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LETTER FROM ECSDA TO ECB ON TARGET 2 SECURITIES

The information on the current state of the T2S proposal made available by the ECB in December and January has enabled the members of the ECSDA to form initial views on the feasibility study, the conclusions of which are due to be presented to the Governing Council, we understand, no later than March of this year. This letter sets out some of the key areas where ECSDA believes that there is a need for further detailed work. While it is reasonable that there should not be full clarity on these points at this very preliminary stage in the proposal, there is a lack of clarity around some key aspects of the proposal, its costs and its benefits which need deeper consideration in the feasibility study and a public market consultation before a “go/no go” recommendation to the Governing Council can sensibly be made. The potential impacts for the market and for Europe of this proposal are significant and we believe that it would be inappropriate at this early stage for the ECB to make a firm commitment to implement T2S.

ECSDA is aware of the difficulties faced in the cross-border securities settlement and has always played an active role in delivering effective solutions. Significant results have already been achieved. Barriers identified by the Giovannini Group have been already removed or will be overcome well before 2013. Several projects undertaken by the CSDs have started to provide concrete results. The adoption of the Code of Conduct will give further momentum to these initiatives. ECSDA appreciates that it is also the intention of the ECB to contribute to improving the cross-border settlement process. It is, however, important that we, as an industry, take the time to investigate in sufficient detail the impact of the ECB’s proposals in order to ensure that value will be delivered to the market and to the consumer.

The subjects set out below are the principal ones where further work is required before strategic commitments can be made. ECSDA is prepared to undertake detailed work on some of these and can actively contribute to the debate.

The role of the ECB

ECSDA members continue to be uncertain about the role of the ECB in this proposal. The proposal risks a blurring of responsibilities between the accepted role of the ECB as a public authority and its proposal to become a monopoly supplier of IT-infrastructure for CSDs regarding their settlement services to the securities industry. In order to ensure the feasibility of the proposal, it is essential that the implications of such a potential conflict of roles, and the possible strategies for managing those conflicts, should be considered in greater detail.

In establishing T2S, there is a risk that the ECB could put itself in a position where it combines the roles of a monopolistic supplier of IT-infrastructure for CSDs regarding their securities settlement services and



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regulator of issues impacting the securities settlement landscape. As an example of how such a conflict of roles could impact the market in practice, several ECSDA members have noted the apparent reluctance of the ECB to confirm that, as a public authority, it would not withdraw the provision of central bank money payment services and access to collateralised liquidity from any CSD which chose not to use T2S as IT-infrastructure. Like the ECB, ECSDA believes that if T2S is to succeed it must be because its value proposition is sufficiently compelling and not because the ECB has withdrawn payment infrastructure services from the CSDs which chose not to use T2S as IT-infrastructure. If there is to be competition between public sector and private sector providers, it must be on a level playing field.

More generally, the feasibility study has not sufficiently considered the wider questions of governance and accountability. The ECB is generally held to be the world's most independent central bank. ECSDA believes that this is appropriate for the execution of monetary policy, but that it would clearly be inappropriate for an IT-infrastructure provider. Whereas the ECB is probably exempt from the application of competition rules with regard to its monetary policy activities, we would like to understand the extent to which this may well be applicable to the settlement activities envisaged by T2S.

The discussion of these issues is insufficient in the feasibility study and it is in the interest of the whole market to develop strategies to deal with them effectively and sustainably. The question of governance is also a pressing one in the sense that the decision-making process for the T2S project itself needs to take account of potential conflicts of roles and, of course, needs to be accountable to the wider financial and investor communities. The current proposal is that the only decision making authority should be the Governing Council of the ECB but there is a clear case for developing alternative decision-making approaches in order to strengthen the legitimacy of the ultimate outcome.

More generally, and with some reluctance, ECSDA feels that there have been some features of the current discussions, which fall short of good practice. For example the time given to respond to T2S project papers is extremely short (often only a couple of days); the T2S project has a noticeable tendency to overstate the level of market support; the T2S project's conclusions are heavily based on assumptions, the explanations for which they have not shared with CSDs or market participants; moreover, we note that the T2S project has adopted a stance in several areas of asking CSDs and market participants to disprove its assertions rather than setting out to prove their validity itself.

Legal considerations

There is a contradiction between the ECB's statement that there are no legal problems to be addressed in its proposal and its observation that the law would need to be changed in several jurisdictions in order for it to be implemented. ECSDA members are very much aware of the constraints which apply to themselves in this area and of the difficulties of putting law change on the critical path of infrastructure projects. We suggest



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that the ECB should share its analysis of what law changes would be required in order to ensure that the legal complexity of the proposal has not been underestimated.

ECSDA also questions the ECB's suggestion that securities settlement should be considered as being "ancillary to" the payment: the prime purpose of a securities trade is to transfer ownership of securities and it is the payment which is ancillary, not the transfer of securities. The logical corollary of the ECB's argument is that Article 22 of the ESCB Statute provides a legal basis for the ECB to assume responsibility for the transfer of any asset (whether financial or non-financial) against payment. This conclusion is surely questionable.

Impact on market structure

The ECB states very openly that in order for T2S to be an effective proposition and to deliver a single securities market for the eurozone, it must enable market participants to have a single point of access to the securities of the entire eurozone.

The ECB notes that a prerequisite for achieving single point access is that each CSD moves up the value chain and becomes a "European custodian". ECSDA agrees with the logic of the ECB's comment but does not believe that this will happen. The functions of a custodian are altogether different from those of a CSD in terms of the risk profile involved (including the extension of credit), the need to cope with non-standardised activities with much lower levels of automation achievable and the need to engage in activities normally considered as higher value added than the commoditised services ordinarily provided by CSDs. The custodians above all deliver a corporate event capacity to the investor community which resolves fragmentation between the various eurozone markets. For all CSDs, the change would involve taking themselves outside their traditional area of expertise and into new untested areas and would expose many to substantial investment requirements, and even require changes to the national regulatory environment for some CSDs who are not allowed to offer these services today.

Consequently, we believe that if T2S were to proceed, it would rapidly promote a high degree of internalisation and concentration within the books of a small number of the largest custodian banks. Counter-intuitively (in view of the objectives of T2S to promote the use of central bank money), this would result in a migration of settlement activity from a structure which today (on a domestic basis) is predominantly in central bank money in the quasi-official CSD sector to one in which it is predominantly in commercial bank money both for domestic and cross-border purposes in the private custodian bank sector. Though the historic drivers are different, this would be similar to the Fedwire experience in which, anecdotally, only 15% of US government bond transactions settle on the books of Fedwire itself and the remaining 85% settles in the books of two large custodian banks.



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We do not believe that this market restructuring was one of the original objectives of the T2S proposal, rather that it has become apparent as an unintended consequence as thinking has progressed. This raises policy questions about the concentration of risk, the impact on the competitive landscape, the appropriate regulatory structures and the freezing out of the agent bank, broker dealer and retail constituencies from having direct access to multiple markets. We note the ECB's statements that it is aware of and apparently comfortable with these consequences. However, we believe that it is imperative that these impacts be properly explored and understood (including by European banking and financial services regulators) before the Eurosystem commits to proceed any further with T2S.

The impact of this market restructuring should be incorporated fully into the feasibility study in order to draw reasonable conclusions about the probable revenue base of T2S itself. As it stands, the increased internalisation of settlement which would be likely to result in the books of custodians means that the transaction volume assumptions used in the feasibility study are too high. In addition it is based upon the working assumption that all of the existing euro settlement in central bank money transferred to T2S. Consequently, the revenue base of T2S is likely to be much below the levels assumed.

General considerations on scope, efficiency and risk

To date, the ECB's focus has been on what is within the T2S perimeter. For the most part, while the descriptions provided have been clear, they are still at the level of headings (e.g. "providing matching services", "providing settlement optimisation mechanisms" etc). While there is no reason to assume that the ECB will not be able to provide the required detail in due course, the ECB has yet to acknowledge adequately that T2S would comprise only one part of the process chain. There is therefore a crucial need to address the issues raised along the full length of that process chain. In particular, significant issues arise in relation to the fragmentation of processes which are currently fully integrated in single systems into separate processes in separate systems (the CSDs on the one hand and T2S on the other). This requires an end-to-end understanding of the entire settlement, corporate actions, collateral management and client reporting landscape. This understanding must address the impact of fragmentation from an efficiency, risk and cost perspective and the business case itself must be justified on this end-to-end basis and not, as is currently the case, by reference to what is within the perimeter alone.

In this regard, ECSDA has deep concerns at the way in which the ECB has compared its notional average IT processing costs per T2S transaction of 28 euro cents with the settlement fee of the CSDs. Aside from the question of whether the volumes concentrated on T2S would in fact facilitate a fee of this level, the cost incurred by a market participant would be the sum of the T2S fee, the cost of the additional messaging arising between each CSD and T2S and the fee charged by the CSD for those aspects of the overall



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settlement service which remain within its system. It is this cost which should be compared with existing CSD fees. The comparison being used by the ECB is therefore misleading and needs to be clarified.

Among the key drivers for CSDs in their system developments are to ensure end-to-end efficiency, low risk and low cost. The CSDs have approached the T2S with these considerations in mind and remain concerned at this stage that the fragmentation of functions between the CSD platforms and T2S introduces new areas of inefficiency, risk and cost which have not been properly explored. ECSDA itself is working on these and will share its conclusions with the ECB in due course. These issues are, by their nature, at a detailed technical level and they relate, *inter alia* to the unavoidable increase in complexity, risk and cost resulting from splitting previously integrated function between separate systems and to the ECB's assertions that CSDs do not need to hold securities balances in order to be able to provide corporate action, collateral management and client reporting services. ECSDA will analyse these areas. In the meantime, we believe that it is incumbent upon the ECB to demonstrate that its proposal adequately addresses these problems. At one level, all such issues are capable of being solved by technical solutions. The question is whether those technical solutions can be implemented without any adverse impact on efficiency, risk and cost for CSDs and market participants.

Development and other impacts on CSDs

As its understanding of the implications of the technical features above becomes clearer, ECSDA members individually will attempt to assess the investment costs for themselves to interface with T2S. We note that the ECB has asserted that the total investment cost for all the eurozone CSDs combined would be € 172 Mio. The yearly savings among the CSDs have been estimated to EUR 85 million, a figure that has been based upon the annual reports of the CSDs and the assumption that IT costs can be reduced by 50%. We consider this assumption to be far too simplistic. The development impact on CSDs will vary from one case to another based on a variety of architectural, functional and service level considerations and the CSDs themselves are finding it difficult to assess the impact which each will face given the current level of information available. We therefore consider that the ECB's figure cannot be relied upon as input to a business case at this stage and that the figures must be worked upon by the CSDs themselves.

ECSDA will also consider the long term impact on CSDs' ability to develop their corporate actions, collateral management and client reporting services in a T2S environment. From our own experience, we note that most changes and enhancements to these services touch upon the core processes of securities balances, account structures and book entries at some point. It therefore seems likely that each CSD would have some dependency upon the willingness and ability of the ECB to make adjustments to the core T2S engine in order for the CSDs to continue to develop and enhance those services which remain with them. If our starting assumptions are correct, it raises the prospect that the ECB will become the guardian of future



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changes even in non-settlement areas. There are difficult questions here of how the ECB would resource that development and how it would prioritise and arbitrate between the development needs of competing CSDs, each of which may operate with different business models. This aspect should be considered during the on-going discussion of governance.

Additionally, we note that this constraint is already beginning to show itself in the harm being done to current development programmes and innovation and suggestions from some quarters that these should stop until T2S is delivered. Were this to happen, the removal of those of the Giovannini Barriers owned by the private sector would come to a halt and the delivery of the benefits which flow from removal would be postponed by several years. This would be most undesirable given the very real progress being made in the removal of Barriers 1 (messaging) 3 (corporate actions) and 7 (opening hours).

Conclusion

In conclusion, ECSDA feels that the T2S feasibility study is insufficient to serve as a basis for a committed decision at this stage. The T2S project has been making a growing number of statements relating to the scope, feasibility, budget and pricing for T2S (and even its impact on European GDP) with a degree of firmness and certainty which cannot be justified at such an early stage of the proposal.

T2S poses many significant questions to which there are not yet satisfactory answers. ECSDA is willing to contribute to the debate in a thoughtful way and to draw upon the long experience of its members in identifying both the pitfalls and, if possible, potential solutions. It is imperative, however, that this be done in a sensible timeframe and in an atmosphere which encourages collaborative debate and expert discussion. That atmosphere will be difficult to sustain if the ECB makes a “go/no go” recommendation to the Governing Council in the timescales currently being considered.

Yours sincerely

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