Target 2 Securities and T+2 Settlement
Challenges and opportunities for the European Fund Distribution

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The European trade and post-trade landscape has been dramatically reshaped in the perspective of achieving better financial integration and setting up a single market. According to the European authorities, financial integration leads to enhanced competition and reduces the costs of intermediation, while at the same time allowing to better share and diversify the risks. Target 2 Securities (T2S) is at the core of the European harmonisation project.

The T2S project is slowly but steadily becoming a reality with the first wave of Central Security Depositories (CSD) integrating the new European settlement platform by 2015.

As from 2015 to 2017, 24 European CSDs (within or outside the Eurozone) will connect to the common T2S platform in order to facilitate a more efficient and safer cross-border securities market. T2S aims not only to reduce the cost of settling securities transactions, but also to create collateral savings for market participants. These savings are increasingly perceived as a strategic necessity by market participants at a time when the demand for high-quality collateral continues to rise, as a result of both the crisis and the new regulatory developments.

T2S settlement will be organised in central bank money (starting in euro but other currencies may join afterwards) connecting CSDs, national banks and direct connected participants.

Closely related to the T2S project, the CSD Regulation (CSDR) aims to harmonise both the timing and the conduct of securities settlement in Europe, as well as the rules governing CSDs which operate the infrastructures enabling settlement.

The proposed regulation introduces an obligation on market operators to represent all transferable securities in book-entry form and to record them in CSDs before trading them on regulated venues.

The initial impact of the new CSDR will consist of a common settlement date that will not be later than on the second business day after the trading takes place. T+2 settlement is planned to be harmonised throughout Europe from October 2014.

These structural transformations within the post-trade value chain have a direct impact on the organisation and operations of its major stakeholders. Market infrastructures, custodians and asset managers are currently preparing their new business models in line with these developments.

The investment management industry is also making preparations for this new environment. Would T2S and T+2 represent a new business opportunity? Is it a threat for the primary market distribution? What are the main challenges for the industry? Deloitte Strategic and Operations Director, Laurent Collet, sat down with Chris Prior-Willeard (CEO, BNY Mellon), Dominique Valschaerts (CEO, Fundsquare) and Olivier Portenseigne (CCO, Fundsquare) to discuss these different questions and have a better insight on how the fund distribution can be organised in Europe within a T2S/T2 environment.

Deloitte: How is your company currently preparing for the new T2S environment?

Chris Prior-Willeard
We have been planning for T2S for a long time. In 2010 we identified that T2S would be a powerful driver for change in our business in Europe and included this and other drivers in our immediate change agenda. We have tried to lead the education of the industry and clients on T2S and are active at all levels of the project's governance.

In terms of our preparation, we are actively working towards becoming a Direct Connected Participant (DCP) to T2S, Payment Bank and our CSD is currently in the Wave 4 of the T2S integration plan.

Dominique Valschaerts and Olivier Portenseigne
There is a clear trend and strong will from regulators to push for greater transparency and standardisation of order processing and settlement. For that reason, the post-trade European securities market is poised for more integration to reduce costs and cross-border settlement risks. As a consequence, the European Central Bank has decided to build—and will soon deliver—its T2S infrastructure aimed at creating a single Eurozone security settlement system leveraging on the 28 domestic CSDs.

The two main centres in Europe for cross-border distribution, Luxembourg and Ireland, are set up under a primary market with the dominance of the so-called transfer agent model. Their success is primarily based on their open and flexible model that is able to cope with all kinds of business rules, whether they were set at the level of the product, country of distribution or type of distribution.

When it comes to fund share, T2S will face a certain number of challenges that will have to be answered if it wants to be successful. The major ones are the following:

- T2S will integrate post-trade settlement of the Eurozone, whereas Luxembourg and Ireland are now distributing their funds in more than 55 countries and far beyond Europe. 50% of fund shares are held outside Europe.
- T2S will facilitate settlement for euro-denominated securities, whereas more than 40% of fund shares are denominated in another currency. Would a fund buyer have two or more types of settlement model for funds?
- Fund shares sales, as opposed to any other type of security, are driven by distribution and, as such, fund issuers need transparency of their distribution network in order to monitor their sales effort. So far, T2S is not bringing any solution to solve the transparency issue of the CSD model.
- T2S may solve the issue of settlement but another one still remains: order management remains under a complex model. Indeed, in a primary and cross-border market, each fund buyer needs to reach each fund register and transfer agent individually, which will still bring a high level of complexity and cost.

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T2S will also create a number of opportunities for banks and custodians for streamlining and consolidating their settlement processes in Europe, but also for optimising their collateral and liquidity management. These opportunities may create a clear appetite for banks and custodians to move towards a T2S solution.

These challenges — and at the same time opportunities — are creating a kind of schizophrenia in the fund industry whereby it is so far very difficult to bet on whether there will be more appetite for a T2S model than there was for an ICSD or CSD model today.

Fundsquare, designed as a market infrastructure to facilitate cross-border fund distribution, is currently setting its strategic focus on T2S. And since it will bring both challenges and opportunities, Fundsquare, by its nature, will try to reconcile both the Transfer Agency and the CSD/T2S world through an integration principle bringing the best of both worlds. The future operating model and implementation strategy have been defined but the concrete steps of implementation will certainly bring their obstacles as we try to make these two worlds continue to coexist whilst they may have opposite views, business models and economic interests.

Deloitte: Some key distribution markets (notably France & Germany) have historically attracted foreign funds in their domestic CSD. Do you think that the combined effect of T2S and new depositary requirements will trigger a similar dynamic in other key distribution markets, such as the UK, Italy and Spain?

Chris Prior-Willeard

My view is that there are some significant triggers for this development in addition to those you raise. These include growing enthusiasm for using funds as collateral which requires the traditional fund settlement processes to become closer to those in securities markets. Against this, changes like T2S and the passporting provisions of CSDR will amplify the pace of change towards this goal.

The funds market is investor-driven, so the markets are likely to follow investor requirements for collateral and/ or regulatory compliance. The UK is of course different by virtue of not being in the euro and so far not part of T2S.

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France and Germany are historically domestic markets, i.e. having domestic funds distributed domestically despite some attempts to distribute them cross border. That being said and as a matter of fact, cross-border funds that are already distributed in France and/or Germany will de facto be included in T2S. These two very strong domestic markets are served by the two very mature CSDs in terms of fund shares, Euroclear and Clearstream respectively, and will certainly be able to deliver what their respective market expects from an integration into T2S.

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UK, Italy and Spain are coming from a different background and history and much more similar to Luxembourg and Ireland, i.e. with a TA-driven model. As a consequence, these markets may not see the same trend as France and Germany, where fund buyers are more used to going directly to the transfer agent or using an ICSD or an intermediary platform.

T2S will increase competition and potential consolidation across CSDs. The key success factor being their ability to provide additional services beyond pure settlement (provided by T2S) such as asset servicing and order management. The success of T2S will be triggered by the fund buyers moving into this model and the added value they would receive. As a consequence, fund buyers will have to perform arbitrage between the settlement efficiency they could obtain via T2S and all the other services they would require through their CSD in order to properly serve their clients. At this stage, looking at the breadth and scope of services provided by ICSD or CSD, there is no optimal model that could meet all requirements in terms of costs vs quality of service when it comes to fund shares.

Our opinion is that the ICSD, CSD/T2S and TA model will continue to coexist in the long run and it is very unlikely that one model will prevail. This is why we are advocating a collaborative model that will reconcile all needs.

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Deloitte: In your opinion, what are the key impediments to a full deployment of T2S within the European fund distribution landscape? Considering the uncertain evolution of T2S within the European distribution landscape, how is your company positioned with regard to T2S over the next three years?

Chris Prior-Willeard
For full deployment of funds in T2S, fund securities and units will have to be eligible and admitted for settlement in one or more T2S CSDs – in effect transforming them into 'T2S securities'. This has inevitable consequences for the upstream processing functions.

T2S was not designed with mutual funds in mind. Funds were included later on, and hence T2S processes are not specifically fund-friendly.

Also, the harmonisation of settlement arrangements in T2S has not been extended, for example, to tax, accounting and legal provisions associated with investment funds

Deloitte: How do you see the custody business shaping up over the next few years?

Chris Prior-Willeard
Custody has a few dynamic years ahead as the impact of the post-global financial crisis becomes apparent, such as the new regulations in the U.S. and Europe in particular. New capital rules and the bifurcation between central and commercial bank money are examples of a number of significant challenges to the traditional model. Success in future will demand a degree of agility and flexibility, together with a range of alternatives for clients, to engage directly and indirectly with the market. The BNY Mellon CSD is a direct example of this in practice.

Deloitte: Will the €0.15 settlement cost of T2S influence the current fund pricing model?

Dominique Valschaerts and Olivier Portenseigne
Cross-border fund distribution is a highly intermediated business at every level and as a consequence the €0.15 for settlement may not be the total cost of settlement when you add all the layers playing a role in the settlement process.

Transfer Agents will advocate that settlement into a CSD type of model and more importantly in T2S, will generate new types of costs that do not or did not exist in a transfer agent model for the following reasons: Funds using a TA that is not a bank will have to gain access to central bank money via a third-party clearing bank creating an additional layer of costs.

A delivery versus payment instruction is more expensive than a direct settlement between the Fund/TA and the fund buyer due to the costs of holding a cash and security account at a CSD together with the costs of the instructions.

In parallel, we should not forget that CSDs may not themselves be in favour of T2S as they are outsourcing the settlement to the infrastructure. As a consequence, these same CSDs are losing a large part of their current revenues which they somehow need to recover elsewhere. They may propose a minimum service when it comes to settlement into T2S so that their clients may not move to such a model or propose higher fees for other services.

All in all, whether they are CSD or TA, all these actors may find very good reasons not to cut costs, which will be to the detriment of the fund industry. The buyers of each product and service should then be very attentive to what they pay for the service they get so that T2S could benefit all.

Deloitte: UCITS V, UCITS VI, AIFMD, EMIR, MiFID2 …. The investment management industry landscape is being redesigned by the regulatory framework. How do you see this landscape in a 2016 horizon?

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The fund industry in general is facing major challenges linked to the current regulatory pressures, the increased competition with other products (ETF, bank and insurance products, domestic products, etc.) and the difficulty of delivering the promise to the market as being one of the unique investment vehicles that should be used for pensions.

As a consequence, we believe that the fund industry as a whole should realise the need for creating a new model and framework in order to be more competitive and cost efficient. Indeed, the cost of distribution and operations is far more expensive than other domestic markets. Even if the models (domestic vs cross-border) are not completely comparable, there is a need to push further for collaboration. There is a clear need also to level the playing field across all players involved in these activities in terms of standardisation and fees, as there is clearly no room nowadays to create value on commodities activities that should be performed in similar ways. Typical examples of activities are KYC, order routing, settlement, registration of funds cross-border, collection and dissemination of fund data and documents to distributors, etc.

Creating such a collaborative and innovative framework and model would enable players to better allocate capital and resources to more added-value services (distribution support, client relationship, new products) that will bring another spin to the competitiveness of the fund industry compared with other industries and will clearly answer regulators' concerns about

transparency, investor protection and their willingness to move funds into an infrastructure type of model as opposed to multiple bespoke models.

Deloitte: What is your response to the stakeholders of the UCIS cross-border distribution that say that T2S/T2 will have no impact on their current business?

Chris Prior-Willeard

Wishful thinking. The genie is out of the bottle. T2S is real and importantly has significant political as well as commercial support. The project is part of a secular change in European markets that has far-reaching ambitions in terms of their international competitiveness. If, as a result of these changes, benefits accrue to beneficial holders, it is a brave man who stands in the way.

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T2S may not impact them in the short term and from a purely operating model perspective as it will be very similar to the current CSD/ICSD settlement models. But stakeholders should keep in mind the spirit of these new initiatives such as T2S or other regulatory changes.

The spirit of these changes is increasing investor protection, transparency and decreasing costs. This means that every actor at every level should start rethinking its business model in order to achieve this bold ambition. The profitable inefficiency concept will not last very long and companies will have to increasingly show value for money.

Deloitte: DTCC has announced and recommended a T+2 and a potential T+1 for settlement cycle including unit trust, while the same products in Europe will continue to be settled on T+3. Is it an opportunity or a threat for Europe? Why do we have such different approaches between the U.S. and EU. What is the UK's perception?

Chris Prior-Willeard

There has been a range of settlement differences between the U.S. domestic markets and virtually every other market in the world. This has much to do with the U.S. advantage in terms of size, scope and depth of their capital markets and at the same time the success of products such as ADRs designed to bridge the differences. However, the differential is narrowing in view of the steady progress towards dematerialisation in the U.S. and the overall application of technology.

DTCC has had ambitions in Europe over a number of years, but as yet this has not produced any significant product other than the recent announcement of some MOUs.

Deloitte: Are the CSDs the ultimate safe place to be in the future? Do we have to put all the securities business in the SSS? As per AIFMD and UCITS V operating a settlement system, recording of securities in a book-entry system through initial crediting; or (iii) providing and maintaining securities accounts at the top tier level should not be considered a delegation of custody functions.

Chris Prior-Willeard

CSDs are inherently safe due to the manner in which they are regulated. The CPSS IOSCO framework, which provides the benchmark against which CSDs are measured, leaves very little to discretion. And even this is likely to be further tightened by the CSD Regulation. So CSDs which use central bank money for the cash leg of a securities transaction have proper governance and an efficient technology platform implementing a comprehensive rulebook which implements the Settlement Finality directive and offers real advantages over some of the traditional interpretations of the model.

Adequate capital and experienced management complete the picture.

To the **point**:

- The new post-trade landscape will move from a collection of 25 domestic markets to a common level playing field for settlement and collateral management
- Financial institutions have the unique opportunity to revisit their current asset servicing business model, leverage from the regulatory framework and take advantage of the new European market infrastructure landscape
- There will be new opportunities to access different European domestic markets from one counterparty (CSD or custodian) under the new T2S environment
- Custodians are increasingly positioning themselves as one-stop asset servicing providers with direct access to T2S and collateral management services