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Regulatory Handbook 2015/16

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Tis but a scratch!

Rather than introduce this Regulatory Handbook 2015/16 with simple words, the following list will be used, because it illustrates the scale of the job-at-hand: T2S, Basel III, Dodd-Frank, CSDR, MiFID II, PRIIPs, Solvency II, and UCITS V.

That list of financial reform doesn't even scratch the surface of what's in store for financial services. Add to them a dozen other acronyms, fund passport initiatives in Asia, global programmes such as base erosion and profit sharing, and national plots like the US Securities and Exchange Commission's swap data repository rules, and you're undoubtedly bawling your eyes out. But, and here's the rub, the onion is barely peeled.

Regulation no longer keeps the industry up at night. Worse, it dominates days too. Whole teams have been put together to decipher *what it means*, when really many are probably praying for regulators to *make it all not true*. But it is, for better or worse, and the mountain has well and truly come.

What can be done? In these pages are accounts that much and more can and is being done. The prevailing theme of spinning plates that has dominated thought in this area is no longer used (much like, thank goodness, the 'tsunami of regulation' metaphor that has done the rounds for the past few years *shudders*). Instead, clear thinking and sensible thought pervades.

This is what the industry is now. Highly regulated, but safer, sounder and more secure. What's more, new opportunities are arising for the savvy player who knows how to keep his head when all about him are losing theirs.

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An ill wind

Times have changed: regulators regulate, and financial services firms aren't focusing on making money. Brian Bollen wonders why

RegulatoryIntro

Once upon a time, in the pre-lapsarian days before the global financial crisis, regulators of the world's principal financial services industries and institutions were a different breed.

Hard as it may be for younger readers who have come of age post-2008 and the collapse of Lehman Brothers, regulators were then, if not a soft touch, very much of the light-touch persuasion. Even in traditionally left-wing political circles, senior figures boasted of how intensely relaxed they were at the prospect of certain people becoming filthy rich.

Fast forward to mid-2015 and we find ourselves living in an age when banks, insurance companies, asset managers and pension funds are hemmed in on all sides by a series of oppressive regulatory frameworks. The 'watch list' of items appearing on the radar in Europe alone is jaw-droppingly long. It covers a gamut that runs from Target2-Securities, the Central Securities Depository Regulation (CSDR) and Markets in Financial Instruments Directive (MiFID) II, to Solvency II, money market reform and Basel III, taking in along the way the Foreign Account Tax Compliance Act (FATCA) and the Financial Transaction Tax.

"You do anything with an asset in the EU, you get regulation," says Paul North, head of product management for Europe, the Middle East and Africa in the asset servicing business at BNY Mellon. And this is holding back innovation as people need to take into account non-investment elements of their product range.

It is, indeed, almost enough to provoke an emotional response even in the most disinterested market observer. It would take a heart of granite not to feel at least a twinge of sympathy for the aforementioned banks, insurance companies, asset managers and pension funds. And, of course, their service providers, the global, regional and local custodians, and the other boutique providers of essential services.

It has fallen largely, almost exclusively, to them, to address the regulatory requirements that have been piled upon their clients relentlessly in the past several years. Making sense of it all and devising the necessary solutions has been, and will continue to be, a complex, painful and expensive process, which shows no sign yet of losing momentum.

Mark Downing, who runs relationship and coverage teams looking after institutions in the UK for BNP Paribas Securities Services, sees continuing activity in this regard for at least the next two to three years. He divides regulation into three broad categories: (i) those that are related to investor protection, citing the Alternative Investment Fund Managers Directive (AIFMD), UCITS V, Solvency II and the Institutions for Occupational Retirement Provision (IORP) Directive; (ii) those that simplify, or at least attempt to simplify, market infrastructure, such as the European Market Infrastructure Regulation (EMIR), the upcoming CSDR and MiFID II; and (iii) reminders to the investment community that while they might outsource increasing volumes of certain tasks to third-party external providers, they very much retain full responsibility for every last cent of investors' money, and they must monitor and supervise those providers accordingly (the UK Financial Services Authority's 'Dear CEO' letter springs to mind).

"It is an integral part of our role to help clients meet the new demands that regulators continue to place upon them," says North. "We are very conscious of the need to keep pace with change in the market and to evolve continuously. It might be a cliché but if you stand still in this environment, you go backwards. Fast."

Putting a positive spin on the issues is Guillaume Heraud, global head of business development for financial institutions and brokers at Societe Generale Securities Services: "As a result of the ongoing and rapidly moving flow of regulations, we have become ever closer to our clients and their strategies to share a common understanding of the potential impacts and identify what provides more value for them, enabling us to deliver fit-for-purpose services to meet their needs in a cost-efficient way," he says.

Sticking with the French theme, asset owners are most worried about the growing complexity of risk management, according to a recent survey carried out by YouGov for BNP Paribas Securities Services. According to the survey, of 177 asset

owners around the world, 59 percent of respondents cited this as a major challenge over the next 12 months. This complexity is a greater concern for asset owners than regulatory reporting (cited by 33 percent of respondents) or regulatory compliance costs (28 percent).

Mark Schoen, head of asset owner solutions at BNP Paribas Securities Services, said of the survey results: “Complex risk management tops the list of concerns for asset owners, far above the traditional worries that have stemmed from regulation in recent years. The increasingly complex nature of risk management will hit asset owners at the bottom line.”

A separate survey, carried out by managed data service provider RIMES (the third RIMES 2015 Buy-Side Survey), showed how asset managers are gripped in a governance and regulatory battle. As the regulatory focus is shifting from the sell-side banks and moving to the buy-side investment managers and their service managers, growing client demand for data is now having a much larger impact on asset managers’ decisions relating to data management, according to RIMES.

Alessandro Ferrari, senior vice president of global marketing at RIMES, said of the survey: “It’s a tough and unforgiving market environment for the buy-side at present. Facing pressures from clients to increase data sources and deliver higher levels of data customisation, asset managers are also under pressure to reduce costs and meet incoming regulation, particularly in Europe. It’s a perfect storm that means those firms with a robust data management strategy in place will come out on top.”

For all the good intentions of various regulations, the law of unintended consequences will insist on surfacing from time to time. AIFMD asset segregation, for example, will compromise triparty collateral management and securities lending, according to Ross Whitehill, managing director at the BNY Mellon Markets Group. He said in May 2015: “There is mounting concern within the industry that enforced segregation of alternative investment fund assets—and most likely UCITS, depending on regulatory harmonisation with AIFMD—across all levels of the custody chain, as proposed under a recent European Securities and Markets Authority consultation paper, will significantly impact the ability of these funds to utilise triparty collateral management services and participate effectively in securities lending.”

Whitehill said: “The impact on funding and liquidity in the market will, we believe, be very significant affecting growth and investment in Europe.”

The intention of the proposed AIFMD asset segregation rules is to protect the interests of the alternative investment fund’s investors by ensuring that assets are not exposed to events such as bankruptcy of the third party to whom the safekeeping of the funds’ assets may be delegated, he noted. However, taking this to mean that accounts should be segregated down to the sub-custodian level to enhance investor protection, could result in a policy that exacerbates rather than mitigates counterparty, operational and systemic risk, he added.

Looking ahead, the lack of harmonisation between regulators and their separate edicts will continue to be problematic for the industry, suggests Tim Thornton, chief data officer at fund administrator Mitsubishi UFJ Fund Services, making compliance unnecessarily complex and costly. And the absence of clear guidelines does little to help explain to clients just what is needed of them.

But as the old proverb says, it is an ill wind that blows nobody any good, and this state of affairs will have a positive impact for third-party providers. “The main impact on clients is the additional overhead required to become compliant,” says Thornton. “Smaller firms on both the asset management side and the fund services side of the business will find they cannot afford the investment in expertise and processes. It takes scale. The regulators are thus reinforcing an already existing trend of flight to larger institutions.”

The final word for now goes to North of BNY Mellon. One potentially significant upside, he suggests, is that part of the overarching objective of EU regulators is to boost jobs growth. By 2020, the plan goes, Europe will be a much more attractive place to run funds as it should be in better shape economically. “One of the best official papers that I have read in recent times is the green paper on a capital markets union in the EU. It is very well articulated and enormously ambitious in scope. If they achieve half of what they are striving to achieve, they will be doing very well.”

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On a dark and stormy night

Once upon a time, banks ran rampant and under-regulated—but did a handsome regulator vanquish the wicked and restore balance and stability, or did they simply wander down the wrong path to fall prey to the big bad wolf? Stephanie Palmer dons her red cloak and ventures out to take a look

When it comes to regulation, it's becoming clear that while the end may be in sight, the financial services industry has a fair way to go before its own happily-ever-after. Among the reporting regulations, settlement harmonisation initiatives and reconciliation rules, the industry can be forgiven for likening 'the regulator' to the big bad wolf of fairy tales, rather than the handsome prince who rescues, well, the damsel in distress, via glass slipper or soppy kiss.

It's certainly easy to accuse the enforcers of snooping and waiting to pounce. Even more so, it's easy to forget what they're there for in the first place—to protect the industry and the interests of customers, and to prevent another crash.

According to Kinetic Partners's Global Enforcement Review for 2014, the average fines issued by the Financial Conduct Authority (FCA) in the UK increased by 1,590 percent between 2009 and 2013, and a further 66 percent in the following year. A KPMG report issued in April 2015 found that between 2011 and 2014, of the total profits registered for UK banks, 61 percent was spent on customer remediation and conduct issues—a total of £38.7 million.

Bad apples

Fines have been hitting the headlines a lot this year, with BNY Mellon breaching custody compliance rules in the UK, Merrill Lynch being issued record-breaking fines for reporting failures, and the infamous LIBOR and foreign exchange scandals resulting in a bout of guilty verdicts.

The Kinetic Partners report attributed these changes partly to investment in the regulators themselves. They have more funding and resources at their disposal, and better surveillance technology, giving them greater insight into institutions. They are also investing in personnel. Between 2006 and 2013, the US Securities and Exchange Commission (SEC) and the FCA increased their employee numbers by 22 percent and 53 percent, respectively, and the SEC is now actively seeking to hire former financial and criminal law prosecutors.

Monique Melis, managing director and global head of regulatory consulting at Kinetic Partners, a division of Duff & Phelps, maintains, however, that while penalties may have become more common, they're still mainly financial. As long as this is the case, the regulators, however well staffed, won't be as effective as they could be.

She says: "Financial penalties alone aren't enough to deter organisations from breaching regulations and there are other tools regulators have at their disposal that can be incredibly effective. These range from requesting firms submit a variation of permission stating that they won't take on any further clients until they become compliant, to imposing business restrictions and even suspending individuals."

There is a danger, Melis suggests, of firms coming to regard fines for compliance failures as just another business cost, even budgeting for them.

"This won't change culture or behaviour, and ultimately costs will be passed onto customers and shareholders," she says.

When BNY Mellon was slapped with a £126 million fine by the FCA for failing to comply with custody rules, the bank made clear that the figure was "fully covered by pre-existing legal reserves". It said: "Importantly, BNY Mellon remained financially robust throughout the relevant period."

While intended to be reassuring, this kind of attitude suggests that the costs of changing internal systems outweighs that of the financial penalty imposed, especially with an institution of this size.

Tim Howarth, financial services regulatory partner at KPMG, doesn't agree that clients are unaffected. He suggests that banks are already suffering from a return of equity that's below the cost of capital, "which in the long-term is an unsustainable position".

While institutions may have the capital available to pay their penalties, the fines will still effectively reduce returns, meaning less reinvestment and fewer opportunities to grow.

Howarth says: "This presents a challenge for banks that want to invest in the customer journey to reduce the cost of serving customers and

improve the customer experience. Ultimately, this means the cost for the end user isn't going down, but staying the same or even increasing."

According to the FCA, BNY Mellon failed to adequately record, reconcile and protect its clients' assets under custody—a failing that was deemed particularly serious considering the 'systematic importance' of the bank, which is post-crisis speak for 'too big to fail'. However, in agreeing to settle at an early stage of the investigation, the bank was eligible for a 30-percent discount on the penalty, reducing it from £180 million to £126 million.

To its credit, BNY Mellon also launched an internal review with the assistance of an independent third-party accounting firm and external legal advisors. The bank also promised to implement a new framework of improved policies and procedures.

BNY Mellon added in its statement issued at the time of the fine: "BNY Mellon is very mindful of the importance of safeguarding client assets and has been trusted by its clients to do so for 230 years. This trust could not have been earned without robust regulatory compliance in all of our operating jurisdictions, and we regret in this case that we did not meet our standards or those of the FCA."

"As always, regulatory compliance remains a key area of focus as we maintain our track record of safety and soundness as a financial institution."

In another high-profile case, Merrill Lynch was hit with a £13.29 million fine for transaction reporting failures—the highest penalty of its kind ever issued by the FCA. The size of the fine, which was bumped up to £1.50 per line of incorrect or non-reported data rather than the usual £1, was down to the wealth manager's failure to address the root causes of error, even after repeated warnings, previous fines, and 'substantial guidance' from the regulator.

Despite this, Merrill Lynch was also eligible for a 30-percent discount for early settlement, reducing the fine from just under £19 million.

Merrill Lynch declined to comment, but these cases point to a culture of going ahead with non-compliant activities and dealing with the consequences later, rather than adopting a change in institutional culture.

"Clearly the solution is better governance," says Howarth. "The tone at the top is very clear, but it needs to transcend throughout the organisation."

"Successful banks are those who overhaul their organisations and use this opportunity to implement one-in-a-lifetime change to their culture now."

According to Melis, this should be achieved through greater accountability for individuals—making those at the top responsible for the actions of the whole company.

She says: "Sanctions against individuals are the real deal. They are an undeniably powerful deterrent and, unlike financial penalties imposed on the firm, cannot be written off as a business cost."

If the slipper fits

This kind of personal accountability is becoming more prevalent. The FCA has proposed new rules, scheduled to come into effect in March 2016, which will make individuals in positions of responsibility accountable for a firm's failures. If there is more pressure on an individual in a position of power, then, in theory, that person will be more active in ensuring compliance throughout the organisation.

If responsibility falls to a group of too many people, then it is diminished, leaving no one taking an active interest in compliance, and no one treating it as a priority. Of course, this means that the blame is also diffused, as too is the punishment. In reality, the only real consequence for each responsible individual is barely a significant scolding.

According to the Kinetic Partners Global Enforcement Review, in the wake of the 2008 financial crisis, the public is looking for "retribution and accountability", and even those involved in the industry are looking for clarity on responsibility. Of those surveyed, 27 percent of CEOs and 40 percent of employees believed that making executives legally responsible for a firm's activities would serve a company well.

That's not necessarily to say that a firm that failed to detect wrongdoing should be let off the hook, but there's a balance to be struck between finding the individual or group responsible and dragging the whole firm's reputation through the mud.

In May, four major banks, Citicorp, J.P. Morgan Chase & Co, Barclays and the Royal Bank of Scotland, pleaded guilty as institutions to fixing the foreign exchange markets between the UK and the US repeatedly between 2008 and 2012, and were fined a combined total of $5.7 billion, or about £3.6 billion. Although these fines were also record-breakers, they were considered solely the burden of the 'parent level' banks.

Speaking at a press conference on foreign exchange spot market manipulation on 20 May 2015, US assistant attorney general Bill Baer said: "In light of the seriousness of the crimes and the unjustified benefit to the bottom lines of these banks, we demanded parent-level guilty pleas, secured record fines … and insisted upon three years of court-supervised probation."

He added: "Simply put, exchange rates are prices to buy and sell currency. They should be set competitively the same way prices are set in any type of market. Instead, the members of the aptly-named 'Cartel' chat room conspired to gain unlawful profit by manipulating these rates. The banks pleading guilty today are not ordinary market participants. They are market-makers, representing 25 percent or more of dollar–euro exchange rate transactions each year. As such, they were uniquely positioned to manipulate the market."

Although many of the individuals responsible have since been removed from their positions, it was deemed important to fine the institutions as a whole. If nothing else, this brought the issue to the attention of the public, made an example of the banks involved, and took a step towards changing the cultural attitudes of the wider industry.

Baer said: "It is imperative that these banks accept full responsibility for these bad acts and carry through on their commitments to change the culture that allowed this behaviour to go on for years without detection."

And the attitude is similar in the UK. Melis says: "The massive fines that resulted are the biggest financial settlements in UK history, setting a precedent and a tone with regards to how the regulator approaches these issues. It's hardly surprising given that the rigging of these markets directly undermined the confidence in the UK as a trading hub, as well as impacting thousands of consumers and commercial customers."

The breach of public confidence has become more and more problematic since the events of 2008. With more choice available to consumers, a more educated public and improvements in financial technology, plus the scars in the reputation of the industry as a whole, it's more important than ever to give the customers what they want. According to the Kinetic Partners enforcement review, reputational damage can act as a more effective deterrent than financial punishment, and the regulators have picked up on this.

Until 2013, firms could settle with the SEC without officially admitting any responsibility, and in 2014, the FCA made warning notices of regulatory failures publicly available, encouraging some institutions to correct issues in anticipation of a public backlash.

This shift in attitude is not something that can be side-stepped. According to Howarth, the FCA has already made reference to specific categories that it considers 'emerging' or 'potential' risks, including contract terms and servicing standards for existing customers.

He says: "Banks should proactively review their processes as well as these risks, to ensure their back-office process and algorithms are designed in the best interests of the customer. For instance, lenders should ensure that their algorithms for lending move beyond credit checks and include affordability, to reduce unaffordable debt."

Howarth suggests that as well as automating and boosting efficiency, back-office processes should be geared more towards the nitty gritty of financial processes, and customer protection, and made more aware of the consumer that they are ultimately serving. But this is about culture as well as anything else, and Melis believes that the answer lies in education—making back-office

personnel aware of exactly what the risks are, and of how to handle them when they arise.

Melis says: "Just as traders should be trained on compliance procedures, middle- and back-office personnel must have a good understanding of the markets and trading environments. While it can be difficult for back-office staff to fully detect a breach, they should be trained on market integrity and risk, enabling them to spot suspicious activity. Firms should also make sure there is a culture in place where staff can raise any concerns."

The regulatory burden is unlikely to get any lighter, and as the regulators up their games, the only way to stay on track will be to make a lasting change in the culture of the industry as a whole.

"Regulators and law-makers introduce rules ultimately to protect consumers and ensure fair, transparent markets," says Melis.

"At the end of the day, firms must meet their obligations and show commitment to adopting and embedding the spirit of the rules into their organisation, or face regulatory scrutiny and possible enforcement action."

When the fairy dust settles

The focus is finally moving towards individuals affected by regulatory breaches; the end consumer, the pension plan holder, and even, in some cases, the taxpayer.

Responsibility is getting more personal too, with regulators starting to pin the blame on specific perpetrators rather than 'faceless' corporations.

All this is gearing towards more recognition of wrongdoing and more accountability in real terms.

But there is also virtue in leniency. Melis says: "Regulators could do more to distinguish between the types of breaches. This means identifying the true nature of the breach—whether it was unintended, a result of bad management, or in fact intentional wrongdoing—and reflecting that in the penalty."

"What's more, compliance teams which have self-reported are seldom given credit and that should also be taken into account. Acknowledging good behaviour can be just as impactful as punishing bad."

In the treacherous landscape of global compliance, regulators should not be demonised as the baddies that lurk in the shadows.

Nor should they be the handsome prince who rescues a 'victim'. Instead, the industry should be rewriting the characters altogether.

Sometimes the only way to get out of the woods is to appeal to the wolf's friendly side and ask for directions. Or better yet, try the slippers on yourself.

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A regulatory cushion

Innovative technology is the key to managing the regulatory revolution, says Rupert Booth of MYRIAD Group Technologies

"If you have ten thousand regulations, you will destroy all respect for the law." Sir Winston Churchill was berating the post-war Labour government's over-zealous imposition of legislation upon industry and commerce when he spoke these words in 1949. Shortly afterwards, the great man advised that "if you're going through hell, keep going". Now whether or not you agree with the first of these quotes, there is no doubt that the sheer volume of legislation applied to the world of finance today, coupled with the continent-sized bulk of each piece, makes it essential that one abides by the second, driving forwards to meet deadlines and complying with requirements, however dispirited you may feel.

I say 'dispirited' because in recent travels I have listened to many-a jaded manager lamenting the demise of innovation and fun in banking operations, one of them likening the serried ranks of complex industry directives to an over-long list of rules that a child must abide by. Eventually, trying to follow them becomes tiresome and frustrating and falling short of the mark seems almost inevitable. Some of these executives have sounded somewhat defeated, merely resigned to installing industry curbs into their banks, having been taken from their day-jobs to do it. Can this reaction be construed as losing respect for the laws being imposed?

Perhaps it's not outright revolution, but there is a palpable disenchantment with the new order and fatigue as a result of the non-stop implementations. The very selection of a service provider has mutated somewhat in that the part of the request-for-proposal questionnaire relating to regulations compliance now bears greater weight in terms of scoring than the old favourites of swift issue-turnaround and competitive agent deadlines or fees. It seems that operational under-performance carries with it less concern for the buy-side executive than regulatory under-compliance. How times have changed.

This might all sound rather pessimistic, but it's just a reaction to bitter medicine. Much like the economic austerity remedy we have been taking for the past four years, perseverance is the key, and if we keep going through the hell, in time we will indeed get through it, emerging in better shape on the other side. But it needs careful management and close supervision. Every institution subject to these regulations must—or should—have a mechanism to support the business of getting itself compliant.

Doubtless, the projects each is running to meet the requirements are well-advanced and conducted in rigorous fashion, but a distinct advantage is to be had in implementing a technological solution for its programme—one that persists in perpetuity.

It is here that the continually-evolving attitude and approach of the vendor governance and network management platform, MYRIAD, comes into its own. The system provides some solid footing for the observance of many of even the smaller directives. The Prudential Regulatory Authority of the Bank of England requires, of late, that all custodial contracts comply with clarity guidelines on matters such as segregation clauses and procedures for dividend distribution. MYRIAD's job as a central repository for all nostros, related request for information responses and contractual documentation, identifies it as the ideal engine for reconciliation of the relevant pieces; out of this, compliance will follow quite naturally.

The same can be said, in the US, of the Office of the Comptroller of the Currency's 2013-29 recommendations for risk management of third-party relationships. Once the platform is complete with an institution's fully updated, persistently monitored vendor intelligence, applying official recommendations in such a controlled environment would be a straightforward affair.

The application of both new and established regulations to both new and established business has traditionally been the territory of the compliance departments. With the emergence of tighter controls on the transparency of counterparties and assets, clearer and more demanding financial requirements, more complex, investigative tax laws, and the drive towards a more efficient post-trade processing world, this territory has greatly expanded. Working alongside the compliance, legal and risk teams are the network, vendor and banking services managers, ensuring that the laws and regulations are applied equally rigorously to the governance of both the upstream and downstream external relationships for which they are responsible.

Very often, this extra compliance duty requires someone to apply his or her time exclusively to the implementation of the requirements of a piece of regulation, meaning the team is one head down and additional systems must be learned. As mentioned above, day-job duties are compromised and the reduced headcount must be compensated-for by increased efficiency.

The existing and developing capabilities of MYRIAD with regard to regulation support means that those who manage the banks' provider relationships might not have to divorce themselves entirely from their existing responsibilities when they are assigned to new compliance projects. Where new regulations are relevant to the third-party relationship and provider management areas, MYRIAD's functionality will allow the user to perform the 'business as usual' administrative functions in tandem as operational capacity is improved.

Simultaneously, the platform's workflow, documentation and control processes will allow comprehensive reporting on the institution's status with regard to its vendors, custodians and accounts, along with the centralised storage and tracking of crucial compliance documents as regulatory projects are progressed.

It's easy to generalise about this, and of course a relationship platform, however sophisticated, will not be functionally relevant to the operational impacts and requirements of every new piece of banking legislation, so let's be specific. We'll start with the biggest.

The US Dodd-Frank Act was brought into effect in June 2010 to overhaul everything from the transparency of information to the cut of your suit, requiring the implementation of 243 rules that focus upon standardising data, reducing systemic risk and clarifying identity (the legal entity identifier). This vast undertaking, more formally named the 'Wall Street Reform and Consumer Protection Act', meant that a great deal of the resulting data needed a permanent home.

In fulfilling its purpose as a service provider and related nostro database, with the capacity for all accompanying static, MYRIAD provides the logical and most suitable address for just such identification. Not only will the firm's own distinct, group-wide entities, on a global scale, be demonstrable in one place, but so too will those of its vendors, be they custodians, central counterparties, central securities depositories, clients or brokers; all the relationships will be apparent, even if highly complex. As much detail and history as desired may be on display, as much relevant supporting documentation to hand, all in context, all alerted for update, online, all the time. This is transparency at its most clear, and coupled with a highly versatile reporting suite, it is data analysis of superior immediacy and granularity and, therefore, truly risk-averse.

So much of the detail championed by existing and emerging regulation owes its existence to the need for the sound governance and continual monitoring of commercial counterparties and partners, and this practice is what MYRIAD is all about. The Markets in Financial Instruments Directive and the regulation of the same name address the soundness of the post-trade framework, calling for, once again, greater transparency, improved investor protection and segregation. MYRIAD provides fertile ground for supporting them: a central tool loaded with all aspects of market relationships, coupled with the wherewithal to closely examine each aspect and account from a regular and sustained auditory perspective, it is a powerful ally in ensuring that clients and assets are properly safeguarded.

Target2-Securities brought with it the obligation to integrate and unify the highly fragmented securities settlement infrastructure in Europe. Leveraging continual performance review, semi-automated selection of the most suitable, cost effective provider, ensuring the optimum

settlement model and clearing facilities, MYRIAD's versatile reporting is positioned to extend these abilities and monitor the effect of emerging harmonisation on cost.

Even the smaller-picture stuff such as legacy-system clean-up assists the process of becoming risk-efficient. Imposing an increasingly joined-up approach in the administration of market relationships on an increasingly joined-up company makes sense. The regulators like that—it indicates diligence, clear vision and serious-thinking management.

The capital, depository bank and market ID coding requirements enshrined within the Alternative Investment Fund Managers Directive are supported wholly by MYRIAD's focus on data transparency. The thorough and regular due diligence that fund managers must perform upon their EU-domiciled custodian and prime brokerage firms—and vice versa—can be run in semi-automated fashion, through the system's proprietary workflow, helping both depositories and investors achieve the levels of transparency and reporting that are essential.

Even tax reporting does not go unsupported. The Foreign Account Tax Compliance Act's requirement for foreign financial institutions (FFIs) to obtain global intermediary identification numbers (GIINs) from the US Inland Revenue Service is accommodated in MYRIAD's substructure, allowing FFIs to demonstrate such information pan-group and pan-network.

Other far-reaching considerations in data management and compliance are catered for in this way, providing verification for know your client (KYC), on-boarding and tax information. Although KYC is not, in and of itself, an enforced regulation, pertinent legislation exists in the form of statutes such as the US Patriot Act, which makes the process mandatory within banking procedures in the interest of combating fraud and money laundering.

MYRIAD provides further support here, enabling exhaustive classification of clients and vendors, according to any and all circumstances, and creating the capacity to link information to due diligence and to the tracking of related audit trails.

Much of the risk management that is obliquely or directly referenced by all these regulations is encapsulated within the European Banking Authority's guidelines on common reporting (COREP), a suite of principles, particularly those of operational and market risk, from which the core purpose of MYRIAD might be drawn. Meticulous and granular data maintenance, accurate and timely reporting, comprehensive, regular due diligence and consistency across the board are the cornerstones of the platform's functionality, keeping it in touch with the shifting demands of the day.

Regulation is changing the world of finance. Innovative technology is the key to managing that change.

> "Even tax reporting does not go unsupported. The Foreign Account Tax Compliance Act's requirement for foreign financial institutions to obtain global intermediary identification numbers from the US Inland Revenue Service is accommodated in MYRIAD's substructure"

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Flexibility lies at the heart of managing regulatory demands

The technology is on hand to deal with regulations affecting daily operations, reporting and data management, says Darryl Twiggs of SmartStream

Regulators are demanding greater transparency than ever, requiring evidence that robust controls are in place over the risks facing financial institutions. One result of this trend has been an explosion in the growth of inter-system reconciliations, driven by the need to validate internal data and to ensure that effective internal controls are in place.

Our solutions have been shaped to assist clients to respond to authorities' demands for greater transparency in relation to control and monitoring counterparty risk. SmartStream's TLM Reconciliations Premium solution has been developed to help financial institutions cope with the growing volume of intersystem reconciliations that regulatory demands have prompted. Highly flexible, TLM Reconciliations Premium processes all types of reconciliations with great accuracy. This includes inter-system and regulatory reconciliations, as well as ad hoc reconciliations carried out as part of system updates.

The same explosion in reconciliation volumes lies at the heart of SmartStream's decision to develop TLM SmartRecs. TLM SmartRecs facilitates the rapid onboarding of new reconciliations and has been designed to support financial institutions as they fight to overcome the backlog of reconciliations created as a result of regulatory initiatives such as Basel III and the European Market Infrastructure Regulation (EMIR).

Flexibility lies at the heart of TLM Reconciliations Premium. This is an important quality given that collective regulatory initiatives such as Basel III are being transitioned by individual countries into their own legislatures, creating differences in the way requirements are applied. Variations in how local jurisdictions want reporting, for example, to be carried out create considerable challenges for banks with multinational operations. A flexibly architected solution—such as TLM Reconciliations Premium—can assist organisations to handle these complexities.

EMIR, which introduces new reporting and clearing obligations for over-the-counter (OTC) derivatives, is obliging financial institutions to perform routine reconciliations between the third parties and the central counterparties with which they interact. OTC derivatives present particular difficulties as they involve considerable quantities of unstructured data. Both TLM Reconciliations Premium and TLM SmartRecs are flexible enough to assist in this area. They are aimed at coping with daily margin calls and reconciling at contract level, ensuring that sufficient collateral is available to cover these high-risk deals.

(RDU). Available as an on-demand utility, the RDU supplies the highest quality reference data to banks' front-, middle- and back-office solutions, ensuring the best straight-through processing rates and minimising the likelihood that errors and costly disputes arise.

"At SmartStream, we have put considerable developmental effort into ensuring that our customers are able to respond promptly and efficiently to shifts in the regulatory landscape"

Darryl Twiggs
Executive vice president, product management
SmartStream Technologies

Funding and counterparty risk management are of vital importance to our customers. We have extended our liquidity solutions to include both cash and collateral, through the acquisition of IBM's Algorithmics Collateral solution, now rebranded TLM Collateral Management. The solution assists customers to better understand contract disputes, lessen the costs that result from these, and to calculate the daily margin calls mandated by increasing regulation. Its integration into our cash and liquidity solutions allows a comprehensive, up-to-the-minute picture to be created of a firm's exposure, enabling an organisation to mitigate counterparty risk and to respond to market changes in a timely and efficient manner.

At SmartStream, we have put considerable developmental effort into ensuring that our customers are able to respond promptly and efficiently to shifts in the regulatory landscape.

Financial institutions are currently under pressure from regulators to segregate client money effectively. In response, we have developed TLM Client Money, which enables banks to reconcile customer cash and securities while keeping these assets separate from their own funds.

Data, particularly reference data, underpins all control solutions. SmartStream provides a unique utility in the form of its Reference Data Utility

SmartStream has expanded the approach that began with the RDU, making all solutions available through an on-demand utility service. Customers, especially those on the buy side, are now able to take advantage of our solutions, without the need to invest in on-site technology.

With approaching regulatory milestones putting increasing pressure on firms to have controls in place, the ability to achieve rapid deployment at the lowest possible cost is a significant advantage.

Regulatory initiatives are having a profound effect on the way financial institutions carry out daily operations, report to financial authorities and manage data. We take great pride in developing solutions that respond to the challenges that incoming financial regulation has created. SmartStream's technology is highly effective and has been endorsed at the highest level.

September 2014 saw the US Securities and Exchange Commission (SEC) award a contract to SmartStream to furnish TLM Reconciliations Premium and TLM SmartRecs to the SEC's Office of Compliance, Inspections and Examinations.

Looking to the future, we anticipate that regulators have not yet had their full say. At SmartStream, we will continue to respond as regulatory initiatives evolve.

JurisdictionInsight

Directors of Irish funds: marrying the guidance requirements

Multiple guides on Irish fund directors exist. Derbhil O'Riordan of Dillon Eustace unpicks them to come up with best practices

The role of a director of an investment fund has developed significantly in recent years, with numerous regulatory bodies in various jurisdictions issuing guidelines or prescriptive rules on the role of a board of directors and each individual director.

Directors of Irish funds will have to consider their statutory obligations as well as case law in carrying out their duties. However, issues encountered by directors of funds often fall outside of the guidance provided by legislation and case law. The rules relating to UCITS and alternative investment funds issued by the financial regulator in Ireland (the Central Bank of Ireland) provide additional responsibilities and guidelines for directors, but the day-to-day obligations of boards and directors on how they carry out their duties are not prescribed.

It is incumbent on directors to consider best practice when carrying out their roles, and to look to industry guidance in establishing best practice. The Central Bank of Ireland has indicated that directors of Irish funds should pay attention to the Corporate Governance Code for Collective Investment Schemes and Management Companies issued by the Irish Funds Industry Association, and where it is not possible to comply, to issue an explanation as to why. The code could be considered best practice for directors of Irish funds. Irish funds should bear in mind that while compliance with the code is not mandatory, the Central Bank of Ireland has reserved the right, in the future, to mandatorily impose the code on Irish funds where it finds that voluntary compliance is lacking.

More recently, the Alternative Investment Management Association (AIMA) has updated its Fund Directors' Guide (third edition, 2015). AIMA does not purport to be a regulatory body, rather the guide provides guidance on the relevant considerations to be taken into account when selecting directors of alternative funds, as well as the basic tasks that fund directors should carry out. The guide could be considered commercial best practice for directors of alternative funds, specifically including Irish funds.

Independent directors

The code and the guide require the appointment of independent directors. The code recommends the inclusion of at least one independent director while the guide recommends that the majority of a board comprises independent directors. Moreover, AIMA states that "although it is often appropriate for a board to have one or more directors who represent the investment manager or service providers to the fund, such directors can pose a potential for conflicts of interest that need to be identified and either avoided or managed and disclosed appropriately".

The two papers vary slightly on the interpretation of "independence". The code states that an independent director would not be an employee, partner, significant shareholder or director of a service provider firm, or a provider personally of services for which professional fees are received (other than directorships fees) from the fund.

AIMA does not define independence and notes that what constitutes independence will vary in accordance with context. AIMA instead considers that the following factors are relevant in deciding whether or not a director is independent:

- The regulatory regime(s) governing the investment manager;
- The fund's domicile;
- The regulatory regime(s) applicable directly or indirectly to the fund;
- Any applicable codes of corporate governance; and
- Whether the fund is to be listed on an exchange.

Directors' skills and capacity

The Irish Funds Industry Association (IFIA) and AIMA documents agree that a director should have sufficient and relevant knowledge and experience, as well as sufficient time, to carry out his or her duties. Both documents further agree that there is no 'magic number' of directorships that will fit all contexts for all directors. Although it should be noted that the code makes reference to a "rebuttable presumption", which holds that a maximum of eight non-fund directorships may be held without affecting the director's time available to be effective.

In considering whether a proposed director has sufficient time to devote to a fund, the IFIA recommends that a fund should specify and document, on an ongoing basis, the time commitment it expects from each director, and have each director disclose their other time commitments, including time commitments to other boards or whether they are employed in other full-time positions. AIMA points out that what will be sufficient will depend on the particular director's circumstances, including:

- Educational and professional background;
- Relevant experience in the funds industry;
- Training and experience;
- Number of investment managers sponsoring the funds the director serves (as opposed to number of funds and related entities);
- Support available to the directors (both in dealing with mandates and being kept up-to-date with industry and regulatory developments);
- Regulatory status (whether the director, as opposed to the fund, is regulated); and
- Investor and public perception.

Avoiding a detailed discussion on directors' skills, the code states that the board must have a "good balance of skills and expertise". However, the code requires directors to demonstrate that they meet the Central Bank of Ireland's fitness and probity standards before being appointed.

AIMA cautions against selecting 'trophy' and other directors who are too busy to provide a meaningful contribution to the board, to ensure that its effectiveness is not undermined. Guidelines on what a "good" director might be include an examination of prior experience, knowledge of risk management, knowledge of good governance, industry trends and applicable regulatory regimes, and technical knowledge on investment strategy, accounting, valuation and industry types.

Risk management

Directors of Irish funds will be required to adhere to the risk management requirements of either the Alternative Investment Fund Managers Directive (AIFMD) or UCITS Directive, depending on how the fund is authorised. Bearing in mind the legislation, both the code and the guide discuss the board's role in risk management for a fund.

In addressing the function of the board in risk management, the code pays special attention to certain risk factors, including operational risks and those relating to the use of derivatives, security prices, stock reconciliation, failed trades, market timing and late trading, which must be identified, monitored and managed at all times. In addressing these risks under the code, directors will be required to ensure that appropriate internal control mechanisms are in place.

In order to appropriately monitor and manage risks identified in respect of a fund, directors must

ensure that regular reports are received from applicable service providers in relation to such risks and receive ad hoc reports promptly where risk limits are breached. The code also states that the board must put in place sound administrative and accounting procedures, and control and safeguard arrangements for electronic data processing.

The guide recognises that together with review of investment performance, review of the investment manager's approach to risk management is one of the most important functions of a board of directors. The guide focuses on this review process and suggests that the board must be kept informed of the fund's performance by the investment manager by being copied on communications sent generally to investors, including performance updates provided by the fund's administrator as well as the investment manager's investment reports.

The guide also expects directors to receive a dedicated report from the investment manager featuring the latest performance estimates, market review, peer group analysis, performance attribution report and risk report on a frequent basis. The directors should ensure, in reviewing this report, that the risk metrics employed by the investment manager are relevant and complete for the strategy of the fund. The investment manager should also report on any problems encountered.

Disagreement

Contracts of appointment and service level agreements notwithstanding, it is the case that disagreements with service providers to a fund might happen from time to time. Where the code reiterates the requirement that service providers are appointed according to the requirements of the Central Bank of Ireland, and the importance of monitoring such delegates, the guide provides principles for boards to adhere to in addressing any material disagreements with service providers as follows:

- The contractual obligations of the parties should be examined to ensure that any attempts at resolution are in accordance with same;
- Directors should consider appointing a committee, whose members will be independent of the service provider, to gather information and make a recommendation on how to address the disagreement;
- Where appropriate, legal advice should be taken;
- Any course of action taken should be carefully minuted and investor notification should be considered; and
- Where a resolution cannot be reached, termination of the contract should be considered, bearing in mind the requirement for a suitable replacement.

A director appointed to a fund domiciled in Ireland will be subject to Irish and European law. The nature of a fund, however, is that by virtue of its investments, investors and service providers, it is an international business.

Acknowledging the important guidance provided by the code, international best practice standards as represented by the guide should be borne in mind by directors and boards of Irish funds in order to ensure that they, and the fund, are adequately protected in any extra-jurisdictional examination of their role in relation to that fund.

The board must be kept informed of the fund's performance by the investment manager by being copied on communications sent generally to investors, including performance updates provided by the fund's administrator as well as the investment manager's investment reports

Derbhil O'Riordan
Partner
Dillon Eustace

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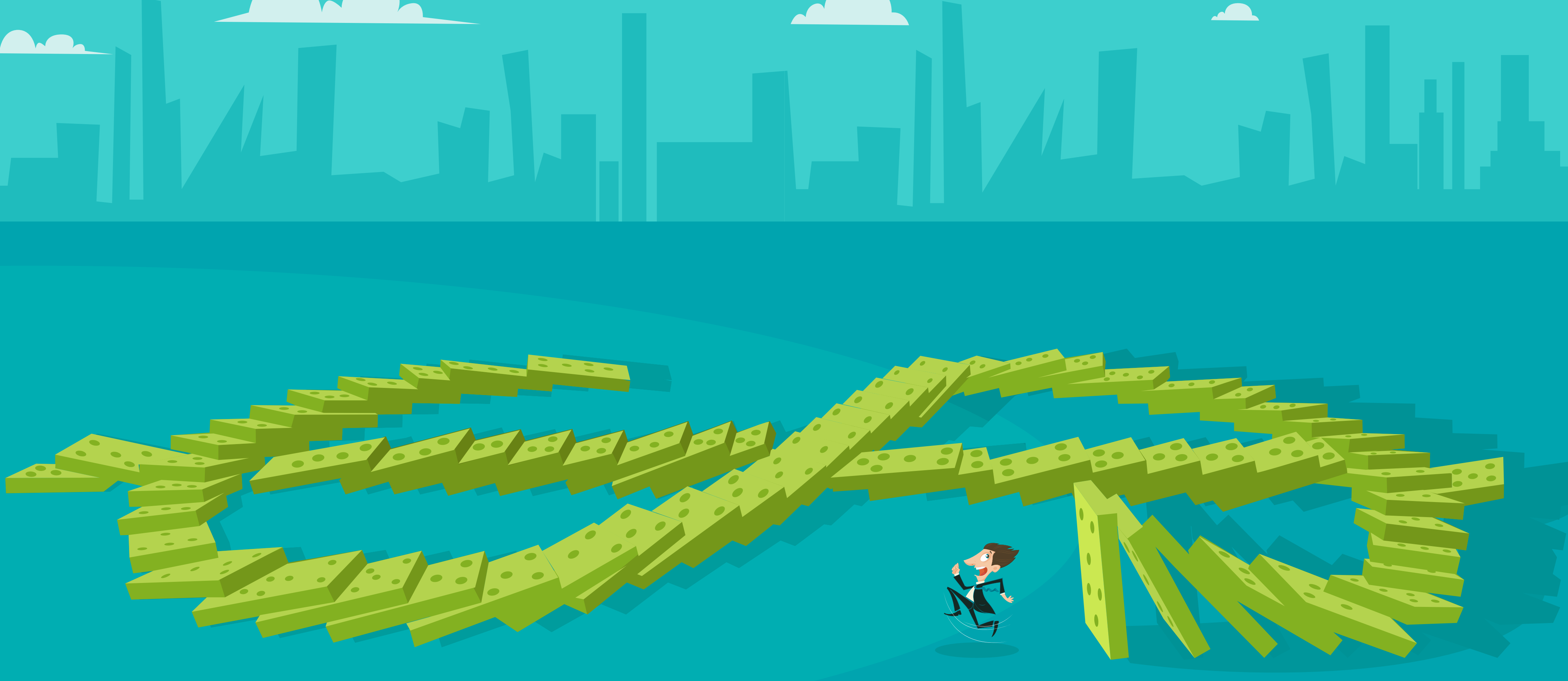
2015: Higher minimum capital requirements will be fully implemented. The leverage ratio and its components will be tracked and disclosed, but will not be mandatory. The LCR will be introduced.

2016: Beginning of the gradual phasing-in of the conservation buffer.

2017: Based on the results of the parallel run period, any final adjustments to the leverage ratio will be made.

2018: The leverage ratio will become a mandatory part of Basel III requirements. Introduction of the NSFR.

2019: Conservation buffer will be fully implemented.



Custody and escrow: impacts of regulation

Clients should seek assistance from their financial advisors to understand this new environment as they formulate a refreshed investment strategy, says Brian Davis of Bank of America Merrill Lynch

Like many bank products and services, custody and escrow have been affected by new regulations seeking to strengthen the global financial system.

Basel III has introduced new capital adequacy measures under the supplementary leverage ratio, and the coverage of cash outflows due to deposit withdrawals in a crisis stipulated by the liquidity coverage ratio (LCR).

The combined impact is expected to increase banks' costs of holding high quality liquid assets (HQLAs) required for certain types of deposit under LCR. As a result, it will change banks' appetite for certain types of deposits, and affect the rate of return on long-term deposits.

Meanwhile, US regulators approved new rules to increase the resiliency of money market funds (MMFs), which are a critical alternative for short-term cash.

Both changes will require corporates and financial institutions (FIs) to reconsider their cash needs and investment policy.

Changing the value of deposits

The LCR calls for banks to differentiate between operational and non-operational deposits, with further distinction based on tenor, term and industry.

The classification of deposits as operational or non-operational purposes might seem obvious: operational deposits are those required to run a business; everything else is non-operational.

However, the definitions used for the LCR are more complex and present potential challenges for both banks and their clients. Part of the complexity is that there is a very broad range of different operational services that a bank may provide that result in clients placing deposits with the bank (such as custody, escrow, agency services, and payment remittance).

The LCR applies seven tests to facilitate the identification of operational deposits. However, these are not service specific, so banks are expected to develop methodologies to apply the tests to each product type, including custody and escrow accounts, before a bank can classify a deposit as operational. Criteria include the client agreement and the business nature of the clients to the custody or escrow account. For example, deposits from non-regulated funds—defined in the final US LCR rules as funds for which an advisor files SEC PF forms (mostly hedge funds)—are non-operational by default, regardless of whether they meet other operational deposit tests.

Regulators appreciate that custody accounts need to keep a certain amount of cash to facilitate operational activities. Therefore, it might be assumed that deposits in a custody account would

Basel III requires banks to make assumptions about how stable cash is as a source of funding, and the amount and nature of liquidity that must be held in reserve against potential outflows. Specifically, short-term operational cash will require 5 to 25 percent of the deposit value to be held in HQLAs, and longer-term investment cash may require HQLAs to be held up to 100 percent of the deposit balance depending on the type of firm and the nature and tenor of the deposit.

TEST	OPERATIONAL REQUIREMENT
One	Subject to 30 days notice for termination or significant switching cost
Two	Held in account designated as operating account
Three	Primary purpose of obtaining operating services
Four	Not held in account designed to create economic incentives to maintain excess funds
Five	Empirical linkage of deposit to operational services and identification of excess funds
Six	Must not be linked to non-regulated fund or prime brokerage
Seven	Limitations on certain correspondent banking deposits

be classified entirely as operational given the nature of flows, such as fund subscriptions and redemptions, dividends and coupon payments, trade settlement, trades, fees, corporate actions and maturities. However, some clients may keep a balance above what is required to facilitate custody-related flows, which would be considered non-operational.

Similarly, escrow services are listed in the final LCR rules as operational in nature (although most deposits from non-regulated funds into escrows are non-operational by default). As with custody, the operational tests need to be viewed in light of the overall account and governing agreement. Simply labelling an account as an escrow does not mean it can be categorised as operational. Escrow accounts are opened to mitigate risks specific to a transaction, such as a merger and acquisition or purchase and sale agreement, and are dependent on legal work and approvals from all parties to the transaction.

When acting as escrow agent, the bank will hold deposited funds in an escrow for the benefit of the parties to the governing agreement. Those funds are held until the stated conditions or requirements permitting release are met, as set forth in the escrow agreement. Clients and escrow agents need to be mindful of the seven operational tests, shown in the table above, when they are negotiating escrow agreements and assessing deposit interest rates.

Floating NAVs and liquidity restrictions

As banks' appetite for certain deposits lessens because of LCR, clients might seek alternatives for non- operational cash. MMFs have long been considered a critical alternative for reserve cash, however, corporates' demand for MMFs could lessen as well in the wake of upcoming regulatory changes.

Specifically, the Security and Exchange Commission (SEC) has approved new rules for the regulation of MMFs relating to portfolio quality, maturity, diversification, liquidity and reporting. However, from a custody and escrow perspective, there are two critical changes. The first is the requirement to abandon the current stable $1 share price for institutional prime MMFs and adopt a floating net asset value (FNAV) by reporting daily changes in the market value of their portfolio. The second important change is that the amendments to Rule 2a-7 provide non-government money market fund boards with new tools—liquidity fees and redemption gates—to address runs during periods of stress.

These two changes raise questions about the role FNAV MMFs will play in custody or escrow accounts. Traditionally, custody accounts may invest excess liquidity in MMFs as it is easily accessible without giving notice.

The MMF can simply be sold when cash is required to settle a security purchase, for example. While stable NAV MMFs were not guaranteed to return full value to the investor, they usually did so. In the future, with the advent of FNAV MMFs and the introduction of liquidity fees, they will likely generate a gain or a loss.

In an escrow account, the introduction of an FNAV, liquidity fees and redemption gates have arguably even greater consequences. Escrow exists to mitigate risk, relating to a merger and acquisition transaction, for example.

If the value of the funds in escrow changes because of an FNAV, or if funds are not available because of liquidity fees and redemption gates, the FNAV MMF may not be an acceptable investment option for the parties to the escrow agreement and may create other risks. The risk management function of escrow could be weakened.

Responding to regulatory changes

For corporates and FIs, it is important to understand the impact of the LCR, which will alter the value of deposits, and the amendments to Rule 2a-7, which will potentially change the role of MMFs in their liquidity management strategy. In response to these changes, clients need to have a clear understanding of their cash needs to determine the level of liquidity they require on a daily basis. It is important to strengthen forecasting capabilities to anticipate cash flow and cash requirements in relation to custody and therefore more easily segment cash into operational and non-operational buckets.

Additionally, many investment policies were last updated during the financial crisis and no longer reflect market and regulatory realities. Custody and escrow clients should review their investment policy in order to reflect market conditions and regulatory changes.

The issues involved are complex and, in some instances, still evolving. Clients should seek assistance from their financial advisors to understand this new environment as they formulate a refreshed investment strategy.

"In response to these changes, clients need to have a clear understanding of their cash needs to determine the level of liquidity they require on a daily basis. It is important to strengthen forecasting capabilities to anticipate cash flow and cash requirements in relation to custody and therefore more easily segment cash into operational and non-operational buckets"

Brian Davis
Head of North America global custody and agency services
Bank of America Merrill Lynch

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CSDR/T2S

June 2015: ESMA to issue draft CSDR technical standards. T2S first wave to go live.

September 2015: European Commission scheduled to adopt technical standards.

November 2015: Technical standards to enter into force and Spanish equities scheduled to move to T+2.

March 2016: T2S second wave.

Q2 2016: Central securities depositories (CSDs) to be authorised and CSDR fully implemented.

September 2016: T2S third wave.

November 2016: CSDs must be fully compliant with CSDR.

February 2017: T2S fourth wave.

Getting it right the second time around

Before the technical details implementing CSDR are set in stone, the regulation's impact on markets needs to be understood, according to Alexander Westphal, adviser to ECSDA

One year ago, Soraya Belghazi's contribution to the 2014 Asset Servicing Times Regulatory Handbook covered the evolving landscape for settlement and custody, outlining in particular the main expected changes for market participants introduced by the Central Securities Depository Regulation (CSDR). The CSDR adoption process has moved on since then, and with the proposals becoming more concrete, we now have a clearer idea about the expected impact of the new rules.

The final text of the CSDR entered into force on 17 September 2014. A first important step towards implementation was achieved on 6 October 2014 when 29 European markets moved to a T+2 settlement cycle, as prescribed by the CSDR, without any negative impact on settlement efficiency.

Many questions regarding the implementation of the rules, however, remain open. The so-called second-level process is still ongoing. Both the European Securities and Markets Authority (ESMA) and, to a lesser degree, the European Banking Authority (EBA) are working on a wide range of technical standards, which will specify implementation details of the law. While the high level assessment of the main changes introduced by the CSDR remains fully valid, I would like to dig a bit deeper into three aspects of the future standards that still present considerable challenges.

First of all, there is the issue of settlement discipline, which has sparked a lot of debate between industry and EU lawmakers. While the European Commission had initially proposed to introduce harmonised rules on settlement discipline based on rather high level principles, the approach has become much more prescriptive in the course of the legislative process. ESMA's proposals in the draft technical standards are now extremely detailed and could substantially affect the way securities transactions are cleared and settled today. While the implementation costs for CSDs and their participants are likely to be substantial, there has been no comprehensive impact assessment of the potential costs and benefits so far.

ESMA did not provide such an analysis as part of its December 2014 market consultation, and the only detailed impact assessment on the issue in fact dates back to the time of the initial legislative proposal, with the European Commission concluding that "any measures that were too prescriptive could become obsolete very quickly in the rapidly changing market environment".

One underlying problem is that there is no agreement on a meaningful target level for settlement efficiency. While the primary aim of CSDR seems to be more generally a harmonisation of the rules (an objective shared by most stakeholders), in the absence of any concrete objective in terms of settlement efficiency, it is not clear how efficient the system needs to be, particularly given that current settlement efficiency rates in Europe are already generally very high, at around 98 percent as shown in past European Central Securities Depositories Association (ECSDA) reports.

Among all of the measures, the ESMA proposals around the introduction of a mandatory buy-in process for failed instructions probably generated the greatest concerns among industry representatives. On this issue, the need for a proper assessment of costs and benefits before introducing any binding rules is particularly striking, given the huge potential market impact. A recent ECSDA impact study, prepared based on monthly settlement fails data collected from CSDs, indicates that the rules could indeed lead to as many as 150,000 buy-in procedures to be initiated per month for a value of €214 billion, or more than €2.5 trillion a year. This is, of course, irrespective of any potential costs of the proposals in terms of reduced liquidity and widened bid-offer spreads.

Apart from the importance of properly assessing the impact of the rules, CSDs and market participants also agree on another important point: a buy-in is the enforcement of a trade contract and should thus be handled at the level of trade counterparties not at the settlement level. Unlike proposed by ESMA, CSDs should not have an active role in the process.

It is important to note that any new responsibilities for CSDs in this respect would bring new liabilities and thus negatively affect their risk profile, going against the very objectives of the CSDR.

Other proposals also require further clarification, such as the harmonised system of late settlement penalties to be imposed by CSDs on their participants for every day that an instruction fails to settle. In principle, there is a broad agreement that a harmonised system of fines is desirable. However, the rules need to be simple, clear and easy to implement. Questions remain, for instance, around the use of reference prices and the scope of the measures.

Most crucial however is probably again the lack of impact assessment and of any specified target level. The penalty rules are likely to introduce an important element of redistribution that in most markets does not exist today. According to the ECSDA study mentioned above, the level of gross penalties to be collected by CSDs could reach around €2.2 billion a year based on the current proposals. Without proper impact analysis it is difficult to say whether the proposed rules and rates are appropriate or not.

There are other proposals in the draft second-level standards, besides settlement discipline, that are still a source of concern. One such issue is the treatment of CSD links. Links between CSDs are important drivers of market integration as they increase the choices for investors, and they are explicitly encouraged by initiatives such as Target2-Securities project. It is therefore important that the CSDR does not introduce new barriers for CSD links.

However, proposals by ESMA to allow EU CSDs to establish links only with markets that have a "comparable" regulatory regime to the one of the EU are not helpful to this end and are indeed unnecessary given that CSD links do not give rise to any risk exposures for the linked CSDs.

Overly strict rules for links could discourage CSDs from maintaining links that have already been established with important emerging markets such as Russia, South Africa and Brazil, but they even raise questions about links to established markets such as the US, Canada or Japan. Recent proposals by the EBA to require CSDs to hold additional capital for the purpose of CSD links introduce further uncertainty in this regard and seem misplaced given the absence of any significant risk exposure through links.

A third aspect of the CSDR, whose impact needs to be fully understood, is the approach to account segregation. Although the respective rules in the CSDR are, in principle, final and not subject to any technical standards, some questions remain around their implementation. Article 38 of the CSDR requires CSD participants to offer their clients "at least the choice between omnibus client segregation and individual client segregation", as well as to "inform them of the costs and risks associated with each option".This means that custodians working with omnibus accounts will have to offer their clients the possibility to maintain segregated accounts at CSD level, and be open about the associated costs and risks. But they also apply the other way around: it is not fully clear how the rules will affect markets that so far operate on a pure direct holding model, ie, where beneficial owner accounts at the CSD level are mandatory.

Member states will have to assess whether their current national rules are consistent with the CSDR approach, or whether changes are needed. In some countries, such as Finland, this process has already led to extensive discussions that are likely to result in legal changes, possibly moving away from compulsory segregation at the CSD level for domestic investors in shares. It will be interesting to see if other countries follow suit and, ultimately, to what degree the CSDR will lead to a truly harmonised account holding model across Europe.

Another question in relation to account segregation is the applicability to non-EU CSD participants. While the European Commission has clarified that the requirement applies to EU as well as third-country participants and their clients, it remains unclear how this requirement can be enforced. As this is ultimately a question for member states, it will be important to ensure a consistent approach across the EU.

To conclude, while the CSDR text itself is final, a number of important open questions remain around the implementation of the rules. Before the technical details of the rules are set in stone, it is important that their impact is fully understood, in particular on issues such as settlement discipline, which are likely to have a substantial impact on the market.

SOLD AS SEEN

Most are already sold on the idea of harmonised settlement in the EU, but buy-ins are among the requirements still eliciting feelings of remorse

Bora Karaagacli
Senior specialist in international relations and reporting
MKK

Brian Collings
CEO
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Tony Freeman
Executive director of industry relations
DTCC

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Stephanie Palmer
Reporter
Asset Servicing Times

What are the key points to take away from the CSDR?

Tony Freeman: The Central Securities Depositories Regulation (CSDR) will introduce a common framework for the authorisation and supervision of CSDs, with the objectives of increasing competition, improving efficiency and reducing cross-border securities settlement costs. Specifically, the regulation will harmonise a number of key aspects of settlement, including market access, settlement discipline and settlement cycles.

The harmonisation of the European settlement cycle to T+2 is a significant move and has already taken effect. Ahead of the CSDR implementation in 2017, a number of infrastructure providers—CSDs, clearinghouses and stock exchanges—across Europe agreed that starting 6 October 2014, transactions should be settled on a T+2 basis. The industry has shown wide support for this initiative. In fact, in a recent survey we conducted, the majority of respondents believe T+2 will become a global standard for settlement cycles.

Moving to a T+2 settlement cycle creates significant benefits, particularly on the cash management side. A lot of trading activity takes place between markets with different settlement cycles, leading to operational complexity.

If a firm invests in a market that settles on a T+1 basis and divests in another that settles on a T+3 basis, there may be a funding gap due to the 48-hour time difference in the settlement of its payables and receivables. As a result, the firm will need access to a credit facility for two days. A harmonised global settlement cycle of T+2 means these complexities can be avoided.

Brian Collings: The CSDR is one of three objectives of European regulators to form an efficient and harmonised European market infrastructure. These include the Markets in Financial Instruments Directive (MiFID) II for trading and transparency requirements, the European Market Infrastructure Regulation (EMIR) for clearing, and CSDR for settlement.

One of the most significant aspects of CSDR to have changed the trading dynamics of the European market is the harmonisation of settlement cycles to T+2, which began in October 2014. The move to T+2 has created greater efficiencies for market participants, including: the reduction of counterparty, market and liquidity risks; increased automation of operational processes across organisations; and a decrease in collateral requirements, which can free up capital for investment.

With the benefits of shortened settlement cycles already being felt in Europe, T+2 is now starting to take shape in the US, which will help to create greater certainty, safety, and soundness in the capital markets on global scale, as well as solve some of the cross-border settlement issues caused by having different settlement periods in different parts of the globe.

Bora Karaagacli: T+2 settlement was successfully implemented throughout Europe and rules on fails management by CSDs, including settlement penalties and buy-ins, were formed. The rules concerning the latter, which came from the European Securities and Markets Authority's (ESMA) second-level technical standards, are still debated.

One other key benefit of CSDR was mandating account segregation rules and electronic settlement in the form of dematerialised securities instead of physical settlement. We at MKK are operating a fully dematerialised system on a beneficiary owner basis in Turkey and I think the system brought about many direct and indirect cost and efficiency benefits for market participants and the economy as a whole. In that regard, I think these were spot on reforms for EU markets, too.

Finally, from a non-EU CSD perspective, there are two articles in CSDR that would have an impact on our institutions. Article 25 mandates third-country CSDs to receive authorisation from ESMA if they intend to provide core CSD services for securities governed by EU laws, either directly or through opening a branch in an EU country. Article 48 regulates CSD links with non-EU country institutions. A regulatory equivalence decision from ESMA will be required for CSDs to be deemed compliant to the requirements concerning these articles.

However, in my view, the requirements for the European Central Securities Depositories Association (ECSDA) recognition of equivalence look vague at the moment. Technical standards should clearly state that recognition of third-country CSDs will not be sought except when those CSDs are planning to open branches within the EU since most of the links between CSDs do not create substantial risk, unlike the situation with central counterparty (CCP) links.

Diana Chan: The key point to take away from the CSDR is that in order to arrive at a safer and more efficient post-trade environment, market participants need to invest in making some important changes. The benefits will be more harmonised operations that reduce the

friction of cross-border securities transactions, enabling the realisation of a pan-European capital market.

The CSDR makes securities markets safer by setting safety standards for CSD infrastructures, which are currently regulated on different national standards in each member state.

The CSDR improves both safety and settlement efficiency by imposing market reform. These reforms include shortening the settlement cycle to a uniform T+2, thereby removing one day's counterparty risk from equities transactions in most national markets. The reforms also include imposing penalties on late settlement and buy-ins for failed transactions beyond a certain period to encourage transactions to settle on time. Timely settlement enables optimal liquidity usage and reduces operational risks.

Iwona Sroka: The CSDR has introduced a range of uniform settlement solutions, in particular in the area of settlement discipline as well as standardisation of services provided by CSDs. From our point of view as a CSD, the CSDR on the one hand structures and clarifies the rules of operation of CSDs in the EU, and on the other hand puts the European CSDs in a demonopolised, competitive environment.

Settlement discipline involves penalties imposed on the counterparty responsible for settlement fails, which will be redistributed to the suffering counterparty. Previously, settlement fails were governed by individual CSD regulations, but now there is a single system of penalties, covering transactions in transferable securities, money-market instruments, UCITS and emission allowances, admitted to trading on a MiFID trading venue, whether they were concluded on a trading venue or as an over-the-counter (OTC) trade. In our opinion, the new measures might not substantially improve the effectiveness of settlement, which is already quite robust under the existing regulations.

The CSDR also imposes the obligation of CSD authorisation, which introduces single standards for all CSDs but increases their costs, including CSDs' capital requirements,

modifications of IT systems, as well as additional supervision costs such as regular reporting and inspections.

Furthermore, the regulation opens free access between CSDs. Some CSDs used to refuse access following their internal rules. The CSDR regulates this and provides open access for CSDs—not only to other CSDs but also to trading venues and clearinghouses.

What is there still to come?

Chan: ESMA's regulatory work programme for 2015 includes nearly 200 activities related to around 15 legislative initiatives in the securities markets. Although most of the activities on the list concern trading and investor protection, some of them will result in various demands on post-trade arrangements.

For example, more regulatory initiatives can be expected around the focus on the efficient use of collateral and the safety of collateral re-use, which will influence developments in settlement infrastructure supporting the movement of collateral.

Collings: The CSDR is looking to introduce a mandatory securities settlement discipline that will include mandatory buy-ins and cash penalties for failed trades. The cash penalties as currently proposed in the draft regulatory technical standards are a percentage of the total failed amount per day of failure—potentially a significant figure, but it is yet to be confirmed who would be responsible for carrying out a buy-in. The CSDR requirements do, however, represent a significant departure from the existing regime. Firms should therefore ensure they are making the necessary preparations to limit the number of settlement fails.

It is important to note that the CSDR governs only one part of the trade lifecycle and so will not singlehandedly change Europe's trading infrastructure. It should, however, be regarded as complementary to, and consistent with, EMIR and MiFID II. With this in mind, firms should ensure they are making preparations to comply with all three regulations, which will lead to more efficient trading processes and reduce risk.

Freeman: The regulatory technical standards, which are due to be published in June 2015 and will form the basis of the rulebook, should provide detail on a number of outstanding issues such as the buy-in process and settlement discipline regime.

In terms of cash penalties for failed trades, the proposed amount set out in the consultation paper appears modest and is less costly than envisaged. The penalties are meant to be a disincentive to delayed settlement but not punitive—for example, a £10,000 equity transaction will cost £1 per day in penalties. While penalties are never popular, if they exist, they need to be effective and at a high enough cost that they discourage non-compliance.

As for the settlement discipline regime, the efficiency target has been set at 99.5 percent. According to most market participants, the current settlement rate in Europe is 97 to 98 percent, which means it needs to be improved by approximately two percentage points, an improvement some believe is difficult to achieve.

That said, ESMA has proposed an 18-month extension to the settlement discipline regime, which, if approved by the European Commission and Parliament, will give market participants more time to make the necessary changes to their middle- and back-office processes so that they can reduce trade fails and increase settlement efficiency.

However, while a number of technicalities still need to be resolved, it is prudent to prepare for 2017 as the implementation date.

For the settlement efficiency regime to be implemented, a large amount of preparation work will need to be conducted, particularly by custodians and CSDs. The CSDs have to agree on a standard definition of a failed trade and build the mechanisms to report them to regulators. The custodians, which internalise settlement processes, need to build mechanisms to report their settlement processes on a monthly basis.

It will also be interesting to see whether the use of legal entity identifiers by CSDs when reporting to their national competent authorities and ESMA about the number of failed trades, is implemented in the final regulatory technical standards.

Sroka: Concerning newly drafted regulations, it should be noted that there are plans for legislative proposals concerning CSD recovery

and resolution. As work is already underway to draft similar regulations for CCPs, it is important to note that a prospective regulation covering CSDs should not follow the same rules, taking into account the specificity of CSDs whose risk profile is very different from CCPs. Such regulation should be based on the international standards set out in the Principles for Financial Market Infrastructures, and possibly clarify them considering the specificity of the EU instead of going beyond those standards.

Given that CSDs are already required under CSDR to have in place recovery and resolution plans, it seems that any additional regulation should focus mainly on cross-border issues, such as cross-border resolution and the elimination of barriers caused by related conflicts of law.

We do not expect any further regulations related directly to CSD activity in the near future, but in the context of the ongoing debate on the capital markets union, a discussion should be raised on issues relevant to CSDs that impact on investors.

These are, in particular, the harmonisation of national laws concerning the exercise of rights attached to shares, specifically the rules of performing corporate actions (for instance, reverse split of shares). The legislative changes should also implement harmonised rules for resolving conflicts of laws in all matters of safekeeping, buying and selling securities, for example, regarding the determination of the moment of transfer of ownership of securities, and the determination of the beneficial owners of securities.

Karaagacli: All in all, CSDR will demand significant changes in business models considering the new level of competition from other CSDs and custodians. CSDs will be more client-focused and they will have to provide more value-added products to differentiate themselves. I think MKK, which was officially designated as a research and development centre in Turkey, constitutes a good example to CSDs providing technology-intensive products and services in areas such as electronic general meetings (e-GEM) and big data projects (e-DATA).

How will CSDR and T2S work in tandem to create reliable market infrastructures in Europe?

Freeman: Industry consensus suggests that CSDR and Target2-Securities (T2S) are inextricably linked—one cannot exist without the other. For example, shorter, harmonised settlement cycles are a prerequisite for T2S, as well as CSDR. This has prompted the market to implement shortened settlement cycles earlier than was mandated by CSDR to ensure readiness for the more pressing deadline of T2S in June 2015. As a result, market participants are now benefitting earlier than expected from the reduced operational risk and increased operational efficiency brought about by the move to T+2.

Sroka: Both CSDR and T2S aim to develop an EU-wide system of open and interlinked settlement and depository infrastructure institutions, which offer non-discriminatory access to investors across the EU.

CSDR is focused on safety of CSDs’ operations and imposes strict supervisory and prudential requirements on these institutions. Settlement discipline solutions are aimed at ensuring nearly full settlement efficiency and the requirements related to links between CSDs are intended to minimise any associated risks.

T2S will be a common platform for settlement between CSDs in Europe, based on state-of-the-art technology and solutions worked out by the European Central Bank (ECB) and participating CSDs. As the detailed requirements of CSDR and the related technical standards were not known at the time of T2S’s design, some discrepancies will occur, especially in the settlement discipline measures. In order to keep the launch of T2S platform, planned to be complete in 2017, as smooth as possible, the European CSDs have made a request to ESMA to apply a longer timeframe (preferably 24 months) to implementation of settlement discipline measures.

T2S is based on settlement in central bank money, which is perceived as the safest method of cash settlement. While the CSDR does not rule out commercial bank money settlement, it does impose major restrictions, encouraging CSDs to perform delivery-versus-payment settlement through central banks.

Both CSDR and T2S are designed to increase cooperation, but at the same time they create competition between CSDs. We should, however, avoid pushing for a reduction of the European depository and settlement infrastructure to a single entity or a minimised number of market operators. This would be counterproductive, distorting competition and creating monopoly positions. Instead, the focus should be on the harmonisation of regulations and communications to favour cross-border investment flows.

Karaagacli: CSDR and T2S have become the major driving forces behind harmonisation in securities settlement practices in European markets. T2S is the market infrastructure leg of creating a single European market and CSDR paved the way for this project to achieve its targets in many areas such as the introduction of T+2 settlement cycle and harmonisation of settlement default management.

In particular, the new settlement cycle was widely adopted in time before the first migration wave to T2S in June 2015, which was a clear success.

CSDR and T2S may also bring about restructurings in CSDs due to significant investment costs to comply with regulatory and system requirements and the increased level of competition between CSDs and custodians. The new landscape will enforce CSDs to widen their products and services with new bank-like services such as triparty collateral management and niche value-added products.

Despite the challenges ahead, I think the changes that are introduced by CSDR and T2S will be essential in creating a single market infrastructure in Europe that is also globally competitive in the longer term.

Chan: CSDR sets safety standards for CSDs and creates the regulatory framework for them to be able to compete with each other. T2S is the tool through which CSDs can compete to provide cross-border services on a single settlement platform. The two initiatives work in tandem to deliver a virtual single market for securities safekeeping and settlement.

A criticism levelled at the CSDR is the cost of the requirement for mandatory buy-ins to the bond market—what do you think?

Karaagacli: I think that the likely financial effects of CSDR on EU CSDs were not fully analysed by the responsible parties. I strongly believe that new responsibilities that were assigned to CSDs in the default management and buy-in processes could create unnecessary costs and risks for the whole system. According to ECSDA member CSD estimates, the costs related to buy-ins could reach an eye-watering €2.5 trillion.

As for default management in bond markets, with the ECB’s quantitative easing and increased investment in corporate debt instruments, there is now a higher risk of defaults in these markets. Coupled with the high value of debt instrument settlements compared to equities, for example, this will create significant amount of risk for most CSDs.

In this regard, I think the European authorities should seek alternative approaches in default management where CSD involvement is limited, because in its current form, second level standards on settlement discipline will be a major concern, not only for CSDs but also for market participants.

Freeman: Buy-in procedures exist today but are not widely used. It is clearly beneficial to have a harmonised EU-wide regime, but the contentious and much-debated issue is the mandatory nature of the buy-in. As currently envisaged, any trade that fails will automatically induce a buy-in.

There have been widespread estimates that this rule will generate many thousands of buy-ins and possibly lead to a substantial reduction in trading activity. The issue is especially pertinent to repo trades, which are an essential funding and liquidity mechanism, but are low-margin and high-volume.

CSDR

Policymakers are generally sceptical about the most apocalyptic warnings from market participants, but strong statistical evidence exists to justify the concern. The final outcome is unclear while we await the June 2015 publication of the regulatory technical standards, but there is a strong expectation that policymakers will agree that repo trades need to be treated separately to ensure the continued orderly function of the government bond markets.

What should clients be aware of in terms of the effect CSDR will have on their day-to-day business?

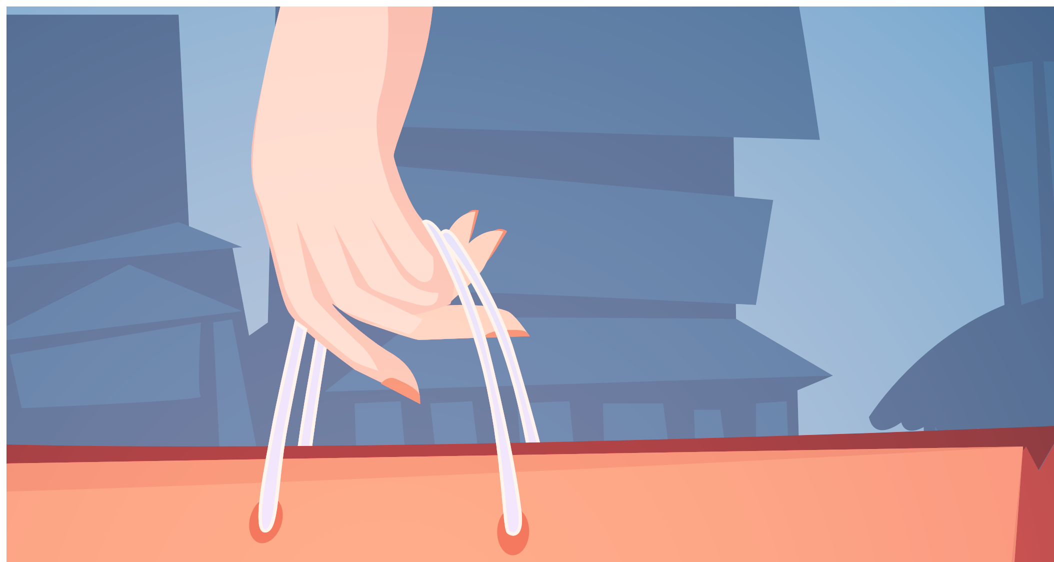
Chan: One of the most demanding aspects of CSDR is the penalty and buy-in regime. Clients should already be working on changing the way they work or improving the way they monitor their activities in order to achieve the highest settlement rate possible.

Collings: CSDR will require firms to settle their trading obligations on the intended settlement date, and require CSDs and other market infrastructures to prevent and address settlement fails. This brings with it the implementation of a buy-in regime and a settlement discipline regime across a wide range of securities. This will affect all clients of every European CSD and will have a widespread market impact, including increased costs if a trade fails to settle.

There are a number of considerations that firms should be making now, to be ready to comply with the implementation of CSDR.

Firstly, they should ensure their back-office systems are operating efficiently and are able to monitor in real-time when trades are approaching the buy-in limit. An alerting system would enable firms to either prevent trade failure, and subsequently a fine, or implement the necessary steps to prepare for a failed trade.

It is also important that firms implement calculation tools that allow them to calculate and evaluate the failed trade penalty. Our experience has shown that many firms are willing to pay the fine without analysing its details or reasons as to why they



have been fined. Calculation-enabling solutions would allow firms to better prepare for potential fines or indeed avoid being overcharged.

Lastly, allocation tools will be essential in helping a firm to establish which counterparties or trading desks are typically causing trades to fail. A trade may, at times, have a very long cycle and involve a variety of participants. One counterparty's failure may disrupt the entire chain and cause trade failure for which another firm may be fined. However, solutions are available that can assess individual position levels relating to the resulting fine and determine which counterparty in the chain is responsible for the failed trade.

Sroka: CSDR aims to improve the efficiency and safety of settlement in the EU through mandating both the recording of securities in book-entry form and the implementation of settlement discipline and buy-in regimes. The regulation introduces also transparency of fees and risks, as well as an option for clients to choose the level of account segregation (segregated or omnibus).

The key issue is the settlement discipline measures and the mandatory buy-in, which will also cover OTC trades. CSDR aims to encourage clients to settle their trading obligations on the intended settlement date, and requires CSDs and other market infrastructures to take measures to prevent and address these fails. In effect, this means new requirements for trade allocation and confirmation between investment firms and their clients, obligatory penalties for settlement fails, and the mandatory implementation of a buy-in regime across a wide range of securities.

This section of CSDR will affect all clients of each and every CSD in Europe and will have a widespread market impact, including changes in procedures, IT systems and costs of operation.

For many CSDs and markets, CSDR will impose fines on a far broader range of securities and transactions than currently is the case.

CSDR requires that any issues of EU-transferable securities that are admitted to trading or traded on trading venues should be represented in book entry form through immobilisation or dematerialisation. This will make a change for markets, where physical securities are still in place. Transparency and unbundling of fees, open access to CSDs and account segregation possibilities should enable investment firms to make the optimal choice of CSD services.

Facilitation of the development of operating links between CSDs may create better opportunities for local investment firms to access foreign markets via domestic CSDs.

Freeman: The successful implementation of CSDR will require greater operational efficiency in the middle- and back-office. According to our research, around 20 percent of the European market is not properly automated and our view is that an efficient middle-office is essential to generating orderly and efficient settlement processes. It is envisaged that CSDR will increase automation of post-trade operations, and that penalties for failed trades will drive behavioural change while eliminating the manual processes that lead to settlement inefficiencies.

Karaagacli: CSDR will establish a legal basis for further harmonisation and consolidation of CSD services. Shortened settlement cycles and strict default management mechanisms will minimise counterparty risks and default rates throughout the European capital markets.

Nevertheless, as I mentioned, there might be huge costs and operational risks related to the settlement discipline rules that enforce default management by CSDs. Consequently, market participants and end investors might end up footing the bill for these costs.

Another aspect of CSDR, which mandates client and omnibus account segregation, can also have some effects on client businesses. CSDs are now mandated to offer both individual and omnibus type segregation to their clients, and likewise, these clients should offer the same level of segregation to their clients.

This is, of course, good news for client asset protection, but bad news in terms of the operational costs of managing individual accounts.

I believe implementing harmonisation in settlement practices will more than offset the possible adverse effects of CSDR. Higher standardisation in post-trade infrastructures will make the European market safer and more efficient for all participants, including issuers, intermediary institutions and investors.

CSD'd it my way

Iwona Sroka of KDPW and KDPW_CCP outlines the hoops a post-trade business has to jump through to become reputable

Poland can be proud of its achievements in the financial sector, a branch of the Polish economy that has been built up almost from nothing in 25 years. During this period, phenomenal progress has been made that enabled the Polish financial sector to achieve a significant position in comparison with other European and global markets and become an undisputed leader in certain innovative arrangements, notably in the area of retail payment systems.

Over the past 25 years, everything has changed. Poland's financial sector went from state ownership to private companies. From having no capital market, payment clearing systems, independent central bank or proper supervision, to having a modern financial market infrastructure.

The Polish financial market can nowadays be described as innovative, compliant with internationally recognised standards, secure, and a safe location for investments.

Looking at the financial market and its infrastructure, it is worth noticing how the KDPW Group built Central Europe's leading clearing and settlement infrastructure. Thanks to services offered in KDPW (the Polish central securities depository, or CSD) and KDPW_CCP (the clearinghouse), the quality and safety of the Polish financial market and its attractiveness to international investors were strongly improved. KDPW Group offers the services of an authorised central counterparty, a registered trade repository, a global numbering agency (ISIN, LEI) and is also preparing for CSD authorisation.

In 2011, KDPW separated its clearinghouse from its CSD to create a more robust distinction between its two lines of business. KDPW now has 65 participants, while KDPW_CCP has 38. In April 2014, KDPW_CCP became the third clearinghouse in the EU to be authorised to clear over-the-counter (OTC) derivatives under the European Market Infrastructure Regulation (EMIR). Our services are provided for the most dynamic economy in the region, but we are interested in attracting more market participants, not only domestic but also foreign, to build economic scale.

Thanks to the right policies, regulations and supervisory standards, the Polish financial sector made it safely through the crisis. None of the banks defaulted and, importantly, the sector grew.

And the Polish economy? According to EU forecasts, Poland ranks third in expected GDP growth in 2014 to 2019 among all EU member states. This is a result of the expected faster economic growth in Poland, as well as the economic growth of Germany, Poland's main trading partner. The optimistic forecast is also driven by the anticipated increase in foreign investments.

OTC clearing in KDPW_CCP

The Polish Financial Supervision Authority (KNF) authorised the clearinghouse KDPW_CCP on 8 April 2014, confirming that it fulfills all requirements for such institutions under EMIR. KDPW_CCP is equipped with a state-of-the-art risk management system (based on the SPAN methodology for organised trading and value at risk model for OTC clearing), a multi-tier clearing guarantee system (cash and derivatives market margins, clearing fund and own capital of the CCP). KDPW_CCP's own capital is currently €52 million.

The EU authorisation allows KDPW_CCP to operate as CCP across the EU, adding the OTC derivatives market to the authorised scope of the clearinghouse's services. Along with the authorisation application, the clearinghouse has filed the list of OTC instruments to be cleared, which are derivatives cleared in Polish złoty. KDPW_CCP clears trades in instruments denominated in Polish złoty, including the following OTC trades: forward rate agreements, interest rate swaps, overnight index swaps, basis swaps and repo. KDPW_CCP is now expecting the authorisation of euro OTC derivatives.

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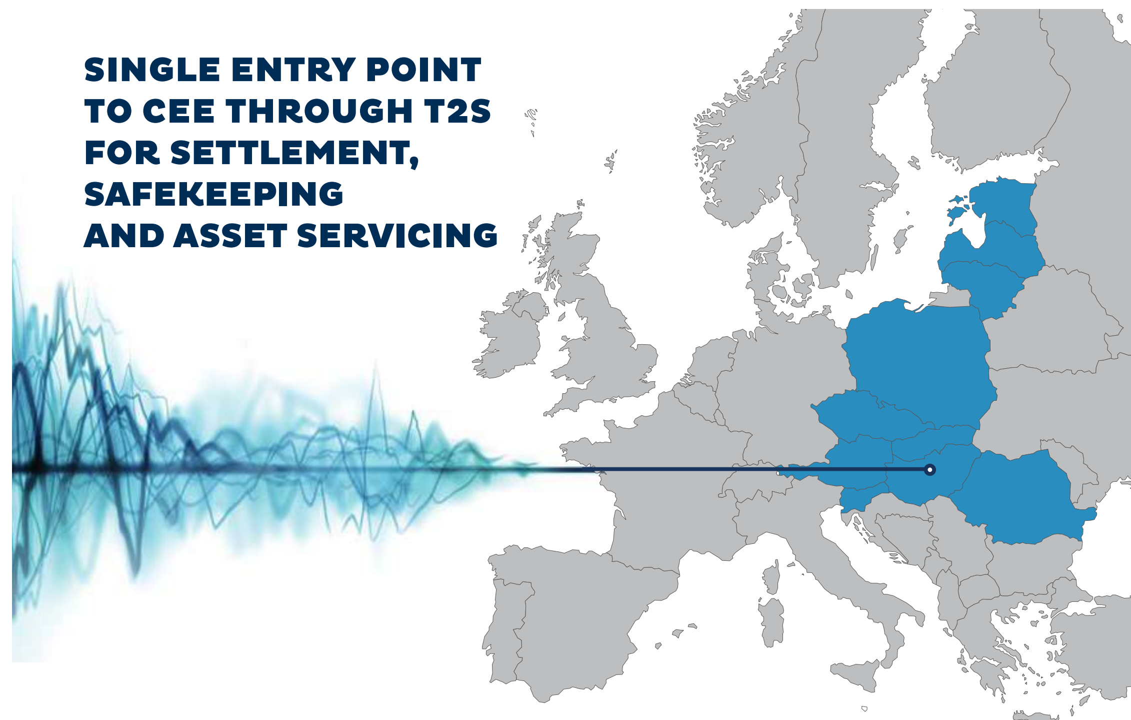

- A single CSD for an efficient T2S access to CEE markets
- Reduced overall costs, complexity and risks as no intermediaries needed
- Harmonized infrastructure services for all Central and Eastern European markets
- Centralized access to securities and counterparties in CEE

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KELER Ltd., the sole central securities depository and a specialized bank in Hungary, founded in 1993 is owned by the National Bank of Hungary and the Budapest Stock Exchange. As a leading CSD in Central Eastern Europe, with more than 20 years of experience, we offer innovative solutions to unleash the business potential of financial intermediaries; our Clients. We keep investing into state-of-the-art technology and experienced staff, so that we catch every opportunity, when it comes to designing a new client solution. Apart from a full range of core and ancillary CSD services, KELER is bringing all benefits of Target2-Securities to Clients via flexible solutions. Going live with T2S, we will offer direct connection and harmonized services in 10 markets within the CEE region. Through an efficient platform we will make all T2S features, all regional instruments, currencies, customized reporting and unified asset servicing accessible in one CSD. www.keler.hu. Follow KELER Group also on LinkedIn.

Trade reporting to KDPW_TR

KDPW_TR offers its services to all companies obligated to report, not only in Poland, but in the whole of Europe. The registration application covered the reporting of all types of contracts under the reporting obligation (commodities, credit, foreign exchange, equity, interest rates and others—irrespective of whether the contracts are traded on or off exchange).

Parties required to report contracts may report them directly to the trade repository at KDPW, for which they must be KDPW_TR participants, or fulfill the obligation through another reporting participant of KDPW_TR. According to EU regulations, the reporting obligation may be delegated to a central counterparty. On the Polish market, it's done to KDPW_CCP.

KDPW_CCP does not charge any fees for intermediary services. Consequently, reporting of derivatives contracts by KDPW_CCP on behalf of a clearing member or its clients does not involve any additional costs to clearing members other than fees charged by KDPW (for reporting a trade to the repository and for maintaining contract details in the repository).

LEI assigning: KDPW_LEI

Every entity required to report trade details, either directly or through an intermediary, must have a legal entity identifier (LEI) that identifies it as a counterparty. Only legal operating units are authorised to issue LEIs.

In August 2013, the CSD of Poland was assigned a prefix (2594) necessary to assign LEIs. The CSD of Poland was awarded the pre-legal operating unit status on 27 December 2013. This confirms that as a numbering agency, KDPW conforms to the global standards of LEI assignment. Identifiers assigned by KDPW are universally accepted and recognised around the world.

Services for international investors

As the Polish market has grown, it has begun to attract foreign investors who currently account for half of all trading on the Warsaw Stock Exchange. They provide additional liquidity and capital, which in turn helps fuel initial public offerings. Not far behind foreign investors come foreign members of its infrastructure institutions—first to the exchange, later to the CCP and CSD.

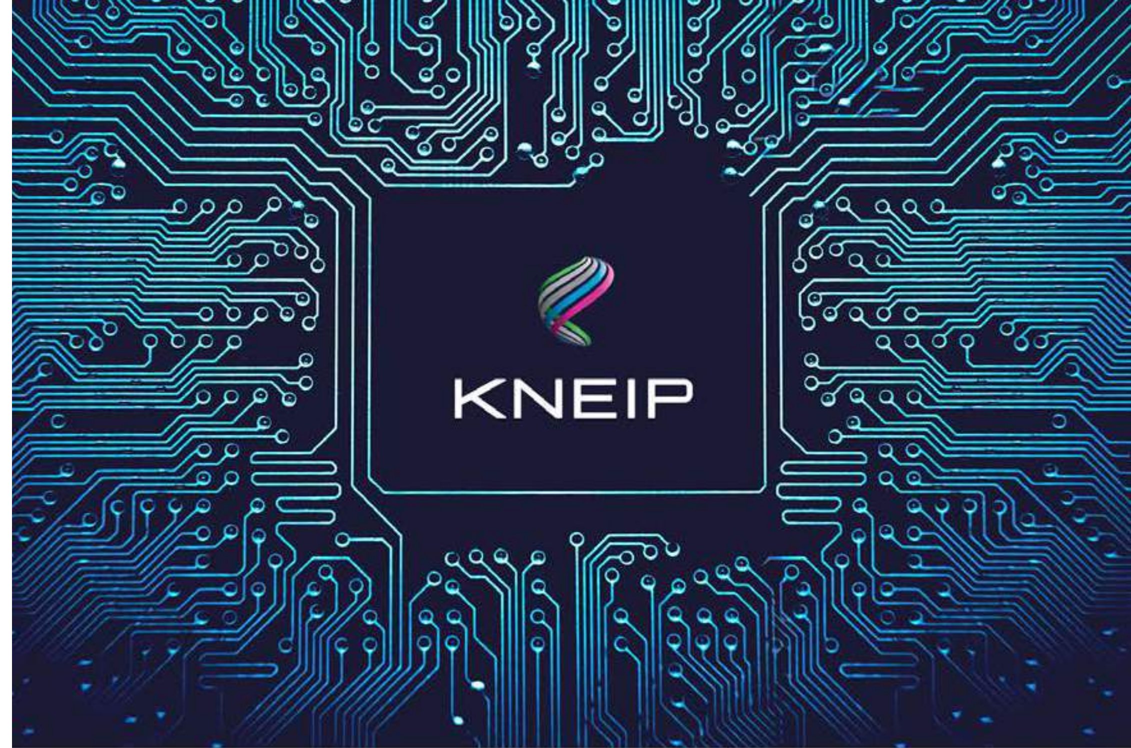
This is a sign that the market is becoming more mature, that it meets the exacting standards of Western financial institutions, and that it inspires confidence in the future. This is true for the Polish market as well.

The increased interest of foreign investors and intermediaries is the result of efforts by the whole Polish market to promote the attractiveness of domestic companies, their growth perspectives, a diversified range of traded instruments and an efficient and well-developed post-trade infrastructure.

The KDPW Group has for many years been implementing a range of projects in response to the changing, more globalised nature of markets. In April 2013, we introduced a service for foreign financial institutions to be able to open omnibus securities accounts directly at the level of the CSD in Poland.

“Not far behind foreign investors come foreign members of its infrastructure institutions—first to the exchange, later to the CCP and CSD. This is a sign that the market is becoming more mature, that it meets the exacting standards of Western financial institutions, and that it inspires confidence in the future”

Iwona Sroka
President and CEO
KDPW and KDPW_CCP



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Harmonious journey

After standardisation and harmonisation, the markets will be well positioned to reap the rewards of the effort, says Henri Bergström of Nasdaq

The Central Securities Depositories Regulation (CSDR) does for post-trade services what Markets in Financial Instruments Directive (MiFID) did for trading in 2007. As of September 2014, authorised CSDs have a passport to provide their services in other member states, and users can choose between all CSDs in the EU. Additionally, CSDs can access any other CSDs, trading venues and central counterparties (CCPs) in the EU.

All the above takes time to become a reality, not only because European CSDs are required to be re-authorised, but also because changing business models take time to go live. Nevertheless, every European CSD is revisiting its strategy and preparing for change.

One of the new opportunities is for securities issuers to freely select the issuer CSD. It is truly difficult for local blue chip companies to change the place they issue their shares because local regulations, market practices and language are often barriers to access. But that is not necessarily the case with products that are traded in both Europe and globally. For example, the place of issue and geographic location of the CSD is less significant for issuers of warrants, exchange-traded funds and mutual funds. All other things being equal, they are likely to choose a service offering in a lower cost country over one in a higher cost country.

Previously, bank-owned CSDs did not provide custodial services in competition with their parents' offerings, but changing governance structures now enable them to compete with custodians in many areas. Meanwhile, custodians have identified certain CSD functions that fit into their portfolios, and they have created offerings accordingly. Instead of competing, CSDs and custodians could also collaborate through outsourcing arrangements.

Vertical siloes where the exchange, CCP and CSD are under one roof may be broken up into separate companies with their own corporate boards and ownership structures. CSDs' offerings are restricted to core functions such as central maintenance, settlement and notary. For risk management purposes, all other services must be put into a separate company. Already that has had implications for Euroclear's and Clearstream's banking licences, for example, especially related to the possibility of requiring additional capital.

Competition will likely be extended to CSDs outside the EU. In October 2014, the European Commission adopted equivalence decisions for 11 CCPs in Hong Kong, Singapore, Australia and Japan to obtain recognition in the EU through cooperation agreements between the European Securities and Markets Authority and its counterparts in those countries. The European Commission is currently assessing other jurisdictions for their equivalence including the US, India and South Korea. Similarly, foreign CSDs could potentially seek equivalence, enabling them to offer post-trade services to European market participants remotely from their location.

Standardised systems and processes

A driver of the new regulations is the relatively high cost of post-trade services in Europe compared to the US. The US has only two CSDs, DTCC and the Federal Reserve, so rules and processes are already harmonised. In contrast, more than 40 CSDs operate in Europe, each with its own market practices, standards and language, which ultimately increases post-trade processing costs and serves as a barrier to cross-border trade.

CSDR provides for the standardisation of market practices and communications methodologies. ISO messaging standards are being, or have already been, implemented to enable straight-through processing, and they make it easier for investors, custodians and CSDs to communicate. This allows the middle and back office to improve operational efficiency in trade processing, including allocations. Standardisation also enables custodians, banks and brokers to outsource commoditised functions, affording an opportunity for existing outsourcers and new entrants to generate new revenue.

Finally, rules and settlement schedules have been harmonised. Following several years of preparation, Europe made an amazingly smooth transition from a T+3 settlement cycle to T+2 in October 2014. This industry-led initiative is expected to increase liquidity while reducing costs and risk.

T2S impact on costs and revenues

On average each CSD in Europe has seven links to other CSDs and custodians. In the industry, it has become known as the 'spaghetti model' comprising nearly 300 links. But now institutions are implementing Target2-Securities (T2S), the European Central Bank's (ECB) new cross-border settlement engine. T2S is designed to allow smoother transaction flow between the European markets and reduce transaction costs in the long term.

Critics argue that T2S is not a significant benefit for CSDs—especially small to medium-sized ones—because it means outsourcing one of their core functions to a third party. In addition to eroding their business model, they must incur significant systems development costs at a time when they are also spending on CSDR compliance.

Since T2S is a non-profit cross-border engine operated centrally, settlement will be a low-cost commodity: the ECB set the transaction fee at €0.15 per settlement. Unless CSDs add a margin on top of that for providing other services, it will be difficult to recoup their T2S investment.

Most CSDs in Europe source their revenue from the domestic market. Smaller ones could get squeezed out by larger ones that have extensive service offerings across a wider geography. To survive they may have to position themselves as niche players or consolidate with other CSDs.

Yet others believe that CSDs can leverage T2S and CSDR to build a profitable business model and horizontal service offering that meets issuers' and investors' needs. For example, some CSDs could outsource settlement to T2S and accounting to a third party, and then focus on specific niches such as asset servicing.

Niche opportunities

Large buy-side firms, mutual funds, pension funds and insurance companies have assets scattered throughout Europe. They usually do not have direct access to CSDs and pay significant fees for custody and connectivity. With the single European passport brought by CSDR, CSDs can hold accounts with all other CSDs and can offer investors direct access to their entire European portfolio.

Custodians charge significant fees for safekeeping of securities and asset servicing. But with T2S investors can easily centralise their holdings in each country into a single pool of assets with the local CSD, thus increasing efficiency and lowering costs. This could be detrimental to small CSDs, however, if large international players aggregate all their assets into one account with a major CSD or ICSD.

Collateral management is another potential niche, albeit one where there is already competition. The European Market Infrastructure Regulation requires CSDs to hold CCP collateral, so CSDs in

the eurozone can auto-collateralise trades using the ECB's collateral pool. Large CSDs such as Clearstream and Euroclear have comprehensive global auto-collateralisation solutions and they can move securities via T2S smoothly and at a low cost, increasing their competitiveness.

Technology implications

Not surprisingly, CSDR and T2S have significant technology implications for CSDs. Most of these entities still operate on legacy systems that run on mainframes and costly architecture tools. It is expensive to support and maintain old databases and programming languages. When these systems were built, the communications methodologies and standards were totally different, and that makes it difficult to interoperate with other systems and implement straight through processing. CSDs that want to leverage the regulations to introduce new services will likely experience a long time to market and a heavy cost burden. Moreover, altering old code and building new services on top of it is always a risky proposition.

To this end, many CSDs are looking to implement new technology based on commodity hardware and open source platforms such as Java so their system is more cost effective. In fact, one CSD found that installing a completely new solution costs less than maintaining their mainframe infrastructure for just one year. In addition, new systems are configurable, so it is faster and easier to add new products and services.

Lessons learned

Europe is setting the precedent for change, and other regions around the world have much to learn from the experience. The Association of Southeast Asian Nations already has an economic, political and capital markets agenda. The Mercado Integrado Latinoamericano has integrated the stock exchanges in Chile, Colombia and Peru. The East African Securities Exchange Association is helping partner states to formulate policy to integrate their markets. All of these initiatives are in the early stages of collaboration compared to the Nasdaq Nordic-Baltic market, for example.

The logical first stage of evolution is to link the exchanges by offering reciprocal direct market access for brokers, and then build CSD-to-CSD links over time and one by one. Over the long haul, a true cross-border offering needs to include provisions for FX and cash controls, taxation and property laws, as well as various accounts (omnibus and nominee) and the legal basis for them. Eventually, laws, regulations, settlement cycles and messaging standards can be harmonised. At each stage they need certain technology features and functions to support their approach.

Europe has encountered many challenges on its journey to standardisation and harmonisation. It started down this path several years ago, and while much has been accomplished, there is still more to do. But in the end, the markets will be safer, more efficient and competitive, and well positioned to reap the rewards of the effort.

> "CSDs that want to leverage the regulations to introduce new services will likely experience a long time to market and a heavy cost burden. Moreover, altering old code and building new services on top of it is always a risky proposition"

Henri Bergström
Head of global post-trade solutions
Nasdaq

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Grasping asset servicing opportunities in T2S

Alexandre de Schaetzen of Euroclear on why the open model is the solution to getting the most from European harmonisation initiatives around settlement

Target2-Securities (T2S) and related harmonisation efforts will have various impacts on asset servicing, from increased corporate actions standardisation to new opportunities to rationalise custody networks. New models are also emerging that give firms the flexibility to use their current local asset servicing provider and take advantage of more centralised settlement and pan-European asset pooling.

When the European Central Bank's (ECB) T2S settlement platform begins operations, it will mark a major step in the harmonisation of Europe's post-trade environment. T2S will enable market participants to rationalise their settlement and liquidity management, significantly reducing the costs associated with cross-border financial activity in Europe.

T2S itself will not fully harmonise asset servicing, however. Disparate standards and practices currently require financial firms to maintain links to many different providers. This will change in T2S as firms will be able to pool assets from across multiple European markets through a single central securities depository (CSD). While T2S will facilitate the cross-CSD settlement, the CSD will take care of the multi-market asset servicing.

As settlement becomes commoditised in T2S, asset services offered by CSDs will play an increasingly important role in driving the choices of market participants within the securities post-trade industry. Some CSDs are taking the opportunity to develop new asset servicing capabilities across T2S markets. This includes providing efficient corporate actions, tax services, proxy voting and all this with optimal processing efficiency, competitive deadlines, dedicated support and efficient and real-time reporting.

New models taking shape

European investment industry regulations, such as the Alternative Investment Fund Managers Directive and UCITS V, are also pushing the decision to revise asset servicing options to the fore. With a focus on ensuring high levels of protection for investors' assets, these new regulations encourage firms to have accounts in a securities settlement system (SSS), such as a CSD or international CSD, to bring those firms closer to the settlement infrastructure with fewer intermediaries in the chain.

This situation has given rise to new models that combine the benefits of asset protection (asset holding within an SSS) and asset pooling (assets pooled in the same CSD, acting as issuer and investor CSD).

For example, the single CSD model, like that being developed by Euroclear, will enable firms to centralise access to T2S settlement and benefit from harmonised asset servicing across the European markets. However, given the local market specifics that will remain for some time, many firms may want to maintain their current asset servicing provider in the first instance and focus on centralising their assets. Many market participants are likely to prefer a gradual change, making decisions as the T2S environment becomes more established.

One new variation of this model that accommodates a gradual approach to adaptation is the single CSD 'operated' model. In this model, a financial institution can establish direct market access in a number of key European markets through a single CSD, like ESES (Euroclear Settlement of Euronext-zone Securities), with the option to use a local agent of their choice for asset servicing.

A major US global custodian is already an innovative early mover to this model, opting to access a number of key European equity markets through Euroclear's single CSD solution, while continuing to use its current local asset servicing agent. Such a flexible solution will enable the custodian and its clients to capitalise on the new single market infrastructure of T2S, while keeping the relationship with their current agent. In addition, by moving their account directly into a CSD, they benefit from liability risk mitigation compliant with the new European regulations.

Opportunities for equities

Probably the biggest opportunity for asset servicing consolidation in Europe is not in fixed income, but rather in equities. Today, fixed income is often already centralised with one or a few providers, while the holding of equities takes place in different locations. This is because the equities landscape is still very much 'silo-based', with trading, clearing and settlement functions mandated in each market. Further centralisation in this area is needed to increase efficiency, with stock exchange flows able to feed into any central counterparty (CCP) where the CCP member decides to consolidate its clearing activity, and CCP flows able to feed into any CSD where the CSD client decides to consolidate its settlement activity.

As a market infrastructure, Euroclear is an advocate for 'open' models across all levels of capital markets—trading, clearing and settlement—and is 'unbundling' services to provide asset servicing to its clients regardless of where the settlement takes place or where their assets are held.

How quickly the equities space will evolve, with 'opening-up' at the level of the stock exchanges and CCPs, remains unknown. However, we see that firms are already closely assessing the rationalisation opportunities within the equities space as it exists today and as it will exist in T2S.

Flexibility in times of change

In these early days of T2S, it is important that firms can move at their own pace, while having options to make further changes when the time is right. Many firms have built up long-standing relationships with CSDs, ICSDs and agent banks and will be reluctant to completely change their models without first examining the full impact of any change.

Moreover, although significant efforts for corporate action harmonisation are ongoing, there will still remain some market specifics in areas such as tax, for which the support of an agent will be needed.

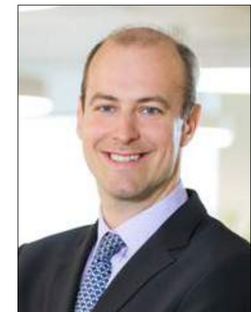
As an open and flexible model, the single CSD 'operated' model will enable a financial institution and its clients to capitalise on the new single market infrastructure of T2S, reduce liability risk and keep existing agent relationships.

This will also allow financial institutions to benefit step-by-step from the expected evolution of the industry's asset servicing models, at first by moving the assets to an SSS to maximise benefits while minimising risks, and later to assess the multi-market asset servicing provided by CSDs.

Preparing for the unknown is a complex undertaking. At Euroclear, we are fully committed to supporting the creation of a single financial market in Europe and fostering the efficiencies this will bring.

We're working closely with our clients wherever they are in their T2S journey to help them adapt and benefit from the new efficiencies enabled by T2S, including in the areas of asset servicing and liquidity management, now and as their T2S strategies continue to take shape.

> The equities landscape is still very much 'silo-based', with trading, clearing and settlement functions mandated in each market. Further centralisation in this area is needed to increase efficiency, with stock exchange flows able to feed into any central counterparty



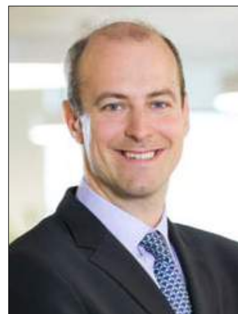
Alexandre de Schaetzen
Director, T2S product management
Euroclear

Trust it, use it, prove it, groove it

It's time for T2S to show how good it really is. Experts take a look

Robert Scott
Head of custody and collateral solutions
Commerzbank

Peter Csiszer
Strategic director
Keler



Alexandre de Schaetzen
Director, T2S product management
Euroclear

Tom Casteleyn
Head of T2S and market infrastructures
BNY Mellon

Isabelle Olivier
T2S programme director
SWIFT

Avi Ghosh
Head of marketing and communications
SIX Securities Services

The first wave of migration to T2S is upon us—how and why did we get here?

Avi Ghosh: Back in 2001, the Giovanni Group identified 15 barriers at the settlement and clearing layers of trading that inhibit efficiency in Europe. Since then, an enormous amount of progress has been made to remove or reduce the effects of these legal, tax and technical considerations, which maintain fragmentation in European post-trade. Following the 2007/2008 financial crisis, even more emphasis has been placed on ensuring that safety characterises post-trade regulatory initiatives.

Nevertheless, redundancies and fragmentation still remain at almost every layer of the value chain, with the EU facing uncompetitive, regulatory interpretations and implementations at national levels. In contrast to the US, which enjoys a relatively unified, low-cost and efficient market infrastructure, trading in Europe (cross-border trading in particular), can be expensive and inefficient. This makes Europe a distinctly less certain, and therefore more expensive and less attractive place to do business.

Target2-Securities (T2S) will play a significant role in strengthening the resilience and safety of the EU financial system. The platform will help to overcome the current fragmentation in the securities settlement layer of the EU post-trade landscape, making an important contribution to the establishment of a single market for post-trade securities services. T2S will also introduce a single set of rules and standards, reducing the complexity of the current market structure. By harmonising areas of post-trade activities, T2S should help to achieve more integrated and efficient EU capital markets.

Robert Scott: We are here because fragmentation of European securities markets meant that settlement had become massively inefficient. Almost every national market had its own legal frameworks, platforms, processes and cost bases, making cross-border settlement in Europe, in particular, expensive and time-consuming. T2S was initiated to bring standardisation to Europe's settlement infrastructure. There was a lot of scepticism a few years ago that this could be achieved, given the enormity of the task. But people are now coming round the idea that a harmonised European market for settlement is going to be a reality.

T2S has really been a considerable beneficiary of other regulation that's come in since the global financial crisis. There's been a wholesale move across financial markets to improve transparency, security and efficiency—from improving asset segregation to moving to T+2 settlement to introducing Central Securities Depositories Regulation (CSDR). It's doubtful that T2S would have been as successful if these other measures weren't being put into force at the same time.

Peter Csiszer: The entire industry became familiar with the vision and original goals of T2S: harmonising and centralising settlement, reducing settlement costs and increasing safety by the use of central bank money. The main challenge today is the successful implementation, where not only the very complex system must prove stability, but also an entire industry will have to migrate to the new operating model.

Beyond the technical challenges, we all question whether escalated costs could be recovered by expected benefits in the short or long term, or not recovered ever. The system project is approaching a ground-breaking milestone. Everybody is looking at the first migration wave as a good checkpoint with a lot of embedded risks.

Will T2S be stable and operational enough to go live? There are a few weeks to go and we do not have assurances, yet. Will CSDs be ready to migrate? It's difficult to estimate, but there are still quite a few red items in their status updates.

Tom Casteleyn: The launch of T2S gives us the opportunity to look back over the nine years since July 2006 when the European Central Bank (ECB) made its first public statement on T2S.

When it was first discussed, T2S was very clearly a single market project. Its basic aim was to rationalise core settlement infrastructure in Europe, and to contribute to economic growth and efficiency in Europe.

Nine years later the terminology has changed—we now speak of a 'capital markets union' instead of a 'single market'—but the basic aim of T2S is unchanged.

Isabelle Olivier: SWIFT's involvement with T2S began when our standards experts assisted with the definition of the ISO 20022 messages used to communicate with the platform. We were selected in early 2012 as one of the two providers of connectivity to T2S and we have been working since then to develop our value added network solution and to help our CSD and bank customers prepare their infrastructures and develop their business models to operate successfully in a T2S environment.

Alexandre de Schaetzen: The goals of T2S are to: (i) create a single settlement engine for the eurozone, after all, every other currency zone tends to have a single central bank money settlement system; (ii) deliver a single integrated central bank money settlement system for the eurozone with cash and stock positions on the same platform; (iii) improve collateral mobility within the eurozone; and (iv) reduce costs and risks and increase efficiency in the eurozone.

To achieve this, 24 national CSDs will outsource their settlement to a central settlement platform providing more efficient cross-CSD settlement, pooling of liquidity through one central bank account for all of the T2S settlement activity, and harmonisation of both the settlement lifecycle and operating window.

T2S will be rolled-out in different waves to adequately balance business opportunities with implementation risk. The settlement volumes of the major markets in Europe are also well spread over the four migration waves.

How well positioned will early adopters be to benefit from T2S?

Scott: It's questionable. A number of universal banks have looked to come up with T2S strategies and build technology and new platforms to support them. However, clients are still largely on the fence because there are still many unknowns,

from the headline rate for settlement to how CSDs will interoperate on pricing, to the account segregation issues surrounding omnibus account structures versus the current regulatory direction of finite account segregation.

It is only likely to be in the third wave and beyond that clients start to get clarity over many of these issues and how it affects them. Additionally, testing of systems to date has largely been in the domain of the ECB. As this now moves to the public domain, and for first-wave participants, there are plenty of issues still to overcome.

CSDs elected which wave they would migrate in, and certainly, some have believed it will provide a competitive commercial edge to be part the first wave. However, this again is questionable with up to 95 percent of clients yet to decide their own T2S strategy and many only starting to explore their options in the last 18 months, with little significant movement to date. That's understandable, given the vast amount of regulatory change that clients have had to withstand over the past few years.

Given the squeeze on headcount and overheads, many firms simply don't have the bandwidth to consider moving from one provider to another just yet.

De Schaetzen: Because of this 'wave-by-wave' implementation, the scale benefits linked to T2S (such as a harmonised operating window for settlement across Europe) will not occur immediately. Only when a critical mass of settlement volume has migrated—after the third or fourth waves—will the full benefits of T2S be realised.

The first priority for many firms will be the mandatory changes required for T2S in the markets where they are active today. After this, they will seek to maximise opportunities from T2S, especially when the extent of the harmonisation across markets has become clearer.

To avoid the risk associated with changing too much at once, firms are likely to move step-by-step to their long-term T2S solution. This might mean focusing on key European markets and taking the first 'no-regret' steps now, while delaying other steps until existing uncertainties are clarified.

For example, some firms are now opening an account in a securities settlement system to maximise asset protection standards—as per regulations such as UCITS V—while still keeping their current provider for asset servicing.

Another opportunity for early adopters would be to pool liquidity through a single cash account in one central bank, allowing them to finance all of their pan-European activity more efficiently.

Ghosh: Early adopters stand to gain a significant advantage over their competitors. Most global custodians and international banks operating in Europe will choose to connect to two or three CSDs rather than just one. This approach will ensure a contingency plan while mitigating against the costs of connecting to lots of providers.

The first wave of CSDs, such as SIX Securities Services, are the very first users of the platform, so will have road tested it more than most others in Europe. By connecting straight away with a CSD that's part of the first wave, clients can ensure peace of mind by avoiding concentration risk with a single, major provider, while being able to test their own processes while T2S is still in its early stages.

By the time the second and third waves of CSDs go live, the first wave will already have used, tested and pushed the platform to its limit. This means first-wave CSDs will have had a head start in being able to provide prudent advice to their clients on what the platform can and cannot do, and where additional services can be developed off the back of it.

It's important to remember that T2S is about far more than just plugging in, and firms will do well to examine all the business and technology opportunities that the initiative presents, particularly in areas such as collateral management and asset servicing. Early adopters will be able to get ahead of the game in these areas, too.

Olivier: The CSDs in the first wave have set out to benefit from T2S as early as possible. Most of them have been strong supporters of T2S all along and want to demonstrate this.

We have seen that in some cases they have been able to attract customers that they would probably not have won business from if they had been in later waves—customers that also want to take advantage of T2S as early as they can.

There are always challenges with being an early adopter but I think the strategy of these CSDs has been successful in terms of winning customers that could otherwise have been out of reach.

Csiszer: Early adopters went into the project with ambitions to use the opportunities and grab fresh business. They would expect T2S to have swift transformational effects in the post-trade operating models and clients immediately focusing on the different CSD solutions. However, seemingly compliance and continued stability are the priority requirements of the clients before anyone would go into strategic decisions and reconsider business efficiency and structure. The idea has not proven to be false yet, but benefits pair with challenges for the first movers.

They had the shortest time to adapt their systems and the readiness of T2S is also more critical for them than for CSDs of the later waves. We have not heard of many business decisions made as a response to T2S yet. A larger part of the industry wants to wait and see. Volunteering for the first wave certainly required vision and some courage, but we will only understand whether it was worth it towards the end of the four waves.

Casteleyn: T2S will certainly have market-changing impacts. We believe that T2S will contribute to a process of consolidation in Europe, and that those intermediaries that are early adopters are giving themselves the possibility to extract the greatest benefits from this process, and to minimise the risks for themselves. At BNY Mellon, it is our intention to be among the early adopters.

How have asset servicing providers changed to meet the T2S challenge?

Csiszer: With the launch of T2S, 'asset servicing only' and 'account operator' solutions are getting more and more attention. Investors will have a selection of capable CSDs offering safe direct connection and standardised T2S settlements, however, asset servicing can remain the playground of custodians in the coming years. Traditionally, this has been embedded in custody services from both an operational and a pricing perspective, as these are in fact the core of the custodian function.

Now, the challenge is to unbundle these services and package them as standalone capabilities. Some custodians and markets are advanced with the initiative and their service level, so operations and systems are defined for such solutions.

There are 'asset servicing-only' and 'account operator' agreements, where agents technically copy CSD accounts and positions in their custody systems and provide services on that basis. Such structures might increase asset safety for investors, but increase the complexity of the post-trade flow and require customisation.

The transformation of the market has started, but direct CSD accounts are not yet the priority structure in Europe and it is still unclear whether it will become dominant in the T2S era.

Casteleyn: Asset servicing providers have had different strategies with respect to T2S. Some providers, like BNY Mellon, are early adopters, while others have clearly taken a wait-and-see approach. As T2S has not yet been launched, it is difficult to reach definitive conclusions, but some preliminary remarks are possible.

It has, for example, become apparent how complex asset servicing-only models are, so that it is unlikely that these will become a dominant form of asset servicing, but will be used only by a limited number of market participants.

At BNY Mellon, we believe it is critical that as a global custodian we get closer to the market infrastructure and therefore we are connecting directly to T2S during the first wave and will have accounts at all the major CSDs in Europe. In two countries (Germany and the Netherlands), we are already direct today, both for settlement and asset servicing, while in others we will need to build this out.

When it comes to asset servicing, it is clear that the CSDs are also coming up the value chain and making it easier for us, as a global custodian, to connect directly to the market. Tax services are a good example of this.

Ghosh: In addition to collateral management, asset servicing is the other major area where CSDs will compete for cross-border business. Clients demand minimal operational risks, complexity and costs, high-quality information, and expertise in a range of international markets. As it stands, very few CSDs have sufficiently covered the area of asset servicing, nor do they have an adequate global offering to do so. SIX Securities Services has a stable asset servicing platform perfectly designed to accommodate T2S.

Olivier: The standardisation of settlement in T2S has resulted in many service providers further separating the asset servicing from the settlement part, at least in terms of platforms or business offerings. On one side we have seen some standardisation efforts in asset servicing, driven by T2S, even though there is still a long way to go to achieve full harmonisation. T2S has also prompted some agents to invest in capabilities to position themselves as asset servicing specialists in one or more domestic markets.

In a nutshell, with T2S commoditising settlement activities, asset servicing becomes a key differentiator. This explains the greater focus on this area and the development of this business line by some players.

De Schaetzen: Although significant efforts for harmonisation are ongoing, there will remain some local market specifics in areas such as tax management, for which the support of an agent will still be needed. In addition, certain regulations drive holding structures away from the traditional custody provider. These will give rise to new asset servicing models, like the investor CSD model, which provides single CSD access to all T2S markets, combining the benefits of asset protection (asset holding within a securities settlement system) and asset pooling (assets pooled in the same location).

As a market infrastructure provider, Euroclear advocates for 'open' models across all levels of capital markets trading. In the T2S environment, for example, we are unbundling our services, giving our clients the flexibility to benefit from Euroclear's multi-market asset servicing, regardless of where the settlement takes place or where their assets are held.

Until full harmonisation in asset servicing has been achieved, there might be less need to change asset-servicing providers. Indeed, international CSDs and agent banks today are already able to cope with different market practices and provide a single, harmonised service for their clients. Many financial institutions will therefore continue to use their current asset-servicing provider—if that provider has pan-European asset servicing capabilities. In the medium term, there might be some consolidation of providers as harmonisation will reduce the value of a local agent and increase competition across markets.

Scott: There hasn't been a lot of change to date. But what will become increasingly clear is that as revenue from settlement goes away, it will be vital for asset servicing providers to demonstrate strong local market capabilities. That means having strong connections to regulators, corporates and issuers, and deep local market intelligence about corporate actions.

So it won't be the banks that send their business offshore that do well in this sector—it will be those that retain a strong local presence and connectivity, coupled with a deep rooted understanding of the client and competitive cut-off deadlines on corporate actions. That's why I don't necessarily share the opinion of some of the larger providers that local banks will struggle or go out of business as a result of T2S—in particular, the volume markets.

I think it's also the case now that costs are unbundling as some components disappear, so there is going to be more transparency. Banks will need a better understanding of all of their asset servicing costs. In fact, we are going to see wholesale changes as banks take a long, hard look at their business models. Rather than trying to be all things to all people in all markets, for all products, banks are becoming more selective as to which clients they want to serve and what services they'll offer.

It would also be logical to harmonise asset servicing as well as settlement in the longer

term. Dividend and coupon payments account for approximately 80 percent of asset servicing. If you can standardise that activity across European markets, the additional efficiencies achieved would be substantial.

What will post-T2S Europe look like for end users?

Casteleyn: T2S is a deliberately limited project. The T2S platform has been designed as a lean platform that handles just the core settlement process. This means that the impact of T2S on end users depends not only on the T2S platform itself, but also on how their intermediaries react to T2S, and on the degree to which T2S will lead to a harmonisation of market practices, beyond settlement.

End users will certainly receive benefits from T2S, but the precise nature of these benefits will depend on the intermediaries that they use to access T2S, and on the degree to which their intermediaries take direct advantage of the benefits of T2S.

We believe that with the BNY Mellon strategy, end users will be able to shorten their custody chains, which bring benefits in terms of deadlines and services, but also in terms of risk reduction. In addition, by offering the new T2S settlement features, we believe our clients can benefit from higher settlement efficiency, and as a result, better liquidity and collateral efficiency.

Olivier: For retail investors, not much will change in the short-to-medium term, although in the longer term they may get lower prices and easier access to foreign securities. Institutional investors will gain easier access to a wider range of securities.

The easier access comes from the standardisation and harmonisation, and the wider range from the consolidation that T2S brings. The competitive landscape is expected to change, providing further opportunities for institutional investors to select the best provider for specific securities and businesses. They may also get some benefits in terms of liquidity and collateral management.

Hopefully they will also see a reduction in costs, probably not immediately, but in the longer term.

Csiszer: There is a fair chance that T2S will commoditise settlement, CSDs will compete for settlement volumes internationally and sub-custodians will lose larger parts of their related margins. However, this is not likely to happen in the short term. Settlement services will not become homogeneous all over the T2S geography immediately after the launch of the system. CSDs will be differentiated by their flexibility in interface capabilities, account options, cash settlement solutions, settlement-related service enhancements, and most importantly, their pricing.

The interconnectedness of CSDs will be important to let competition evolve and the transformation happen. The traditional added value of custodians in settlement will be taken over by T2S and the CSDs step by step. Liquidity provision in cash and securities will be the difficult part, but as soon as all currencies are in T2S, which can be a reasonably anticipated outcome in the medium term, and developed CSDs will offer a full set of settlement services, it will also be managed on the lowest level of the value chain.

Scott: It will provide a very efficient mechanism for settlement, greater transparency, increased mobility around collateral and better liquidity management. The cost of doing business in Europe compared to the US will come down, although it will still be some way from parity.

The end user will have more choice, including the opportunity to use one CSD or service provider right across the eurozone, if they wish. It should also be cheaper for clients.

But banks will need to find a way to replace that lost settlement revenue in their profit and loss models, so they may well have to charge more for their products and services. Balance sheet constraints have meant that costs will undoubtedly go up in other service areas as the economics for banks become increasingly challenging while they look to comply with the new capital and balance sheet impacts of regulation.

In terms of overall cost implications within the industry, it's important to stress that the real and tangible saving for clients isn't going to come from the headlines rates for cross-border settlement. The real cost saving will be the removal of all the inefficiency that has built up in settlement and operational/technological infrastructure over the past 25 years. Clients are looking for a quantum change in their cost base and T2S will be a small component of this.

Ghosh: Once implemented, the idea is that T2S will have a transformational effect on Europe's financial markets and deliver a wide range of benefits. T2S will give market participants much more choice in terms of providers of settlement services, as in many jurisdictions they will no longer be bound to domestic CSDs.

In the short term, we are likely to see new CSDs emerge, but over time the costs of initial development and high ongoing expenses for CSDs limited to a domestic market should eventually force consolidation, with many domestic CSDs reduced to a registrar function.

As participating in multiple CSDs is expensive, it is likely that market participants will consolidate their business to a limited number of providers (or even a single provider). In this sense, T2S could be a catalyst for harmonisation across Europe, helping to create a single competitive financial market and contribute to ultimate financial integration in Europe.

Perhaps most importantly, T2S is expected to drastically reduce risk in the EU post-trade environment. Securities and cash accounts will be integrated onto a single platform, and a single collateral pool will help banks to optimise their liquidity and collateral management processes, helping to generate significant collateral savings.

De Schaetzen: While it is certainly a key element, settlement is only one component of the post-trade processing flow. To create a really efficient cross-border settlement environment for Europe, one therefore needs to look end-to-end from trade to settlement.

T2S is the beginning of what is likely to be a long journey. What is clear is that in the beginning firms will continue to maintain their inventory of securities at different places. They are looking for open market infrastructure solutions that allow them to choose their asset servicing provider independent from their asset location and to pool all of their assets together for collateral

management purposes. This way, they are able to balance service quality with risk and asset protection priorities and financing needs.

If we can open up the flows between exchanges and CCPs, and between CCPs and CSDs, we will remove some barriers to a more efficient European capital market by providing more choice and increased competition, which will be of great benefit to the end users.

T2S will definitely act as a catalyst for harmonisation, which will benefit the whole EU capital market up to the end user. First of all, T2S will allow easier access to markets. Secondly, T2S will allow a smoother communication flow between issuers and investors. In the medium-to-long term, this will render the European financial landscape more attractive to investors, which in turn will benefit the issuers by providing them with an increased investor base.

What do you have to say to those jurisdictions still thinking about T2S?

Scott: It's understandable that some jurisdictions are sitting on the fence and waiting to see the outcome of the first wave and beyond. Frankly, it's only when the effects of the third wave are known and the likes of Clearstream come on board that we'll all have a clearer understanding of where volumes are going to go and the impact on pricing and service.

I'd say to those jurisdictions: "Look at the successes and failures of early adopters, see what you can learn from the technology, platforms and service models that emerge, and then define the right business model for you."

Csiszer: This is a complex question and each market has its own priorities, therefore it is not obvious that joining T2S is the right decision for all. The most important is to make a conscious decision based on thorough analyses of the topic. Surely there is a substantial investment required and it might not even be able to be recovered quickly, but on the other hand, if you opt out, there is a loss of opportunity and a vulnerability to the competition and the expected transformation of the post-trade industry.

Staying out is a way of not coping with the change and not adapting. It will become critical if T2S goes beyond its short-term goals and even attracts volumes from outside of its territory. In that scenario, the system and its participating CSDs will eat into the flows of the outsider markets, and it might not be easy to reconsider decisions and quickly catch up with the trends.

De Schaetzen: At this stage, those European markets still considering T2S are waiting for its delivery to understand how successful T2S will prove to be.

They will be interested to see not only how T2S operates from a technical perspective, but also how successful it is in generating cross-CSD volumes and whether it will achieve the ambition of better integrated European financial markets. This could bring us to the 2017 to 2020 horizon before we see CSDs in other jurisdictions outsourcing their settlement to T2S.

Outside of Europe, there are other continents with fragmented markets that may want look to replicate (part of) the T2S concept. For example, some big Asian markets have several domestic CSDs, each servicing different types of instruments. Those markets might see parallels with the T2S initiative and assess how the model could be transposed in one way or the other in their respective country, or even eventually, as T2S in Europe, across countries in the region.

Once Europe has delivered T2S and the necessary associated harmonisation, the battle will not be over. Indeed, financial markets are more and more global these days, and the ultimate goal is to achieve better integrated markets at the global level. Such extended harmonisation, combined with the use of open models enhancing competition, will result in the ultimate ambition of better-integrated financial markets worldwide.

Casteleyn: T2S has been designed as a multi-currency platform. The benefits to all current and future users of T2S will increase as more jurisdictions use the platform. We should encourage such jurisdictions to take the step of joining T2S.

Olivier: Some jurisdictions have expressed their intention to join—Norway and Sweden, for example. I think many markets will watch what happens and jump in when it becomes obvious that the platform is working well and delivering benefits.

It's not an easy business case for CSDs, but if T2S does deliver tangible value, their markets will push them to participate. For markets outside of the eurozone, there is a barrier in that their CSDs need to have legal entities in the eurozone, and for markets where the securities industry is already very strong, and where players operating locally can already facilitate access to global markets, there may be less need to join T2S. We may see bridges created to enable interoperability between T2S and other settlement systems in such markets.

Ghosh: While it's too early to determine what other countries (such as the UK) will eventually decide on T2S, there are several important considerations for those who are about to take the leap.

As it stands, too many firms are viewing T2S as a mere technical project, but they would do well to remember that it is not just about cost-savings. T2S is an opportunity to help your business achieve what it wants to achieve. While a lot of firms right now are focusing only on connectivity, all should be looking at the business and technology opportunities that the initiative presents. Focus on what's of strategic value to you, and partner with one of the leading CSDs to design a migration path that takes you beyond the go live date in 2017. As T2S evolves, you will need to be ready to evolve with it.

Dodd-Frank

July 2015: deadline for comments on the SEC's proposed amendments on payment disclosure requirements.

November 2016: US presidential election.

January 2017: If elected, the Republican Party proposes to repeal parts of Dodd-Frank, including indemnification requirements for accessing swap data and to exempt banks with less that $10 billion in assets from the Volker Rule. President Obama has pledged to 'veto' the plan if it comes to him.

January 2017: Democrats propose more reserved tweaks to ease the burden of the legislation.

Speaking Dodd-Frank-ly

Billed as the end to 'too big to fail', has Dodd-Frank actually bitten off more than it can chew and ended up too broad to succeed itself? Stephanie Palmer reports

When US President Barack Obama signed the US Dodd-Frank Act into law in 2010, for many it stood for the beginning of the end of the financial crisis.

The legislation was designed to mean the end of institutions deemed 'too big to fail', making the whole financial services industry fairer and safer, in the US at least.

In the years that followed, the financial services has had its regulatory ups and downs, and it still seems that industry professionals can't quite agree on whether Dodd-Frank has been a success.

According to a paper issued by the Harvard University Mossavar-Rahmani Center for Business and Government, Dodd-Frank, among other significant regulations, have hit smaller, community banks, hard.

The State and Fate of Community Banking explains that the market share of these banks has dropped from more than 40 percent in 1994 to about 20 percent in 2015. Between 2006 and 2010, their share of the market dropped by about 6 percent, whereas in the months following the implementation of Dodd-Frank, the fall was almost twice that.

Authors Marshall Lux and Robert Greene, suggested that these smaller asset managers and lenders are suffering from disproportionate losses and a decline in small business lending revenue, leading them to consolidate their operations.

"Dodd-Frank has exacerbated the pre-existing trend of banking consolidation by piling up regulatory costs on institutions that neither pose systemic risks nor have the diversified businesses to support such costs."

The report went on to say: "Consolidation is not inherently a bad trend, but policymakers should be concerned that a critical component of the US banking sector may be withering for the wrong reasons—inappropriately designed regulation and inadequate regulatory coordination."

"An increasingly complex and uncoordinated regulatory system has created an uneven regulatory playing field that is accelerating consolidation for the wrong reasons."

The paper offered a particularly scathing review, but Lux and Greene aren't the only ones highlighting consolidation as an issue. Paul Gibson, a business consultant at Sapient Global Markets, suggests that through acquisitions and proliferation of siloed systems, some institutions have got themselves in a muddle. "The industry has got to a place where it is impossible to understand the complete product and risk exposure. What they're now trying to do is consolidate, but it is a huge undertaking and so will not be solved in the near term."

He adds: "What we are going to be seeing over the next three to five years is a consolidation of back office processes and further movement towards outsourcing and use of utility or managed service type models for those functions to try and bring down the costs."

The legislation has just put extra pressure on institutions, which, while intended to improve security, has led to small banks being somewhat bombarded with rules, and therefore additional costs, that they just don't have the resources to cope with. The consolidation that the industry has seen, and will continue to see, could lead to efficiencies if it was properly structured and planned for, but in a rush for compliance, it's the smaller, arguably less culpable banks that have suffered the most.

The Lux and Greene paper added: "The top five bank-holding companies control nearly the same share of US banking assets as they did in the fiscal quarter before Dodd-Frank's passage. Meanwhile, community banks with $1 billion or less in assets have seen a significant decline, while large community banks have also suffered losses, albeit at a less drastic pace."

"The rapid rate of consolidation away from community banks that has occurred since Dodd-Frank's passage is striking given that this regulatory overhaul was billed as an effort to end 'too big to fail".

Overseas, Dodd-Frank has caused a not dissimilar state of confusion. Although, technically, the act only applies to US-based institutions, it was born out of the 2009 G20 Pittsburgh Summit, and the other G20 jurisdictions are still in the process of implementing their own legislation.

Jim Myers, senior manager of business consulting in treasury and risk management at Sapient Global Markets, says: "Dodd-Frank has cross-border implications which will become clearer as other jurisdictions implement their versions. That will lead to added complexity for the multinational banks that have to deal with different implementation of all the agreements. It has proved difficult, but we have started to see better cross-border conversations."

Gibson adds to this, saying: "The US Commodity Futures Trading Commission (CFTC) really took the commitments from the Pittsburgh Agreement and implemented them quickly, and since then, everyone has been playing catch-up."

"If the US hadn't made that decision then some of these regulations might not have been implemented globally, and I don't know how long we would have been waiting for that—it could have been unnecessarily delayed."

"It's difficult to know whether moving so quickly was a good thing or a bad thing. Everyone agreed that the regulations were needed, but the pace of implementation arguably had a negative effect on the market because we've ended up with multiple interpretations, approaches to regulatory reporting and differing timelines."

When other jurisdictions bring their Dodd-Frank alternatives to the table, there is a worry that firms will find themselves reporting the same compliance

data to various different regulatory bodies—a problem that many international institutions are already struggling against.

"As it stands, the multi-layered, sometimes contradictory, nature of the current regulatory environment continues to cause concern. Participants' unease traces back to individual rules as well as to the cumulative effect these new regimes have on the markets," says Gibson.

Operationally, Gibson argues, firms have a great deal to consider. As electronic trading rules are finalised participants will need to review and select electronic trading platforms—a process that could require rationalisation of existing platform connections so as not to incur unnecessary costs.

Trade execution will require effective order aggregation and smart routing for best execution, while data analytics will play a role to ensure collateral efficiency, leveraging CCP margin calculations based on real-time market prices.

Trade capture, confirmation and clearing processes will also require system rationalisation across asset classes and products.

As the industry moves down the regulatory timeline, the main points of contention in Dodd-Frank seem to be harmonisation and simplification—both ultimately leading to a safer and fairer environment for both institutions and their clients.

The Lux and Greene paper preaches clarification on the extent of the rules for small and community banks, and exceptions for those banks they call 'too small to succeed'. It concludes that the industry should reform its regulatory processes in the near future, in order to avoid any unnecessary stresses for the small-fry institutions.

The authors wrote: "To ensure better-designed regulation in the future and avert unintended consequences that jeopardise lending market vitality in the US, more robust economic analyses of financial regulatory rulemakings are needed."

"Simple, predictable policy prescriptions are often best at mitigating complex risk."

Myers agrees that more consideration of Dodd-Frank's effects on smaller players is one of the more pressing issues. While the big banks will have dedicated compliance departments, legal teams and very strict guidelines as to what's expected of them, the rules are fuzzier for small- to medium-sized market participants.

Many are left unsure as to what they're supposed to be doing when it comes to their processes, reporting obligations and derivatives trading practices. At the same time, the effect that Dodd-Frank has had on the 'too-big-to-fail' institutions isn't crystal clear, either.

Myers says: "I hope we will see a common-sense approach as to how this is going to affect 'too big to fail', how it's really going to affect the end users and the small- and midium-sized banks, and those that are struggling with figuring out what it is they're supposed to do."

Gibson places more importance on moving towards a global harmony, with the same requirements applicable wherever a firm may be trading. He says: "It would be nice to see harmonisation between reporting in Europe and the US. I think the industry would appreciate a push towards working together rather than just driving ahead separately."

He accepts, however, that while this may well come about, the changes might not be as monumental, or as fast, as many may hope. "We are likely to see some progress, but I don't think it is going to be to the extent that everyone would want."

With a US presidential election coming up in 2016, politicians are throwing around threats to tighten the Dodd-Frank regulation, to relax the red tape around the industry, or to scrap the legislation altogether. Whichever way the election goes, it could have a huge impact on financial services. But, at least in the short term, Myers believes that it will be all talk and little legislative change.

"We are going to see a lot of rumblings coming from the US about modifications to Dodd-Frank," he says.

"But in the next 12 months, significant movement from legislators that is completed and signed by the president is highly unlikely."

Liquidity, dark pools, collateral pools … the options are seemingly endless. But before you drown in a sea of choices, it may be worth talking to the people who have an interest in keeping you afloat.

As one of Europe's few truly international post-trade service providers, SIX Securities Services has learned to adapt to changing landscapes, chart new and innovative courses and deliver to the highest standards of quality. The result is satisfied customers, who enjoy having experience and expertise at their side.
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Unlocking the potential.

May-August 2015: Public consultation following implementation of EMIR.

August 2015: European Commission to review consultation results and prepare general report on the regulation so far. Will submit to European Parliament and Council and submit proposals if necessary.

August 2015: Pension scheme exemption to expire.

December 2015: Margin variation requirements scheduled to be implemented for non-centrally cleared trades.

December 2015-2019: Initial margining requirements to be phased in.

EMIR

A regulatory time bomb

With EMIR generating so much uncertainty, some firms haven't properly prepared. SS&C GlobeOp's Diven Chatrath explores the consequences

There was a lot of uncertainty about the European Market Infrastructure Regulation (EMIR) and what exactly it was meant to achieve. One of the biggest challenges for the industry was the constant change that we saw right through 2013 to February 2014, when EMIR reporting began. Firms weren't able to build automated solutions because they were unsure what they were investing in, or what technology they would need, given that there would almost certainly be change down the road.

First, there were constantly moving timelines. We didn't have, until November 2013, the final list of trade repositories for the beginning of reporting in February 2014. Then there was the problem with scope. To begin with, credit default swaps and interest rate swaps had to be reported, but then the regulators asked, when should foreign exchange be reported? And what about exchange-traded derivatives? By the time reporting began, it included all over-the-counter derivatives and exchange-traded derivatives.

Finally, there was a big challenge around data. Data aggregation was a key part of the regulation. It included what time the trade was done, and with whom, which is quite static information. In the next 12 months, the focus of the market has to be addressing the enormous volume of data that has been reported. So much data has been reported to repositories, and now market players are questioning what they are doing with it.

Data danger

Communications are in progress between the trade repositories, but clients, which have been expecting a sensible number of exceptions to come back to them, are instead receiving a very high number. We should be focusing on normalising the data and creating 100 percent understanding between the repositories. The European Securities and Markets Authority (ESMA) is putting projects in place to improve the quality of data, so we are expecting to see some improvements, perhaps in 2016, or maybe even by the end of 2015. It may still be another year until everything is normalised and understood, but in the meantime, we expect a lot of noise.

For asset managers, another big issue has arisen around valuations. The regulation requires valuations to be generated and reported, but a lot of asset managers have relied on counterparties to do this, rather than generating these values themselves in the middle office. They had to revisit their lifecycle management when it came to valuation and collateral, and they faced a choice: manage it in-house, delegate it to the counterparties that already had the valuations, or go to their fund administrator or specialist service provider, which could provide middle- and back-office services.

This is really at the heart of the whole issue. Some managers invested in themselves, putting in significant hours and money, but they represent a very small percentage. Those who used the fund administrators were fine—although not all fund administrators provide this service—but those that delegated to a third party, a counterparty or dealer, could run into real problems.

They may have managed the trade and even the collateral valuation, but EMIR's Article 11 requires complete transparency in the way that these valuations have been derived. Obviously, no big bank that is reporting on behalf of its client is going to appreciate the disclosure of its mark-to-model and mark-to-market valuation policies.

When the regulator asks for the procedure for valuations, most of these firms are going to fail to produce that because they are dependant on a counterparty that will not share the underlying details.

When you delegate, you delegate a function, not a responsibility. If something goes wrong, a firm cannot turn to Goldman Sachs or Credit Suisse, which are actually doing them a favour by reporting for them, and make them responsible for the penalty. If there is a failure, the reputational damage will be far greater than the cost of meeting the regulation in the first place, so many of those that have delegated find themselves in a potentially difficult situation.

Even today, while some of the larger asset managers have recognised the problem and are implementing a solution to address it, some of the smaller managers are still delaying their response.

It is just a matter of time before the first high profile failures hit the press. There are a lot of regulatory data sets that firms are dealing with, and even the regulators appreciate that they may not have time to pay close attention to each one. But now firms are taking a closer look and realising the true nature of their position. It may happen in 2015 or early 2016, but it is inevitable that we will see a sudden rush of firms looking for new solutions.

"Even today, while some of the larger asset managers have recognised the problem and are implementing a solution to address it, some of the smaller managers are still delaying their response"

Diven Chatrath
Director
SS&C GlobeOp

Q2 2015: Public consultation covering guideline mandates in MiFID II.

June 2015: Final regulatory technical standards to be submitted to the European Commission.

October 2015: FCA MiFID II conference.

December 2015: Final ITS and guidelines submitted to the European Commission. Consultation on implementing MiFID II requirements.

Early 2016: EU legislation on MiFID II implementing measures to be finalised and published.

June 2016: FCA Policy Statement to be published on implementation of MiFID II.

January 2017: MiFID II to be applied in practice and rules to come in to effect for all investment firms.

Growing pains

MiFID II has some growing up to do, but it's looking to emerge as a broader, stronger and wiser reflection of its older sibling

The little brother to the original Markets in Financial Instruments Directive (MiFID) II is built to be bigger, broader and stronger—introducing new obligations, wider-reaching restrictions and more transaction reporting for the buy-side.

More than a simple upgrade to the existing model, MiFID II is a whole new beast, and when it comes in to full force in January 2017, market participants must be prepared to change more than a few minor details.

There are re-categorisations to get processes working around, a tightening of best execution standards, and new conflict of interest rules ready to catch-out unsuspecting asset managers, but one of the biggest challenges could simply be understanding what it is that's changing and exactly how it will affect individual institutions. The new rules look set to be much more complex than the original.

Henry Raschen, head of regulatory and industry affairs for Europe at HSBC Securities Services, says: "The greatest challenge will arise from the completeness of implementation, including 'proving the negative'. In other words, many firms will understand the statement of the new requirements, but identifying all the relevant areas of one's business will be difficult."

Specifically, Raschen identifies the conflict of interest rules and how they could affect cross-border activities. The onus will now fall on investment managers to identify a potential conflict and actively prevent it from happening, rather than just reporting it.

Just to seek out the interests of third parties will require significant data collection and cooperation between both EU and international jurisdictions, and slick processing to boot.

Raschen says: "The MiFID regime is moving very much from one of disclosure towards prohibition, or preferably avoiding the situation arising entirely, with disclosure being a last resort."

The difficulty in demystifying the regulation is exacerbated by that fact that, so far, some details are yet to be clarified—in fact, the public consultation paper was only published in March 2015, and, according to the European Commission, the legislation should be signed into law in July 2016.

It's a way off yet, but if the details aren't clarified by then, it doesn't leave much leeway before the proposed implementation date.

According to Jean Devambez, head of solutions for asset and fund services at BNP Paribas, many firms will find it hard to anticipate the changes that they will have to implement, and so they'll struggle to start preparation properly.

He says: "The effect of this will also be felt across the industry where service providers will be making an effort to anticipate their clients' needs without sufficient clarity until late in the day."

Devambez adds that this could be particularly evident in the changes to the disclosure of costs and fee structures which, as well as posing commercial challenges, will have be integral to compliance.

On top of this, there could be significant changes to be made in products and distribution models, as required by the investor protection aspects of MiFID II.

Devambez says: "Asset managers will have to adapt their product governance and distribution chain to guarantee better transparency for investors."

"For example, managers will define targeted clients for individual products at the point of creation and monitor throughout a products' lifecycle that it is sold to the targeted clients. This will involve regular information flows with their distributors."

Ultimately, this leads to additional responsibility on the shoulders of asset managers: which will have to consider liability for correct reporting; whether their data is correct for the type of reporting they're engaged in and how they're going to source this; the feasibility of delegating this responsibility to a third party; and crucially, whether it remains commercially viable to stay in a business with such burdens.

Raschen says: "More comprehensive and detailed buy-side transaction reporting under MiFID II will create a major shift in responsibilities. At present, transaction reporting is usually carried out by the sell-side for 'free' within the normal trade execution charges. Asset managers will now have to carry out much reporting themselves."

The move towards more rigorous best-execution procedures is also expected to increase the administrative burden. Investment firms will be expected to take 'sufficient' steps to get the best possible results when executing orders for clients—as opposed to 'reasonable' steps.

Execution policies must be clearly issued in layman language, and as Raschen put it, firms will be obliged to "summarise and make public, for each class of financial instrument, the top five execution venues where it executed client orders in the preceding year, on an annual basis".

Asset managers will also be prevented from making any gains from routing clients' orders through any specific trade or execution venue, a move which links directly to the conflict of interest rules.

Again, this simply increases the administrative obligations of the back office, especially, according to Raschen, for those orders executed outside of regulated markets, multilateral trading facilities and organised trading facilities.

The bottom line for back-office services is that any increase in processing responsibility will lead to an increase in costs if firms can't find a suitable way to implement them.

Despite its potential pitfalls, Devambez anticipates MiFID II being just as successful as its older brother. He maintains that as long as it stays "focused and simple" it will bring benefits for investor protection, and therefore the industry as a whole. But that's not to say that it's going to fall in to place without any blips.

He says: "It will bring additional complexity and the cost of adaptation may be significant. However, we believe the industry can extract value and find opportunities and we foresee innovative and disruptive models appearing in this environment of new regulation and digital technology."

According to Devambez, it's equally as important to take a note of the business opportunities that arise from MiFID II as it is to stay on top of the challenges.

The changes present chances for re-engineering and design partnerships between investment managers and the asset services, fund distributors and brokers they work with. A more harmonised approach can lead to benefits in operational efficiency as well as in the required compliance.

He adds: "Clearly each asset manager will need to define their adaptation strategy. However the opportunities in MiFID II are to be found when asset managers share adaptation strategies with their key partners."

The original MiFID allowed industry participants from various EU countries to access a range of securities markets, and placed importance on making sure investors were well looked after.

MiFID II shares these attributes, but as an additional bonus, it also seeks to reduce some of the systemic risk that's been identified since the crisis of 2007 and 2008.

It will take hard work to implement, but the final benefits will be many. Over-the-counter derivatives executions will be more tightly regulated, and trading venues and reporting obligations will be largely reorganised, but despite such upheaval, the consensus is that this is an evolution of MiFID in the right direction.

Raschen sums up the mood, saying: "Undoubtedly a vast amount of preparatory work is needed by participants and regulators to implement MiFID II, but the work will ultimately make for a safer financial system."

PRIIPs

December 2015: Supervisory authorities of Europe (EBA, EIOPA and ESMA) submit draft technical standards to the European Commission.

December 2016: Implementation of PRIIPs Regulation.

December 2018: European Commission to review regulation, including general survey of practical implementation.

December 2019: Exemptions for companies trading UCITS expire—PRIIPs KID to replace UCITS KIID.

PRIIPs

New KID on the block

Mario Mantrisi of KNEIP compares the KID to the KIID and finds much for asset managers to do, with first movers likely to come out ahead

The Packaged Retail Investment and Insurance-based Investment Products (PRIIPs) Regulation will go live on 31 December 2016, but asset managers should get ready for it today. It will introduce the key investor document (KID), a maximum three-page plain-language document for retail investors. At first glance, it might be tempting to think that this will be a piece of cake to provide, as the fund industry is already producing UCITS IV key investor information documents (KIIDs). But this KID will have a far greater impact on asset managers than it may seem.

Cognisant of these challenges, the European Commission has granted a five-year grandfather period to the KID before deciding on its future, which in principle will give the fund industry some time before adapting the new KIDs. The big question is, however, how will investors react when those two documents are presented to them by distributors? Although KIIDs and KIDs will be similar, they will not be identical.

Unlike the KIID, the KID does not demonstrate investment rewards based on past performance, but on scenarios showing potential rewards and maximum losses on invested capital. This is brand new for an industry in which sales arguments have always been based on past performance. Even if the distribution arm has not relied on this so far, risk and performance teams will have to increase their contribution to the elaboration of the KID.

A heavily debated element of the UCITS KIID was the synthetic risk reward indicator (SRRI). The European Securities and Markets Authority concluded that a number from one to seven—based on the volatility of the fund—would represent a common denominator to express the risk using an indicator that could easily be understood by retail investors. As the KID will be applicable to widely varying types of financial instruments, the challenge for regulators will lie in finding a common approach for a unique risk indicator that summarises the combination of different risk categories (not just volatility), and in finding a balance of the risk components that does not disadvantage any type of instrument.

The regulation requires going further in terms of cost disclosure. Indeed, the ongoing charges should encompass all fees, including those related to transaction and performance. This will represent a new challenge for asset servicers, as a new total expense ratio method will have to be put into practice.

PRIIPs should not be looked at in isolation, especially in relation to the Markets in Financial Instruments Directive (MiFID) II. This directive will come into force some time after PRIIPs and, among others, will focus on strengthening investor protection through new responsibilities in terms of product governance. Indeed, manufacturers will no longer have only a pre-sale responsibility, but ongoing oversight duties. At this stage, manufacturers are still exploring how to cope efficiently with them.

In any case, whatever solution is found, it is deeply tied to the information present in the KIDs. As we expect an increased exchange of information between distributors and manufacturers for the purpose of MiFID II, one should consider how to dematerialise the information in KIIDs and KIDs.

Aside from KID/KIID content data, PRIIPs and MiFID II also require the manufacturer to ensures that the right product is targeted at the right audience.

Considering the fragmented intermediation of the distribution chain, the industry will face a real challenge to pass on the information and the documents themselves. As for UCITS KIIDs, the industry will have to consider efficient document delivery, especially as the PRIIPs regulation strongly encourages physical remittance during face-to-face meetings with investors.

Another challenge is related to document production. The sheer mass of documents to be produced under PRIIPs is exponentially greater than that of the UCITS KIID. Although it is impossible to estimate the actual workload, by looking at the proportion of revenues within the financial industry stemming from structured retail products, one has a good indicator of the incredible amount of issued instruments that will all require KIDs. Furthermore, the frequency of issuance of many of those instruments is high, and cannot be compared to, for example, amending term sheets.

Considering the increase of responsibilities and processes placed on distributors, they will undoubtedly put pressure on manufacturers early on to supply them with both documents for UCITS funds. This will, in turn, raise the question of asset managers whether they should start producing both documents proactively well before the end of the exemption period.

PRIIPs is a big step in the direction of a unique level playing field among investment products. The fund industry has pushed for this for a long time, especially as the transparency requirements and heavy regulations imposed on them have penalised them so far.

Many actors within the fund industry, however, have paid little attention to PRIIPs because of the five-year exemption period for the UCITS KIID.

Although many implementation details are still expected within second-level regulation, the industry should not wait until then and start proactivity defining its strategy and structure its implementation for PRIIPs. As we've seen before, the first movers will come out ahead.

> “Considering the increase of responsibilities and processes placed on distributors, they will undoubtedly put pressure on manufacturers early on to supply them with both documents for UCITS funds”

Mario Mantrisi
Senior adviser to the CEO and member of the executive board
KNEIP

Solvency II

June 2015: Annual reporting deadline for Solvency II preparatory phase—for individuals.

30 June 2015: EIOPA to submit final set of technical standards to European Commission.

July 2015: Annual reporting deadline for Solvency II preparatory phase—for groups.

Q3 2015: Publication of final guidelines followed by ‘comply-or-explain’ exercise by EU member states.

1 January 2016: Implementation of Solvency II directive.

April 2016: First reporting deadline for undertakings under Solvency II in 2015.

Down the rabbit hole

Solvency II means supplying look-through data for funds, funds-of-funds and funds-of-funds-of-funds. Des Pierce of SS&C GlobeOp explains why there's no knowing how far asset managers might have to burrow

While Solvency II mainly affects insurers, a significant proportion of the insurance industry have their assets managed externally by asset managers. Alas, this puts another regulatory burden on the asset management sector.

Often, it's more than just transactional data or the typical information that would be stored for investment purposes. It also includes a lot of detailed reference data, including underlying securities and exposure details. So having a robust data management infrastructure is very important. Ultimately, asset managers will have to provide data directly to insurance companies, in terms of assets that they manage on behalf of the insurer, but they will also get indirect requests for the look-through information for their funds that an insurance company may be invested in.

The obvious problem is that this reference data may not be readily available, and it may have inaccuracies that will then feed up to the insurance company. That could lead to incorrect calculations that are provided back to the regulator, and there is still a question mark over where liability sits if something goes wrong. In such an event, there is likely to be some finger-pointing, and it will be a challenge to figure out who is responsible for the underlying data.

Sourcing that information in the first place is not straightforward. Items such as complimentary identification codes, legal entity identifier codes and credit ratings are not always kept in an investment book of record, so even deciphering who to source from is a struggle. That's exacerbated by the growing trend, in a low-yield environment, of insurers looking for more complex asset classes such as syndicated bank loans or real estate to find better returns.

The regulation, as it stands, requires an insurer to report underlying information from all its portfolios. An insurance company might mandate an asset manager to manage a quantity of money, and that manager could invest in stocks and bonds, but also in to another fund. That secondary fund could then invest in stocks and bonds, and also another tertiary fund, which could invest in yet another fund. As it stands, there is no limit to the degree to which an asset manager has to drill down to find the extent of the underlying exposure.

While recording the data and finding an ownership tree is a challenge, recording and understanding that information is a greater challenge still, because that data is not stored and widely available in the marketplace. There are lock-out periods where data can't be shared, and an unwillingness, in some cases, for fund managers to share that information.

The Pillar III disclosure requirements of Solvency II are very broad in terms of what information needs to be provided, and there are a number of different templates required for this.

The insurance companies have assumed that the Pillar III asset reporting requirements are something that their asset managers will deal with. However, many asset managers are only now waking up to the requirement and may not have identified their solution yet.

The asset management sector is going to have to focus on the asset templates, and it will be important that they understand what is required from them and have a robust solution to cater for the multiple requests they may receive.

There does seem to be a solution emerging, however, as asset management associations throughout Europe are getting together to define a single, triparty template. The goal is to satisfy the Pillar III requirement that asset managers will be expected to fulfill, but to do it all on one common data exchange template, as opposed to seeking to satisfy numerous different templates issued by different sub-regulators.

The template is not final, but we have seen a number of drafts, and we have seen good pick-up and acknowledgement from the asset management sector that this would be a preferable solution. It has been, frankly, an all too uncommon development in regulation generally, but it has been a positive step.

Two thousand and sixteen will be a year of transition as we phase into the Solvency II programme. While the regulation has been there for a long time, January 2016 is the first official filing point and asset managers are under pressure to be ready in time. Their readiness has not been helped by the ambiguity that still exists around key areas such as materiality for look-through reporting.

An asset management firm might have a number of custodians, service providers and systems, and they all need to be coordinated and talk to each other, while satisfying the complex data requirements that Solvency II demands.

Firms should be looking at what their solution is, if they have not already identified it, and actively assessing service and software solutions for enriching large data sets.

The triparty template should help a lot of asset managers to streamline the data that needs to be provided, but if firms don't already have a strategy in place, it will be a challenge to identify a solution now, implement it, test it and be ready for the January filing deadline, particularly if they have a lot of capital coming in from insurance companies.

But the main problem will be with the look-through data. Asset managers will get requests right across their portfolio range, and they will see demands indirectly through funds-of-funds investment when they might not expect it. In these cases, having a Solvency II data solution in place and ready to provide these data sets will be imperative.

"The triparty template should help a lot of asset managers to streamline the data that needs to be provided, but if firms don't already have a strategy in place, it will be a challenge to identify a solution now, implement it, test it and be ready for the January filing deadline"

Des Pierce
Head of international institutional outsourcing
SS&C GlobeOp

September 2015: ESMA draft of technical standards and procedural guidelines to be finalised and submitted to the European Commission.

Q3 2015: ESMA remuneration guidelines to be finalised and published and second-level measures finalised.

Q3 2015: Consultation on proposed amendments to be published in FCA handbook.

Q1 2016: FCA to publish progress reports in run-up to implementation.

18 March 2016: EU member states should adopt UCITS V in to national law, publish the regulations and administrative measures, and send a copy of the provisions to the European Commission.

UCITSV

UCITS V: investor protection and asset safety

What do UCITS V changes to the EU directive require of depositories? Rolf Bachner of BNY Mellon takes a look

Picking up the baton from the Alternative Investment Fund Managers Directive (AIFMD), UCITS V continues to fine-tune investor protection by further mitigating asset safety risks.

Importantly, it corrects the current 'unintended anomaly' whereby professional investors in alternative investment funds enjoy higher investor protection, asset safety and transparency standards than retail investors in UCITS funds.

UCITS V depository provisions

The UCITS V depository provisions closely follow those in AIFMD, albeit with subtle differences. The text is organised logically, describing what the depository must do, what it can delegate to others to do, who can be a depository, what liability depositories have and how the depository must be independent from the fund's management company. A UCITS fund must appoint and enter into a contract with a single depository. That depository must then ensure that the fund and its management company carry out their activities in accordance with applicable laws and fund rules.

The depository oversees the transfer agency and the fund accounting functions, monitors adherence to investment restrictions, as well as the timeliness of settlements and the correctness of income distributions.

The depository is responsible for keeping an inventory of all cash accounts of the fund and ensuring that all the cash flows in and out of these accounts are properly monitored. In particular, the payments made to buy units in the fund must be monitored as a safeguard for investors.

Safekeeping duties are split between assets in custody and other assets. Assets in custody include assets that can be held in a custody account and are mostly those that are listed on a recognised exchange. These assets in custody have to be held in segregated accounts.

While this may sound straight forward, there is an ongoing debate on this topic and the European Securities and Markets Authority (ESMA) launched a consultation on this, which closed in January 2015 and was conducted in the context of AIFMD. The resulting technical advice will probably be used as input into the UCITS V second-level text as well. This should ensure equivalence between AIFMD and UCITS V on this point.

The depository must keep a record of other assets, that is, those that are not assets in custody. For UCITS funds that don't hold real assets, these are mostly derivatives. The depository must also verify that the fund really owns these assets and maintain a record of that ownership.

The assets in custody, as well as those not in custody, must be combined into a comprehensive inventory of all the assets of the UCITS. The depository must send a statement of this asset inventory to the management company on a regular basis. It is not yet defined what "regular" is in this context, and it is not obvious what the management company will use this information for, as it currently relies mainly on the fund accountant's record.

The intention may be to ensure that the depository has a comprehensive record that is fully independent of the fund accounting record. While management companies tend to delegate fund accounting to an outside service provider, it is still a management company activity and therefore the fund accounting records cannot be considered independent from the management company.

UCITS V lays out strict rules on asset re-use. Neither the depository nor any of its delegates are allowed to lend the fund's assets out. It is only the fund, acting on its own account, which can do that. Furthermore, the market value of the collateral received must be equal to or above the value of the asset lent out.

Insolvency is a key theme in UCITS V. The legislators are trying to ensure that if the depository or its delegate were to become insolvent, the investors' assets held through the fund would be unavailable for distribution among the depository's creditors. ESMA asked in a consultation in 2014 what should be meant by the requirement for a sub-custodian to take "all necessary steps" to ensure that the UCITS assets are not available to its creditors should it become insolvent. The resulting technical advice states that the delegate needs to provide, to the depository, independent legal confirmation that any UCITS assets are segregated and unavailable to creditors in the event of insolvency.

After describing what the depository's functions are, the directive sets out which of these can be delegated to other entities. Only safekeeping can be delegated. This is in recognition of the fact that while the depository is located in the domicile of the fund, the assets of the fund may be invested all over the world. The depository therefore needs to draw on safekeeping agents.

The directive sets out clear conditions under which the depository can delegate safekeeping. It must have good and objective reasons to delegate and exercise all due skill, care and diligence in selection and ongoing monitoring of the safekeeping delegate. The delegate must, in turn, have the structure and expertise to carry out its functions, and be subject to regulation, capital requirements and external audits.

UCITS V sets clear criteria for the types of institutions that are eligible to become depositories. Firstly, the depository has to be located in the domicile of the UCITS. Secondly, it must be either a central bank, a European bank (otherwise known as a Capital Requirements Directive IV credit institution), or an equivalent entity that member state regulators have a little bit of leeway to define.

The depository's UCITS V liabilities are similar in nature but potentially different in scope than they are under AIFMD. While it is still assets in custody, as opposed to other assets, that are in scope, the liability can't be delegated or excluded by any agreement. The buck stops with the depository and to underline this, the UCITS V directive states that any agreement that attempts to limit the depository's liability is void.

UCITS V also increases the scope of assets subject to restitution liability. The directive now states that central securities depositories (CSDs) may, in some instances, provide custody services. When a CSD provides custody services to the depository, this is considered delegation of safekeeping under the terms of the directive, and the delegated assets are deemed in scope for restitution liability.

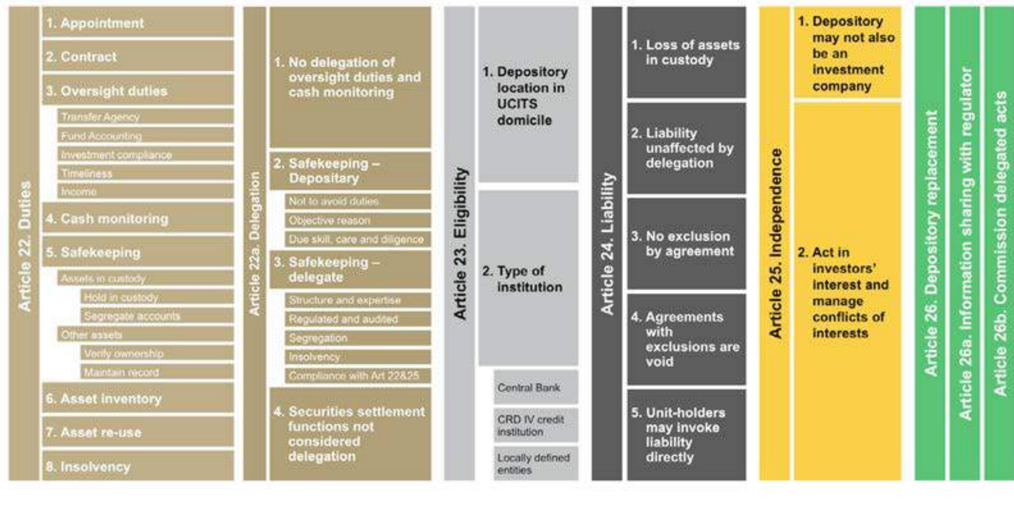
The final UCITS V articles focus on the depository, mandating the independence of the depository from the management company, providing guidance on the replacement of a depository and the information that a depository has to share with its regulator.

The second level of the directive is expected in the autumn of 2015. The contractual provisions are the first, and possibly the most important, topic that the European Commission has been asked to address in the second level. The earlier the second level can be issued, the better, as it will enable the industry to conclusively work through the contracting requirements, for which, at that point, only a handful of months will remain.

> "The buck stops with the depository and to underline this, the UCITS V directive states that any agreement that attempts to limit the depository's liability is void"

Rolf Bachner
Managing director and EMEA funds product manager
BNY Mellon

The depository provisions



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