MAKE LIGHT OF CSDR AT YOUR PERIL, CLEARSTREAM CEO WARNS CSDS

The CSDs of Europe are currently labouring over complicated applications to their national regulators. The licences these are intended to secure will give them the right to operate, and the freedom to compete for business from other CSDs, but will also lay new obligations on them which will cost time and money to fulfil. In the next few years, European CSDs must comply with higher prudential standards, implement a tougher securities settlement regime, decide whether they wish to provide banking services, offer all clients segregated accounts and adopt LEIs. No wonder Phil Brown, co-CEO of Clearstream Banking, thinks CSDs are under-estimating the impact of the Central Securities Depositories Regulation (CSDR).

"The Central Securities Depositories Regulation (CSDR) is the CSD equivalent of the new Markets in Financial Instruments Directive (MiFID II) and the European Market Infrastructure Regulation (EMIR)," says Phil Brown, co-CEO of Clearstream Banking.

"MiFID II is about consumer protection and the regulation of the cash side of the securities markets. EMIR is about the regulation of the derivatives markets. CSDR is about the regulation of post-trade activities such as settlement and CSD safekeeping. Partly because it is about the less glamorous side of the securities industry, and regulating activities apparently far removed from the end-investor, its importance as a piece of regulation has been greatly under-estimated."

For anyone still struggling to grasp the significance of CSDR, time is running out. By 30 September 2017, all central securities depositories (CSDs) aiming to provide a service within the European Union (EU) had to submit to their national regulator a lengthy application for a licence to operate. For the first time, CSDs are being forced to operate under a single regulatory regime on a pan-European scale.

CSDR came into effect in September 2014 and one of its landmark harmonisation measures – the settlement of securities transactions on trade date plus two days (T+2) – was finally achieved in September 2016 when Spain migrated to the T+2 settlement cycle. Once licences are granted – at the earliest by the end of April to early May next year - the CSDs of Europe will all comply with a single set of governance, transparency, prudential and operational requirements, including mandatory buy-ins and cash penalties for late settlement.

Settlement discipline regime will be demanding

Implementing the settlement discipline regime, and especially the mandatory buy-ins, will be challenging for CSDs. The cash penalties (which range in size from 0.15 basis points to 1 basis point, according to the liquidity of the instruments being traded) will be administered mechanically, with CSDs calculating and applying the penalty and redistributing the cash collected to the customer suffering the settlement failure. CSDs will have to build that capability into their settlement systems.

But mandatory buy-ins pose an even sterner challenge. For centrally cleared securities, the central counterparty clearing house (CCP) will buy in the securities. For non-cleared securities – that is to say, trades on non-cleared trading venues and OTC transactions – a buy-in agent will be responsible for buying in the securities.

Since most of the bond market is not cleared, the scale on which buy-in agents will be obliged to enter the market and buy undelivered securities could be substantial.

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"An interesting question for CSDs is: where does the data to trigger a bi-lateral buy-in come from?" says Brown.

It is not just the CSDs which are pondering the impact of buy-ins. The investment banks which control the bulk of trading in European securities are still hoping the European regulators will mitigate the likely effects of the buy-in regime.

As operator of the TARGET2-Securities (T2S) settlement system, the European Central Bank (ECB) has set up a task force to explore the various impacts of CSDR, including the effects of both cash penalties and buy-ins on the services it provides. After all, T2S is now the sole supplier of settlement services to the domestic markets of Europe, and it cannot yet comply with the settlement discipline regime of CSDR.

"At the moment, the task force is continuing discussions on whether the necessary functionality should be embedded in the T2S platform, or be developed as a separate functionality outside the platform, in anticipation of the final CSDR text on settlement discipline," explains Brown.

Issuers can choose their CSD

The settlement discipline regime is not the only way in which CSDR interacts with T2S. The regulation also allows issuers to choose the CSD into which they will issue their securities, breaking the monopoly CSDs have long enjoyed over issuers based in the same jurisdiction. Brown says bond issuers are already taking advantage of this choice, not to get a better deal on issuance services, but to reach more investors.

"Competition for issuer business is happening already in the debt markets because T2S plus CSDR is creating a single market for bonds," he says. "Issuers have looked at who buys their debt, and figured out it does not matter where they are based, but it does matter where the securities are issued, to give them access to the maximum number of investors."

Clearstream, he adds, is attracting debt issuers because they know that issuing bonds into the investor CSD at Clearstream facilitates settlement in central bank money via the Clearstream account at T2S. "Clearstream Banking Luxembourg has settlement links to CSDs in Belgium, Netherlands, France, Spain and Austria.

What we are currently engaged in is migrating these links to access T2S via Clearstream Banking Frankfurt, as well as harmonising our services between the CSD and the ICSD," says Brown. "These new links and service offerings will open in 2018. The direct CSD-to-CSD links in effect create a single settlement platform covering 90 per cent of fixed income transaction volumes in the eurozone. It gives bond issuers a choice over where to issue."

He expects equity issuance to follow a similar path eventually, as issuers come to appreciate the decoupling of equity capital-raising from domestic CSDs.

T2S plus CSDR affects the trading as well as the issuance of securities. CSDR insists CSDs offer open access to their services, including to other CSDs. Clearstream (and Euroclear) have long serviced investment banks trading Eurobonds and, to a certain degree, local markets' bonds, but T2S will accelerate that trend by allowing the investment banks to open a single European securities settlement account. Asset servicing - income collection, tax reclaims, proxy voting and corporate actions processing – remains for now largely with agent banks.

Both Clearstream and Euroclear already provide some global banks with a complete service: these banks rely on them to settle all their European trades and safe-keep the assets in their accounts at the CSDs. Brown stresses, however, that agent banks will continue to be important service providers after CSDR beds down, and that Clearstream remains fully committed to working alongside them in the new post-CSDR world.

Collateral management is yet to take off

"The way people buy sub-custody in Europe is beginning to adapt to the post-T2S world," says Brown. However, there is one field in which this is conspicuously not the case: collateral management.

The combination of quantitative easing (QE) and record-low interest rates has curtailed the expected growth in collateral management. Counterparties which were expected to rely on a third-party collateral manager to find their cheapest-to-deliver collateral are now posting cash, because cash is plentiful, earning a negative return, and easy to post bi-laterally.

"When the environment returns to normal, the value and utilisation of collateral management will become more obvious," predicts Brown. "The collateral management solutions provided by Clearstream, using the T2S platform as facilitator, will also become much more valuable."[1]

Impact of banking licences likely to be muted

The impact of CSDR in allowing CSDs to obtain banking licences is hard to gauge, but most observers expect it to be muted, because of the costs and complexity of an unfamiliar activity. Brown says that even Clearstream, which has in any case had a banking licence for decades, expects CSDR to demand a lot of its management and systems.

An obvious case in point is the way CSDR regulates the extension of credit by CSDs. As a general rule, under CSDR only the Eurosystem and other central banks (if they are borrowing their own currency) and a variety of other government agencies and multilateral development banks can receive unsecured credit from a CSD. All other debtors must collateralise their borrowings, to rules set by CSDR.

"CSDs will have to make sure such credit extensions are collateralised," notes Brown. "We must ensure credit exposures via our electronic bridge with Euroclear are

1 See Marc Bayle, "*The future of collateral management in Europe and beyond*," Market Infrastructure Forum magazine 2014, pages 142-147, and Yves Mersch, "*The future at your fingertips – the European market infrastructure of tomorrow*," Market Infrastructure Forum magazine 2016, pages 24-30.

Rewiring Securities Post Trade Whitepaper

“There is an opportunity for somebody to come into the market and offer payment services to CSDs that want to offer non-euro currency settlement,” explains Brown. “Any CSD that does non-euro settlement today will need that service, unless it has a banking licence itself.”

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fully collateralised at all times, intra-day and intra-night as well as overnight. Any CSD with a banking licence that is currently advancing credit to its customers is going to have to invest in enhancements to its systems.”

Those enhancements would be an unusual investment to make when the settlement of euro-denominated securities has migrated to T2S, which settles transactions in riskless central bank money. However, as Brown points out, securities traded in Europe, but denominated in currencies other than the euro, cannot yet be settled in T2S. Transactions in sterling and US dollar bonds, for example, must settle in commercial bank money. CSDR forbids CSDs from providing the service to other CSDs.

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Investor protection is an important aspect of CSDR

The obstacles to CSDs developing banking capabilities are central to the character of CSDR. In a sense, the entire regulation is about protecting investors and preserving financial stability. CSDR requires CSDs to apply for a licence to do what they have always done, because it wants them to operate to a minimum standard.

“If MiFID was about making the trading of securities more secure, and EMIR was about making the trading of derivatives more secure, CSDR is about making the post-trade processing of securities more secure,” says Brown. “Once CSDR is in place, anyone investing in any of the EU-27 markets can be confident that the CSDs in all of them are operating to certain minimum standards.”

But some argue the safety measures are a case of overkill. After all, CSDs appear to be virtually riskless utilities. Because they never pay before they get paid, they assume no credit risk in their core business. But, as Brown warns, they can still lose securities. Physical securities can be misplaced, or stolen, and digital securities hacked.

So he thinks CSDR is right to insist CSDs reconcile every day the number of securities they hold with the number in issue, and to require suspension of settlement in any security where a break reflects an undue “creation” or “deletion” of securities which cannot be resolved within 24 hours.

“The reconciliation requirement is driven by asset safety,” says Brown. “It is comparable to the asset restitution regimes of the Alternative Investment Fund Managers Directive (AIFMD) and the Undertakings for Collective Investment in Transferable Securities (UCITS V).”

The reach of CSDR even extends to inter-CSD relationships. If the assets of a customer of one CSD are held in another, the records must be matched between the two CSDs. A further requirement is imposed on clients of CSDs to reconcile daily their holdings with the CSDs where their assets are held.

“As CSDs, we do not have to police that reconciliation process, but we do have to facilitate it,” explains Brown. “We have to make sure we have sufficiently robust reporting tools to enable clients to get that data out of our systems and reconcile it with their books and records.”

He adds that Clearstream is well-placed to comply, because it already reconciles transactions with its clients on an intra-day basis, and positions on a daily basis. Other CSDs may have to invest in new technology and revised processes.

Segregated accounts and LEIs now mandatory

Another expense many CSDs will have to incur to comply with CSDR is the provision of segregated accounts. CSDR requires CSDs to offer all clients segregated accounts, and to ensure that clients are fully aware of the levels of protection afforded, and the costs and risks associated with these, so that they are in a position to make an informed choice.

“We will see service quality improve, and choice widen, as a result of competition,” he predicts. “It is not going to happen at the end of this month, but it will definitely happen over the next few years.”

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Some CSDs in Europe already offer segregation down to the level of the underlying retail investors. Others (like Clearstream) provide segregated accounts to banks, but have until now left it to the banks to further segregate assets in their own books if that is what their underlying clients require.

Now even these CSDs may have to offer another level of segregation, as will CSDs which do not yet offer any level of segregation. Both will have to invest in new technology to provide segregated accounts to client specifications, at disclosed prices.

The costs will not halt there. CSDR also lays an obligation on EU issuers to replace any physical or registered securities they issue with electronic book entries. This is work which only CSDs can do, by dematerialising or immobilising the certificated securities, and representing them in digital form. CSDR requires dematerialisation in all EU markets for new securities to be accomplished by 2023, and existing securities to follow by no later than 2025. "It is a good thing to have these targets," argues Brown.

Another CSDR measure Brown endorses is the mandatory use of LEIs for client data and for issuers, mimicking what EMIR introduced for derivatives.

"Remember what happened in 2008," he says. "Counterparties thought they had an exposure to a particular organisation but found they actually had an exposure to a different one, because it was a different legal entity. Any measure which clarifies counterparty risk is a good thing."

At present, CSDs – unlike banks, CCPs and trade information warehouses - do not recognise clients by their LEIs. So CSDs will now have to require all their clients to obtain LEIs, and add the LEIs to the correct entries in their client databases. If they hold accounts in the name of clients of their clients, they will have to know their LEIs as well.

Adoption of LEIs, dematerialisation of physical certificates, the provision of segregated accounts, more frequent reconciliations and implementation of a tougher settlement discipline regime will all require the investment of time and money by the CSDs of Europe.

At the same time, they have lost their settlement revenues to T2S, and now face the threat of competition for the issuers, banks and investment banks that make up their current client base, while complying with a regulation that deliberately suppresses their appetite for risk.

Phil Brown nevertheless welcomes CSDR. "We will see service quality improve, and choice widen, as a result of competition," he predicts. "It is not going to happen at the end of this month, but it will definitely happen over the next few years."

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