Beyond T2S

Buying custody in the new European landscape
Introduction

When the European Central Bank launched the TARGET2-Securities (T2S) project in 2011, it planned to harmonise settlement for Eurozone securities through a single platform. Six years and four implementation waves later, T2S is no longer a project, it is a reality.

The markets accounting for the bulk of anticipated volume have already migrated. With the implementation of the post financial crisis regulations now in full swing, the question we now need to ask is; how do you integrate the benefits of T2S into your European custody strategy?

What are the benefits? The T2S framework agreement initially signed between the ECB and participating CSDs summarises the ambition of the project:

- Facilitate post-trading integration by supporting core, neutral and borderless pan-European cash and securities settlement in Central Bank Money;
- Enable harmonised and commoditised settlement services in an integrated technical environment with cross-border capabilities;
- Provide EUR cash funding for T2S transactions through Direct Cash Accounts within T2S, linked to Target2.

At its heart is the ability to enable DvP settlement (delivery versus payment) in Central Bank Money, initially in EUR but eventually in any participating currency, harmonising the securities settlement infrastructure in Europe in the process.

In concrete terms, while intermediaries in the securities value chain have long been engaged in persuading their customers that they have the necessary tools and products to deliver maximum benefit from T2S, the proof of the pudding is in the eating. Post implementation, what are the concrete benefits that these ambitions have brought to participants?
Expectations and reality

At the outset, the key expectation from the market was that implementation of the aforementioned aims would reduce the cost of securities settlement in Europe. Such cost saving is, however, difficult to achieve in the context of a rolling implementation programme. While participants are paying for the project, cost reductions are still on the horizon.

The target is deceptively complex for three reasons. On the one hand, reducing cross-border transaction costs to domestic levels presupposes that domestic settlement costs in the various individual Eurozone markets are uniform, which is not the case. Secondly, as no intermediaries are removed from the end to end process, the insertion of a new participant has had the effect of adding a layer of cost, at least initially. Thirdly, some of the potential economies of scale will only become evident once migration is complete.

Notwithstanding the fact that anticipated cost reductions have yet to be realised, other benefits have become evident.

The deepening of market integration is a benefit in itself, driving harmonisation across EU settlements, such as a T+2 settlement time frame and the introduction of a mandatory settlement discipline regime. The T2S settlement engine brings us a step closer to a single market for financial services.

Investor protection is a consistent theme within multiple regulations such as; Alternative Investment Fund Manager Directive (AIFMD), Units in Collective Investment Trust Schemes (UCITS V), Markets in Financial Instruments Directive II (MiFID II) and Central Securities Depository Regulation (CSDR). This is leading to demand for greater levels of asset segregation within the custody chain and at the CSD level. As participants change their service model in relation to T2S, it is also an opportunity to review the account structure models available to meet these demands.

The importance of collateral mobility and liquidity optimisation is becoming paramount. Operationally, collateral management has become more streamlined. However, one of the challenges is the need for collateral to meet a broader range of compliance requirements with regards to regulations such as; BASEL III, European Markets Infrastructure Regulation (EMIR), Dodd Frank, Securities Financing Transactions Regulation (SFTR) and MiFID II. In a post T2S environment, focus should be on reducing pressures on High Quality Liquid Assets (HQLA). This can be achieved through mobilising domestic assets and optimising cash and collateral by having a single view of asset pools. In addition, with the auto-collateralisation function embedded in the workings of the T2S platform, settlement fails will inevitably decrease.

Putting in place an optimal service model that balances regulatory demands can return cost efficiencies through a revised operating environment. For example, efficiencies in treasury management, settlement operations and reconciliations via single access to the T2S markets.
COLLABORATION AMONG SERVICE PROVIDERS COULD RESHAPE THE VALUE CHAIN ITSELF
Connectivity is just the start

Several connectivity options to T2S are available in the market from different points along the transaction chain. A survey conducted jointly by Deutsche Bank and Global Custodian magazine in mid-2016, indicated that a fair share of market participants were still in a wait-and-see mode regarding their choice.

This is to some extent understandable. The fact that T2S was conceived pre-crisis and then realised post-crisis in an entirely reworked regulatory framework has encouraged a cautious approach. Caution is not, however, an excuse for hesitation. Any financial institution doing business in European securities markets needs to satisfy itself that its operational needs and strategic objectives are being effectively met by its service relationships.

With four migration waves complete, the question is no longer one of connectivity but rather of broader European custody strategy and how to take best advantage of T2S in achieving broader strategic aims.

Since the launch of T2S, collaboration among service providers along the value chain is introducing the potential to reshape the chain itself. Attention has shifted beyond finding how best to achieve cost reduction to maximising the developing opportunities that have become evident as the landscape has changed.

Additionally, the need to meet new regulatory obligations is focusing attention on three broad themes related to risk reduction: asset safety, collateral and liquidity optimisation. Realising these benefits is not automatic, and there are still choices to be made.
How is the custody landscape changing?

T2S has expanded the range of options for participants with the ability to align service architecture more closely with strategic priorities.

Infrastructure change

- **Settlement harmonisation**
  - A single settlement day and a harmonised settlement process

- **Central bank money**
  - The ability to centralise settlement funding from a single Central Bank

- **Reduced settlement cycle**
  - Shorter, uniform settlement cycles increasing operational efficiencies

Regulatory change

- **Investor protection**
  - More liability in the intermediary chain and segregated structures

- **Risk reduction**
  - A reduction in risk from the securities industry is leading to business model change

- **Asset mobility**
  - Higher capital requirements and a need to utilise more eligible assets

- **Liquidity optimisation**
  - Regulatory pressure to reduce liquidity exposure to providers

- **Transparency**
  - Regulatory reporting requirements to ensure transparency of service provided

Client value add services

- **Global reach**
  - A single point of access for managing global assets to reduce complexity

- **Local market expertise**
  - Market proximity and expertise, resulting in best-in-class deadlines

- **Market visibility**
  - High infrastructure costs in local markets impacting market visibility to clients and counterparties

- **Best execution**
  - Proliferation of exchange platforms increasing costs associated with providing best execution to clients
Priorities and choice

Some of the obligations that market intermediaries are required to address, such as those relating to account structure and flow financing, have been broached in the first two whitepapers in this series: Balancing collateral efficiency versus investor protection and optimising liquidity management in securities settlement. Each institution will however, have its own priorities regarding the three themes identified above. These will have a major impact on their choice, not simply on the securities service provider but also on the service architecture as a whole.

A client’s own strategic priorities should be the starting point for any selection process as they may point to different possible paths. A one-stop shop is no longer necessarily as attractive as it once was.

This can be illustrated by exploring two contrasting sets of client needs in more detail and the new choices that T2S offers in achieving them:

Example #1: Global custodian

Let us first take the example of a global custodian, placing a high priority on asset safety. The global custodian may want to consider holding accounts in their own name at an Issuer CSD and consider the account operator model from a custodian as an option. Whilst assets are in their own name at the CSD and thus, have reduced provider risk they now have obligations regarding reporting and tax in each local market. Depending on how onerous the global custodian considers those obligations, they may instead prefer a custody model that includes segregated accounts, accepting an element of provider risk but releasing them from the tax and reporting obligations. Each of these approaches will come at a different cost.

A global custodian who prioritises maximum investor protection combined with local market expertise and liquidity optimisation will have a choice between account operator and segregated custody models. This is not necessarily a binary choice. In certain markets they may be comfortable with one model but not in others. They might find the same provider can support both models with a single point of access and a single cash account that still maximises cash offset opportunities across markets.
Account Operator – Own Account at Issuer CSD:
Utilising Commercial Bank money

Full Service Custody – Segregated Account at Issuer CSD:
Utilising Commercial Bank money
Priorities and choice

Example #2: Broker-dealer

A broker-dealer may regard its principal challenge as maximising liquidity and collateral access across the various European markets in which it operates. They may see advantages in selecting a partnered approach that includes the benefits of maintaining their assets with an Investor CSD, with links to tri-party collateral services along with a regional servicing provider expertise and the requisite banking facilities. With an Investor CSD acting as a single access point and providing the broker’s tri-party collateral programme, the bank can utilise a greater array of the broker’s domestic assets through these programmes to their counterparties and service partners as required, reducing pressure on HQLA. The connection to a tri-party can also assist in areas of reducing liquidity exposures with service providers. For example, flow financing (see our whitepaper ‘Optimising liquidity management in securities settlement’) or other solutions to help meet more general time-sensitive obligations in different markets, providing cash where and when the broker needs it.

If collateral mobility is less important to a particular broker-dealer, they may instead choose a single hub provider for more direct market access. They would then accept the settlement cost for those occasions where domestic collateral needs to be moved from the local market to the CSD that is operating its tri-party programme. The need for collateral mobility is key in this decision for this type of client.
Full Service Custody – Omnibus Account at Issuer CSD:
Utilising Commercial Bank money

Account Operator Model – Own Account at Investor CSD:
Utilising Commercial Bank money
FULL IMPLEMENTATION OF T2S WILL NOT RESOLVE QUESTIONS ABOUT THE FUTURE STRATEGY FOR EUROPEAN CUSTODY
First things first

Strategic questions should be asked before selecting an operational approach and then operating priorities need to be compared. This will at the very least narrow the service choices to be made.

Clients need to identify their priorities before considering their choice of providers in a European context. Among the questions they will need to address are the following:

- Do I want to be handling my own settlements?
- What access do I need to central bank money?
- What level of visibility do I want in the market?
- In terms of asset protection, am I comfortable with a segregated custody model or do I prefer an omnibus model?
- How integral is collateral mobility to my trading strategy?
- How important is local market presence and expertise from my provider?

These questions are not specifically about T2S itself but about strategic European custody options. Answering them will not immediately lead to a single obvious service solution but it should at least narrow the appropriate options. Full implementation of T2S will not resolve questions about the future strategy for European custody.
Late mover firms may find that an inability to maximise cash benefits and efficiencies will impact the cost model used to charge clients.

The models discussed in this series of whitepapers, whether relating to asset safety, liquidity optimisation or collateral mobility, are already live in the market. Now is the time to match your individual needs with those models.

Although we are seeing the emergence of new technologies in the custody arena, these are more likely to effect the components of the value chain opposed to the models and services you can now implement in a post-T2S Europe.