services and the IT industry. Mostrey agreed information-sharing was essential but warned it must be done safely, or it risks becoming a vulnerability in its own right.

She emphasised the importance of purely technological measures, such as patching, access management, monitoring the perimeters of systems, and profiling normal behaviour inside as well as outside the organisation.

But Mostrey added that mitigating cyber-risk entails measures that reach far beyond technology alone, such as formulating planned responses to successful attacks, and raising the awareness of employees about phishing, malicious attachments and impersonation. Marc Bayle also stressed the importance of changing the "mind-set" of employees.

Cyber-threats do not respect organisational or national boundaries

The need to adapt the mind-set must be applied with equal force to regulators and regulated, added Mostrey. "In making market infrastructures more resilient, a whole lot has been done by regulators, but we have to put a caveat around cyber-security, which is a new emerging risk, which was not fully captured by all the regulatory initiatives," she said.

She thinks that cyber-threats evolve too rapidly for conventional regulatory treatment, since these take years to develop and implement. In this speeded-up environment, said Mostrey, lays a powerful incentive for FMIs to be regulated not as part of the critical infrastructure of nation-states but as the components of an international network of critical infrastructures.

"We interact together in an international eco-system," she said. "The last thing we want to do is have a regulatory model by country. We need harmonisation. We need to take a cross-border angle, because it is the only way we will get forward. But we also need to be agile, because we do not want to be working on yesterday's threats, and ignoring the new threats of today."

Bayle said the recent cyber-security guidance issued by central banks and securities regulators was in line with this agile, cross-border approach to managing the risk. The European Commission directive on the security of network and information systems (NIS Directive), for example, is being implemented by EU member-states on an accelerated timetable.

The NIS Directive also encourages the development of information-sharing mechanisms between FMIs. "The idea is to create a circle of trust amongst a few, where there is a capacity to share information," explained Bayle. "This requires quite some cultural change. You cannot just wait until there is a legal assessment, which will take months to share information, because that plays to the advantage of the hackers."

Mostrey thought FMIs should endorse the logic of the NIS Directive, and create "circles of trust" of the kind described by Marc Bayle, where details of cyber-incidents can be shared safely. "The strength of our market is to be inter-connected and very open," she said. "But in the case of a cyber-incident, this can become a weakness. In an inter-connected environment, you become as vulnerable as the weakest link."

Speed of settlement can help as well as hinder cyber-attacks

It is important, added Mostrey, to recognise that real-time gross settlement (RTGS), and the instant payments services now being developed by FMIs, increase the importance of cyber-security. "I foresee some types of cyber-challenge, where you say, `Well, if it has been done already, and it is secure in the books of a number of parties, it helps,' but I can foresee situations where it is harmful, and you would want to have the opportunity to step back from what has happened," she said.

"The quicker your system is working, the more resilient you have to be, and the more important the capacity to re-start without creating additional disruption in the system," agreed Marc Bayle. "When we move to this new technology it is important that we do not bring additional risks into our systems. Our priority is to bring safety and efficiency to the market. We are FMIs. We are the backbone of the market infrastructure. We are not there to introduce fancy or risky elements. It is not our role."

He added that the vulnerability of the entire eco-system to cyber-attack made it important not to stigmatise market participants that are hacked successfully, since that inhibits information-sharing. "It is not a failure," he said. "They are victims of a process which is sponsored by well-organised, and often state-sponsored, entities. They are not incompetent because they have been hacked. The earlier you share information, the better for the reputation of your institution, and for the strength of our eco-system."

One new tool for managing cyber-risk is artificial intelligence (AI). Mostrey saw a role for AI in enhancing cyber-security, and added that AI will also be useful in making sanctions screening more efficient. Marc Bayle agreed AI could help detect abnormal behaviour within digital systems, but was less enthusiastic about the immediate potential of digital technology in general.

Bayle explained that a central bank has to assess technology from a regulatory as well as a technical perspective. Naturally, central bankers are concerned that it should not undermine their ability to implement monetary policy, regulate providers of financial services, or access the data they need to maintain the stability of the financial system.

Distributed ledger technology (DLT) is not ready for immediate application

This was especially true of distributed ledger technology (DLT). "Decentralised technology is somewhat opposed to the idea of a central bank," joked Bayle. In fact, the ECB has run proofs-of-concept with DLT, and concluded it is insufficiently mature to deploy in critical infrastructural services. A recent payments project with the Bank of Japan, for example, found DLT struggled to cope with an extended network of users.

"The degree of efficiency decreased with the size of the network," said Bayle. "A centralised technology would work better." Similarly, work by the ECB on the issue of digital currencies on to a distributed ledger did not suggest that the

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Sibos, Toronto: Tuesday 17 October 2017

View the entire conversation **here**

Conversationalists

Marc Bayle de Jessé
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new technology brought any benefits additional to those created by the instant payments platform the ECB was now building with conventional technology. Bayle thinks corporate actions and tax reclaims processing were more promising use-cases for DLT than payments in central bank money.

These disappointing experiments allowed Bayle to dispose unequivocally of the suggestion that the ECB would, if it were embarking on the T2S project today, use DLT. "The answer is, `No,' because we do not believe the technology is today mature," he said. "We would consider it. We are not blind. We have considered different technologies. But we came to the one we have chosen for well-rounded reasons, such as safety, business continuity and stability. Tomorrow we would follow the same reasons, and consider DLT in the light of them."

Mostrey agreed, arguing that DLT could not yet meet the criteria by which FMIs must judge systems - resilience, robustness and scalability – and practical implementations were therefore for the longer term. Mostrey struggled to see, for example, how DLT could, in its present state of development, support high volumes of activity. "You need proven solutions – and solutions proven in extreme circumstances," she said. "Today we are not there at all with DLT. We cannot put our infrastructure in jeopardy for an adventure."

She added that, after ten years of heavy re-regulation of the securities industry in the wake of the financial crisis, it was also understandable that the regulators were cautious about opening the global financial system to the "trust-less networks" promised by DLT. "We should look beyond the technology," said Mostrey. "Combine it with how business models might evolve. DLT as a technology can still have a sensible implementation with a central authority, though it has been one of the first claims of DLT that it can work without a central authority."

Bayle thought the value of DLT would eventually be found not in capacity or speed – as he pointed out, conventional RTGSs were already capable of making instant payments in high volumes – but in the power to disintermediate organisations from the processing chain. "The challenge lies elsewhere," he said. "It is in the chain of intermediaries – in the chain of different actors fulfilling their role."

But even as a disintermediating force, the impact of DLT would be attenuated. "Some intermediaries may be redundant, but I would be surprised if all of them are," said Bayle. "The value-added of the network, of the different actors with their capacities, will have to be justified. We may eventually get away with some of the steps which are not necessary, but not all of them. I think Lieve and I are safe, as a central bank and a CSD, for some time."

Market infrastructures must remain open to the possibilities created by new technology

Mostrey did not see this as an argument for doing nothing. She urged FMIs to remain open to new technologies, and to form partnerships with FinTechs rather than devour them, to keep alive their culture of innovation. Together, she said, incumbents and new entrants could learn from each other. Established FMIs could look at their activities in new ways, while helping to manage the risks new entrants are bound to discount.

"That is where the richness will come from," said Mostrey. "From the dialogue between these new views, these new examples, between sometimes cutting corners wisely, and sometimes a bit less wisely. But that synergy has the potential to bring a lot of value to the market."

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