

Target2-Securities Land of opportunities?

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To the Future

In 1989, the second volume of the epic Back to the Future saga hit the box office and transported us into the year 2015 alongside Marty McFly and Dr. Brown. Who might have thought that one of the main developments of 2015 would be a European market infrastructure rather than flying cars and portable fusion power? Target2-Securities (T2S), a new Trans-European Automated Real-time Gross Settlement Express Transfer System, is being conceived to turn a page on how the settlement of securities is performed with the announced aim to:

- Reduce domestic and cross-border settlement costs
- Facilitate access to international securities
- Reduce operational risks
- Foster the harmonization of post-trading activities

This ambitious project is being rolled out in four phases, or migration waves, throughout 2015-2017, linking more than 20 Central Securities Depositories (CSDs) and more than 20 national central banks (NCBs) into a single settlement platform. The participants of the first migration wave joined the T2S eco-system on 22 June 2015, except Italy that postponed its entry until the end of August to resolve some technical issues. It is no secret, especially for those who are familiar with pre-production phases of major IT system implementations, that the technical complexity of the upcoming move is not making the first participants' lives any easier. Indeed, there are some not entirely unreasonable heebie-jeebies about how it will all work and what will happen if something goes wrong. We are putting more and more eggs into one basket, and the only way to ensure the eggs do not break, is to make this basket as robust and stable as possible. Let us leave this challenge to Eurosystem, which is the owner of this project, and turn our attention to a brighter side, namely the opportunities that T2S offers its participants.

Depending on the participants' type, the impact and opportunities vary quite significantly, so we should analyze them from the viewpoint of the interested party. Central Securities Depositories that see their settlement business, i.e. the revenues from settlement activities, being outsourced to a central platform, seem to be among the most impacted. Global custodians are seeing rising competition from CSDs in asset servicing. Only banks and broker-dealers seem to have nothing to lose, but do they really?

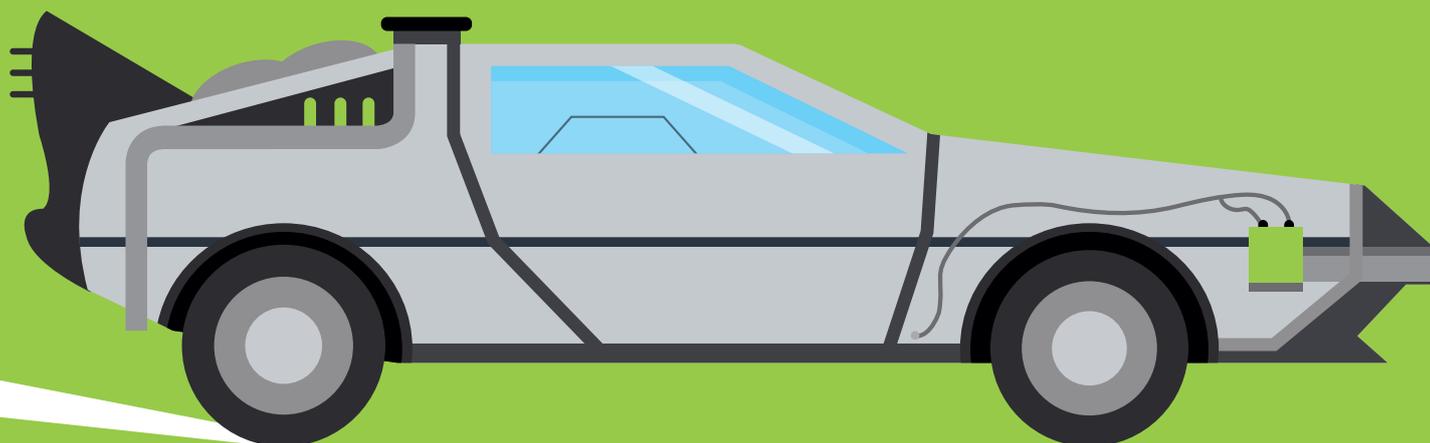
CSDs: Upcoming nightmare or a perfect time for a change?

As previously mentioned, the CSDs will see part of their business disappear following a transfer of their settlement activities into a centralized technical platform. In addition, customers will have a right to choose any CSD to perform the settlement and other activities, instead of using their national CSD. French investors might now use a German CSD to settle their transactions instead of using a French CSD, and vice versa. The time of national monopolies has gone for good. If we add all the costs and hassle associated with the set-up of new interfaces and connections to T2S, the full picture may seem more bleak than inspiring. However, is that really the case? Crises always create opportunities for those who know where to look. T2S could give a competitive advantage to those who are not afraid of embracing a change. A person who suddenly turns blind will enhance their other senses to compensate for the loss; similarly, the CSDs should think about changing their business model by enhancing their value proposition to customers.

Settlement is only a brick in the post-trade value chain, leaving CSDs with other activities, and hence revenue streams, including asset servicing, corporate actions processing, tax and regulatory reporting, and collateral management.

Since CSDs will remain, for the most part, the front end for customers, they should understand that the quality of the services they offer will determine their competitive advantage. This is undeniable. Competition often leads to consolidation, and some post-trade experts even predict that we are moving from 25 national CSDs to 4-5 European CSDs (EUCSD) that will dominate the European post-trade landscape.

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Global custodians: missing T2S opportunity could jeopardize survival

Global custodians, on the other hand, will see increased competition from CSDs in the field of asset-servicing activities. To keep up with the new challenges they should also focus on enhancing their value proposition. Target2-Securities offers an excellent opportunity for global custodians to provide an integrated solution to their customers, offering their traditional “core” service, such as safekeeping and asset servicing, as well as a new single point of access to T2S through direct participation (Direct Connected Participant model). In the new world, the line between the activities of global custodians and CSDs becomes less obvious, as players of both categories enter each other’s territory. This means that the competition is growing stronger and may ultimately lead to fewer players in the post-trade arena. Similar to CSDs, global custodians’ business could see a wave of consolidations.

Banks and broker-dealers: bright future ahead if the change is embraced

Finally, banks and broker-dealers seem to have fewer challenges resulting from new changes introduced by T2S than the global custodians and central securities depositories. Indeed, they are not losing a part of their business as CSDs are, nor are they seeing increased competition, as is the case for global custodians. The main challenge that banks and broker-dealers face, is to ensure they do not miss opportunities to review their business and operational models. Why is this a good idea? Because the banks and broker-dealers who review and adapt their business and operational models within the Target2-Securities landscape, could reap the benefits of T2S by:

- Reviewing/reducing the number of interfaces to post-trade infrastructures to provide settlement services to their clients (e.g. reducing the number of CSDs they use)
- Reorganizing the sub-custodian network (e.g. reducing the number of local custodians, using services of fewer/single global custodians depending on the required services)

- Getting a clear picture of the use and availability of collateral by using the collateral management services now offered by CSDs and global custodians
- Rationalizing the collateral pool by concentrating collateral eligible instruments in fewer places/markets to increase their accessibility and readiness for use when required

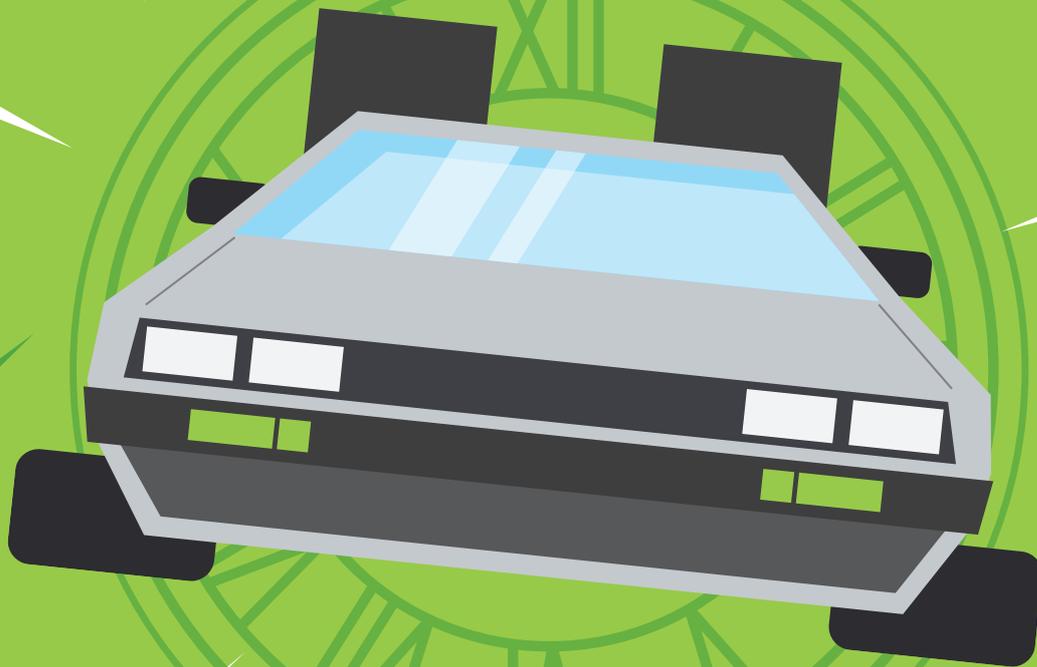
Where are we heading?

Target2-Securities, the main European market initiative in the post-trade world, will introduce major changes to the settlement landscape and the way that market players operate. The biggest change will happen in 2016 when major CSDs (Clearstream and Euroclear groups) will join the T2S club.

CSDs seem to be the most impacted and should think about changing their business model by enhancing their value proposition to customers, especially in the domain of asset servicing. Competition from CSDs that step up into the territory of global custodians will force the latter to find ways to differentiate their activities by focusing on quality of asset servicing and proposing new types of services, such as cross-border settlement for their clients. Competition between CSDs and global custodians will be more evident and may lead to some consolidation of the industry, leaving out the “weak actors” who failed to change their business model.

Banks and broker-dealers, the players that seem to be impacted to a lesser extent, should not make the mistake of doing nothing. They can reap the benefits of Target2-Securities by optimizing their custodial network and collateral management.

Defining a winning strategy – where do I want to play in the new T2S environment? – is a complex exercise, since it involves not only T2S but also other aspects such as collateral, EMIR, CSDR, custody reforms (UCITS V, AIFMD...) among others. Sometimes, due to market evolutions and regulatory changes, players are forced to rethink an already crafted T2S strategy. Indeed, take the example of BNY Mellon, a global custodian that, following certain obligations of CSD Regulation and delays in the EMIR implementation, revoked its CSD license after investing significant effort to become a CSD.



Marty McFly might tell us: *“Beware the consequences of a wrong decision!”*

Complexity is also inherent in the definition of the new post-trade landscape within its new limits. It encourages players to think outside the standard national box and develop new settlement and new distribution business within the Eurozone. The most obvious mistake that the companies might make right now is to hide their heads in the sand and let things evolve. The time has come to decide where in the T2S world your company will find its place. Are you asking yourself this question?

Everybody has a chance to get a slice of the new pie, but only proactive and daring players will see the size of their slice increase, whereas those who fail to change might see their future darkening. Marty McFly might tell us: “Beware the consequences of a wrong decision!”