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GC 30 YEARS

Special Network Forum

ANNUAL MEETING EDITION

Welcome to our special NeFo Athens edition!

In a few short years, the Network Forum Annual Meeting has become an established part of the industry calendar. For this year's event in Athens, Global Custodian has looked at our own recent coverage of topics on this year's agenda and made a selection of these articles available in a special digital edition.

Some industry developments have moved on apace since we covered them in print or online and you may find one or two of the articles included here are 'of their time'. They nevertheless provide useful historical background. Others remain the subject of lively debate, which will no doubt be enriched by this week's interventions.

The contents page indicates the original publication date of each article and the relevant session on the NeFo agenda.

While many of you will already be subscribers to Global Custodian, a special discount offer is available for our 30th Anniversary year. Click here and enter PROMO CODE "GC30" or contact subscriptions@globalcustodian.com for any queries.

Make the most of Athens. I lived here for a couple of years in a previous career and thoroughly recommend it (but go easy on the τσίπουρο!).

Richard Schwartz
Special Projects Editor
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Printed by: Warners Midlands PLC

SUBSCRIPTION RATES
Global Custodian magazine publishes five issues per year.
GlobalCustodian.com publishes daily.
Annual subscription:
$565 - magazine only;
$715 - web only;
$890 - package.
For more information contact
subscriptions@globalcustodian.com.

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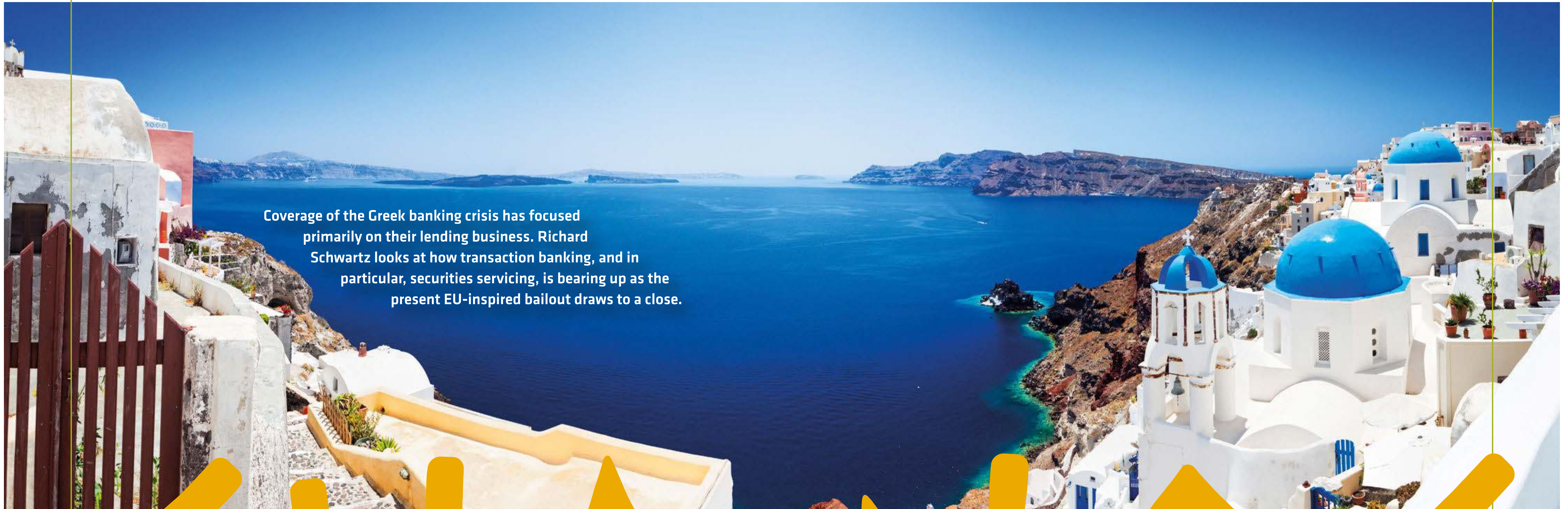
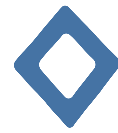
[MARKET REVIEW | GREECE]

ECONOMIC CLIMATE CHANGE



Coverage of the Greek banking crisis has focused primarily on their lending business. Richard Schwartz looks at how transaction banking, and in particular, securities servicing, is bearing up as the present EU-inspired bailout draws to a close.

[MARKET REVIEW | GREECE]



ver the years, Greek banks active in securities services have built up a range of expertise that goes well beyond vanilla sub-custody. Prior to the crisis, competition was keen for international mandates with a choice of well-rated providers from both domestic and foreign banking groups.

From a foreign investor perspective, that landscape has changed over the past eight years. While the same choices are still available in principle, the Greek sovereign debt crisis and the ensuing capital controls have seen many cross-border clients shift their mandates to Greek branches of foreign banks, primarily Citi and BNP Paribas. "Over the past few years, foreign investors and their global custodians have been constrained in their selection of agent banks in some markets by the impact of sovereign ratings," says Panos Papapetrou, head of strategy planning for Piraeus Bank's securities services division. "Greece is one of those markets, but the limitations referred to mask a vibrant local provider capability."

Restructuring imperatives as a result of the crisis have also played their part. "Some foreign institutional investor clients came our way through a network we maintained in the region outside Greece," says Christos Dallis, director, treasury and investment operations, National Bank of Greece. "As part of the restructuring plans all Greek banks had to undertake, we are largely divesting from these markets."

With Greece's sovereign rating acting as a disincentive for foreign institutional investors to appoint local financial institutions as service providers, these banks have been looking both to attract new client segments and service new asset classes. "My view is that the sovereign ratings downgrades did have an impact. However, our name and reputation partially counterbalanced country risk considerations and we were managing pretty well, even having lost our investment grade rating for a couple of years," adds Dallis. "It was capital controls that really had the major impact, since risk tolerances for Greece were set to zero. To win back substantial foreign clients, we will have to see a total lifting of capital controls. The good news is that they are now relaxing at an accelerated pace."

HELICOPTER VIEW

As far as future prospects for local securities services businesses are concerned, much depends on the bigger picture, both regarding the health of the Greek banking sector and the economy as a whole. "In Greece, banks and the state go up and down together," says Prof. Gikas Hardouvelis, professor of finance and economics in the department of banking and financial management at the University of Piraeus and Minister of Finance of the Hellenic Republic from June 2014 to January 2015.

From that perspective, the onus is on the state to create the conditions for the banking sector's recovery. On the plus side, the country has returned to marginal growth after eight years of recession. Speaking in Athens at the end of April at the launch of its latest Economic Survey of Greece, Angel Gurría, OECD Secretary-General, suggested that Greece's reform efforts are finally paying off. "The Greek economy is growing again, at rates of 2.0% in 2018 and 2.3% in 2019," he noted. "If our estimations are right, by 2019 Greece will be growing at a faster rate than the Eurozone average."

Gurria also pointed out that the Greek Government's primary balance had gone from a significant deficit in 2015 to a surplus of more than 3.5% of GDP in 2016 and 4% of GDP in 2017, exceeding the European Stability Mechanism (ESM) targets. This would be sufficient for Greece to repay its debt premiums each year without further borrowing, though whether this level of surplus is sustainable into the longer term is far from certain. Gurria nevertheless insisted that in addition to addressing the issue of debt sustainability, large but realistic primary surpluses would be important to the country's recovery. "A primary surplus of just above 2% of GDP will have to be maintained for an extended period," he said. "This will require further changes to the tax system to make it fairer and more growth-friendly by continuing to fight vigorously tax evasion, simplifying the tax system, and enhancing the effectiveness of public spending."

Turning to the banking sector specifically, he stressed that, "Greece needs to continue tackling the challenges facing its banking sector... Though the capital ratios of Greece's banks currently exceed regulatory thresholds, the stock of non-performing loans remains high and, along with capital controls, contributes to tight financial constraints."

More broadly, says Hardouvelis, Greek banks suffer from three related challenges: non-performing loans (NPLs) on the asset side of their balance sheet, precarious deposits on the liability side, which have only stabilised because of capital controls introduced in June 2015, and a still vulnerable capital base. While total regulatory capital is well above the minimum ratio of 10.5%, much of this is in the form of Deferred Tax Credit rather than hard equity.

"Banks have seen the worst of the crisis," says Dr Aris Kyroudis, formerly a senior executive at Elias A. Petropoulakis, a large local broker, now retired,

"The limitations referred to mask a vibrant local provider capability."

PANOS PAPAPETROU, HEAD OF STRATEGY PLANNING, PIRAEUS BANK'S SECURITIES SERVICES DIVISION

June 2019

"We may now begin to discern a relatively positive outlook amongst all client segments, which will be further reinforced by a more stable political and nancial state of affairs."

ANNA FAKIOLA, HEAD OF SALES AND RELATIONSHIP MANAGEMENT FOR PI- RAEUS BANK'S SECURITIES SERVICES DIVISION.

but still close to the market. He points out that, for the most part, the systemically important banks in Greece remain largely dependent on income from residual lending activity. "Imagine any other industry, where the manufacturer was not able to offer the product they were set up to produce," he comments.

In September 2017, the gross value of NPLs for Greek banks stood at 106 billion, around 47% of total loans, while the ratio for non-performing exposures (NPEs), including all loans, advances, debt securities and off-balance-sheet exposures, stood at 42%. A significant share of NPEs comprises loans to SMEs and residential mortgages. Hardouvelis suggests that while some 25% of NPLs are what might be called 'strategic', with the debtors hoping to take advantage of some future debt relief or court-related delay, 75% are real.

In June 2016, a plan was launched to reduce NPLs and NPEs over three and a half years through a combination of write-offs, loan sales and other modes of restructuring. The first two NPL sales by Greek banks took place in the second half of 2017, while in late May, Piraeus Bank, Greece's largest lender, agreed to sell a 1.45 billion ($1.7 billion) portfolio of secured, non-performing business loans to Bain Capital Credit.

Provisions for the banking sector now amount to almost half the gross value of NPLs, higher than the EU average. "Provisions against these non-performing assets make at least some recognition of income from loan sales a reasonable expectation," says Kyroudis, adding that the banks' decreasing reliance on emergency funding and the dilution of government ownership are all positive signs.

ON THE WAY UP

Where does that leave the transaction banking businesses of the Greek banks and, more specifically, their securities services divisions? Hardouvelis does not see them getting to the front of the queue in terms of strategic consideration. "Sovereign ratings affect everything, even the ability of the banks to get money from their own central bank," he says.

"Transaction services are a small part of the banks' overall problems." Hardouvelis cites the example of foreign companies refusing to accept Greek bank Letters of Credit as a bigger problem for banks' senior executive management. Kyroudis points out that in the current climate, even if fee-based services were to grow, the impact on the banks' earnings profiles would be muted. "Increasing fee-based income by 10% would make little dent on earnings," he says, "while 10% growth on a loan portfolio would make a substantial impact."

Papapetrou at Piraeus Bank acknowledges that, "Local banks are placing their focus on improving their balance sheets, and within this emergency context, securities services divisions are reorganising themselves." At the same time, he says, "fears of market risk dominated the decision-making processes of foreign market participants with regards to selecting a local provider."

This is confirmed by Christos Garoufalis, head of custody network management and development at NBG. "From conversations we have been having over the past few years, it's more of a risk issue than the client being unhappy," he says, "but the custody divisions of our banks are intermediaries, not principals and the risk aspect is overplayed. It's a matter of wider perception. Once the macroeconomic climate gradually recovers, I think things will lighten up."

In that regard, Anna Fakiola, head of sales and relationship management for Piraeus Bank's securities services division, sees signs of hope. "Following Moody's upgrade of Greece's credit rating by two notches from Caa2 to B3, the country looks set to return to market-based funding following the conclusion of its current bailout program in the summer," she observes. "Sentiment on the side of foreign institutional investors seems slightly improved. With capital controls still on but somewhat relaxed, we may now begin to discern a relatively positive outlook amongst all client segments, which will be further reinforced by a more stable political and financial state of affairs."

In the meantime, local custodians are looking to exploit opportunities where they find them. "Private equity and distressed asset funds are gradually appearing in the market to exploit Greek opportunities," explains Piraeus Bank's Papapetrou. "Greek systemic banks appear to be the main asset pools and triggers of such funds, owing to pressures to clean their encumbered balance sheets."

Opportunities still exist in the current climate. Papapetrou points to outsourcing of operational activities for local asset managers, new banks in the market, fund distribution services, stock lending, collateral management and the provision of one-shop stop services, encompassing a broad range of services.

The National Bank of Greece's Dallis also sees opportunities in the local market. "We have a strong domestic brand name," he says. "Following an initial contraction, our assets under custody from domestic investors are again expanding, particularly over the last two years and in regard to their assets abroad." The Athens stock exchange has meanwhile introduced 'mini-bonds' to allow corporates to fund their activities in the absence of access to the euromarkets. "With that comes custody, agency and clearing business," says Dallis.

The domestic pension market is also growing. "One of the key reforms in 2012 was the passing of a law that allows for private pension funds to be formed," he notes. "There are at least 10 formed over the last five years that I know of and the law prescribes the need for an independent asset manager and custodian. We are active in that market. It is very fulfilling when you start with a new fund of 200 million that within five years is up to 700 million."

"Banks have seen the worst of the crisis."

DR ARIS KYROUDIS, FORMERLY A SENIOR EXECUTIVE AT ELIAS A. PETROPOULAKIS.

Since this article was published, Greece has exited the bailout programme. While non-performing loans have been cut by over 20% over the past four years, they remain an issue to be resolved. Meanwhile, indigenous Greek banks will remain hampered in competing for the servicing of inward foreign investment until the country's sovereign debt ratings return to investment grade.

[MARKET REVIEW]

AN INDUSTRY DIVIDED:

THE PERCEPTIONS AND REALITIES OF THE CAPITAL MARKETS UNION

The capital markets union has drawn wide criticism for failing in its various objectives and the road won't be any clearer with Brexit on the horizon. GC looks at the current state of play and assesses whether there's still hope for the project. By **Charles Gubert**

To some, the final instalment of The Godfather trilogy was derided as an abject travesty and a desultory conclusion to what had been one of the finest film sagas in living memory. In contrast, other critics were more restrained, accepting that while the motion picture did not live up to expectations, it was entirely watchable and by no stretches 'awful'. The EU's heavily publicised capital markets union (CMU) is now entering its fourth year and elicits a similar response. The initiative pitches industry experts who think the entire programme should be jettisoned against those who see it as a perfectly manageable albeit slightly flawed legislative initiative.

"That CMU was established in the first place is an achievement in itself. Europe is heavily reliant on bank financing and it is positive that policymakers recognise the need to diversify funding sources and promote deeper and more integrated capital markets within the EU. Our view of CMU is that there have been successes in areas like sustainable finance, but also limited progress in addressing structural impediments to cross-border integration, most notably around inconsistent tax practices and legal systems" says Pablo Portugal, managing director at the Association for Financial Markets in Europe (AFME).

Is CMU launching at possibly the worst time ever in EU history?

Policymakers behind CMU are operating in a stressful European political environment punctuated by ongoing Brexit discussions and the systemic risks posed by fragilities in the Italian banking system. Experts concede the tricky headwinds have undermined CMU. Portugal acknowledges that while Brexit creates challenges, the EU 27 should use it as a catalyst to get CMU right. "From a strategic point of view, the biggest financial centre in Europe is leaving the EU. Now more than ever the EU 27 needs to increase the capacity of its capital markets." Despite this, cracks – partly inflamed by Brexit – are emerging in CMU.

Clearing divisions

For instance, CMU proposes to better regulate third-country central counterparty clearing houses (CCPs) by creating a two-tiered supervisory mechanism comprising tier one, non-systemically important CCPs and tier two systemically important CCPs, have divided the industry in equal measure. While providers accept that tighter supervision of third country, SIFI (systemically important financial institutions) CCPs is a perfectly acceptable policy objective, there is consternation that the proposals could result in European Securities and Markets Authority (ESMA) demanding that tier two CCPs relocate into the EU in extremis, thereby increasing fragmentation and margining costs for derivative users. As a leading clearing destination for euro denominated swaps, this could hit the UK badly.

Fund managers pull back on CMU

Along with market infrastructures, asset managers have also been left nonplussed at CMU, angered by how the EU has sought to streamline the bloc's fragmented cross-border distribution rules. Despite the provisions having the right intentions, they have been criticised for being uninspired. Asset managers have also voiced disapproval about CMU's revisions to the pre-marketing rules under the Alternative Investment Fund Managers Directive (AIFMD) for being highly constrictive. Another CMU invention – the European Long Term Infrastructure Fund– aimed at drawing more capital into illiquid assets – also bombed, mainly because the product is badly structured and appeals to a very narrow target market.

ESG: Good progress so far but caution is still needed

Moving forward, the CMU has its sights set on promoting sustainable finance, principally encouraging more asset managers and asset owners to incorporate sustainability measurables into their investments. This is already happening organically evidenced by a recent BNP Paribas Securities Services (BP2S) survey, which found that 75% of asset owners and 62% of asset managers hold 25% or more of their investments in funds incorporating ESG (environment, social, governance), a massive rise from 2017 when that figure stood at 48% and 53% respectively. In addition, 65% of respondents told the BP2S study that they align their investment frameworks with the UN Sustainable Development Goals (SDGs).

Very few people would dispute the benefits of stimulating sustainability in financial services, particularly as there are growing concerns about greenwashing, namely asset managers misrepresenting their funds to investors as being ESG compliant. Just as MiFID II (Markets in Financial Instruments Directive II) tightened up product governance rules by imposing strict target market requirements on fund manufacturers and distributors, the EC is looking – as part of CMU – to create an ESG taxonomy or benchmark to stop managers from greenwashing their products. In theory, this is not a bad idea as it will help investors compare and contrast the ESG policies and practices of underlying or prospective managers.

Managing the taxonomy

"We support the establishment of an effective taxonomy as we believe it will help provide better standards for the industry. However, we also believe the taxonomy needs to be flexible, adjustable and proportionate. We also accept that the taxonomy is something where international alignment is desirable," said Portugal. If the taxonomy is unwieldy, asset managers may find it harder to develop dynamic ESG products. With the EC working to an ambitious time-line and growing industry concerns about ESG data quality, there is nervousness that a badly structured ESG taxonomy risks becoming counterproductive.

What happens next?

The catalogue of CMU let-downs is growing, and it needs to be sorted, otherwise the financial services industry will become increasingly disillusioned. What began as a promising and bold endeavour has not met industry expectations. With the UK potentially exiting the EU in late 2019, the scale and ambition of the CMU could be slashed even further. This cannot be allowed to happen, otherwise it will provide further ammunition to the CMU's loudest critics, many of whom have repeatedly argued that the scheme be totally shelved.

The Global Custodian Forum:

Post-trade industry takes next steps in search for efficiency

Topics discussed at the forum included achieving buy-side operational efficiencies, new front-to-back service models, blockchain, ESG and tokenisation.

Overcoming efficiency challenges was a common theme through the Global Custodian Forum in London this week, as buy-side operations teams and post-trade firms look to new outsourcing and technology models.

The start of the day focused on the current macro challenges facing asset managers and hedge funds, where buy-side participants explained the current motivations behind outsourcing both IT infrastructure and middle and back-office functions.

But one concern that was raised was the amount of legacy technology that is still currently in place, which is causing a significant hurdle in buy-side firms having efficient data management capabilities. Both buy-side firms and post-trade service providers still have a lot to do to overcome legacy platforms to ensure there is both consistency and accuracy in the data they need.

As well as data, fee and margin pressures on the buy-side have helped sparked the move to a front-to-back model offering from custodians. This has been evident in acquisitions and partnerships from the likes of State Street, Societe Generale and – on the fund services side – SS&C. With heightened demands for data for the front-office, asset managers are opting to partner with new service providers as opposed to reinvesting in technology. Challenges still remain when it comes to uptake though asset managers seem in favour of the offering.

Custodians feel they are in the right place to provide an end-to-end solution for asset managers not only challenged by operational efficiencies, but also to provide harmonised data services to help investment decisions of their clients.

The second half of the day explored far newer concepts for securities services providers, including environmental, social and governance (ESG) investing, new technology blockchain-based technology platforms and the tokenisation of assets.

Asset managers and asset owners are making a real push into the ESG space, with ESG principles becoming a significant factor when investing. Panelists explained custodians are also in a unique position to be a partner for ESG firms, especially on the analytics and reporting side. They can also provide ESG data alongside performance management data that custodians can provide. Some of the challenges raised were the correlation between ESG data providers as more and more enter the space and regulators taking a prescriptive approach as opposed to a principal-based one.

The panel on bringing blockchain to life explored how the technology can be used as a basecamp for market participants and other post-trade firms to then explore where else they can achieve value.

Yet panelists speakers debated whether blockchain fill force incremental or fundamental changes to business processes. There could be incremental changes as business decisions become increasingly influenced by

technologists that are exploring the use of the technology internally on a micro scale. But it also can be fundamental as the industry becomes increasingly digitised.

For blockchain technology to achieve wider adoption today, it was established that it has to coexist, communicate and interoperate with today's legacy platforms.

The final panel of the day discussed the rise of tokenised securities as a new asset class, not just cryptocurrencies but also new digitised forms of bonds, equities, loans and potentially real estate. However, for this asset class to take off with institutional investors, established providers of safekeeping are needed to link the old world with the new.

Yet a number of issues still need to be addressed, including the legal title of the asset and the cyber security of the asset, and many existing providers are waiting what regulation might be enforced before launching any new services for tokenised securities.

Panelists highlighted how each service provider going it alone will lead to slow progression and pointed out how an industry organisation such as SWIFT could implement standards and governance.

[IN DEPTH | T2S]

Should we view T2S as a failure?

An 11-year project with immeasurable costs and missed targets, but one which has delivered on its promise to harmonise Europe's settlement market, should we class T2S as a success or failure? Asks **Jonathan Watkins**.

There are some things in this world that should be left alone. A classic example of this is the Ark of the Covenant in the first installation of the Indiana Jones movie series, whereby the opening of an ancient chest releases a vortex of flames which subsequently melts a crowd of Nazi soldiers seeking immortality. That's a huge spoiler alert for anyone who has spent the best part of 40 years trying to avoid the ending, but it's an important message: somethings are best left untouched.

When deciding whether to write our first in-depth TARGET2-Securities (T2S) feature in 12 months or not, we had to weigh up this conundrum. Has everything already been said and written about T2S and its achievements, possibilities and pitfalls? Or is it time to dig up the subject again and see what we can find. Despite the risk of the aforementioned vortex of flames, we decided to open the chest and look inside. We wanted to discover whether T2S should quite simply be classed as a 'failure' or not.

Here's a quick bit of background for those of you unfamiliar with the project, or a refresher if like us you've taken a bit of a break from tedious T2S hot-takes. Initially proposed in 2006, the T2S initiative was designed to create a harmonised European settlement platform to remedy many of the barriers and inefficiencies hindering EU cross-border clearing and settlement.

For each transaction, settlement instructions from the central securities depositaries and the central bank are matched by T2S when they enter the system. T2S then settles the transaction on a delivery-versus-payment (DvP) basis.

Through five waves of implementation, 23 CSDs across Europe were onboarded, and two currencies have been linked to the platform – the Euro and, more recently, the Danish Krone. Costs following the completion of the project were proposed at a maximum of 15 cents per settlement.

Whichever way you look at it, the project took a long time to complete and suffered a number of setbacks on proposed timelines, this opened the door for widespread criticism and debate around the worthwhileness of the initiative.

The caveat to any condemnation of the project is that it was conceived pre-financial crisis and then realised post-financial crisis, where the capital markets and financial services world was tipped upside down.

On 18 September 2017 though, the landmark moment occurred for European market infrastructure occurred with the end-point of an arduous 11-year programme to harmonise Europe's post-trade settlement activities as the final Eurozone markets went live on TARGET2 Securities (T2S).

What defines a 'success'?

“Rome was not built in a day and nor was T2S. It has come with some delays and as we know it's not entirely there yet. But has it failed? Not at all. Has it delivered? The promises have delivered, you could argue it hasn't reached 100%,” says Thilo Derenbach, general manager of the Clearstream Banking UK Branch.

When assessing whether T2S should be classed as a failure let's look at the dictionary definition of the word: “the neglect or omission of expected or required action”. Ultimately, if the primary objective was to harmonise the European market then T2S has been successful. However, the proposed benefits went deeper than the infamous harmonisation tagline used to justify the project. Cost reductions, increased volumes, real cross-CSD settlements, improved corporate actions and collateral management processes, liquidity benefits and lower safekeeping fees were all touted as positive side-effects. Some of these objectives have yet to be met, and given the time and money spent on the initiative, frustrations have been voiced frequently. The definition of success is “the accomplishment of an aim or purpose”, so right now we cannot herald T2S as an undisputed triumph.

Derenbach believes however, that T2S was a facilitator for some of these benefits as opposed to them being primary objectives of the project.

“Either people were misrepresenting what T2S was able to do or expecting things from an infrastructure that it wasn't supposed to do,” he explains.

“T2S is a conduit. It facilitated the foundation for us to be able to do some of these things. For the prime broker, for the global custodian, they want to see more. It's not something T2S can deliver but it's something it can facilitate.

“Let's use this harmonisation and build these services on top. One of my statements has been to say 'build it and they will come' but with my slight modification to make it 'enhance it and they will come'.”

Have we come too far?

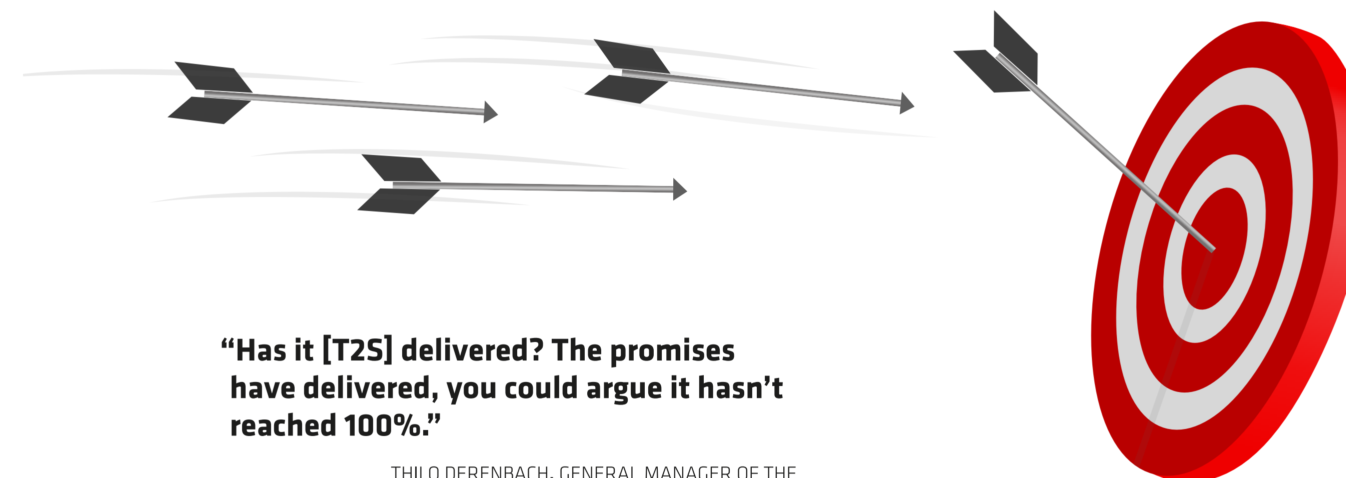
Across the securities services industry there remains a “we've come too far to go back” mentality whereby most of the stakeholders in the project have to stand by the initiative. But the evidence they present to support the project speaks for itself, the costs per settlement are now lower and there is market harmonisation, but plenty of participants have footed the bill so far, without a return on investment just yet. Whether it's a success or failure might depend on which angle you are assessing it from.

“Whether it was a success or not really depends on what you are judging it on,” says Virginie O'Shea, research director at Aite Group. “From the perspective of the ECB - it works and it does what it is supposed to do to some extent. It brought some markets into alignment with each other, so it didn't come out as much of a cost saving, but more of a harmonisation.”

BNY Mellon says from its own perspective, T2S has fulfilled its promise and benefitted both its own business model and the industry.

“T2S has largely delivered on its promise and when I say that I mean its promise for us,” explains Tom Casteleyn, head of product management for custody, cash and foreign exchange at BNY Mellon. “Firstly, the standardisation of settlement, but it has also given us a framework for standardisation of other parts of the post-trade value chain. While it hasn't come up with a unified way to do registration in Europe yet, it has given us a framework to do that and there are initiatives on the way especially on corporate actions. If it wasn't for T2S we wouldn't be where we are to standardise in Europe.”

> **“If it wasn't for T2S we wouldn't be where we are to standardise on Europe.”**
>
> TOM CASTELEYN, HEAD OF PRODUCT MANAGEMENT FOR CUSTODY, CASH AND FOREIGN EXCHANGE, BNY MELLON



> **“Has it [T2S] delivered? The promises have delivered, you could argue it hasn't reached 100%.”**
>
> THILO DERENBACH, GENERAL MANAGER OF THE CLEARSTREAM BANKING UK BRANCH

Opinions differ

From a buy-side perspective, speaking at the Global Custodian leaders event in 2016, former Schroders COO Markus Reutimann described the initiative as a project of “compromises and excuses that has missed all its targets”.

Other opinions and views have varied over the years. In 2017, ECB executive board member Yves Mersch stated that various tax and corporate action issues will not be addressed by T2S. At Sibos 2018, John van Verre, head of global custody at HSBC Securities Services, said “10 years later we still have a fragmented CSD structure, we still have no solution for corporate actions, we still have no harmonisation of issuance.”

His comments echoed similar sentiments from the same conference in 2017, where speakers lamented that the industry had “come too far to change” in response to notions of blockchain replacing the current settlement system.

Going back to 2017, some of Global Custodian's headlines included: “Industry participants warn asset safety and segregation issues will restrict proposed benefits of the ECB's T2S initiative.” Along with, “T2S could be unfit for to make use of the expected volume of segregated accounts.”

In a ECB report released in December 2018, Eric de Gay de Nexon, head of strategy, market infrastructures and regulation, Societe Generale Securities Services, commented in the report: “Real cross-CSD settlements remain marginal, volumes are below initial assumptions and total costs have not decreased as anticipated. As for the expansion of service offering, that is still seen as evolving.” The opinions of de Gay de Nexon were one of the only candid answers in an otherwise obvious T2S marketing ploy containing the views of multiple stakeholders.

What his comments point to are that while many of the desired outcomes have not been realised, this is not to say they won't be in the future. There is still room for these benefits to come to fruition, particularly around collateral management and corporate actions.

Collateral opportunities

Moving forward, for example, the ECB is planning to integrate T2S with the TARGET2 cash payments platform for the Eurosystem and to harmonise collateral management by launching the Eurosystem Collateral Management System (ECMS) in 2022, which will harmonise collateral frameworks for central banks.

For the former, T2S could allow banks to pool their assets and securities across markets on a single venue for settlement. These advantages include reduced collateral buffers and optimisation tools.

According to a white paper published by Deutsche Bank in March 2017, collateral and liquidity movements are of 'paramount importance', due to collateral management becoming more streamlined, as well as the need for collateral to meet a broader range of compliance requirements.

In a post-T2S environment, the paper suggested focus should also be on reducing pressure on high quality liquid assets (HQLA). Mobilising domestic cash assets and optimising cash and collateral across markets through a single view of asset pools has been identified as a possible solution to reduce pressure on HQLA.

Both the European Central Bank (ECB) and international central securities depositories (ICSDs) have looked at ways of overcoming these hurdles and improving collateral flows.

The ECMS initiative will have a significant impact on collateral flows within T2S as central banks have seen their role within the collateral management process increase as a result of certain asset purchasing programmes and other financing procedures to banks.

“The collateral management aspect - especially for intra-bank collateral management - will be developed in T2S, and if you look at that in conjuncture of T2 and T2S and introducing ISO 20022 for standards for settlement and collateral messages, you see there is quite a significant harmonisation agenda,” says Casteleyn.

"10 years later we still have a fragmented CSD structure, we still have no solution for corporate actions, we still have no harmonisation of issuance."

JOHN VAN VERRE, HEAD OF GLOBAL CUSTODY, HSBC SECURITIES SERVICES.

On the corporate actions side, there is also room for improvement. A report by the ECB in March 2018 found certain markets have not met standards on corporate actions. In the report, the ECB differences in national rules relating to corporate actions have been identified as one of the most critical barriers to an integrated EU post-trade environment.

Standard problems

The Corporate Action Sub Group (T2S-CASG) was formed in-line with the new system to focus on developing market claims and transformations, and continues to try to tackle the corporate actions standards issues.

"Standards problems are underlying it [T2S], and to get that fixed there would have to be a regulatory mandate and there simply aren't enough mandates out there," adds O'Shea.

"The biggest opportunity was placing regulation and the project together more closely, there would have been less costs and more adherence if CSDR had come in at the same time."

One of the biggest differences in technology now compared to 2006 is the arrival of distributed ledger technology (DLT), and naturally the use of this has been linked to T2S.

A report from Standard Chartered in 2016 added fuel to the fire when it suggested blockchain could potentially replace T2S if the technology developed exponentially quickly.

"T2S was built around the world when they started that lengthy process, but the world is changing," says Tom Wooders, head of clearing solutions at GPP. "Blockchain has the potential to revolutionise this part of the industry. Traceability, transparency, automation that's what DLT could bring to the table and therefore one has to wonder whether this is an area where new solutions could come to the fore.

"T2S was built around the world when they started that lengthy process, but the world is changing. Blockchain has the potential to revolutionise this part of the industry."

TOM WOODERS, HEAD OF CLEARING SOLUTIONS, GPP

With the projects going on around the world using DLT – proxy voting, settlement, ASX replacing its post-trade systems – the technology has been pretty much suggested as a solution to any industry problem. Some have dismissed its intervention when it comes to T2S though.

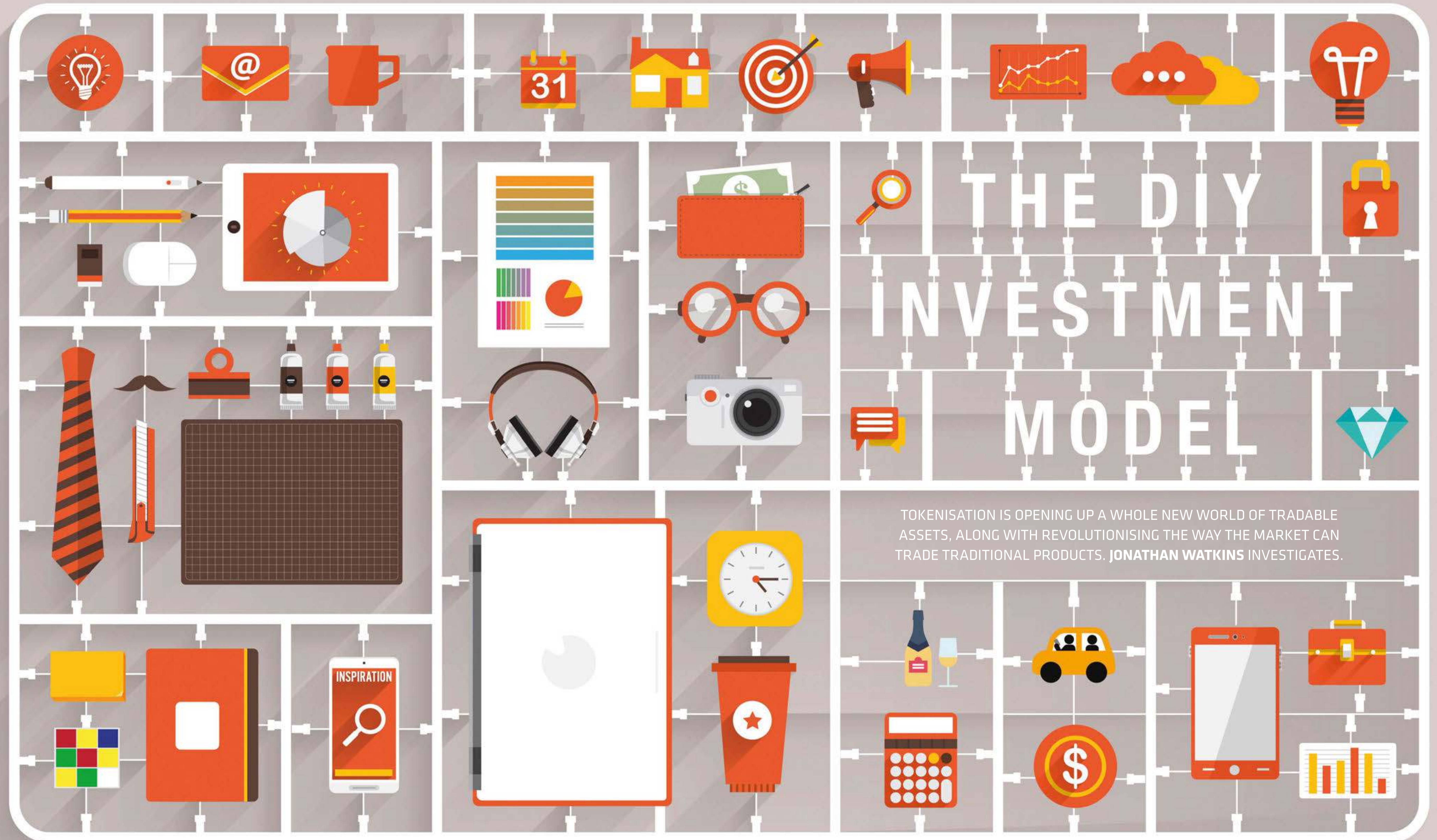
"DLT is a step too far," adds Casteleyn. "There is no proven implementation of that scale and scope that would justify that decision. It would have been investigated but personally I don't think if you would start such a project today you would concentrate solely."

The ECB has also warned adoption of blockchain technology in post-trade processes could destabilise its pan-European securities settlement platform. While benefits of DLT in the securities settlement and asset servicing process can be seen, there would be issues harmonising DLT platforms with the principles of T2S.

"An instance where DLT solutions currently under development appear to be diverging from standards agreed in the T2S community is that of securities and cash account numbering, where the use of public keys to identify DLT users may diverge from T2S agreed standards," the ECB said in its report.

So the chest has been opened and the elements of T2S to assess have been released for judgement by the market. The ultimate goal of harmonising the European settlement market has been a success, but it took a long time and a lot of money to get there, while issues remain around corporate actions standards, the lack of harmonisation regarding withholding tax relief procedures, the differences in supervision of securities issuance and many of the touted benefits not yet realised.

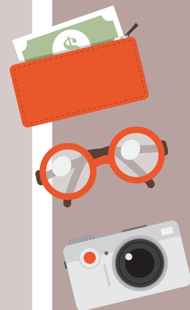
[COVER STORY | TOKENISATION]



THE DIY INVESTMENT MODEL

TOKENISATION IS OPENING UP A WHOLE NEW WORLD OF TRADABLE ASSETS, ALONG WITH REVOLUTIONISING THE WAY THE MARKET CAN TRADE TRADITIONAL PRODUCTS. **JONATHAN WATKINS** INVESTIGATES.

[COVER STORY | TOKENISATION]



What if I told you the portfolio of the future could contain horses, artwork and Beyoncé tickets? If your first thought is 'who is Beyoncé?' then I suggest spending more time away from your desk. But if your response is 'that sounds interesting, how could this possibly occur?' then read on as we're about to explore how tokenisation is set to open up a whole new world of trading non-bankable assets, along with adding efficiency to existing products.

Let's say you wanted to invest in real-estate without fronting up a whopping six-figure sum; well tokenisation is a method that converts rights to an asset into a digital token. So theoretically a $500,000 apartment could be divided up to 50,000 tokens, allowing for fractional ownership. Underpinned by blockchain technology, which would ensure irrefutable records of ownership, these tokens would be issued on a platform supporting smart contracts allowing them to be traded.

> "We can build compliance into these smart contracts, so that you don't need a headcount of hundreds or thousands."
>
> JOSEPH LUBIN, CEO, CONSENSYS

This could work with anything from a Monet painting to fine wine where assets can be broken down into pieces – digitally of course, please don't attempt to tear a Monet to pieces and claim Global Custodian told you to do so.

"We've had all these different kinds of instruments that need to trade on their own specialised kinds of markets," explains Joseph Lubin, CEO of Consensys. "We are starting to realise all these instruments in essentially the same form whether it's a cryptocurrency, a debt instrument, an equity, or a Beyoncé ticket, it's all just one of these cryptographic tokens."

New investment opportunities

This is uncharted territory for a financial industry where new products have been few and far between over the best part of a century. The emergence of exchange-traded funds and cryptocurrencies have been eye-openers, but exposure to movies, museums and diamonds will be something else entirely.

"Everything that was not in the reach of the financial industry now becomes something you can start looking at," says Valerio Roncone, head of product management and development at SIX, which announced a new initiative to create an integrated infrastructure for the digital asset value chain back in July. "Take an art gallery or museum, today the museum has to go to the government to ask for money, tomorrow the museum can tokenise a part of its collection and the public can buy it. You can have a token against it and that token can be traded and integrated in your portfolio, you own a share in something you would not have been able to have to this extent in the past."

While this may sound similar to the way shares are traditionally bought and sold, it's the underlying technology which sets it apart. Ledger technology allows any form of value to be transferred at low cost, in real-time and in a trustless environment, with KYC/AML issues taken care of through smart contracts. It also removes many of the intermediaries and complexities in the process, opening up these asset classes to new customers and blurring the lines between public and the more traditionally bilateral private markets. Ownership information, rules and enforceable rights are coded into the distributed ledger in the form of smart contracts. Through DLT, movements and authenticity can be reliably and securely tracked and verified.

"We can build compliance into these smart contracts, so that you don't need a headcount of hundreds or thousands and financial institutions and you can specify how different instruments can trade and then there will be no reason why I can't buy Apple stocks with my Beyoncé ticket at some point in the future," adds Lubin, known as one of the founders of Ethereum.

Custodians take their stance

Matthew Pollard, co-founder and CFO of Archax, an institutional digital asset exchange, writes that through tokenisation "the act of transferring an asset from seller to buyer is simplified."

"Transactions on a distributed ledger lessen or remove the roles of the intermediaries historically used to facilitate the transaction," he adds. "It reduces costs, increases transactional velocity and helps price discovery on assets that may have historically suffered from liquidity discounts. Put simply, as an issuer, this technology should drive down the cost of capital and reduce liquidity discount."

Custodians are already backing tokenisation as the future with support for the notion already voiced by the likes of Standard Chartered, State Street and SIX Securities Services.

"There are a lot of assets that are not very tradable and not very liquid, but by their nature they are 'old world' assets, real estate for example," explains Margaret Harwood-Jones, global head of securities services, Standard Chartered. "If you can create them in a digitised form, then in terms of marketability and tradability they move to a very different league.

"We are working with the financial markets business at the bank on another such opportunity where they have structured finance products which we are turning into digitalised form to allow for more effective trading around those instruments."

So in its most simplistic form you take an asset, tokenise it and then create a digital representation through distributed ledger technology, with the clear benefits being a lower barrier to entry, a secure and efficient underlying technology and a liquid asset.

Real-life examples

Whether this will take place through an existing market infrastructure or pave the way for disruptors to truly carve out a space for themselves in modern finance, only time will tell. Both will likely bid for their places in this new ecosystem, as we await to see who will issue these tokens in question.

A real-life example of tokenisation occurred with Andy Warhol's 14 Small Electric Chairs artwork, which was sold to qualified participants on Maecenas, an art investment platform built on blockchain, in the private beta launch of the platform. The multi-million-dollar piece attracted over 800 sign-ups within weeks and the auction raised $1.7m for 31.5% of the artwork at a valuation of $5.6 million.

Maecenas tokenised 14 Small Electric Chairs by converting it into tamper-proof digital certificates or "fractions" based on the Ethereum network. Buyers then purchased fractions of 14 Small Electric Chairs with Bitcoin, Ether or the ART token, a cryptocurrency created for Maecenas.

Tokenisation is not confined to these non-traditional assets either, with equities, bonds and commodities also primed for this feasible system of the future.

> "Today the museum has to go to the government to ask for money, tomorrow the museum can tokenise a part of its collection and the public can buy it."
>
> VALERIO RONCONE, HEAD OF PRODUCT MANAGEMENT AND DEVELOPMENT, SIX

"The numerous benefits for tokenising assets on distributed ledger technology (DLT) are generally speeding-up transaction times, improving transparency, streamlining business processes, and reducing costs," explains Michael Tae, corporate vice president, corporate strategy, Broadridge Financial Solutions. "But specifically for institutional investors, I would breakdown the benefits into three key areas. First, investors gain significant operational efficiencies into the markets across the trading and post-trade lifecycle of the securities industry. Secondly, increased portfolio liquidity and velocity of alternative assets via improvements in areas such as collateral management. And lastly, from the creation of new avenues for capital generation."

> "There are a lot of assets that are not very tradable and not very liquid, because by their nature they are 'old world' assets."
>
> MARGARET HARWOOD-JONES, GLOBAL HEAD OF SECURITIES SERVICES, STANDARD CHARTERED

But unlike the Warhol example, in the case where you have tokenised an existing tradable asset such as an equity or bond, how do you settle in a fiat currency across multiple markets and time zones?

STOs to be the talk of 2019

"On the one side you have a token for the digital asset," explains Tom Zeeb, head of securities and exchange services, SIX. "If you digitalise the fiat currency, create a token out of sterling or euros or Swiss francs or dollars by segregating the underlying currency in a CB account, then you can settle real time, instantly, without having a liquidity gap and you can also go across time zones."

This is similar to the broad principle underpinning depositary receipts, the difference being that the account holding the fiat currency is under the control of the central bank and the resulting tokens would be used purely for settlement purposes and not tradable in their own right.

Tokenisation is also being used to raise capital as an alternative to a costly and complex initial public offering (IPO). With initial coin offerings (ICOs) coming under scrutiny from regulators and feeling

less familiar to traditional investors, suddenly security token offerings (STOs) have become the latest revelation born out of the cryptocurrency world.

"The numerous benefits for tokenising assets on DLT are generally speeding-up transaction times, improving transparency, streamlining business processes, and reducing costs."

MICHAEL TAE, CORPORATE VICE PRESIDENT, CORPORATE STRATEGY, BROADRIDGE FINANCIAL SOLUTIONS

Unlike ICOs, these security offerings are tied to something with intrinsic value, something easy to explain to an institutional investor, and also a regulator. Like their ICO counterpart, it's still a process of producing a token through a public offering to enable funding, but more akin to the real world of purchasing a share as its backed by a 'real-world' asset while it can also carry voting rights, decision making, or even dividends.

"STOs hit that sweet spot in the middle, they make the market more efficient and it means there are less middle men," explains Hirander Misra, CEO of GMEX. "You're creating asset packages with different STOs: think of it as an ETF backed by assets, you create a NAV on the fund on the value of those assets that are underlying. Equity-related STOs are one component, the other is gold, the other is stablecoins. Based on high-risk, low-risk, medium-risk you can package them accordingly. You get a diversity of assets.

"Family offices aren't FinTech guys, they don't know the difference between good and bad ICO. They do understand equity and value...when you talk about the merits of STOs and link it back to private equity for example, you are talking a language they are understanding."

Evidently one of the major benefits is being able to mobilise assets that have been traditionally difficult or complicated to move, with some of the aforementioned new asset classes exemplifying this.

Solving collateral mobility

A consortium of banks, custodians and market infrastructure providers are also looking at applying tokenisation to collateral, to solve some of the widespread costs of collateral mobility.

The system using tokenisation to reduce eye-watering costs of moving high quality liquid assets (HQLA) could even be ready at the start of 2019.

HQLAx is a securities lending platform using R3's blockchain technology, supported by Deutsche Boerse's Clearstream and six banks including Goldman Sachs, Credit Suisse and ING.

The initiative allows collateral to stay fixed with the legal entitlement moving and being held for safekeeping by a custodian.

Following a successful securities lending transaction on the platform at the start of March between Credit Suisse and ING, HQLAx is now looking ahead to the future with sights on receiving clients on the platform at the start of 2019, with actual use of the service likely taking place early next year.

Mobilising high quality liquid assets has become a huge burden and cost for the securities services industry, but those involved in HQLAx believe

"Family offices aren't FinTech guys ...when you talk about the merits of STOs and link it back to private equity for example, you are talking a language they are understanding."

HIRANDER MISRA, CEO, GMEX

that by creating a token so that the securities don't physically move themselves will solve widespread problems, along with creating a tradable new asset class.

Speaking to Global Custodian on the side-lines of Sibos 2018 in Sydney, Philippe Seyll, co-CEO of Clearstream Banking, explained the taking-off point for the platform will be to onboard a major player with tri-party capabilities.

"There has to be more than one custodian with a tri-party capability operating on HQLAx. We are in advanced discussions with two global custodians of potentially onboarding them onto the platform," said Seyll.

"We are planning to be ready with HQLAx by the end of the year, and could see the first live transaction between a global custodian take place in the first quarter of next year."

What place Bitcoin and cryptocurrencies have in the financial markets of the future is uncertain, but the underlying blockchain technology is ushering in a new era for the capital markets. Custodians are readying themselves for this wave of tokenisation in a sign that this could be the future, and one they want to be a part of.

[C S D R]

CSDR: the final countdown

Tony Freeman, executive director of industry relations at DTCC, outlines how ready the industry is for CSDR and the incoming Settlement Discipline Regime (SDR).

The CSD Regulation has been a slow burn. Conceived after the financial crisis and enforced legally since 2014, it's been a very long time coming. To most of us CSDR has had – so far – no direct impact. European CSDs, of which there are still about 40, have had to register and comply; however, this largely has been a technocratic exercise.

This will all change in September 2020, when the wider impact of CSDR will become apparent. Following a two year lead-in, the Settlement Discipline Regime (SDR) will come into force. The SDR is the CSDR component that aims to improve settlement efficiency in Europe, and its scope is wide.

CSDR is designed to harmonise settlement standards and promote competition, plus a key objective is to improve settlement efficiency. As the CSD market in Europe is not at all homogenous, there is no official data designated to quantify settlement rates for the region as a whole. Individual markets do publish their own data; however, the methodologies used to gather the data are not harmonised and therefore, the data is not suitable to create a blended figure.

CSDR's unofficial – but obvious – aim is to raise settlement rates from about 97.5% to more than 99%. This target has never been explicitly stated in the legislation or any of its accompanying documentation, probably because it's hard to manage what can't be measured. The numerous structural differences between Europe and other – supposedly similar – markets result in invidious comparisons, but the policy objective is for settlement efficiency rates to match those achieved in the US. Some markets in Asia present another target as settlement fails are almost unheard of in that region.

So, how ready is the market for CSDR? With 15 months to go, it may seem like there's plenty of time to prepare, but this is probably a false assumption. Market change of this scale requires industry collaboration. It's always valuable if an individual firm improves its processes, but when the market as a whole works together, the benefits are exponentially more powerful. The successful move to T+2 in 2014 was a similar initiative which required industry collaboration; and since the financial crisis, there have been several examples of positive change facilitated by a collective approach in the derivatives markets.

The most productive way to prepare for the SDR is an analysis of the causes of failed trades. If a trade does fail, there are three issues that will arise: financial penalty, the management of a possible buy-in process and relationship fall-out. Regarding penalties and buy-ins, there is no discretion allowed and no size thresholds apply. The penalties may not be large in value, but the administrative burden will be high. But perhaps the biggest issue is the potential impact on relationships, because when a trade fails, someone has to take responsibility for the failure. This could lead to some difficult conversations between clients and their brokers and custodians about who should cover the cost of a failed trade.

So, what are we hearing from our clients about industry readiness? It is alarming that some buy-side firms, even in Europe, still have no awareness of the SDR, and in the Americas and Asia-Pacific there remains very limited awareness of the regulation's global reach. Like MiFID II, the SDR is extra-territorial, meaning anyone holding European stocks is impacted. Similar to T+2, the

SDR has no centralised project management, and there exists no coordinated campaign to raise industry awareness. Preparations are entirely left to market participants, to educate and coordinate amongst themselves.

Some buy-side firms have stated that they are looking to their brokers and custodians to come forward with solutions, indicating a failure to acknowledge the community aspect, and of even more concern is that this passive point of view demonstrates that buy-side firms do not recognise their role in collaboratively tackling CSDR's directives. We are also hearing from multiple investment managers that they view inventory management by broker dealers as the root cause of failed trades and it is widely believed that securities lending is mostly to blame.

The truth is, the market is highly interconnected and all participants are responsible. With not much more than a year to go before the implementation deadline, now is the time to start analysis and preparation. There is some evidence that broker dealers have started industry outreach; however, this is less visible amongst the custodian community. An optimistic view would be that collaboration and preparation are happening behind closed doors, but with little evidence of this, it appears that the industry has a long way to go to close the gap by September 2020.

What's in a name?

Are distinctions between developed, emerging and frontier markets still useful?

> "[A market] might be seen as an emerging market because of its fundamentals, but not from the perspective of capability or operations. There are many lenses that you can use."
>
> CHARL BRUYNS, HEAD OF INVESTOR SERVICES, STANDARD BANK GROUP

What is an emerging market? The term after all suggests an economy in transition from one state to another, but the divisions between developed, emerging and frontier markets by those who use them to create investable indices have seen remarkably little movement of individual countries from one category to another.

Organisations such as MSCI, S&P and FTSE Russell all have solid metrics behind their rankings. The MSCI Emerging Markets Index, perhaps the best known in the investment world, represents the performance of large- and mid-cap securities in 24 Emerging Markets. It is built using MSCI's Global Investable Market Index (GIMI) methodology, which is designed to take into account variations reflecting conditions across regions, market-cap segments, sectors and styles.

As of March 2018 it had more than 830 constituents and covered approximately 85% of the free float-adjusted market cap in each constituent country.

The MSCI Market Classification Framework involves three broad criteria: economic development, size and liquidity as well as market accessibility. In order to be classified in a given investment universe, a country must meet a specific set of requirements in all three criteria. Market accessibility, for example, aims to reflect international investors' experience in investing in a given market.

Indices such as those produced by MSCI are used by professional investors for investment analysis, performance measurement, asset allocation, hedging and the creation of a wide range of index derivatives, funds, ETFs and structured products.

For Charl Bruyns, head of investor services at Standard Bank Group, headquartered in South Africa, a distinction can be made between markets as investment destinations and the operational framework and infrastructure of the markets. These do not always coincide, he suggests.

Some of the distinction has to do with the nature of purchasing decisions. "The way I look at it, clients really buy the exposure they want," says Bruyns. Some investors, for example, buy according to the MSCI indices and then allocate their money according to the weightings in the index concerned.

But do banks and investment managers share the same concepts of risk? In buying services, for example, banks and broker dealers will often look for solutions through corridors and regions. When it comes to custody for example, broker dealers seeking high volume opportunities will come through a corridor to access those opportunities, while an investment manager wanting exposure on a portfolio is more likely to look at distinctions between market classifications according to an index provider.

A global custodian looking for service providers in a region may be looking at operational criteria that are not reflected in the indices. Bruyns takes the example of South Africa itself. "From a market maturity perspective, it's up there with the top international markets," he points out, "It might be seen as an emerging market because of its fundamentals, but not from the perspective of capability or operations. There are many lenses that you can use."

Illustration: iliveinoctober

In addition, says Bruyns, if you look at the size of the market versus GDP, South Africa is relatively mature. "In start-up markets, GDP is really driven by other areas of growth," he says. "A large contribution from financial markets suggests a mature market." For these reasons, Bruyns is sceptical of the decision by Global Custodian magazine in 2018 to move South Africa from its major markets to its emerging markets agent bank survey.

Margaret Harwood Jones, global head of securities services at Standard Chartered, makes a similar distinction between investment and operational services, though, she says, "The distinction is still very relevant to many of our clients as these classifications are used as the backbone of their investment appetite, suitability and strategies."

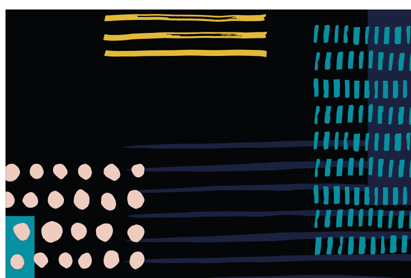
As a custodian in many emerging and frontier markets, she notes, "There is direct – almost mechanical – correlation between transactions volume spikes and indices re-balancing. The intensity of these peaks can be quite extensive when a low volume/ low assets-under-custody frontier market is re-classified as an emerging market, such as last year Pakistan's upgrade into the MSCI emerging market index. "

At the same time, the nuances and boundaries between emerging and frontier markets are becoming a little less prevalent from a post-trade perspective, she says: "We are observing an increased trend in advocacy for more alignment of local practices with global standards at securities market infrastructures ("SMI") such as Central Securities Depository and Stock Exchanges. More mature SMIs also leverage their expertise and create joint ventures or partnerships to further develop newer securities markets (e.g. Korea Exchange and Cambodia exchange)."

In some cases, the distinction between emerging, frontier and nascent markets does not provide a clear guide to where market opportunities lie. Standard Bank covers over 14 markets in Africa and continues to expand even where foreign access is yet to be confirmed. Not all of these markets will individually generate sufficient activity to justify stand-alone investment in capability, but should be seen as part of a bigger picture.

In some markets, given their size, the economics may not at first glance appear to stack up, but if you really want to be a reliable regional bank for your client base, you have to recognise that they want a regional capability. Secondly if a bank that is established were to pull out of a market, it would send the wrong message and open up opportunities to competitors. "We need to look at these markets in the longer term and help enable them to grow. Exiting would make that more difficult," says Bruyns.

There are some markets that may currently be sub-scale, but where efforts are evident to support the growth of a savings industry, a necessary underpinning for longer term success. The domestic savings industry should dominate at least 60% of the market, with perhaps 40% foreign investors coming in. But if that 60% local participation is missing in the market, the huge dominance of foreign investors brings the possibilities of sustainable growth into question, not to mention



"There is direct – almost mechanical – correlation between transactions volume spikes and indices re-balancing. The intensity of these peaks can be quite extensive."

MARGARET HARWOOD JONES, GLOBAL HEAD OF SECURITIES SERVICES

the risk of added volatility driven by by foreign investor sentiment.

There are four key questions in this regard, says Bruyns. What is the local savings industry doing? What savings products are coming onstream? What are the pension fund regulations? And what moves are there to stimulate more liquidity into the market? "Those are the things that keep us interested in engaging," he says. "Of course, custody will be the basic product and then we'll start moving up the value chain with more product capability, but we'd need to see a sustained potential for the capital markets growth to invest in a significant capability."

From an operational efficiency perspective, there are grounds for optimism in some of the emerging and frontier markets, whether long-established or with little or nothing in the way of legacy. Harwood-Jones suggests that new technologies, with lower entry costs, can help these markets to leapfrog some of their more developed peers. She points to West African markets such as Ghana and Nigeria that are very actively looking at distributed ledger technology proof-of-concepts in the securities space. "In ASEAN, too, markets like Thailand, Singapore, Indonesia and Malaysia have or are in the midst of shortening their settlement cycle to T+2 as they upgrade their platforms, often with SWIFT Standards," she says.

She adds that the emergence of regional and global players can bring further consistency of service across developed, emerging, frontier, and next frontier markets thanks to the implementation of single common custody and asset servicing platforms.

"As these markets are moving through the stages of maturity, we also expect an increase in efficiency and product availability such as securities lending and short selling, e-voting solutions for proxy voting, along with reduction in settlement cycle and overall more real-time data flow," says Harwood-Jones. "Other considerations such as openness to foreign ownership, ease of capital inflows and outflows, foreign exchange (FX) liquidity, efficiency of operational framework, competitive landscape and stability of the institutional framework, along with solid corporate governance and investors transparency principles, can be more challenging."

To be or not to be

Do such challenges mean that on occasion, a securities services provider will reluctantly have to forego the opportunity to open a new market? Harwood-Jones makes the point that, while major indices providers already have broad coverage of emerging and frontier markets, there are still many countries that do not yet qualify according to the criteria of economic development, market size, liquidity, and accessibility, despite having stock exchanges. "There would indeed be cases where we would not yet enter a given market," she says. "This is due to factors such as smaller market cap, low liquidity, low volume, very little or nascent market infrastructure. These markets would also pose higher risk of post trade inefficiencies".

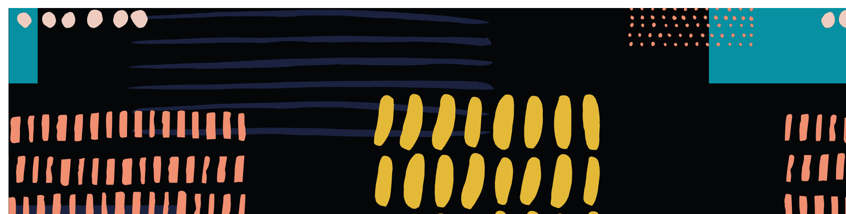
Even with the benefit of scalable and highly market-adaptable custody platforms, she says, "The cost of entry can still be prohibitive against the business case and limited client demand, when considering the capital costs of setting up local branches or subsidiaries, together with onshore operations and infrastructure."

For Harwood-Jones, there are instances where a local market and regulatory environment, "may not meet our strict internal standards in terms of asset safety protection, financial crime compliance, anti-money laundering, or ensuring that local regulations do not have unnecessary barriers for cross-border flows."

As countries move through the stages of development, she suggests, "They would become more transparent and attractive to foreign investors and their service providers, such as Standard Chartered, who can share their expertise in international best practices via their thought leadership and advocacy activities."

Engagement in a particular market may not be an all-or-nothing proposition. "Given the level of international regulations to protect the investor, if I'm not happy with a market infrastructure and capability to start active investor services, I may nevertheless establish some presence as I see things moving," says Bruyns. "But I've also had demands for a market where I've said, 'I can't provide the desired level of service in this market for these reasons, so if you come into this market, there is a risk on you that you have to make sure is properly documented and contracted with your investors."

"As a custodian, I don't necessarily see the end-client," says Bruyns. "I may not know if it's a big private investor with a large portfolio who wants to be first into the market or if it's an alternative investment fund or a pension fund, unless the bank tells me. If they're a long-term investor and all they want is custody and coupon collection on government securities, we may be able to provide that."



[MARKET REVIEW | EUROPEAN CLEARING]

CLEARING TAKES CENTRE STAGE

AS BREXIT THREATENS DERIVATIVES FRAGMENTATION

London stands to lose a significant amount of clearing business from European derivatives traders as a result of Brexit. How will this fragmentation affect Europe's clearing landscape, asks **David Whitehouse**.

[MARKET REVIEW | EUROPEAN CLEARING]

London has dominated European swaps and futures clearing, and clearing houses, such as LCH, ICE Clear Europe and LME Clear, are key institutions in the financial system. Scale has been key in the long process through which this dominant position was achieved. Markets, though, need and demand certainty, and the process of Brexit has done anything but deliver it.

UBS has estimated that LCH, the London clearing house owned by the London Stock Exchange, is likely to lose at least 25% of its euro clearing volumes as a result of Brexit. Deutsche Bank, Barclays, and HSBC have all moved some of their euro-denominated clearing business to the continent. Will this fragmentation continue? What will the derivatives clearing industry look like in five 10 ten years time?

The equivalence path

London has benefited from its access to the European Economic Area (EEA). By using a UK licence as a European "passport", foreign firms can offer services throughout the EEA. A disorderly Brexit would risk the loss of UK "passporting" rights and access to these clearing systems. FIA, the trade organisation for the futures, options and centrally cleared derivatives markets, has warned that the reciprocal loss of derivatives market access for businesses based in the UK and the EU in a no-deal scenario could lead to a significant increase in costs for pension funds, asset managers, insurers and corporates.

> "There is a significant pipeline of new pension fund, asset management and hedge fund clients who are coming on board."
>
> MATTHIAS GRAULICH, MEMBER OF EUREX CLEARING EXECUTIVE BOARD.

The Bank of England (BoE) estimates that EU-based companies have over-the-counter derivatives contracts with a notional value of £69 trillion at UK clearing houses. The BoE warned last October that derivatives contracts maturing after Brexit would be at risk unless regulatory certainty was addressed. The nightmare scenarios seem to have been avoided, at least for the moment. The European Commission's decision in December to agree a temporary one-year equivalence for UK central counterparty clearing houses (CCPs) has reduced the immediate risks.

Clearing houses are meant to reduce the risk of a domino effect of defaults if party to a contract fails to pay. They have grown in importance since the 2008 financial crisis, after which the G20 made it mandatory to settle most derivatives trades through them.

Rafael Plata, secretary general of the European Association of CCP Clearing Houses (EACH), which represents 19 central counterparty clearing houses (CCPs) in Europe, believes the one-year equivalence measure is "a step forward for financial stability and very much welcomed." But, he says, it's only a first step.

The next step is recognition by the European Securities and Markets Authority (ESMA) for UK CCPs. ESMA has recently granted recognition for LCH, ICE Clear Europe and LME Clear in the case of a no-deal Brexit. Clearing houses, Plata stresses, can't function without mutual recognition. A disorderly Brexit and lack of permanent mutual recognition would be "especially difficult" for ongoing derivatives contracts, as marking to market would be much harder, and contracts might come to be seen as unsafe. Plata wants ESMA to provide temporary recognition for UK CCPs, which ESMA has a mandate from the European Union to do. He stresses that the UK also needs to provide recognition to EU CCPs. "It's a two-way street," he adds.

Shifting rationales

According to Marc Giannoccaro, head of development, execution and clearing at CACEIS Investor Services in Paris, the heavy defeat of Theresa May's Brexit plan in parliament in January has left a situation of "complete uncertainty. The number of possible scenarios for Brexit is very large." The one-year equivalency, Giannoccaro argues, is in itself a source of uncertainty. He says that it would be "absurd" if permanent equivalency was not the ultimate result of negotiations.

Giannoccaro doesn't expect dramatic short-term changes in derivatives clearing. In the case of interest-rate swaps, he says, France has found that there are many technical and liquidity problems involved in creating new capabilities and transferring existing positions. "It's not as easy as that to build from scratch. Listed derivatives are a silo as they have to be cleared on the spot," Giannoccaro notes

However, the economic rationale for euro-area institutions offering derivatives clearing in the UK will start to change. To be able to continue to offer listed derivative clearing services in the UK, CACEIS is obliged to study the creation of a new funded unit in the UK for which there is little or no economic or industrial rationale. This would mean more systems and personnel would be needed, and the risk for the industry as a whole is that costs for the client will increase. "Access to the UK market will become more expensive. There is a risk that clients will decide to invest elsewhere," explains Giannoccaro.

Philip Forkan head of derivatives, clearing and collateral management at WSNGC, a consultancy for banks and brokers, agrees that Brexit uncertainty has created concerns about bottlenecks. The one-year equivalence agreement, he says, "gives more of a window" and will help to ensure that the cliff edge is avoided.

"UK-domiciled funds, are currently experiencing outflows which are going into euros and dollars instead. The need for portfolio rebalancing means that the uncertainty is leading to an increase in derivatives volumes," Forkan says.

Forkan doesn't anticipate that Brexit will lead to market disruption. "Derivatives markets are quite robust," he says, but what the markets need though is "certainty and clarity – even if it's not good news."

He does predict a long-term process of fragmentation which could become self-reinforcing. "Clearing will be more regionally than centrally-based. Once fragmentation starts, it becomes easier to break down existing positions," Forkan adds. Many countries, for example the US, may want to claw back clearing in their own currencies. US institutions such as ICE, he says, are "looking at this very intently."

Behaviour changes

One company that hopes to benefit from Brexit is Eurex, the derivatives exchange owned by Deutsche Börse. Eurex has targeted a 25% share of euro-denominated swaps by the end of 2019. It remains difficult to say exactly when the target will be reached, says Matthias Graulich, a member of Eurex Clearing Executive Board. "There is nothing natural about a year-end when a new market is being built."

However, Graulich explains the euro-denominated swaps business is progressing well, and Eurex now has a market share of 11%. January was a record month with average daily volumes of about €140 billion, compared with €50 billion in 2018. Long-dated swaps also saw their largest-ever average daily volumes in January. "There is also a significant pipeline of new pension fund, asset management and hedge fund clients who are coming on board," Graulich says.

> "Derivatives markets are quite robust but what the markets need is certainty and clarity – even if it's not good news."
>
> PHILIP FORKAN HEAD OF DERIVATIVES, CLEARING AND COLLATERAL MANAGEMENT, WSNGC.

The Eurex programme, under which derivatives clearing profits are shared with the users, has definitely helped in achieving this. The profit-sharing programme has helped to make bid-offer spreads on Eurex fully competitive with those on LCH, Graulich argues. Brexit also helped, which he adds has "stimulated a thought process about what to do in case of a hard Brexit."

The Brexit process brought to the fore underlying issues which had lurked in the background, such as risk diversification and the need for greater competitiveness, he says. "Brexit required people to take action." This process has now become independent of the specific final outcome of Brexit. "It's clearly good from an overall systemic risk perspective," says Graulich.

Political brinkmanship over derivatives clearing is likely to continue, and even if the politicians tacitly agree that the worst scenarios will be avoided, markets are unlikely to be willing to tolerate indefinite uncertainty.

> "Access to the UK market will become more expensive. There is a risk that clients will decide to invest elsewhere."
>
> MARC GIANNOCCARO, HEAD OF DEVELOPMENT, EXECUTION AND CLEARING AT CACEIS INVESTOR SERVICES.

Karel Lannoo, chief executive of the Centre for European Policy Studies in Europe, sees signs of financial behaviour already changing, with LCH moving business back to Paris. For derivatives clearing, he expects "more fragmentation overall, and hence more cost. For 20 years the UK has played the game of economy of scale, and they risk losing it." While Lannoo has no doubt that London will remain the most important European financial centre, he expects that there will be a process of attrition through the prolonged uncertainty, and that in three years time, derivatives clearing in London will be "scaled down from today."

"There is a business logic to pooling products in the same currency," argues Graulich. Eurex has sought to position itself as the incumbent for euro-denominated products, and, in the long term, Graulich expects this logic to triumph regardless of Brexit's final form. "People will see that these efficiencies are superior," says Graulich, and expects Eurex will take a significant portion of post-Brexit derivatives clearing as a result. By the same logic, he says, dollar-denominated swaps may in the future be increasingly cleared in the US.

The EU knows that derivatives clearing is not going to move overnight, Lannoo says. Complex combinations of infrastructure and expertise that are hard to find in the euro area would need to be assembled. Derivatives markets can only thrive in the presence of a range of accompanying markets, he notes. But much bigger movement of derivatives business is possible over a longer timeframe of 10 years, and the EU and US both could stand to become the beneficiaries of this.