Joining the dots of the new regulatory framework for a better understanding of the new securities infrastructure landscape

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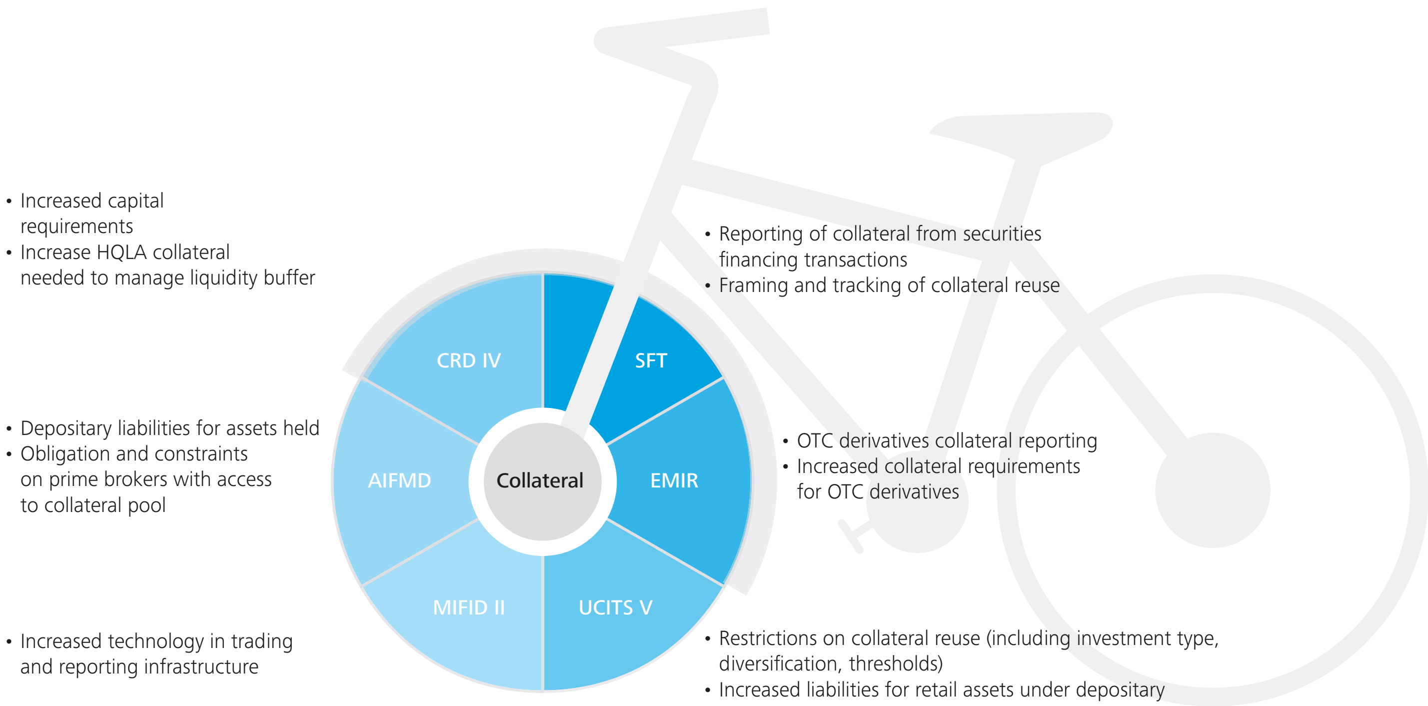
The harmonisation of the European asset servicing landscape has been one of the major objectives of the financial authorities for more than ten years.

In the wake of the market turmoil of 2008, a battery of regulatory measures and market events has been shaping the future European market infrastructure. Among the key aspects of this transformation, we will focus on the market infrastructure and post-trade-related aspects, and factors relating to collateral.

The Financial Collateral Arrangements Directive (FCD) and Settlement Finality Directive (SFD) are two of the regulatory responses to the major increase in cross-border financial flows in a highly fragmented European market. Welcomed by the market, these directives have proven to be a step in the right direction, but there is still room for improvement. The use of collateral has continued to increase, leading the industry to call for an extension to the list of assets eligible for use as collateral with the European Central Bank. On 13 June 2013, the European Central Bank announced greater flexibility in terms of assets accepted as collateral (e.g. asset-backed securities). Furthermore, the need for High-Quality Liquid Assets (HQLA) for bank liquidity buffers as per the CRD IV definition drove market players to a scramble for the 'most wanted' assets (e.g. debt of G20 countries), which resulted in the collateral market drying up due to a lack of definition of HQLA Level 1 (extremely HQLA) and Level 2. We are therefore seeing a profound change in market practices and methods in an environment in which infrastructure is also transforming collateral management in Europe.

The challenge facing the sector mainly consists of achieving proper understanding and implementation of the various regulations, all of which are aimed at improving market efficiency and investor protection, but with a different rationale, objective and timetable in each case, making it difficult to adopt a holistic approach to creating the optimal operating model for the future. Our subject, collateral management, will be impacted by, for example, EMIR, MiFIR, the ESMA guidelines on UCITS and AIFMD.



Against a backdrop of profitability pressure and cost cutting, asset servicing organisations do not have much choice other than to chase one regulatory hot topic after another, ensuring they are compliant as soon as the regulation enters into force. Nonetheless, it remains vital for the medium/long-term strategy of post-trade providers to maintain a holistic view of the target operating model of the European post-trade industry.

We regularly observe that the opportunity to step back from the wave of new regulations and take the time to have a global view of the final destination is a must that unfortunately few institutions can afford. Despite the obvious need to adopt a staggered implementation timetable in parallel with the regulators' timetable, it is reasonable to believe that the winners will be the financial institutions that succeed in adapting their operating model using a holistic strategic approach in terms of asset servicing.

The evolving regulatory framework is having a profound effect on the asset servicing sector and impacting the entire value chain from the initial trade to post-trade and custodian services. Below we focus on AIFMD, EMIR, the Central Security Depository Regulation (CSDR) and the future Target 2 Securities (T2S) platform, which will not only transform the depositary's role, responsibilities and operating model in terms of collateral management, but also reshape the whole European custody landscape.

First, you need to learn the rules of the game, then you have to play the right cards

What are the main transformations?

T2S—a level playing field for collateral management

In a nutshell, the European T2S platform will facilitate the consolidation of pockets pool of collateral into a large EU pool of collateral. It will provide greater harmonisation at the European level for securities collateral and settlement activities. This is a new strategic factor that depositaries will need to take into account when considering their future EU custody network.

Where it was a clear 'must have' to appoint at least one sub-custodian in each country in which a bank was operating accounts, T2S will make it possible to appoint one counterparty (a global custodian/CSD) as the main means of access to the other European CSDs. This new open architecture will create opportunities in the provision of collateral management services.

T2S will create a level playing field for European market infrastructure and stimulate competition among industry players. In terms of collateral management, this market event, which will centralise all local market access, based on a single hub, represents a major opportunity for asset servicing firms to build a pan-European and international open architecture via its European T2S hub, almost a one-stop-shop for collateral management without changing the physical allocation of the assets used as collateral.

From OTC to a regulated market place—how to manage collateral

Besides the aim of EU regulators and the market to harmonise the post-trade infrastructure, another key objective is to shift derivatives transactions from over-the-counter trading to a regulated market infrastructure.

The European Market Infrastructure Regulation (EMIR) is aimed at organising the derivatives markets respectively for trading and clearing on recognised regulated platforms such as Organised Trading Facilities (OTFs) and Central CounterParties (CCPs). As a result, the market estimates that approximately 80% of financial derivatives products (it is expected that IRS and CDS will be subject to the CCP model), which are currently traded OTC will become subject to a streamlined trading environment.

The intention is that OTFs and CCPs will reduce risk and enhance transparency in relation to these transactions. CCPs act as the sole counterparty for market participants, thereby minimising the risk of derivatives counterparties defaulting.

EMIR will impose requirements in terms of reporting, risk mitigation and collateral management. One result will be that participants will have to provide collateral under margin requirements (initial and variable margin) in order to access the CCP. Although the definition is not yet available, the technical standard for non-centrally cleared transactions is likely to impose additional requirements for collateral exchange. In both cases, whether centrally cleared or not, collateral will need to be segregated with no (or limited) opportunities for rehypothecation or reuse.

Securities financing—the other collateral issue

Among the proposals regarding shadow banking, the EU issued a proposal aiming to regulate securities financing transactions in order to *"dampen risks and pro-cyclical incentives associated with securities financing transactions such as repos and securities lending that may exacerbate funding strains in times of market stress"*. According to the Financial Stability Board, regulators will apply similar rules to EMIR for the repo and lending market, but in addition to mandatory reporting of transactions to trade repositories, rehypothecation will be restricted under specific conditions.

This will probably lead to the rise of repo marketplaces (such as Eurex or LCH RepoClear) with a centrally cleared model, as well as tri-party repo and lending transactions.

Asset servicing firms seeking the optimal T2S, CSD and CCP operating model will be well advised to adapt their collateral management capabilities in parallel to their infrastructure connectivity. In addition to timely trade confirmation, portfolio reconciliation or dispute resolution, managing collateral will become more than a competitive advantage in this context of asset centralisation and collateral pools. Mark-to-market valuation, eligibility assessments or assistance to set up the client's intragroup exemption criteria will be essential to lock in asset manager clients looking for a post-trade one-stop-shop. Some players are preparing to set up operations along the lines of Clearstream's global liquidity hub or the BNP Paribas Securities Services intraday liquidity facilities.

The safekeeping of collateral will also change under the new regulations. EMIR and AIFMD both impose requirements in terms of appropriate safekeeping of financial assets used as collateral. The general principle consists of the obligation for a depositary to hold all financial assets (i.e. including collateral) within its sub-custody network. As a result, keeping financial assets in custody generates an obligation of results for the depositary, meaning that it will need to return any loss of financial asset collateral without undue delay. This strict liability for the depositary generates additional custody risk for the depositary bank. It will be vital to define a sound collateral safekeeping strategy in order to be in a position to mitigate the risk of financial losses on the financial assets held within the sub-custody network.

Depositaries shall be aware that legal title transfer of financial collateral given by their AIFs will remove the obligation to maintain the assets within its sub-custody network and hence the strict liability in terms of assets. On the other hand, financial collateral received by the fund with title transfer will become an asset to be kept within the network, with full liability in the event of the loss of the asset.

As an illustrative example, when financial asset collateral belonging to the investment fund is held with a prime broker or a counterparty of the fund, the depositary faces major challenges. If the depositary bank appoints a counterparty holding financial assets of the fund as a sub-custodian, which is the direction the market currently tends to take, the depositary will need to keep safe these financial assets with the same standard and care as in its traditional network. Considering that prime brokers do not use the same network as the depositaries, it will be a major challenge for depositaries to prove due care and diligence in terms of the safekeeping of financial assets given as collateral without title transfer. For example, we can mention the obligation for the depositary to monitor the pre-agreed rehypothecation limits when the fund's long assets are fully given as collateral to the prime broker, which reuses these assets based on complex indebtedness calculations for which any further segregation and asset allocation reporting on their street side becomes a major challenge.

In addition, appropriate segregation of the collateral is also one of the key issues that arises when dealing with a clearing member who wishes to access a CCP. The counterparty may either choose to have **omnibus or individual segregation of** records and accounts for direct and indirect clients. As a result, reconciliation and day-to-day administration of the collateral will be made more complex by this potential dichotomy of segregation between two counterparties.

Central Securities Depository (CSD)—the place to be?
The question of liability and segregation of collateral may take on a different meaning when being considered in relation to a Securities Settlement System (SSS). The SSS concept is the current regulatory definition of the CSD and ICSD market infrastructure. The AIFMD (and this will probably be the case for the forthcoming UCITS V and VI) has provided a specific status for the asset in safekeeping under the SSS regime.

As per the directive, safekeeping in a SSS is not considered a delegation of custody function. Therefore, when assets are deposited with a SSS, the depositary can consider adopting a risk-based due diligence approach (as opposed to full-fledged due diligence). This is less obvious when the SSS further sub-delegates the safekeeping of these financial assets to a non-SSS institution. In this latter case, a full-fledged due diligence could be considered. In the case of a full SSS safekeeping chain, the requirements for asset segregation as set out in AIFMD would not apply.

In the event of a loss of financial instruments to be held in custody occurring at the level of a full SSS safekeeping chain, the normal liability regime of the depositary (i.e. obligation to return lost financial instruments except in certain circumstances) applies as a matter of principle. However, the depositary may allege that the loss at the level of a full SSS safekeeping chain is an external event beyond its control and equivalent to an obligation of means in terms of safekeeping.

Under EMIR, Central CounterParties (CCPs) are required to hold collateral assets posted as margin or default fund contributions at a SSS level, where possible.

The main rationale for these considerations relates to the fact that market infrastructures such as CSDs as well as CCPs and organised trading facilities are subject to a specific regulatory framework (EMIR, CSD, MiFIR) in addition to national legislation, EU and global standards (such as the ESCB/CESR and CPSS/IOSCO recommendations for SSSs), making an obligation for a depositary to return lost financial assets or even settlement risks in general rather unlikely.

CSDs will also be subject to their own specific legislation (CSDR), which is being prepared by the Commission. The regulation will provide the CSD with a European passport and harmonise a common T+2 settlement cycle in Europe, while imposing dematerialisation for securities issuance. The CSDR is key to preparing the CSDs ahead of the introduction of the T2S platform.

Regulations must be understood as a full set, not independently

The major global custodians have understood these new regulatory and market dynamics. Bank of New York Mellon set up a new CSD early this year, and has signed the T2S Framework Agreement. J.P. Morgan has also chosen to enter the CSD arena under a partnership agreement with the London Stock Exchange (Monte Titoli post-trade infrastructure), with a new CSD to be in established in Luxembourg.

The ability to centrally manage and use collateral divided up into multiple location pools is probably one of the major challenges financial institutions will have to address in the coming years.

The combination of custodian collateral services, together with CSDs and integrated CCP market infrastructures, could constitute a strategic approach to addressing the collateral management challenge.

Is the new securities target model really that easy to define?

Obviously—and unfortunately—not. The trend towards market infrastructure consolidation is clearly there and will gather pace in the next few years. The custody business is also being reshaped in line with the different market and regulatory trends. The development of collateral transformation (upgrade to a higher quality) is the best illustration, in addition to collateral and liquidity outsourcing offerings.

More competition and globalisation will also impact the number of EU sub-custodians. On the other hand, there are a series of financial, regulatory, tax and operational challenges, such as day-to-day asset administration (e.g. corporate actions, tax reporting) that will still require dedicated local and sub-custodian expertise that not all CSDs can directly provide.

Joining the dots...

What will the securities business look like in the next three years? As we have seen, several regulatory and market considerations are driving the new framework, and the current business environment will be different as the EU market becomes much more integrated.

The efficiency of collateral management will be particularly crucial in the coming years, and will require new business approaches and services. Estimates point to the demand for collateral increasing by US$4-5 trillion in the next few years as a result of the new regulatory framework. Combined with the reduction of the European Central Bank's liquidity injections (such as ECB LTROs), we will consequently see the cost of collateral increasing, and therefore, the cost of funding. Furthermore, financial institutions will face a dilemma when allocating collateral among OTC derivatives, liquidity and regulatory collateral.

To address this dilemma, financial institutions should carry out an impact assessment of current and future collateral organisation and solutions and evaluate their capacity to meet the new requirements, as well as taking advantage of a central and holistic view of their needs and assets in terms of collateral. This will result in prioritising collateral allocation, and optimising the global pools.

Leveraging the new European post-trade environment and defining the future strategic business model of its custody network is also a strategic topic on the 'to do list' of EU financial institutions. As we have seen, this exercise is closely related and must be carried out while bearing in mind the collateral management framework.

All participants in the post-trade value chain are currently facing the question of their future business model in the new European environment. The answer to the question is far from being trivial, as it will probably drive the business operations of these participants for the next decade. We are already seeing strategic changes, including alliances between CSDs and global custodians.

It appears that major global custodians are starting to position themselves (via a CSD infrastructure) as an integrated approach for asset servicing at European level. Most other financial institutions that operate in asset servicing now have a unique opportunity to take advantage of this new landscape, while anticipating the new regulatory requirements (collateral margin), achieving business operational efficiencies and developing new business opportunities. In order to achieve this strategic objective, joining the dots of the regulatory framework is probably the right approach…

Conclusion:

- The European market infrastructure will dramatically change in the next few years following the introduction of a new regulatory (EMIR, AIFMD, CSDR, etc.) and market framework (T2S)
- The new post-trade landscape will move from a collection of 25 domestic markets into a common European level playing field for settlement and collateral management
- HQLA is increasingly requested, as collateral assets will impact both derivatives and funding costs
- Efficient collateral management will be required to anticipate and meet the future margin requirements as envisaged by the new regulations
- There will be new opportunities to access the different European domestic markets from one main counterparty (a CSD or global custodian) under the new T2S environment
- This potential centralisation may also offer the opportunity to develop a central and consolidated view of collateral capability and needs
- Global custodians are positioning themselves more and more (via the CSD infrastructure) as one-stop asset servicing providers with direct access to T2S (and EU domestic markets) and global collateral management services
- Financial institutions have the unique opportunity to revisit their current asset servicing business model to anticipate the new regulatory framework and take advantage of the new European market infrastructure landscape