Europe's Post-Trade sector: the view from Paris. A lunch-time round-table discussion with Verena Ross, (ESMA), Joël Mérelère (Euroclear and ENSDA), and Florence Fontan (BNP Paribas Securities Services).

Held on Wednesday, February 8, 2012 from 12.30 to 14.15.
At the offices of Clifford Chance Europe LLP, 9 Place Vendôme, 75001 Paris.

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The round-table enabled the Fellowship to catch up with the work of ESMA, the European Securities and Markets Authority, at the beginning of a year in which post-trade issues will bulk large on ESMA’s agenda. The discussion also focused on securities settlement, in recognition of Paris’s role as home to important custodian banks. The meeting was held under the Chatham House rule, which meant participants are not quoted in this summary; nor have any views been directly attributed to any party.

The meeting was planned for February when it was expected that the Commission’s proposals for legislation to regulate the key settlement infrastructures - Central Securities Depositories (CSDs) and International Central Securities Depositories (ICSDs) – would already have been published. In the event, the Commission proposals for a CSD regulation (CSDR) did not appear until March. However, there was a lively discussion based on an earlier leaked draft of the document.

The discussion also covered the European Central Bank’s Target2 Securities project (T2S) for a single platform to which Europe’s (I)CSDs should outsource their core securities settlement function with the aim of overcoming barriers to cross-border securities settlement. At the time of the meeting, discussions were still under way between the ECB and the (I)CSDs about the Framework Agreement that the (I)CSDs will have to sign to confirm their participation in the project. T2S was launched as an idea in 2006 and is due to start operating in 2015.

ESMA’s post trade agenda in 2012.

ESMA’s post-trade agenda in 2012 consists of drawing up the draft technical standards prescribed in EMIR, the European Market Infrastructure Regulation, that sets EU-wide regulation for CCPs, Trade Repositories and clearing Over the Counter (OTC) derivatives contracts as well as preparing the supervisory powers that ESMA will have over repositories.

ESMA has a heavy workload. The still young agency (it only began operating at the beginning of 2011) increased its staff from 35 to 65 in 2011 and will grow further in 2012. In the course of the discussion, the meeting heard how the French government favours giving ESMA sufficient power and resources to do its job.

The Paris meeting took place the day before EMIR cleared its last major legislative hurdle when a “trialogue” negotiation involving the European Parliament and the Danish Presidency of the Council of Ministers, with the assistance of the European Commission, ironed out the last political disagreements over the EMIR text. The round table heard how ESMA had begun work on the technical standards, its biggest immediate challenge. It hoped to deliver these by the end of September, so that the EU could have EMIR in place to meet the September 2009 G20 Commitment
of having clearing of standardised OTC derivatives and reporting of OTC contracts to trade repositories in place by the end of 2012. ESMA’s end-September deadline was tight but an improvement on the previous date of end-June, which would have been impossible in the light of delays in agreeing EMIR.

ESMA has set up three task forces with national securities regulators to carry forward EMIR related work. These are handling i) the regulation of OTC clearing; ii) the regulation of CCPs and iii) the reporting and registration of OTC data and access to repositories. It was underlined that this work is not taking place in isolation but in contact with other regulators in the US, Canada, Asia (including Japan, Hong Kong, Singapore). Such coordination is not an easy task, however.

Dealing with (I)CSD regulation would be a job for ESMA in 2013, although it emerged that ESMA had started to pull together data concerning settlement fails to see whether they showed any trends or risks. Overall, ESMA was trying to identify systemic risk and improve regulatory coordination in the awareness that a solid post-trade infrastructure was a key factor in the ability of economies to withstand crises. ESMA considered that T2S should act as a catalyst in this regard and would be an important part of a stable post-trade infrastructure in Europe.

For (I)CSDs, T2S is one of several challenges in 2012. They also faced Commission proposals for (I)CSD regulation and will be affected by other EU-wide laws such as EMIR; the planned revisions of MiFID; the possibility of securities law legislation; the impact of various pieces of prospective legislation on their ability to provide collateral to the market; and a mooted financial transaction tax for the EU. There were, as one participant commented, a lot of unknowns including unknown unknowns.

**T2S**

Opposing views on T2S were discussed extensively around the table. The (I)CSDs appeared far more sceptical than the custodian banks. The meeting heard from one participant how the initial objective of the project was to cut the cost of cross-border settlement in Europe. DTCC in the US had been the benchmark in mind. However, Europe with its national frontiers, different languages, laws and taxes was inherently more complex than the US.

The idea behind mutualising the core settlement function of (I)CSDs at the ECB was to cut costs and get the (I)CSDs to compete. But in reality competition would take place between custodians and those (I)CSDs that could go up the value chain and develop services for investors. Only a limited number of CSDs would be able to do this (those in big countries - France, Germany, Spain and Italy, for example.)

In this participant’s view, there would be no immediate savings because of the cost of decommissioning obsolete equipment and connecting to the new platform.

Harmonisation was an important precondition if T2S were to bring benefits. But here the problems lay in different laws, regulations and taxes which would have to be addressed by EU member states, regulators and central banks. Without harmonisation in these areas, this participant warned, there would be no cost savings.
While agreeing that harmonisation was key, another participant argued that T2S could act as a strong catalyst in bringing this about, adding that it offered other advantages.

Looking back, this participant argued that Europe only ever achieved progress on harmonisation when there was a big project underway. A previous case cited was when the Euroclear group worked on a single settlement solution for the Euronext equities markets in France, Belgium and the Netherlands. T2S would similarly force harmonisation.

Another argument advanced in favour of T2S was that it would greatly simplify the systems of custodian banks. They would only have to connect to one instead of 27 settlement infrastructures. This would produce savings, although perhaps not immediately. At this point a strong plea was made for users to be properly involved in the governance of T2S.

Another participant asked the meeting to focus on the basics, which were how to make the market more efficient for the user and the investor. If Europe wanted a domestic financial market, it had to define the relevant architecture. There was no alternative to having a central market infrastructure to fulfil the vision of a single financial market and T2S was a step towards this vision.

Another speaker said it was important in the end for Europe to have one securities settlement system instead of 41. Such integration would produce an expansion of the market.

**Looming (I)CSD regulation**

The Commission’s CSDR proposal did not appear until March 7th – a month after the Paris round table. The discussion at the round-table was based on a leaked draft report which included the proposal that (I)CSDs using commercial bank money to settle securities trades should do this through settlement banks rather than any in-house bank. At the time of the Paris meeting, this proposal was the subject of intense behind the scenes lobbying in Brussels with the (I)CSDs arguing that the Commission’s plan, if unrevised, would seriously damage their business and that of ICSDs in particular, and jeopardise their ability to supply collateral to financial markets. The proposed regulation, when finally published, has maintained a bias in favour of CSDs using settlement banks but with a provision for an (I)CSD, if licensed as a bank and backed by its home regulator, to gain special Commission permission to offer banking services ancillary to settlement.

Less controversial were the provisions in the leaked draft (and final published proposals) to provide an EU-wide legal definition of (I)CSDs and prescribe strict rules for their operation. With the aim of increasing safety in the securities settlement business, the Commission proposed to: impose the issuance of securities in book entry or “dematerialised” form; harmonise the period for settling securities at two days against the current 2-3; and impose tough measures to deter costly and dangerous settlement fails. As with EMIR, the Commission aims to further the single market: by giving (I)CSDs the right of access to the securities settlement systems of other (I)CSDs as well as trade feeds from other (I)CSDs and trading venues. Issuers will have the right to issue their securities in any authorised (I)CSD in the EU.

Working from what was known of the Commission’s plans for a CSD Regulation, participants supported the idea of CSDR in so far as it would foster harmonisation. There was less support for some other aspects of the leaked draft, however.
One participant, noting that the leaked draft aimed to make the settlement market safer and more competitive, wondered how far these two goals could be compatible. CSDs were already safe infrastructures. But there was concern that the Commission’s plans would increase risk if, as the leaked draft suggested, it proposed to take banking activities away from the (I)CSDs that currently held banking licenses and hand over the cash leg of (I)CSD settlement activities to custodian banks.

On the other hand, another participant argued that the Commission’s position had to be seen in the context of a general move by authorities to place infrastructures at the centre of financial markets following the crisis. This system had worked pretty well in the cash markets, which had continued trading and settling securities through some turbulent days in 2008 and was now being applied elsewhere.

Perhaps optimistically, this participant predicted a bright future for infrastructures because they would expand into new structures and markets. At the same time, intermediaries (such as custodian banks) would gather together all the activities of investors and channel them to infrastructures and play an important risk absorbing role. It was only right, this participant argued, that some sort of firewall be put between the (I)CSDs and the intermediaries so that the infrastructures were secure and safe and the custodian banks could also absorb risk.

Infrastructures, this participant argued, should settle in central bank money (as envisaged by T2S). If they wanted to compete with settlement banks then there should be a level playing field (and the approach in the leaked draft was one way of achieving this). In the view of this participant, the Commission was not trying to kill off Euroclear or Clearstream Bank Luxembourg (the two big ICSDs). But all market players, infrastructures and custodians, had to adapt their business models to make the market safer.

Looking ahead to consideration of the CSDR by the European Parliament and EU Council of Ministers, another participant predicted a difficult negotiation in the council, which is where the EU member states are represented in the EU’s legislative process.

Other issues

There was a warning that other EU legislation outside the post-trade area could have an impact on aspects of Europe’s post-trade business. In particular, the Alternative Investment Fund Managers Directive (AIFMD) imposed heavy fiduciary and safekeeping responsibilities on custodians which would limit their willingness to re-use assets under their control as collateral.

Another participant made the point that harmonisation should be pursued across European financial markets and not just in connection with T2S.