Transaction Banking & Securities

# THE IMPACT OF T2S IS ABOUT TO RESHAPE SECURITIES AND PAYMENTS INDUSTRIES IN EUROPE

The financial crisis of the first years of the new millennium pushed national and international financial and monetary Authorities to re-think the payments and securities settlement context. With reference to the Eurozone, the ECB decided to evolve the security settlement landscape by adopting the same approach they had followed for wholesale payments with the introduction of “TARGET 2”. In other words, to build a single shared technical settlement platform managed at centralised level and offered to Central Securities Depositories (CSDs).

TARGET2-Securities (better known as T2S) is exactly that: a single shared platform, owned and operated by the Eurosystem, that has been offered to all CSDs interested to adopt it on a voluntary basis. At the moment, 23 CSDs have already expressed their commitment to adopt the new platform by by February 2017. “Early birds” – including the Italian CSD Montetitoli (part of the London Stock Exchange Group) – will go live on T2S on 22 June 2015.

T2S is probably the largest project ever launched by the European Central Bank (ECB) in terms of resources and efforts. The rationale behind this tremendous effort relies on the fact that settlement is a critical process of systemic importance: it performs the closing of any securities deal as it allows the technical exchange of securities against cash, mainly in central bank money. For this reason, national securities settlement systems are (usually) considered as part of respective domestic payment systems.

T2S is part of a bigger picture aiming to build a single European payment system including retail payments (via SEPA), wholesale payments (via TARGET 2) and collateral management issues (via the Collateral Central Banking Model, also known as CCBM). Jean-Michel Godeffroy, chairman of the T2S Programme Board stated that "the ultimate objective of T2S can be summarised in just a few words: to make Europe a better place to invest" (T2S OnLine - Quarterly review - No 11, Winter 2012).

The involvement of the Eurosystem in building T2S and the sponsorship of all European Authorities, including the EU Commission, has generated large expectations around the project. Among others, it is expected that T2S will contribute to:

- reduce the current fragmentation of securities settlement infrastructure in Europe;
- harmonize settlement services in Central Bank Money (CeBM);
- reduce costs of cross-border securities settlement to domestic level;
- increase competition among providers of post-trading services and break up monopolies;
- support to EU Financial Services Action Plan and contribute to removal of Giovannini Barriers;
- reduce risks;
- promote lower overall collateral requirements, reduce collateral costs and improve liquidity management.

But expectations are never for free: if there were no doubts that the introduction of T2S mainly impacts on national CSDs that decided to join it, there is now a general consensus on the fact that T2S will affect the current market positioning of all intermediaries currently operating in the Eurozone, i.e. global custodians but also local agents, Central Counterparties (CCPs), trading venues and asset managers. In order to remain competitive they should all take critical decisions as if stay or not in the securities business and, if yes, how to comply with the new business framework. In brief, they should assess their current business model in relation to the new scenario and, if necessary, think about adopting a brand new one. Furthermore, the impact of T2S on the organization, the operations and the IT structures of all those securities industry actors will be significant.

It was said that T2S will break up the current CSD monopoly at domestic level by "separating the 'infrastructure' from the 'service'" (Ben Weller, June 2012). This was often (mis)interpreted as a commoditisation of the settlement services that will lead CSD to find new sources of revenues with higher margins: those services generally offered by Global and Local Custodians. The extent to which CSDs will succeed in offering other services, eminently banking, depend not only on legislation that will be introduced with the CSD Regulation but primarily on the reaction of those players whose business will be attacked by CSDs. CSDs will have to find a trade-off between:

- develop a wide range of services in favour of a wide range of clients - from broker-dealers to the local custodians and asset managers - and thus collide with Global Custodians

or

- "refine" and expand existing services in favor of Global Custodians (and of larger Local Custodians, able to act as concentrators in relation to other domestic operators) and of Central Counterparties (CCPs), giving up to serve smaller or less sophisticated clients.

Some of today's most competitive CSDs at domestic level risk to get a worse market positioning as T2S will lead to an increase in their operating unit and to a greater competitive pressure on securities settlement fees.

As for CSDs, T2S represents a mix of opportunities and threats for Global Custodians. The few large operators that can be considered as truly global (i.e. those that act directly in any, single, financial center with their own organization) will probably plan, in the long term, to rationalise the number of CSDs they work with. In the short term, they would probably decide not to change the current business model based on direct membership. As the majority of them work through local entities that offer them agency services, they will be geared to reduce the number of current local providers; this solution will imply that they have to plan additional costs to insource skills and know-how.

T2S could have significant implications also for the sub-custodians (ie. the smaller local operators which normally act as local agent for global custodians). Even for them it could be necessary to rethink / refine their business model in order to keep the current competitive position. This will imply new investments and their operating costs will rise in the medium term. In addition, not all sub-custodians will be able to cope with the new challenge: they are fully aware about this issue that explains why an high percentage of sub-custodians expressed a negative opinion on T2S. The fragmentation of European markets was, in fact, the key to their success so far. Concerns also arise from the fact that there is a significant probability that the national CSDs in T2S may extend their operating scope to local custody services (in particular in the field of management of corporate actions, taxation, etc.). This event would hardly be counteracted by the local custodians, who would lose not only revenue but also their raison d'être. In fact, there would be space for only few operators who can aspire to the role of single point of access to a country involved by T2S and the ideal candidate is surely represented by the national CSD. The most likely consequence is, in the medium term, a consolidation of local operators or their conversion to the role of traditional commercial banks.

CCP will play a key role in the post-T2S. Indeed, there are many clues to substantiate this statement. The new rules on OTC derivatives, the giving up to CCBM2 project, the increasing centrality of the role of collateral and – last but not least – the need to balance any negative network externalities, will make CCPs to become the key players in the development of the securities industry, even more than in the past. As the eminently domestic character of CCPs will lose importance progressively, only those structures able to support the growing demand for more sophisticated services, characterized by an international footprint , will survive. The others would probably be subject to mergers or acquisitions. The increased international competitiveness, together with the improved interoperability induced by T2S, could "crowd out" also those very efficient structures which, in terms of size, number of non-domestic participants and range of served asset classes, would be perceived as less "appealing".

Also companies who manage trading platforms will not remain indifferent to the advent of T2S. An easier access to standardised settlement services and harmonised custody services will blow traditional domestic boundaries, opening to greater contestability of the trading business and, ultimately, to an increase in competition. The use of a plurality of interoperable CCPs, the level of specialization on one or more asset classes, the range of products offered and the level of sophistication of the same, the ability to adapt to a more international context - characterized by a greater dynamics / responsiveness - are only some of the potential variables to be considered. T2S will probably not have a direct impact on trading platforms management companies in terms of operating costs or trading fees. More likely, it will push for an increase of competition between those companies.

In conclusion, if for someone T2S can pose a threat to its competitive position, for someone else it could represent a source of new opportunities: “At the moment, the buzzword in the market is “collateral”. We are seeing considerable growth in secured borrowing. Also the future legislation on CCPs and OTC derivatives (EMIR) will require more margining. All regulatory initiatives point to the greater demands for more high-quality collateralT2S will enable banks to make very significant savings in collateral when settling securities transactions. T2S will eliminate the need for banks to hold multiple buffers of collateral in depository systems across Europe. Banks will have the possibility to have a single buffer based on their entire European business. A single pool of assets and liquidity automatically nets the short and long positions between various countries. A single settlement engine, central bank auto-collateralisation, a harmonised schedule, and many other features of the T2S platform, will also enable banks to reduce the amount of collateral that is left idle."(Gertrude Tumpel-Gugerell's keynote speech at the ECB's conference on "Securities settlement in 2020: T2S and beyond", Frankfurt, 4 October 2011).

The recent financial crisis has exacerbated the relation between efficient management of collateral and its impact on capital adequacy needs of European banks. Following completion of a capital exercise, the European Banking Authority (EBA) determined in 2011 that the aggregated shortfall - corresponding to a minimum Core Tier 1 ratio at 9% - exceeds over € 100 billion.

Under the pressure of the new market discipline agreed at G20 level to mitigate and – to a certain extent - prevent any new financial and monetary crises of systemic impact at global level, retail and wholesale payment systems will necessarily evolve and unsecured interbank deposit markets would be gradually replaced by guaranteed ones.

Collateral is more and more a precious resource as it is more and more scarce: the current way of managing collateral shows some inefficiencies both internal (i.e. related to the specific business model of each market actor) and external (i.e. determined by the fragmentation of markets and platforms). These inefficiencies are estimated at about € 4 billion per year, of which about 10% originating from processes of over-collateralisation.

Financial institutions aiming to keep their competitive positions in the new scenario will have to define strategies for integrating cash and securities in order to optimize risk and profitability management. Banks will look for more efficient collateral- and risk- management tools that, being integrated with payment and compliance processes, are able to work in a proactive way instead of simply reacting to market inputs.