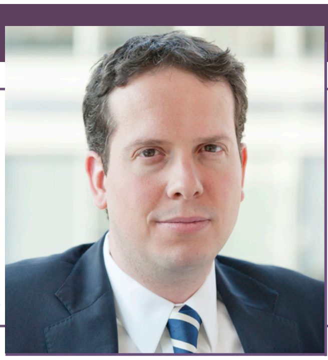
Dominic Hobson

talks to

Marc Robert-Nicoud



The consequences of T2S

TARGET2-Securities, the single securities settlement system for Europe being built by the European Central Bank (ECB), is scheduled to go live in 2015, with central securities depositories (CSDs) joining the platform in four successive phases between June 2015 and February 2017. With the bulk of euro-zone transactions likely to be settling in T2S from 2016, the time for CSDs, custodian banks and broker-dealers to make strategic choices is now. Dominic Hobson asked Marc Robert-Nicoud, the executive board member in charge of strategy at Clearstream, how the depository services group is approaching the challenge on behalf of its customers and partners and its shareholder.

In April 2014 Clearstream announced the acquisition of the Global Securities Services arm of Citco. The acquisition is characteristic. For Clearstream, it will extend an existing service (mutual fund order processing) into an adjacent area (hedge fund order processing) rather than a new market, and is being made at the behest of existing clients. The purchase also avoided any suggestion that Clearstream would use it to compete with its customers for the business of fund managers. Clearstream is not an organisation that likes to reinvent itself, or place bets on what its customers might like to buy next, or compete with its clients. Instead, it aims to listen carefully, and extend and adapt existing services on behalf of existing clients, or in conjunction with existing partners.

The response of Clearstream to the multiple opportunities created by regulation fits this pattern exactly. The banks that use Clearstream are facing not just higher direct costs as a result of the rising burden of compliance, but even heftier indirect costs in the shape of higher capital, liquidity and collateral charges. "Our reading of regulation is that it will increase the costs borne by our customers and, if our customers wish to stay in the same business, they will have to reduce those costs," explains Marc Robert-Nicoud, the board member in charge of strategy at Clearstream. "At the same time, our customers want to work out how to get the best out of the opportunities created by regulation. We are offering and developing the solutions that enable them to cut costs, and exploit opportunities."

TARGET2-Securities (T2S) is the obvious case in point. As operator of the central securities depository (CSD) in Germany, the largest economy in Europe, Clearstream Banking Frankfurt (CBF) has the natural advantage of scale within T2S. Its bulk is supplemented by the additional weight of a €6 trillion international central securities depository (ICSD) in the form of Clearstream Banking Luxembourg (CBL) as well. On the face of it, the combination ought to intimidate the smaller European CSDs, but Robert-Nicoud is confident they do not see Clearstream as pursuing an expansionist strategy. "When Deutsche Börse was in merger discussions with NYSE Euronext in 2011-12, for example, Interbolsa, the Portuguese CSD which is owned by Euronext, was extremely enthusiastic about working with Clearstream," he says. "We were equally enthusiastic about working with them. I have never encountered any sense that our intentions are seen as aggressive." As Robert-Nicoud points out, Mathias Papenfuss, a board member of CBF and COO of CBL, is currently the chairman of the European Central Securities Depositories Association (ECSDA).

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The relationship between Clearstream and Iberclear, the Spanish CSD, is close enough for the two CSDs to share ownership of REGIS-TR, a European derivatives reporting joint venture, and to have founded the "Liquidity Alliance." Every member of this group, which now boasts as members ASX in Australia, Cetip in Brazil and Strate in South Africa as well as Iberclear, has purchased the Clearstream collateral management system. When it comes to cementing relationships, technology of this kind is a powerful tool, but Robert-Nicoud insists the Liquidity Alliance remains a partnership of equals. "Our partners chose to purchase the technology on the basis of what made sense for them, in their markets," he says. "But they also recognised the longer term strategic benefits of connecting pools of liquidity in their markets to pools of liquidity in other markets."

Robert-Nicoud adds that an approach which is collaborative as well as commercial appeals to CSDs and (importantly) national regulators concerned about losing domestic securities activity. In his view, that makes it more likely to succeed. "They can see that other CSDs have a different strategy, based on attracting liquidity into their system," explains Robert-Nicoud. "Our view is that this model is unlikely to lead to a free flow of collateral around the world. As the need to move collateral more freely across borders becomes evident over the next few years, the fact that we share a vision as well as a technology means that the movements between their markets and ours will occur more naturally and spontaneously."

This approach was endorsed by the Business 20 group (B20) in its recommendations to the Group of 20 (G20) meeting in Russia in September 2013. In advocating centralised collateral management services as the obvious way to optimise collateral allocation across borders as well as in domestic markets, the B20 singled out the Liquidity Alliance as a working example of the common usage of platforms and standards by equal partners without the need for specific legislative or regulatory initiatives. "The best approach is to empower the local CSDs," says Robert-Nicoud. "The r egulatory obstacles to the creation of a single, centralised pool of collateral are simply too great."

The technological obstacles to global collateral management are not trivial either. Clearstream knows exactly how hard it is to put even one central securities depository (CSD) on the same technology platform as a single international central securities depository (ICSD). The organisation has instead mastered how to integrate operational processes and the management of those processes across separate technology platforms. "Our clients and prospective clients feel that they are in discussion with Clearstream," says Robert-Nicoud. "Whether it is CBF or CBL is more of an account-opening discussion than a relationship discussion." A €12 trillion liquidity pool, created by making the domestic securities held in Clearstream Banking Frankfurt and the eurobonds and other international securities held in Clearstream Banking Luxembourg available through a single window, is the clearest expression of this managerial and operational integration.

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As it happens, the trigger for its creation was T2S. "T2S was a blessing," says Robert-Nicoud. "What it did for us is focus our minds on how to take Clearstream to the next level. The scale and complexity of large strategic projects makes it difficult to deliver them at all, let alone on time and on budget. The coming of T2S, by making substantial change necessary rather than optional, forced us to consider what services we could offer a post-T2S marketplace, and to a fixed, externally imposed deadline. We had to think in concrete terms about exactly what investments to make." Not all of that €12 trillion of liquidity will settle in T2S, but it does provide a single environment in which customers of Clearstream can settle both domestic European transactions and ICSD business. Furthermore, their settlement activities are supported not just by a single point of connection, but by securities lending and financing and collateral management services which support assets held in both the CSD and the ICSD.

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Collateral management and securities lending and financing are services whose growth prospects are tied to regulatory measures, such as increased capital ratios and centralised clearing of swaps, because they enlarge the appetite to optimise and transform as well as consume collateral. Another regulation - the mandatory reporting of swap positions and their associated collateral values - lies behind the formation of REGIS-TR with Iberclear. In devising services to exploit both opportunities, it is significant that Clearstream has chosen not to work alone. "Our natural response to any strategic challenge is partnership," says Robert-Nicoud. "This is partly because we always pay close attention to cost control, but mainly because we do not see it as part of our brief to take over other markets. Instead, we want to work together to help make other markets grow, so ours can grow with them."

Link Up Markets, a joint venture between 11 CSDs in Europe and Africa, is an illustration of what he means. From the outset, it was both a strategic alternative to the Euroclear strategy of building a single European CSD by acquisition, and a partnership with other, like-minded CSDs. However, Link Up Markets soon developed a strategic logic of its own. It gradually encompassed non-European CSDs, and so evolved into an information-sharing network.

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Initiatives such as Link Up Markets have helped Clearstream develop a reputation for being trustworthy, while remaining sufficiently commercial to attach some value to service as well as price. This unusual corporate personality explains why a number of banks, including those that provide outsourcing services to fund managers themselves, have identified Clearstream as a sound and non-threatening source of utility services in some of the most troublesome areas of post-trade processing. Of course, Clearstream is also creditworthy (it has AA ratings from both Standard & Poor's and Fitch), demonstrably committed to securities services (it pursues no other business), operates four utilities already (CBF, CBL, LuxCSD and REGIS-TR) and does not compete with banks for buy-side business.

Robert-Nicoud certainly recognises the opportunity. "There is nothing new about outsourcing, but banks are now under greater pressure to reduce their costs than ever before," he says. "In-sourcing is not an established business for us, but utilities do make sense for any back office process which is not a competitive differentiator. Again, we would not look to do any of this work on our own, but only in conjunction with partners, and at the invitation of customers."

Robert-Nicoud adds that this sensitivity to cost is changing customer attitudes towards fees. "Of course, our customers will continue to pay custody, transaction and connectivity fees, but they already see these fees as marginal in comparison with the inefficiencies they are supporting in some post-trade processes, and in relation to the additional capital, liquidity and collateral costs imposed by regulation," he says. "They now see us as a provider that allows them to save a lot more money by working with us than they ever pay us in fees."

Robert-Nicoud predicts that this will prompt substantial changes in business models, in which banks will not simply outsource post-trade functions to a price-competitive service provider, but adopt a holistic approach in which they take into account the ability of a provider to cut the cost not just of asset-servicing but of capital, liquidity and collateral as well. "The fact that Clearstream is part of an integrated exchange organisation (Deutsche Börse Group) that combines a central counterparty (Eurex Clearing) and a collateral management engine (Clearstream) under one roof is a key differentiator," says Robert-Nicoud. "This is a unique set-up that allows us to develop products others struggle to match and to offer our customers efficiencies others cannot propose."

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Clearstream has already itemised the savings it expects banks and broker-dealers to make from consolidating their cash and securities holding in a single account as T2S goes live in phases through 2015 and 2016. In a study prepared in conjunction with Oliver Wyman, Clearstream reckons that the simplification of operations, the pooling of collateral and the netting of cash settlements could save a broker-dealer with c. €100 billion in trading assets and liabilities across the major T2S markets up to €70 million a year. Across the same markets, a global custodian with c. €400 billion of assets in custody could achieve annual savings of up to € 50 million, and a regional bank with c. €140 billion of securities on deposit up to €30 million.

Robert-Nicoud points to further potential efficiencies that could accrue to clients through the relationship between Clearstream and sister company Eurex. Clearstream has already developed a pair of common collateral management products with Eurex Clearing, e.g. GC Pooling (which provides collateralised lending and borrowing via Eurex Repo and Eurex Clearing) and GC Pooling Select (which enables corporates to invest surplus cash on a collateralised basis via Eurex Clearing). But a number of new initiatives between Clearstream and Eurex are now under discussion, which will help clients use and re-use eligible collateral in custody with CBF and CBL.

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Robert-Nicoud, who does not expect them to be unveiled before 2015, says the delay is a measure of their complexity. "A number of our competitors are now looking to follow our example, in offering combined depository and clearing services, but they are not easy to get right," he says. "The synergies seem obvious – a user of Eurex Clearing needs to meet a margin call, and Clearstream has a lot of assets usable as margin – but it took us a long time even to find a common language across the CSD, the ICSD and the CCP. And if you want to offer a service that is genuinely innovative, you have to take the co-operation between the depositories and the clearing house far beyond a common language, and develop a whole new operating model."

Fortunately, says Robert-Nicoud, T2S is making it is easier to develop whole new operating models, simply because it is making change necessary. In fact, he thinks that T2S has the potential to clear many of the remaining barriers to a single European capital market identified by Alberto Giovannini in his two reports of 2001 and 2003. This is because the T2S objective of borderless settlement across the euro-zone will not be fulfilled unless a number of national settlement standards and conventions are eliminated. "It will be harder to eliminate the barriers that rest on national laws and taxes, because they raise questions of company law and fiscal and national sovereignty," says Robert-Nicoud. "We have seen, for example, that the Securities Law Directive, which would have helped greatly to foster a single securities market in Europe, was postponed."

T2S has the potential to re-launch even that aborted initiative. "In fact, T2S will make it more pressing to eliminate all of the remaining Giovannini barriers because, if expectations are fulfilled, there will be more cross-border transactions happening in Europe," concludes Robert-Nicoud. "That alone will force the uncleared barriers back on to the agenda." To adapt successfully to such a dynamic sequence of events, and remain competitive as cash and securities consolidate in single accounts and trades net and settle in central bank money through T2S, banks and broker-dealers will need to re-think how they manage all of their post-trade processes, and not just securities settlement. If Marc Robert-Nicoud is right, they will be glad that Clearstream has done a lot of the re-thinking for them already.

clearstream | DEUTSCHE BÖRSE GROUP

phone: +352-243-36115
email: communications@clearstream.com
www.clearstream.com