Securities post-trading infrastructures efficiency and resilience

Introduction

The Chair explained that post-trading infrastructure in the EU has undergone significant changes in recent years. New actions are underway in the regulatory space including the Central Securities Depository Regulation update (CSDR Refit) and a targeted harmonisation of insolvency rules proposed in the context of the Capital Markets Union (CMU) action plan. In the Eurosystem space, there has been action and momentum with the TARGET Services consolidation, the implementation of the Eurosystem Collateral Management System (ECMS) and the work on wholesale central bank digital currencies (CBDC).

1. State of play in terms of harmonisation and integration of the EU post-trading space

1.1 Progress made and remaining issues

A Central Bank official confirmed that there have been significant improvements in European post-trade integration over the last two decades. Many of the original Giovannini technical barriers have been tackled, such as differing business hours, infrastructure, settlement cycles, and the lack of settlement finality and remote access to infrastructures, and others have been significantly reduced, such as those relating to messaging standards and issuing practices. TARGET2 Securities (T2S) has been key in these improvements, both in terms of technical infrastructure and of the harmonisation of rules needed to support its implementation. CSDR has also fostered regulatory harmonisation and progress in terms of governance, business continuity arrangements and operational risk management. The implementation of market standards for corporate events and collateral management has also fostered further integration and harmonisation.

A fully integrated post trade landscape is nevertheless still a faraway goal, the Central Bank official observed. The relative value and volume of cross-CSD settlement is still very limited. Differences in national market practices subsist despite common market standards. More importantly, differences in national securities, corporate and tax laws prevent the full integration of the EU settlement space.

Another Central Bank official added that there are efficient post-trading infrastructures in Europe at the domestic level, but cross border transactions are not sufficiently integrated and remain a small fraction of the overall business. The CSDR Refit will also improve the supervisory framework for overseeing the market and the CSD passporting regime, which should contribute to a further integration of post-trading.

An industry representative explained that the CSDR goes beyond offering a harmonised legislative framework for CSDs. There are safety elements in it, which is important for CSDs, whose primary objective is resilience and preserving financial stability. Some measures of the CSDR Refit also aim to support the competitiveness of CSDs, allowing them to offer additional services to issuers and investors along with their core services. The CSDR Refit also reduces some of the red tape but it does not tackle the main legal and fiscal hurdles to cross-border settlement.

A Central Bank official stated that TARGET Services, including the new consolidated platform as well as ECMS, provides European financial participants with an attractive service offer for the safe and efficient movement of cash, securities and collateral. TARGET Services also acts as a catalyst for further harmonisation and standardisation in the European capital markets, which will contribute to building a deeper and broader European CMU. The consolidated platform for example now has a multi currency capability that may support cross border payments and facilitate access to central bank liquidity.

1.2 Next steps for enhancing the harmonisation and integration of EU post-trading

A Central Bank official stated that the Eurosystem will continue to play a catalyst role in terms of integration by focusing on the remaining barriers and achieving a high level of compliance with existing market standards in the fields of corporate events and collateral management. The Eurosystem, as an operator of central bank money infrastructure, contributes significantly to the evolution of TARGET Services. Five additional CDSs joined T2S at the beginning of September 2023. Initiatives such as the EU Issuance Service (EIS) being rolled out for the bonds issued by the European Commission will also be further leveraged, building on T2S.

Another Central Bank official noted that deeper fragmentation issues remain to be tackled, such as differing taxation rules, securities and insolvency laws. Eurosystem central banks will contribute to these integration efforts by making sure that the new provisions of the CSDR are enforced in a consistent way and advocating the importance of harmonisation in their domestic market.

An industry representative emphasised that concerning taxation, the Commission recently proposed the Faster and Safer Relief of Excess Withholding Taxes (FASTER) Directive, which aims to make withholding tax procedures in the EU more efficient and secure and could facilitate cross-border investment by making the reclaim process faster and smoother. This proposal, which requires unanimity to be adopted needs to be promoted towards the member states. Another industry speaker highlighted the work conducted by the European Post Trade Forum (EPTF) in the wake of the Giovannini group to lift barriers to cross-border settlement which has also been beneficial.

2. Measures proposed to improve settlement efficiency

2.1 CSDR Refit improvements

An industry representative noted that settlement efficiency is currently an important topic for the post-trading industry. The CSDR Refit should allow an improvement of the provisions of the CSDR on settlement efficiency, notably concerning penalties and mandatory buy ins (MBIs). The fact that the penalty mechanism can be reviewed on a regular basis is also very positive as that can ensure that it remains proportionate.

The industry speaker noted that the EU is the only major jurisdiction where MBIs are used. There is a different regime in the US with no late matching penalties and no MBIs. Settlement inefficiencies are penalised through additional costs in the US but are not forbidden like they are in the CSDR. The decoupling of penalties from MBIs and the restriction of the use of MBIs proposed in the CSDR Refit are an improvement. For example for securities financing transactions (SFTs) such as repos, penalties make sense, but MBIs are useless. A two step approach has also been adopted whereby outstanding fails will be considered at the end of the extension period and MBIs would only be implemented at a later stage. There is however still room for improvement concerning MBIs. The implementation of MBIs is operationally challenging for firms and for clients and unnecessarily costly for the industry. There is hope that the Level 2 measures of the CSDR Refit to be drafted will be well calibrated and focus the use of MBIs in such a way that cost and competitiveness impacts are limited.

Another industry speaker agreed that in the US there are no real penalties, it is closer to clean up costs. In other jurisdictions, such as APAC, the penalties regime is stricter however. To address settlement failure in the future, three areas need to be assessed - the accuracy of the information and of instructions, the communication, and fixing issues faster – which are all part of modernising the market infrastructure.

A Central Bank official observed that settlement efficiency has significantly improved in Europe over the last 12 months. This is in part due to rising interest rates which have increased the cost of inefficient settlement, but it shows that progress can be made on these issues. What was missing were the incentives. If the situation continues to improve MBIs might no longer be needed.

2.2 The opportunity of shortening settlement cycles and moving towards T+1

An industry representative noted that with the forthcoming implementation of a T+1 settlement cycle in the US, Canada and Mexico, ongoing work in this area in the UK, and the report due to be published by ESMA by 2024 about settlement efficiencies in the context of CSDR, there is an opportunity to start a broader discussion in the EU about improving settlement efficiency and how automation and standardisation could benefit the European market notably in the pre settlement space. This should be part of the next steps of the CMU initiative. The US Securities and Exchange Commission (SEC) proposal about settlement cycles also discusses the confirmation / affirmation process[1], which is partly in the pre settlement space. In the US, a central matching service is offered for confirmation / affirmation with the generation of a unique transaction identifier (UTI) for each security, which is a positive development in terms of standardisation.

A second industry representative observed that the outcome of the market evolutions being tested in the US and Canada is uncertain. Firms and clients might not be ready to implement T+1 by 28 May 2024, the deadline fixed by the SEC. The US project should nevertheless be followed closely by EU market stakeholders, because it will have a concrete impact on EU firms and their clients trading US securities. A first impact is on the operational processes. Firms and clients outside the US will have to adapt their operating model to the new DTCC rules related to T+1 such as cut-off times. Secondly, impacts can be anticipated on specific products which have a US component such as exchange-traded funds (ETFs) composed of foreign stocks, cross-currency FX and depository receipts, for which there are no exemptions from the US rules.

The opportunity of moving to T+1 in the EU should be assessed carefully with a detailed cost/benefit analysis and an evaluation of the expected incremental benefits compared to the settlement efficiency measures of CSDR, the industry speaker stressed. The EU and the US markets function differently and there is a huge cost involved with this evolution. The EU is a complex and fragmented market, with many CCPs, CSDs, currencies and national specificities unlike the US. There is moreover no US equivalent of the EU Settlement Finality Directive (SFD), which means that irrevocability aspects are very different in the US.

A third industry representative observed that settlement efficiency is currently a prime focus of

1. The confirmation/affirmation process refers to the transmission of messages among broker-dealers, institutional investors, and custodian banks regarding the terms of a trade executed for the institutional investor. Because the trades of institutional investors involve larger sums of money, larger amounts of securities, more parties, and more steps between order entry and final settlement, institutional trades are usually more complex than retail transactions.

ESMA and the European Commission with multiple taskforces working on this issue. One question is whether additional tools should be introduced in the processes of CSDs, such as partial settlement or shaping, to increase settlement efficiency. There are also discussions about whether the EU should align with the ongoing approach being discussed in the UK. Concerning the shortening of settlement cycles, it is important to realise that this goes beyond CSDs and requires an evolution of the whole ecosystem towards a new standard, which is why further assessment is needed.

The first industry representative noted that there are some misunderstandings about what is happening in the US, where the shortening of settlement cycles is an evolutionary process. When the US moved from T+3 to T+2, Europe was ahead, but it was clear that a move to T+1 would happen eventually in the US. That was anchored by the SEC's decision, which took into account the proposals made by the industry (SIFMA, ICI, DTCC) in this regard. The possible move to T+1 is often discussed in the EU as if it were to happen immediately, but this is not the right approach. The settlement cycle can be decoupled from the reflection about the efficiencies that can be brought into the market, for example on trade allocations, to progressively evolve towards a shorter settlement cycle. Automation and standardisation will be key in this regard. It is moreover hoped that the EU and UK can coordinate on this work.

A Central Bank official agreed that settlement efficiency is an opportunity that needs to be further assessed, and it is important to assess the potential benefits of T+1 for the European market and learn from what is happening in the US, despite the differences between the markets.

Another Central Bank official noted that the Eurosystem is ready to make further functional improvements in TARGET Services and T2S in particular to accompany market developments such as T+1 settlement and facilitate cross border CSD settlements.

3. Leveraging the potential of DLT in the post-trading space

The Chair moved the discussion to other changes happening in the post-trading landscape related to new technologies and the opportunities their deployment might offer to move forward on the journey towards an integrated, efficient and robust infrastructure.

An industry representative commented that the existing infrastructure of the equity and bond markets in the EU is quite efficient. While the benefits of an end-state based on a totally distributed DLT system can be imagined, it is necessary to realise that such a move would involve a very challenging transition from the current state. The whole ecosystem will have to evolve towards a new market organisation: CSDs, intermediaries and also the issuers. In addition, the economies of scale from this new technology will only materialise progressively and the scalability of the DLT technology is still to be significantly increased to deal with large volumes. This also means that legacy and new DLT systems will be operating in parallel for a long time.

The DLT pilot regime can help to test new solutions and act as a catalyst in the market, but it will only provide learnings on the feasibility of DLT systems on a small scale and in a very controlled environment, the industry speaker stressed. A different approach will be needed to prepare the transition path towards a new settlement system for core securities and to test interoperability and connectivity on a large scale. This requires a comprehensive reflection at market level on how settlement efficiency can be improved while maintaining resilience. Different drivers need considering such as technology and the reduction of settlement cycles. A 10 year period is the standard period for large developments such as this. In the shorter term, optimisations should focus on financial instruments that are less automated with less efficient processes. In parallel a path for the future may be devised building on the learnings of these initial improvements.

A Central Bank official emphasised that the Eurosystem monitors and analyses technological developments that may be relevant for future TARGET Services enhancements. One of the aspects is the role that central bank money settlement could play in the context of new technologies like DLT. Practical explorations will be carried out together with the market starting in May 2024, to gain insight into how different solutions could facilitate interactions between TARGET Services and DLT platforms. This demonstrates the practical willingness of the Eurosystem to keep pace with the current dynamics related to technological innovation. Market participants are asking for further process improvements that can speed up transaction processing and cut down risks and costs. From a financial stability perspective, it is also important to provide future proof, safe and efficient settlement mechanisms functioning in a continuous way and ideally settling in central bank money. This is exactly why the Eurosystem recently announced to launch explorations in the context of the 'new technologies for wholesale settlement contact group'.

A technological big bang is not expected however, but an evolution, where interoperability may play a key role, between different evolving asset chains and in connection with TARGET Services. Concerning the connection with TARGET Services, a 'trigger solution', that has been experimented by the Bundesbank, could provide a technological bridge for the settlement of DLT based wholesale transactions in traditional central bank money in TARGET Services. This quick-win would enable the Eurosystem to foster the development of innovative DLT platforms without the need to provide DLT based central bank money in the short-term.

With regard to the DLT pilot regime, the Central Bank official considered that it has a raison d'être, since existing EU regulation on securities markets is only applicable to tokenised transferable securities. However, the value threshold that has been set, as well as the limited period of application, may lower the attractiveness of this specific regulatory sandbox, particularly for established players in the market. In this respect, it is uncertain whether it can truly be a gamechanger.

A second Central Bank official stated that Central Banks have a role of nurturing innovation in a safe and controlled environment. Innovations such as DLT, smart contracts and tokenisation should be embraced, even if their potential is not yet fully demonstrated, but in a safe way. If an accident occurs at an early stage in the development of a new technology, it will be discredited and discarded, which may lead to missing out on the potential of this innovation. In this perspective, the Eurosystem is devising different solutions to provide central bank money that may allow carrying out the settlement of transactions on DLT systems in a safe way. It is urgent to start discussions about how to develop these solutions, which require significant investment and time to mature, and how to transition from the current state.

A third Central Bank official stated that the ECB is endeavouring to leverage TARGET Services and the systems and technical know how of Central Banks to support innovation. Trials and experiments involving the market will take place in the near future. A survey is currently being conducted by the ECB to gauge the preliminary interest among financial market participants and DLT operators for participating in these experiments.

Conclusion

The Chair noted a broad agreement amongst the panel that innovation should be embraced in its widest sense, but an immediate big bang cannot be expected. Progress is been made on the collective journey of market participants and Central Banks to improve post trading infrastructure. There is momentum and different opportunities are emerging related to settlement efficiency and technology, which is very positive. Transitioning towards a new optimised system is nevertheless a long term project that involves the whole market ecosystem and requires appropriate assessment and planning.