TARGET2-Securities
Creating value through partnership
TARGET2-Securities (T2S) has been on the industry radar for many years but now it has become real: Clearstream and more than 20 other CSDs have signed the T2S Framework Agreement and committed to the project. The industry must now move from contingency planning to a concrete business approach, from blueprints to T2S readiness. In this document, Clearstream’s Executive Board and T2S experts share their perspective on the changes T2S will give a view of the future post-trade landscape and outline Clearstream’s value proposition for its customers.

4  Jeffrey Tessler  
Greater choice, greater opportunities

Mark Gem  
An integrated and unique T2S service offering

10  Philip Brown  
Why “smart partnering” is a model that works

Stefan Lepp  
Creating a broader, deeper and perfectly mobilised collateral pool

18  Patrick Georg  
Tailor-made to provide an integrated T2S securities solution

20  Marc Kieffer  
Reducing the cost of funding

Mathias Papenfuß  
Overcoming the operational challenge

26  Martina Gruber  
Best of all worlds for our clients

28  Yves Baguet  
Significant change will bring significant customer opportunities

30  Mark Gem  
Transforming the European securities landscape

34  Karla Amend  
The T2S timeline
TARGET2-Securities (T2S) has been a long time coming. This initiative had already begun to take shape on the European Central Bank’s drawing board before the collapse of Lehman Brothers and the ensuing banking crisis of 2007/2008 which prompted the wave of financial regulations we are facing today. The majority of these new regulations focus on risk management and market transparency while T2S has been designed to achieve a long-awaited and more fundamental aim: to create an integrated European securities settlement system that would be more efficient and cost-effective to compete on the global stage. For Europe, a great deal depends on T2S and Clearstream continues to take a proactive leading role in helping to make T2S a success.

T2S exposes us to a number of significant changes across all layers of our business, far beyond settlement in central bank money across Europe, which is the actual scope of T2S. The project raises many questions that we will have to answer in the course of our journey until T2S launches in 2015 and it comes with tough cost and implementation challenges, particularly in the current turbulent market environment. But I firmly believe that the long-term gain will significantly outweigh the short-term pain and that T2S will lead to a more secure industry that is stronger and better equipped to face the future. Greater harmonisation and more streamlined processes mean greater efficiency and reduced risk, both key priorities for today’s financial markets and every customer.

Clearstream and LuxCSD were among the first to sign the T2S Framework Agreement in May 2012. There are now 23 CSDs across Europe which have committed to T2S (pending signature by Cyprus). This has removed all doubts of whether T2S would really happen – and we now have to focus on what is needed to ensure a smooth transition to the future pan-European settlement environment. Throughout the T2S journey, Clearstream has been an active participant in a number of working groups and advisory bodies which have sought to ensure that T2S works for the infrastructures, for the financial institutions, for the market as a whole. We will continue to work very closely with our customers and our partners to ensure that the transition to T2S is as smooth and as successful as possible.

This document aims to set out an overview of Clearstream’s approach with regard to T2S and our value proposition for customers. We will be uniquely positioned to give our customers the widest possible choice of services through our combined CSD and ICSD franchise, in central bank or in commercial bank money, with top quality asset servicing close to the markets, award-winning collateral management and innovative investment fund services. It is my firm conviction that T2S will increase the opportunities available to our customers – and Clearstream looks forward to getting there together with you.
We will continue to work very closely with our customers and our partners to ensure that the transition to T2S is as smooth and as successful as possible.
T2S is revolutionising the European post-trade landscape by creating a single settlement environment that should bring domestic market efficiency to the cross-border securities settlement space. The envisaged result is a borderless pan-European infrastructure for real-time securities settlement in central bank money.

In May 2012, Clearstream Banking Frankfurt (the German CSD) and LuxCSD (Clearstream’s joint venture with the Banque centrale du Luxembourg) were among the first CSDs to sign the Framework Agreement with the European Central Bank that commits them to participate in T2S. These two entities, as all other participating CSDs, will effectively outsource their settlement processes to the T2S platform operated by the Eurosystem.

Such a fundamental change to the securities settlement business means that Clearstream, along with every other European market participant, has had to undertake a comprehensive strategic audit to verify we were moving in the right direction to maximise opportunities for our customers in the post-T2S world. Our industry is already taking on major investment projects to ensure compliance with an unprecedented wave of upcoming regulation. T2S clearly brings additional challenges at a time when we are already hit hard by the crisis and the continuing aftershocks.

Mark Gem
Member of the Executive Board
Head of Business Management

If we invest in change, let it be significant and value-added
A positive approach

At Clearstream, our approach is pragmatically positive: if we invest in change, let it be significant, value-added change that brings tangible advantages and opportunities for our customers, for our partners and for the industry. T2S should enable more efficiency and, therefore, greater security and transparency. Additionally, T2S will encourage greater consolidation of liquidity enabling Clearstream customers to take advantage of our world-leading collateral optimisation services.

The centralised IT settlement platform of T2S means that a major priority for our European customers will be to source value-added post-trade services which go beyond settlement and which increase their efficiency and global capabilities. Clearstream’s strategic review has resulted in a verification of its major development programme that will fully integrate our domestic and international business streams to enable our customers to benefit from the best of all worlds: access through a single entry point to settlement in central bank or commercial bank money, enhanced asset servicing and a consolidated liquidity pool enabling customers to benefit from Clearstream’s collateral management and securities lending products and services.

This strategy is not new but is a concentration of a number of initiatives, many of which already exist or are advancing well. It is our view that the commoditisation of settlement requires CSDs to move up the value chain in order to satisfy the sophisticated needs of their customers.

Clearstream’s T2S offer to customers

Clearstream’s establishment as both a CSD, in Germany and Luxembourg, and an ICSD serving the international community from its base in Luxembourg and nine other locations around the world, plus its situation within the Deutsche Börse Group, means it is uniquely positioned to leverage the potential of T2S to the advantage of its customers:

- Clearstream will offer integrated ICSD and CSD services with a harmonised connectivity through a single window and at a competitive price.
- Customers can pool their liquidity and thereby improve the fungibility of assets while taking advantage of Clearstream’s superior collateral management capabilities to decrease the cost of collateral and liquidity management.
- Clearstream will provide close-to-market asset servicing through our local agent bank partners.
- Clearstream delivers easy access to services delivered by its Deutsche Börse Group sister companies Xetra and Eurex.

In short, the T2S environment enables Clearstream to expand its offering to customers to offer a greater choice of transaction channels, a greater reach through our expanding global network of markets and even greater business opportunities. ▶
Choice of settlement options

Customers can use one or more participating CSDs to access the T2S settlement environment to gain cross-border capabilities with domestic ease and secure settlement in central bank money. However, T2S will not provide custodian services nor any liquidity re-use services. An alternative settlement option is to use an ICSD such as Clearstream which can transact international securities in commercial bank money across a global network of more than 50 markets.

Clearstream’s business development strategy is to bring these two streams together to give our customers the opportunity to access both streams (domestic and international), both funding options (central bank and commercial bank money), with all holdings able to take advantage of enhanced asset servicing and collateral management services. Clearstream’s clients will be able to access all ICSD and CSD counterparties from both ICSD and CSD accounts. Indeed, an important benefit for Clearstream customers will be that we will treat European domestic and international assets as a single liquidity pool. Collateral will be able to be seamlessly transferred at any time between CSD (T2S) accounts and ICSD accounts.

The key to Clearstream’s T2S strategic approach is therefore to maximise choice and this is the reason why Clearstream is continuing to invest in technical developments and better processes to improve the Bridge with Euroclear.
Valued partnerships

An important philosophy for Clearstream in the last decade has been to work in partnership with other actors in the financial sector rather than to seek to consolidate. By working with partners who offer best-in-class services and local market expertise, Clearstream is able to expand its global network and service coverage in a cost-effective and time-efficient way.

Consequently, an important component of Clearstream’s strategy will be to improve its asset servicing offering by leveraging the specialist capabilities of the best local asset servicing suppliers in each market. Tasks currently carried out by Clearstream will become the responsibility of the local agent and so will avoid unnecessary duplication of processing. This “Single Network” approach will deliver key benefits for Clearstream customers including greater speed and streamlining to bring greater efficiency and better market proximity through Clearstream’s agent partners who have dedicated local market expertise.

The total cost of T2S ownership

Many infrastructures have already invested a great deal of resources in preparing for the T2S initiative over a number of years. Adaptation costs are to be borne by all participating CSDs and Clearstream believes that most if not all CSDs will, for at least a limited period of time, share some of these costs with their clients while, post-T2S, the majority of Clearstream customers will find that their combined bill for settlement and custody should be roughly the same or less than they pay currently.

The Eurosystem T2S pricing model has always made it clear that cross-border transaction fees should be reduced and this has been one of its key selling factors. However, we expect there will be big differences in CSD pricing strategies determined by the size of the CSD and the extent to which they can absorb the adaptation costs.

The cost of T2S is a major concern in the market and so far little is known about how the various providers will manage this burden. Clearstream has been the first player in the market to announce an extensive solution plus our plans to manage both the adaptation and ongoing costs associated with T2S.

In terms of adaptation, we plan to pass on about one-third of the overall development cost - the external portion - to our customers via an investment contribution of EUR 0.094 per instruction settled on the German CSD’s settlement system CASCADE between 1 April 2013 and our planned migration in November 2016, with a total cap of EUR 30 million for the market. We will give our customers the option of deferring payment, depending on what best suits their business model, so that our customers have the greatest possible flexibility to make the migration to T2S as smooth as possible. This co-investment will give our customers the opportunity to participate in our T2S success: benefits from the growth in Clearstream’s business following our migration to T2S are planned to be shared with customers. We will therefore help offset the T2S investment contribution through a one-off share in the possible profits Clearstream makes through T2S. Adaptation costs are also linked to fee incentives such as a safekeeping discount of up to 60 percent for the German CSD.

In the future T2S environment, we are committed to providing T2S settlement at the lowest possible price, that is the price charged by the ECB with no margin and no additional settlement fee.
As you will be reading throughout this paper, T2S is a project that will materially change the way our industry works, and how we all work together. It is just one of a number of regulations and regulatory initiatives that are revolutionising the post-trade landscape and are prompting all financial institutions to reassess their business and are forcing them to commit vast sums in order to adapt their systems to comply. Some of Clearstream’s clients have reported that their non-discretionary investment in favour of regulatory compliance has increased rapidly and is consuming a huge portion of investment capital – we calculate that it may be as high as 70% of total capital investment – with the consequence that, increasingly, banks are left with limited funds with which to develop their services.

To put some context around the scale of this challenge: some estimates show that roughly 8,500 financial institutions in the European Union will bear a EUR 50 billion cost in making the requisite IT changes to meet the regulatory challenges. At the same time, of course, banks are facing more intense demand from their clients for technology and service enhancements that meet their increasingly complex needs. These two opposing pressures, when combined, create a formidable profit and loss challenge.

Why “smart partnering” is a model that works

Partnership is at the heart of our T2S strategy
Has M&A had its day?

Even until quite recently, acquisition of scale through M&A was, for many banks, the default tool employed to deal with the recurrent margin squeeze in our industry. However, a series of recent high-profile failed merger bids between exchanges have shown that M&A may face political hurdles, and that infrastructures may need to find different routes towards growth. In the custody space, there have been no major global acquisitions since before the financial crisis began in 2007. When we ask why, we commonly hear that, post crisis, management have not been able to access the requisite capital to fund large-scale M&As and shareholders may have been unwilling to take the risk of such transactions. This latter observation may be explained by research which argues that mergers generate the expected returns in less than 50% of observed cases and frequently even destroy shareholder value.

One of the reasons for this historical acquisition of scale was to lower unit costs of production. But, of course, every deal always discussed the clear target of "revenue synergies". Thus, deals were justified by firms expanding their product range and their customer base, claiming the benefit of being able to offer the maximum number of services to the maximum number of customers [the famous “one-stop-shop”]. One of the issues has been, however, that many banks did not just want to be a one-stop-shop, they also wanted to be the factory, the raw materials supplier, the logistical supply chain and the shops next door selling “complementary” products.

This approach came at a high – and increasingly untenable – cost, especially as the financial sector is such a fast-moving industry with continuous development of services, asset classes, instruments and markets that expand in complexity and reach.

A major global custodian, for example, might today have more than 30,000 staff supporting its business from some 75 locations worldwide. Each time it makes an acquisition, it adds to its locations, its systems and its staffing, with new products structured as end-to-end businesses. This is not the generation of economies of scale; it is the aggregation of adjacent businesses with independent cost bases. Hence, when there are changes to regulation, the costs of adaptation hit the institution multiple times and in multiple jurisdictions, as it is required to bear all the costs of the IT changes across all its activities. In the current climate, where we are facing the impact of widespread regulatory changes to operations and processing, such costs can be astronomical. Cost is only one part of the equation, however, banks which offer a fully comprehensive range of services can sometimes become jacks of all trades but masters of none.
An alternative option

This is why we believe that large suppliers who self-manufacture everything will decline, and we expect the supply chain to somewhat consolidate down to niche specialists who supply the very best quality, at the greatest value, and to multiple upstream banks. For example, Clearstream operates an alternative business approach to the do-it-yourself model. Although we are a EUR 11 trillion custodian, we have just 1,500 staff and operate from 10 offices worldwide. We have a relatively lean operating base but successfully deliver access to more than 50 markets worldwide. And we do all of this by working closely with a network of local partners.

Instead of attempting to establish ourselves as a local custodian, Clearstream has taken the strategic approach to work with partners who are local market experts and to tightly integrate these partners into our process flows. We call this “smart partnering” and it might be defined as creating a partnership in which both counterparties are committed to the sustained success of the activity. It is not about creating a merely convenient alliance under a rolling contract but a long-term commitment to each other that seeks to eliminate duplicate work while playing to individual specialisms and strengths.

This approach is not new to Clearstream. We have long been promoters of collaboration and partnership arrangements which have helped us increase our range of capabilities with regard to eligible instruments or products and our global reach. In this way, we have been able to expand opportunities for our customers in the most cost-effective and time-efficient way possible. Partnership is now at the heart of Clearstream’s T2S strategy as we continue to create an extensively interlinked environment that enables our clients to gain the most from T2S.
Creating best value

T2S will take care of the settlement activity but our customers need to be able to access top quality asset servicing solutions – and these services need to be able to perform well with both the expected increased volumes and with increased complexity.

Clearstream has an attractive solution for a world with T2S: our “Single Network” initiative will demonstrate “smart partnering” in action between Clearstream and expert local agent banks. It will ensure that our customers can benefit from the very best asset servicing available, the advantage of close market proximity, expert knowledge and, of course, the requisite local specialist experience. We expect that processing steps such as information collection, event set-up and maintenance, balance capture, entitlement computation, instruction processing and reconciliation will move from their current working location at Clearstream to our agent bank partner to offer a more streamlined service that avoids unnecessary duplication.

Another example of smart partnering, Liquidity Hub Connect, is already being developed to enable agent banks to participate in the world-leading collateral management and securities lending services available in Clearstream’s Global Liquidity Hub. The first partner to commit to joining Liquidity Hub Connect is BNP Paribas Securities Services with more expected to follow in time.

Of course, the T2S initiative is a large-scale example of partnership as all participating CSDs will outsource their settlement activity to T2S. In order to remain competitive, CSDs are likely to consider moving up the value chain and deliver new services in the area of reporting, specialist servicing and collateral optimisation.

It will not be feasible, however, for them to self-manufacture all of these services and T2S will act as a catalyst for further partnerships elsewhere in the service chain. Consequently, the structure of the settlement and custody business is now beginning to change and over the coming years it could be expected to change radically. The supply chain is transforming from a straightforward vertical chain to one which is more horizontal and based on an open architecture. This is where smart partnering has the most value.
T2S is certainly a major game changer for Europe’s securities services industry and the financial institutions it serves. European financial institutions are now going through the process of choosing the suppliers who will enable their access into T2S and who will provide custody, advanced asset servicing and collateral management capabilities.

The change in industry structure will have the effect of CSDs being required to supply a number of services outside their traditional scope. Fortunately, Clearstream has all the points covered: it operates both as a CSD in Germany and in Luxembourg, a joint venture with the Banque centrale du Luxembourg, and as an ICSD offering access to a global network of more than 50 markets. Market participants entering T2S through either CSD will be able to consolidate all their holdings in a single pool so that their international and domestic assets available for use as collateral can be transferred at any time between T2S accounts and ICSD accounts in Clearstream. This will enable customers to take full advantage of the collateral management and securities lending services in the Global Liquidity Hub.

**Collateral management is a global priority**

The ability to pool all available collateral comes at the perfect time as the financial industry faces the impact of an unprecedented wave of regulations. The combined effect of just two pieces of legislation, the European Market Infrastructure Regulation (EMIR) and the Capital Requirements Directive (CRD) IV, will mean that European banks face the need to commit even greater collateral to cover their exposures to satisfy regulators. In fact, Basel III would require banks in Europe alone to find an aggregate shortfall of stable funding of EUR 2.78 trillion in order to comply fully with the additional liquidity requirements, according to the Quantitative Impact Study of the Basel Committee on Banking Supervision (April 2012). It is clear that the implications of regulations in the Basel III framework have now become a major factor in supply chain decisions.
Creating a broader and deeper collateral pool

Before the crisis, customer buying decisions tended to concentrate on price, the level of service and the quality of the relationship they might enjoy with the securities services supplier. However, now the global need for capital and for liquidity management has made collateral management the key decision factor for financial institutions when choosing their securities services supplier. The reality is that the majority of infrastructures and financial institutions around the world do not have sufficiently sophisticated collateral management systems to cope with the complexities of the global markets and they are running out of time.

This explains the industry reaction to Clearstream’s pioneering Liquidity Hub GO (Global Outsourcing) service that enables CSDs, exchanges, CCPs and central banks to buy into our collateral management services on a white-labelled basis. Liquidity Hub GO went live with Brazilian CSD CETIP in July 2011 and is now in various stages of development with South African CSD Strate, the ASX Group in Australia, Canadian CSD CDS and Clearstream’s first European partner, Spanish CSD Iberclear. Talks are currently ongoing with a number of other infrastructures and institutions worldwide.

As noted above, CSDs are moving outside their traditional scope in order to stay in business in the post-T2S world. Clearstream’s unique, white-labelled outsourced solution is enabling more suppliers around the world to stay in the collateral game and is becoming an important new dimension to Clearstream’s Global Liquidity Hub.

High cost of fragmented collateral

Clearstream took the strategic decision some years ago to invest significantly in its Global Liquidity Hub which has now developed into a unique value proposition combining collateral management, securities lending and repo services with near-time interoperability across global markets. This has left Clearstream uniquely placed to ensure its customers will be able to benefit from the opportunities presented by T2S to consolidate their domestic securities and their international securities in one accessible liquidity pool.

The advantages of this approach are proven: a study undertaken by Clearstream with Accenture into the internal fragmentation of collateral clearly demonstrated that a great deal of collateral was not being optimally employed. The research involved 16 Europe-based global and local institutions collectively holding assets of approximately EUR 14 trillion. It showed that the vast majority of banks had no overall view of their available collateral and so were unable to mobilise it appropriately. Accenture calculated that around 10 to 15% of all available collateral was left unused, translating into a cost to the industry, on an annual basis, of more than EUR 4 billion. There are very few institutions in the financial sector that have sufficient collateral management systems which are able to cope with the increasing complexities of today’s global market.

The consolidation effect of T2S should help broaden and deepen the Global Liquidity Hub pool of available collateral in order to make collateral management more efficient and cost-effective for market participants struggling to comply with the new collateralisation requirements. Clearstream’s customers will be able to pool their T2S-settled assets with their international securities holdings in order to optimise the collateral process.
The Global Liquidity Hub

Clearstream’s ongoing commitment to developing the Global Liquidity Hub can only increase the opportunities that will be created for which it delivers multiple secured collateral products and services, open architecture and multiple settlement locations. Clearstream’s position within the Deutsche Börse Group enables Global Liquidity Hub customers to benefit from access to GC Pooling through Eurex Repo and Eurex Clearing in addition to €GC through LCH.Clearnet. Its solutions, available to all participants, whether directly through Clearstream or through one of its partners using Liquidity Hub GO access, include a comprehensive and flexible suite of products in central bank pledge, triparty collateral management (including repol) and securities lending. The Global Liquidity Hub has a wide range of counterparties from central banks and CCPs to banks, brokers, corporates, asset managers, insurance companies and other non-financial companies. Cash, fixed income, equities, some funds and gold are all eligible in the Global Liquidity Hub which has more than 430 participants.

The Global Liquidity Hub is now undergoing a period of significant expansion: cash-rich corporates are now taking advantage of secured lending through triparty repo opportunities which maximise their returns while GC Pooling Select, being developed with Eurex Repo and Eurex Clearing, will become available to corporate cash lenders in early 2013. This service will be rolled out initially in Germany with other markets to follow. Additionally, Liquidity Hub Connect, a smart collateral management partnership approach with agent banks and global custodians, is a service rolling out with BNP Paribas Securities Services but will include more partners in the future.

Understanding the described approach to technically pool and optimise collateral from all different industry layers without forcing asset transfers out of well-established and proven asset locations leads to a strong value proposition for the customers of the Global Liquidity Hub. The additional option to mobilise this optimised collateral pool to cover exposures at clearing houses, central banks, triparty repos or any other type of exposures on an automated basis creates further substantial value for the users of this unique service model.
Clearstream’s customers will be able to pool their T2S-settled assets with their international securities holdings to optimise their collateral process.
LuxCSD was created specifically to enable the Luxembourg financial community to participate in T2S with an equal advantage as institutions in the other Eurozone countries. The new infrastructure, which was created in July 2010 as a joint venture initiative by Clearstream and the Banque centrale du Luxembourg, is well on course to achieve this objective. Luxembourg has always been traditionally oriented towards cross-border business. Indeed, its cross-border investment funds volumes are second to none in Europe and the financial centre is widely recognised for its international competence.

The scale of this cross-border business, as compared to the quasi-inexistent domestic market, meant that Luxembourg did not need its own infrastructures until quite recently. It was only the introduction of the Euro that prompted the Grand Duchy to created its own central bank in mid-1998 and now LuxCSD has been created specifically to participate in the T2S initiative.

Today, LuxCSD is delivering issuance, custody and settlement in EUR central bank money as well as in other currencies through commercial bank money for a wide range of securities including investment funds. Post-T2S, it will use a relayed link through Clearstream’s German CSD to access the complete network of markets in T2S to which Clearstream is connected. LuxCSD customers can take advantage of its seamless interoperability with Clearstream’s ICSD and its wide range of markets of international and domestic counterparties. This enables LuxCSD customers to benefit from Clearstream’s proven ICSD infrastructure with the added security benefit of settlement in central bank money.

Streamlining the funds industry

LuxCSD will also serve as a T2S access point for investment funds settlement in central bank money in the same way as it does for other asset classes. It delivers routing services for fund orders and functions as a centralised facility for the issuance, settlement and custody of investment funds.

T2S customers will be able to access automated order routing services for investment fund shares through Clearstream’s Vestima platform, a single entry and reception point for domestic, international and offshore funds. For fund providers and transfer agents, LuxCSD is minimising the impact of T2S by providing them with access to CSD settlement in EUR central bank money through Clearstream’s robust fund issuance mechanisms.
LuxCSD customers gain seamless access to T2S along with all the advantages of Clearstream’s ICSD reach and high quality service levels
Clearstream views T2S as providing a number of opportunities throughout the transaction lifecycle for all stakeholders. For issuers, a major advantage will be the ability to reduce their overall funding costs and broaden their investor reach. Traditionally, national CSDs are very focused on supporting local (that is, national) issuers who are targeting mainly local investors. The T2S single settlement platform will have a wider scope and will allow issuers to enjoy pan-European distribution. This means that a CSD could, if it chose, significantly expand its issuance and distribution offering and extend it to all issuers wanting to reach investors anywhere across Europe from a single primary issuance location.

Of course, Clearstream already does this today through its ICSD franchise – and to a certain extent also through its CSD offering – with issuers from around the globe using 96 denomination currencies, more than 20 legal frameworks, 43 settlement currencies and distribution channels to more than 50 CSDs worldwide.

Going forward, Clearstream will therefore leverage its global issuance and distribution expertise to enhance its CSD services even further. For example, consider a French issuer targeting, among others, local Italian and German investors. Today, it is possible to do it but the costs are significant as either the issuer needs to be present or represented on each local market or the investors need to bear the cost of appointing local custodians in the issuer’s home market. However, a French issuer using Clearstream in a post-T2S world will be able to have a single global issue deposited with a Clearstream CSD – the German CSD (Clearstream Banking Frankfurt) or LuxCSD – distribute it through T2S to German, Italian or any other European investors while continuing to benefit from the security of central bank money primary funding as the issuer is accustomed to today on a home market.

Furthermore, thanks to the single seamless integration of Clearstream’s CSD and ICSD businesses, the issuer will also be able to distribute the same global issue to non-European investors worldwide, that is beyond the T2S area. And, of course, the investors themselves will be able to keep their preferred custody set-up following implementation of T2S, irrespective of whom the issuer is and where the primary distribution has actually taken place.
Clearstream’s Global Issuer Services customers already have the benefit of our issuance and distribution expertise:

- Four European-based expert issuer services teams plus one based in Asia: in London, Luxembourg, Frankfurt, Prague and Singapore;
- 99.99% distribution settlement efficiency through dedicated distribution monitoring;
- A new security made eligible every eight seconds;
- More than two million eligible securities;
- Securities positions across 11,000 issuers coming from 130 countries.

Numerous in-depth studies have highlighted that access to global issuance is a key factor in reducing the overall funding cost for issuers. Clearstream approaches T2S as the opportunity to leverage its global issuer hub, underpinned by best-of-class issuance and distribution services that bring tangible benefits to both the issuer and investor communities.

The T2S single settlement platform will allow issuers to enjoy pan-European distribution
By any measure, T2S is a large-scale project. It involves the ECB and the Eurosystem in addition to CSDs, CCPs, investment banks, commercial banks, national central banks and any other financial institution active in the European securities markets.

The Eurosystem is technically the owner, developer and future operator of T2S while the ECB is the ultimate decision-maker on T2S. However, the Eurosystem has delegated the technical work to four central banks – France, Germany, Italy and Spain – which share responsibility for building the system while the connectivity system has been outsourced to SWIFT and SIA-Colt.

T2S is a major factor in Clearstream’s business development strategy and has been for some years now. We have been working closely with the ECB project team since the beginning of the project and this has given us an important insight into how we can enable our customers to gain all the advantages that T2S can offer.

T2S is due to go live in 2015. Clearstream and LuxCSD are not yet ready but development work is on track and our new strategic programme is in place to ensure that all the projects and initiatives we undertake are aligned and adhere to the ambitions not only of the Clearstream business strategy but also the Deutsche Börse Group’s strategic roadmap. We therefore have a well-directed path and we are progressing well along it.

The key to success is to not lose momentum during T2S implementation.
Harmonisation is key

Harmonisation is a key success factor of T2S and efforts in this direction should not cease with the implementation of T2S. Clearstream believes amendments to EU legislation are required to remedy the current problems arising from inconsistencies between the European countries in which CSDs operate and which lead to limitations to cross-border links between CSDs.

The alignment of European regulatory frameworks before T2S goes live would be optimal for the industry but Clearstream realistically expects that harmonisation will peak a few years after T2S implementation. The deciding factor will be how the private and public sectors continue to co-operate throughout the implementation of T2S and beyond.

The key to success is not to lose momentum during the T2S implementation phase when the focus shifts from intensive collaboration between market participants, the Eurosystem and regulatory bodies to more internalised T2S impact assessment and implementation efforts.
Single customer connectivity

Clearstream’s connectivity solution is the way our customers will access T2S. The aim is that any customer will be able to gain access to the full range of services – whether via Clearstream’s CSD to T2S or through its ICSD, in central bank money or commercial bank money – and have a comprehensive view of all their positions all through a single connectivity point.

This is a major part of our T2S strategy and involves fully integrating the various connectivity systems currently in place throughout Clearstream. The result will be a better working experience for our customers and will also be key in facilitating the consolidation of all assets into a single pool for more efficient use.

Different ways to connect to T2S

There are three different ways to access T2S: one direct participation route, where T2S is accessed directly, or two indirect routes, through which T2S is accessed either through a single CSD or multiple CSDs. For our customers, their choice of interconnection with T2S is the key decision they will have to make as it will obviously impact all their development work and their processing model.

The majority of Eurozone CSDs, including Clearstream, will have a direct connection to T2S. For customers, however, three options exist and the choice should depend on the business strategy and appetite to absorb different levels of impact combined with the transaction volumes to justify the cost.
Option A
Customers connect directly to T2S. Either a shared value added network (VAN) or a dedicated link (DL) can be implemented. Two VAN network providers, SWIFT and SIA-Colt, have been selected by the Eurosystem to provide the connectivity. In addition, DL will be provided by an existing Eurosystem solution, CoreNet. This option provides the closest proximity to the settlement engine but bears the most significant financial impact. Customers will require an ISO20022 link to a dedicated account in T2S, which should be requested via a participating CSD.

Option B
Customers connect indirectly to T2S via CSDs, retaining existing relationships with multiple service providers. This option is likely to be chosen by customers wishing to retain existing relationships with sub-custodians and multiple CSDs while minimising their adaptation costs as the CSD will absorb most of the T2S impact. Customers choosing this option will not be realising interoperability efficiencies.

Option C
Customers connect indirectly to T2S via a CSD, replacing existing links to agents, custodians and local CSDs by a global CSD player(s), significantly reducing interoperability costs. From Clearstream’s point of view, this model is the most efficient for customers and is likely to be the most prevalent as it provides customers through a single connectivity solution underpinned by a single custody and collateral management platform access to any of the CSD settlement agents. Additionally, customers have the option to implement direct technical connection to the T2S platform in parallel with this model.
Clearstream’s function as the German central securities depository linked to its Luxembourg-based international central securities depository delivers the best of all worlds to our clients: they will gain the great advantage of being able to enjoy central bank money settlement in conjunction with ICSD-level asset servicing.

Customers will also have the benefit of greater flexibility of choosing their funding route, in either central bank or commercial bank money, all within an integrated environment delivering a high-quality consistency of service. Additionally, all domestic and international securities will be consolidated in a single liquidity pool enabling full collateral optimisation.

Making seamless connections between all the systems of Clearstream’s various entities – Clearstream Banking Frankfurt (the German CSD), LuxCSD (the joint venture CSD for Luxembourg) and Clearstream Banking Luxembourg (our ICSD) – will involve creating a new Clearstream connectivity solution. Customers will be able to use the enhanced connectivity suite as a window to all Clearstream’s services regardless of their location in our CSDs or ICSD. However, customers wishing to retain the current Clearstream Banking Frankfurt CSD connectivity solution will be especially accommodated.

The adaptations which the German CSD will make to move into the T2S world are yet another evolution in its long and successful history. Many of our customers have been with us for a long time through our corporate changes: Deutscher Auslandskassenverein and Deutscher Kassenverein merged back in 1996 to become Deutscher Kassenverein AG, which was renamed Deutsche Börse Clearing AG in 1997 and then evolved again in 2000 to become part of Clearstream. The growth of the company has encouraged it to create innovative solutions with its sister companies in the Deutsche Börse Group.

Clearstream Banking Frankfurt customers already take advantage of links with other European domestic markets and this network will expand to include all the T2S markets. T2S, therefore, will be another important evolution for the CSD. It will bring greater opportunities such as pan-European issuance, advanced asset servicing and the benefit of consolidated collateral management.
An integrated environment delivering a high-quality service
TARGET2-Securities will bring major change, this is clear. It will not only significantly alter the business landscape and the way the European market works but it will also substantially change the IT landscape of all Eurozone CSDs and the two ICSDs while requiring all participating institutions to undertake system adaptation work.

Clearstream functions as both a CSD and an ICSD and, therefore, T2S presents us with a major challenge to ensure that our systems are ready in order for our customers to take full advantage of the opportunities available following migration. Fortunately, Clearstream has the expert technical and project management experience plus a well-designed strategy that will not only deliver the work on time and cost-efficiently, but it will also be top quality and will offer excellent benefits to our customers.

Minimised impacts

A main priority for Clearstream’s IT strategy is to minimise the impact on its customers. This is achieved by making sure that Clearstream takes on the bulk of the necessary changes so that our customers do not have to. We are creating the common components – that is, components that function in Clearstream Banking Frankfurt (the German CSD), LuxCSD (the Luxembourg CSD) and Clearstream Banking Luxembourg (the ICSD) – where they make good technological sense while interfaces and formats benefit from the greater standardisation required by T2S. The overall goal is to be as cost-efficient as possible while minimising risk for our customers.

Key customer benefits

Clearstream understands that its customers want to benefit from the full range of opportunities from the outset – and that means from day one following migration. We aim to deliver customers access to a full network to all T2S CSDs which have been fully assessed for monetary policy operations. Additionally, Clearstream customers will gain from a new central position management capability that enables them to have access to all CSD and ICSD counterparties from both CSD and ICSD accounts and also realignment of any Clearstream accounts independent of any system outside Clearstream, including T2S, in real-time and at any time.
The central position management will also enable customers to transfer collateral seamlessly at any time between their accounts, whether CSD or ICSD, and take advantage of Clearstream's collateral management functions such as automated allocation, optimisation, unlimited substitution, valuations and margin calls not only across the customer's CSD and ICSD accounts but also across any account operated by our partner infrastructures in the outsourced collateral management service Liquidity Hub GO and our partner banks participating in Liquidity Hub Connect, a service that enables custodians to offer their clients state-of-the-art collateral management while the assets remain where they are.

A new CSD landscape

T2S will irrevocably change the European landscape, particularly for CSDs. Today, most of the IT application landscape of market infrastructures, such as CSDs, is reasonably integrated and many stand alone without any cross-border activities. However, T2S is solely an outsourced settlement platform and so participating CSDs will need to decouple settlement of their clients' trades from its integrated system and to mirror all the positions held in T2S within the multi-CSD landscape.

T2S is concerned only with settlement and so all "downstream" and custody systems will need to be adapted in order to work within the T2S context. These necessitate major IT changes for all participating CSDs – however, these changes will be sufficient only if the CSD intends to offer its customers a basic T2S service. By contrast, it is Clearstream’s strategy to ensure that its customers gain the benefits of the opportunities to streamline and optimise their post-trade securities services through a number of added-value services that substantially enrich its client proposition. Of course, these services will obviously require additional IT adaptation but will have the result of allowing customers a very flexible range of funding options.

In summary, the IT challenge of T2S is not a technology challenge, it is a programme management challenge. Our task is to deliver this major transformation on time and with a low risk approach for the market.

A single portal

The IT challenge for Clearstream has been to ensure that customers can access the full range of services with minimal adaptation of their own. In order to achieve this, we have opted to streamline and optimise our IT landscape by introducing the common components mentioned above. This strategy will help deliver the services described above in addition to reducing running costs through greater efficiency.

A key example of the new streamlined service is that customers will be able to access all their accounts through a single portal and a single connectivity system, if they choose. Offering our customers choice is in response to the clear message that we have received from our customers, and especially the German community, that they would appreciate only having to make a minimum of IT changes on their side. Therefore, we will ensure that the existing connectivity and reporting mechanism will be maintained for them or they can choose to take advantage of the new features and capabilities delivered through a new connectivity product which is being created.
The European securities industry now faces an enormous challenge. It must adapt quickly not only to the world of T2S but also in order to comply with the unprecedented new wave of legislation that is on its way. Investment costs will be high but, ultimately, the industry should be more standardised, more streamlined and more secure.

Clearstream has a strategy to meet the challenges and it has already embarked on making the changes that will ensure our customers are not only able to fully engage with all the opportunities of the integrated European securities market but that they also have the flexibility we can offer as a global securities services supplier. Clearstream will be able to deliver its customers a single entry point to CSD settlement in central bank money, international settlement in commercial bank money, excellent asset servicing through strategic partnerships with agent banks and optimised collateral management from a consolidated liquidity pool.

Market player impact

We have our plan and we know where we are going. But, of course, T2S will have an enormous impact on all market actors. The landscape will transform fundamentally with traditional divisions between the various market players – such as CSDs, custodians and agent banks – becoming less defined. Many market actors will need to diversify beyond their normal scope in order to gain competitive advantage. Indeed, T2S will encourage many market participants to completely reassess their strategy and even their business model.

CSDs

CSDs will face increased competition when national monopolies break down and this will mean they have two basic choices, either to establish links and develop cross-border asset servicing and other value-added services, such as collateral management, or to downsize and focus on servicing the local market as issuance utility, registrar, notary, etc. In addition, CSDs face the impacts of the Central Securities Depository Regulation which could limit the services they can offer. All of this comes at a time when T2S development, operational changes and migration efforts will consume available investment through the next few years.

It is likely that only the (I)CSD groups and the largest CSDs (for example those which are part of exchange or banking groups) will have the resources to improve their services or move up the value chain in parallel with their T2S adaptation and migration. One option for CSDs is to partner with an ICSD.
Agent banks and sub-custodians
Domestic agents and sub-custodians also face having to follow CSD adaptations plus the additional competition from CSDs which have taken the decision to move up the value chain and additional competition and/or loss of business with global custodians which will benefit from economies of scale. They have the additional burden of upcoming regulation that could change the liability regime while the sovereign debt crisis is severely impairing banks’ funding capabilities as Basel III forces them to raise Tier 1 capital. It might be expected that some banks may choose to divest their sub-custody businesses to raise cash if they are able.

Domestic agents have some choices:

- to follow their CSD’s adaptation plan and compete on service quality and price in their domestic market;
- expand through acquisition or organically into new markets to build economies of scale;
- exit the business by selling to a global custodian or a sub-custodian which is looking to expand.

Some domestic agents may be successful partnering with an ICSD or global custodian to take on its international sub-custody network and so become the go-to transaction bank for their home market enabling the consolidation of domestic and international volumes.

Global custodians and pan-European custodians
For global custodians, and a handful of large pan-European multi-market custodians and universal banks, T2S is a major opportunity to get closer to the infrastructure, consolidate operations and reduce costs. They are all impacted by having to follow CSD adaptations in all European markets, and these are the most likely banks to opt for direct technical connectivity with T2S.

Institutions in this category also face additional competition from those CSDs trying to move up the value chain and possibly from sub-custodians wanting to expand into new markets. However, the most intense competition can be expected between members of this group. They also face the additional challenge of new regulation that could change the liability regime, reinforcing their drive to open own branches or operations centres and disintermediate agents.

Global custodians and pan-Europeans might choose to adapt in one of the following ways:

- to access each CSD individually using a direct connection option for technical standardisation and so make IT savings;
- consolidate with one or two CSDs;
- use a combination of the two previous points in order to optimise the benefits of scale and market proximity;
- combine the previous options with sub-custody in specific markets where they have no specific needs.

Broker dealers and investment banks
Investment banks are continuing to adjust to post-crisis reductions in M&A, derivatives trading, and cash equities trading, while the ongoing sovereign debt crisis affects both their fixed income trading and their funding models. They are likely to be the first movers to re-engineer their networks to reduce operating costs and optimise collateral utilisation. Broker dealers are currently facing similar challenges as investment banks due to the reduction in volumes, still it is foreseen that they will continue to settle in commercial bank money, as opposed to investment banks.
Regulatory risks

Other countries might follow France in implementing a financial transaction tax (FTT) which would have a very negative impact on trading volumes. This poses a significant project risk to T2S as it is based on very high volumes and a cost recovery pricing model.

The CSDs that have signed the T2S Framework Agreement, such as Clearstream and LuxCSD, now share this risk with the Eurosystem and, indirectly, with their customers. T2S would mean that an FTT would have the effect of not only reducing revenues but also to do so without reducing volume-related costs. This is because it raises the cost per transaction while the total is fixed.

The CSD Regulation aims to harmonise securities settlement and introduce prudential rules for CSDs across Europe in order to enhance market safety and create a level playing field. The aim of enhancing efficiency is clearly complementary to T2S. However, the proposal to prohibit CSDs from offering limited banking services in the same legal entity will pose problems for those CSDs whose strategy is to move up the value chain and offer services such as collateral management. The Deutsche Börse Group is raising these concerns during the consultation period.

T2S is forcing an important overhaul of the fragmented European securities industry. The necessary harmonisation and greater security brought by T2S will lead to a more efficient environment that is necessary for the European market to sustain its competitiveness within the global marketplace.
Industry evolution at-a-glance
How T2S might change the European securities landscape

**Until 2015**
ICSDs and global custodians will compete for a handful of mandates for those customers looking to avoid the T2S adaptations of their home markets.

**2015 to 2017**
The industry as a whole will focus on maintaining stability during CSD migrations to T2S.

**T2S + 6 months**
Innovators and early adopters such as global custodians becoming a direct participant and investment banks looking to secure network savings as soon as possible will implement sweeping changes and competition between CSDs will begin to have an impact.

**T2S + 2 years**
The early majority will re-engineer their networks to the now stable reality of a European post-trade market environment based on T2S.

**T2S + 4 years**
The late adopters (e.g. the many customers asking CSDs to shelter them from the change) will re-engineer their networks based on the new standard strategy (that is, the most successful models) of the last two periods.

**T2S + 5-10 years**
Successful CSDs, agents and global custodians will continue to gain significant volumes, while failing strategies will drive M&A, downsizing, and market exits.
It has been a long journey since the possibility of providing centralised settlement services for securities transactions was first discussed back in July 2006. The proposed launch date has slipped more than once so that now the go-live date is now anticipated in June 2015. The causes for these timeline shifts have ranged from the high number of outstanding critical contractual issues, additional time required to accommodate changes in T2S user requirements or insufficient time allowed for the finalisation of the user connectivity solution. The signed commitment to T2S by the first CSDs, including Clearstream and LuxCSD, has reduced the elements of uncertainty around the project and participants are now making their development plans concrete. We now have the opportunity to move forward and shape the future together.

The T2S journey

It is not just the Eurosystem that needs to undergo a transformation effort in order to implement T2S; whole market communities looking to connect to T2S will need to adjust their internal settlement systems and processes to enable interaction with the platform. The end-to-end functionality of the T2S solution will be tested first by the Eurosystem during an acceptance testing starting in February 2014 and later on by all the participating market participants, including CSDs and national central banks, during a user testing phase commencing in October 2014.

The Eurosystem has planned for three scheduled migration waves in June 2015, July 2016 and November 2016 in order to reduce and spread the project risk. CSDs participating in one of the later waves will not necessarily have more time for their implementation efforts as the integrated nature of T2S requires CSDs migrating in later waves to participate during test efforts of early-migrating linked CSDs and vice-versa.
Implementation

Clearstream plans to migrate to T2S in Q3 2016, in the third migration wave, as this will allow the longest possible time for testing. However, this is dependent on the composition of the migration waves which should be confirmed by the ECB in Q1 2013.

Clearstream Banking Frankfurt customers who are settling securities on the ICSD platform (Clearstream Banking Luxembourg) will be exempt from the migration, as well as any cash settlements in commercial bank money. Clearstream Banking Luxembourg will continue servicing customers who prefer settlement in commercial bank money.

Clearstream customers will be able to take advantage of Clearstream’s existing extensive network of links which already support cross-border capabilities. Additionally, they will be able to benefit from seamless interaction between their Eurozone ICSD and CSDs positions and can choose to settle in commercial bank money or central bank money while having a consolidated view of their positions at Clearstream.

ECB = European Central Bank
URD = User Requirements Document
ES = Eurosysteem
GC = Governing Council of the ECB
GFS = General Functional Specification
MoU = Memorandum of Understanding
We now have the opportunity to move forward and shape the future together.
Clearstream Banking Frankfurt and LuxCSD:
High level implementation overview


Concept phase
Specification phase
Build phase
Internal test phase
External test phase

Market & member readiness
A. Impact analysis
B. Customer support
C. Training/Readiness monitoring

Internal readiness
D. Impact analysis
E. Process design and implementation
F. Training/Readiness monitoring

ECB timeline

ECB phases
T2S migration

Development  User testing  Migration period
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