T2S – Global Campaign – Thought leadership

Author : Hugh Palmer, Senior Product Manager, Financial Institions & Brokers, SGSS

Executive Summary

T2S is a reform that seeks to unify the technical platform for settlement across European markets with the objective of contributing the construction of a single market in the post-trade space to encourage growth in volumes notably for cross-border transactions and collateral. 23 central securities depositories covering 21 countries have today engaged to migrate their settlement activities to this platform.

The harmonization of the settlement process leads to its commoditization, fueling expectations for lower costs and for new market access models for institutional buy-side investors as well as for the sell-side firms.

T2S is a significant challenge for today's custodians for whom it disrupts the operational models, leading to significant investments in the light of diminishing margins and renewed competition at a pan-European level.

Custodians with a limited coverage across the zone will be marginalized, whilst those with a wider footprint across this new region, a deep understanding of the impacts of T2S on the customer offerings and a clear strategy and capacity to invest in upgraded harmonized and mutualised platforms have real opportunities to further strengthen their positions.

Selecting the right partner for T2S is paramount to benefiting from what your custodian as safekeeper of your assets should be delivering first and foremost: protecting your interests and opening the door to leveraging the benefits of T2S.

PART ONE

How will T2S impact the market participants?

First of all, we can today distinguish three main categories of market participants that are members of central securities depositories:

- Chiefly domestic players, i.e. those that have a large concentration of their business on their home market and that have most often built up an international client base on the back of a domestic business although custody is not a core product
- Regional custodians, i.e. those actors that have a significant franchise across a group of markets – usually geographically adjacent – through a physical presence with the capability to offer either multi-local or single point of entry regional services
- Global custodians, i.e., custodians that propose services across a wide selection of global markets not only to the final clients but also to other custodians. Global custodians can

further be divided into two groups: on one hand those that rely mainly on an external network of local agents and on the other hand, those that have a significant global presence, i.e. their own internal sub-custody network.

T2S creates commonalities between markets and this commonality induces the emergence of a new region whose boundaries are not equal to those of any existing region, e.g., the Nordic region or central and Eastern Europe. The impacts are quite different for each category

Global custodians will remain global custodians, however their strategy in the T2S zone will depend on a number of factors including:

- To what extent T2S is seen to effectively create a single unified market
- The philosophy in terms of network management strategy including, among other items, the approach to risk.
- Their footprint in the new T2S zone.

Indeed, a global custodian with a significant local presence in a number of the major T2S markets will become a de facto regional provider in the T2S space. This local presence, this proximity to the underlying legacy markets, is paramount in the T2S region as although the harmonization of settlement and the option to be a directly connected participant facilitates bypassing local actors for settlement, for asset servicing, a deep understanding and relations with the local markets remains a necessity.

For today's regional players around Europe, it's a case of one foot in and one foot out. As the new T2S region does not match with the existing zones, the regional players may either choose to expand their services across more T2S markets or retreat to the boundaries, focusing their added value on the out rather than in markets. Expanding into the T2S zone would require investments that they may not be able to meet.

With regards to the local single market players, T2S dilutes somewhat the historical advantage they may have had as a 100% local player. Without, in most cases, the capacity or the business case to invest in new operational models, including direct connectivity, their days servicing international clients are potentially numbered.

Of course, niche strategies notably on the outer fringes of T2S may continue to represent a viable alternative for some years to come.

By what approach will firms purchase custody services in T2S?

A) The functional approach

T2S is a disruptive phenomenon in that it creates two main functional divisions in what was traditionally an integrated business area situated at the bottom of the typical three layer market organization including the execution space, the clearing space and the custody space. Securities settlement and the management of the cash leg are two activities that can be spun-off from the historical custody package although securities settlement of collateral remains intertwined with the liquidity management associated with the cash leg.

The cash function is however relatively easy to separate. There is a potential and indeed an interest for a stand-alone liquidity product. This is not entirely new: in the French market, for instance, the status of “client compensé” by which a CSD participant’s cash settlement leg of DVP transactions is settled by a third party is quite common. What changes with T2S is the geographical dimension at which this kind of service model can tomorrow be organized.

Asset servicing is more difficult to carve out as a stand-alone offer from settlement and this for three main reasons:

- Intellectually: as many years of discussions within standards bodies such as the SMPG (Securities Market Practice Group) can testify, positioning activities such as market claims or transformations processing on the settlement or asset servicing side of the fence remains a matter of debate.
- Operationally: asset servicing is usually provided through building stock and pending positions based on settlement information (instructions, statuses, confirmations) going through the same systems. To provide asset servicing only, the question thus arises as to where, how and at what cost settlement and position data can be obtained to constitute the image of the portfolio necessary to execute asset servicing processes, starting with the issuance of event notices for income and corporate actions.
- In terms of responsibilities: linked to the two preceeding items, a key difficulty with building a stand-alone asset servicing only product is in defining very clearly who does what and when between the provider and the client. An example can be found with re-registration in omnibus markets for which T2S does not today provide a settlement integrated solution.

Building an asset servicing only model is thus difficult but not impossible. The decision to take-up this challenge will be dictated by the business case and by the overall strategy. SGSS that has an unique track record in providing such services in a pre-T2S context will build on this experience and indeed execute this model internally between entities to provide an efficient regional one stop shop value proposition.

B) The market approach

Investors and sell-side firms will probably continue for some time to take a national market by market approach to purchasing post-trade services in Europe. But this strategy will gradually diminish. Indeed, as more and more markets share a single platform, the level of harmonization necessary to attain the objective of a single unified market will accelerate. At the same time, CSD Regulation along with T2S will increase competition not only between agent banks but also between central securities depositories with as a result a concentration of volumes in fewer places. A two step approach to provider rationalization can thus be expected, starting with an orientation to selecting a single provider in a multi-local approach followed by a shift to a more truly regional model.

C) The service provision approach

Service provision can be considered chiefly along two axis: either in terms of quality of services provided and/or in terms of the breadth of services provided.

For custodians that are servicing today a wide range of clients including asset managers, asset owners, sovereign investors, supranationals, investment banks, other custodians and brokers, providing only settlement and custody products is clearly not sufficient. Today's clients are looking for a seamless integration of services across the board, from fund valuation through to share class hedging or from transfer agency through to collateral transformation. However, these services are largely dependent on positions or data derived from core activities, i.e., from custody. It thus remain paramount for serious contenders in today's markets to not neglect the foundations whilst building out their service offerings across and up the value chain.

Indeed, T2S is a good reminder that the essence of the post trade business lies in what was commonly referred to as "safekeeping", term that is still relevant even if the assets are no longer physically stored. Indeed, safekeeping implies protecting the assets but also protecting the interests of clients and of the underlying end investors.

So whilst T2S is a settlement orientated project and investment today in this domain to adapt is significant, SGSS is investing more than 3 times the resources in renovating its asset servicing capabilities across the T2S zone.

Naturally, provision of the highest levels of quality of service is fundamental to maintaining a providers reputation in the market, for conserving existing relationships and driving new business.

What is the fundamental impact on custodians in the T2S context?

To sum up the impact of T2S in a few words it can be said that the significant changes to which custodians must adapt, the potential erosion of margins on commoditized activities such as settlement coupled with increased demands on the breadth and quality of services require significant volumes to sustain the need to invest. The entry ticket to the custody business is thus getting bigger as is the critical mass needed to remain a leading player across the zone. To make a parallel with nature, small fish live in small ponds, bigger fish in bigger ponds: the advent of T2S creates a water mass of an unprecedented size in Europe. As the 2nd largest custodian across EMEA, SGSS is in a position to commit with both feet to T2S and remain a partner of choice in the new paradigm.

PART TWO

So what are the impacts and potential benefits for custodians' clients?

The common denominator for all clients – from Fund Managers through to Investment Banks – is the expectancy that their custodian should act in their best interests and, to a certain degree, shield them from the intricacies of change in the markets. Acting in the best interests of clients in the context of T2S implies taking the measures necessary to leverage the benefits of T2S whether the said benefit is directly visible for the client or not. Such measures range from relatively small scale change, for instance enhancing systems to manage efficiently the new settlement tools in T2S such as hold & release or partial settlement to more major strategic change including the implementation of direct connectivity to T2S to shorten the path to the market and optimize the settlement process. Only a handful of custodians in Europe, of which SGSS, are effectively making the investments in this more major change in operational models.

Shielding clients from change does not mean not making changes. What it implies is making it possible for a client to benefit from change but with limited to nil impacts on the processes behind the day to day operational relationship whilst improving the performance and/or the security of that relationship. At SGSS we interpret this along two different axes:

- A change management axis by which the key is providing the right information at the right time enabling clients to digest and prepare for mandatory change and make educated choices on optional changes
- A solutions axis by which the client may choose to delegate to SGSS the effective usage of, for example, a settlement management function such as hold & release. In delegated mode, the client benefits from market level matching earlier in the settlement cycle albeit not being engaged to settle the transaction whilst, typically, incoming securities are not yet available on account. This notion of delegation can be seen also on a much wider scale, for instance, in terms of liquidity management in T2S. Typically, retail or institutional investors will not be looking to become Payment Banks or to manage actively their intra-day purchasing power in T2S. It is expected that the custodian will implement the most efficient model to optimize liquidity in the new environment to guarantee the perfect mix between reducing the cost of liquidity (mobilization of collateral to finance settlement) and ensuring sufficient buffers are available to cover night time settlement and peaks of activity during the day.

But beyond shielding clients from change, acting in their best interests also implies pointing out where changes could be made that are potentially beneficial for the end client. SGSS' objective is indeed to go a step further with its clients beyond transition to explore avenues for transformation. In this context, four main themes have been identified as candidates for transformational strategies:

Settlement, faster & safer: by using the new and enhanced settlement tools incorporated into the design of T2S, it is possible to reduce manual exceptions and settlement failure. In a context where settlement discipline regimes will become more widespread and stringent, this is clearly an area that merits attention. Furthermore, the elasticity of a back-office to deal with volume peaks is linked to the ratio of manually processed exceptions compared to total volumes. The higher the rate of manual intervention to cover non automated or failing transactions, the more staff need to be added should volumes rise.

Optimize your network: managing multiple providers has some benefits but also a number of costs. Looking either side of the Atlantic, network managers at sell-side firms and larger institutional investors can observe a ratio of 10 to 1 in the number of suppliers in markets that are of an equivalent size. More suppliers means more relationships to maintain, more reconciliation, less buying power, more process differentiation and ultimately more staff and more costs. With T2S bringing the legacy markets much closer through sharing a single platform brings to the fore the option to select a single entry point into T2S as a region. But although settlement is harmonized across the participating markets, asset servicing remains heterogeneous and requires expertise that only the local proximity a player installed physically, historically, can provide. It is SGSS' ambition to pull together settlement and asset servicing into one coherent regional package thanks to our combined strengths of direct connectivity to T2S for settlement and local presence in all the major T2S markets.

Optimize your liquidity: traditionally asset managers and asset owners benefit from an optimized management of their cash with their custodian of choice due to largely opting for global custody services. Assets, including 'eligible collateral' are also pooled in one place, on the books of the custodian. This does not mean T2S presents no opportunities. Indeed, here the key is to mobilize such securities through the collateral management programs with the custodian to provide collateral to finance the activities of clients that are short in appropriate forms of liquidity. Among the 'sell-side' clients two sub-families emerge: those financial institutions, on one hand, that have T2 accounts but don't have the business case to invest in the tools to manage a dedicated cash account in T2S and run it on a daily basis, and those institutions, on the other hand, currently funding multiple custodians or central bank accounts around Europe today looking for solutions to reduce the fragmentation of their purchasing power in T2S. For both the former and the latter, SGSS can accompany clients in adopting solutions that take the project effort and running cost out of liquidity management in T2S or that facilitate pooling and netting of cash across markets and mobilization in T2S of collateral to finance settlement through automated repos. More importantly still, SGSS is implementing a liquidity management model in T2S thanks to which it is expected to significantly reduce the pressure on the collateral pool, thus freeing up resources with which we can further support our clients' businesses as a liquidity provider.

Consolidate the settlement process: to get straight to the point, the easiest and most efficient option for the vast majority of our clients across the board is to select a custodian that can provide a broad and efficient access to world markets through a single entry point / client service unit. In the T2S context, "efficient" implies taking the connectivity option that brings the custodian closest to the settlement system: this is the option taken by SGSS to remove the delays and additional costs associated with additional pre-T2S local settlement agents. By being direct market participants, this also facilitates implementation of, for example, segregated holdings structures right the way through to the CSD accounts, a requirement often cited by our clients, notably by sovereign investors and supranational entities. However, for the largest purveyors of volumes in the T2S markets – Top tier Global Custodians, Investment Banks, ICSDs or Investor CSDs – choosing a path to settlement consolidation through self-settlement can be a viable alternative both economically and strategically. This option leads logically to functional unbundling and the need for the support of a provider of 'asset servicing only'. Here again, SGSS is committed to lengthening its unique track record for 'pure custody' provision in the ESES markets and extending the scope to a regional value proposition across the major markets.

Last words…

The above examples illustrate, we believe, some examples of the potential to leverage T2S to optimize or indeed transform settlement, liquidity, asset servicing and relationship management in the new post-trade environment. Along with the impacts for custodians, described earlier in this document, they also clearly underline the importance of choosing the right partner in T2S as custodian, ensuring it has the capacity to invest in change and implement solutions that protect your interests. SGSS would be delighted to be part of your team in these challenging but exciting times.