Analysis

A new era in securities settlement and custody markets

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Finnish securities settlement and custody servicing is undergoing a major reform. The timetable is tight. The controlled execution of the projects, on time, is essential due to the systemic importance of the securities markets infrastructure and the competitiveness of the Finnish markets. The reform is based on the EU Regulation on central securities depositories, and the centralised platform for securities settlement, preparations for which have been headed by the ECB. These projects are considerable in terms of scale and are necessary for achieving sustainable cost and risk reductions.



New system launched

Finland’s national central securities depository Euroclear Finland and its users, along with the other central securities depositories in the EU and their interest groups, are currently preparing for a major EU-wide reform. Two key initiatives – the CSD Regulation and the pan-European settlement platform Target2-Securities (T2S) – will be completed in the next few years, in parallel. The timetable for implementation of the CSD Regulation has not yet been completely finalised.

Euroclear Finland's system 'Infinity' will replace all the systems of the Finnish central securities depository with new generation practices compatible with the T2S settlement platform. The project will also combine the functionalities of the two separate systems currently used, thereby e.g. enhancing the use of liquidity. [1]

The necessary changes will be implemented in three stages. [2] The first stage was launched successfully in February 2015. In terms of timetable, the project is putting strict pressure on the Finnish markets, but there is no room for compromise as regards quality.

Positive outcome of system assessment

The Bank of Finland has assessed the Infinity System[3] in accordance with principles commonly agreed in the European System of Central Banks (ESCB).[4] Based on the assessment, the system meets all the requirements adequately. The system is eligible for use in Eurosystem credit operations and has functioned reliably as part of the infrastructure used in the execution of the ECB's asset purchase programme. In the assessment, the Bank of Finland paid particular attention to the following issues:

- The central securities depository, together with the system participants, must prepare for the possible default of a participant.
- Euroclear Finland must ensure the effectiveness of its governance arrangements and consult stakeholders adequately in the system project.
- Euroclear Finland has introduced an extensive recovery plan[5] that supports risk management, and the maintenance and adjustment of this plan to the requirements of a changing operating environment is of key importance.

The Bank of Finland is closely monitoring that the system project keeps on schedule and that the participants are ready to migrate to the T2S platform according to the agreed project timeframes.

Commencement of structural changes in the settlement and custody markets

The launch of the T2S platform will change the structure of the European settlement and custody markets significantly, as well as competition between central securities depositories and banks. These are also the first steps towards a Capital Markets Union, the objective of which is to remove the barriers to cross-border investments in the EU.[6] The T2S platform supports the creation of deeper and more liquid collateral pools. Improving the financial market infrastructure is, in turn, a key component of Finland's national competitiveness strategy. Tighter competition may increase the consolidation of central securities depositories.

The industry is widely committed to the introduction of a single T2S platform and considers that harmonisation based on transaction netting and consolidated liquidity management will provide economies of scale over time. Finland will join the T2S platform in the last migration wave in February 2017. The other Nordic countries are also extensively harmonising their market practices in line with the T2S model. Consolidation decreases the number of participants and lowers risks. However, practices relating to issuers' corporate actions, such as dividends and various capital arrangements, and company and dividend recipient taxation, differ significantly

across countries. The post-trade processes still involve too many parties, which causes extra costs.

CSD Regulation opens the markets

The aims of the CSD Regulation which entered into force in September 2014 are also welcome overall. The Regulation is an important component of the reform of EU financial market regulation. In EU-level harmonisation, over-regulation must, however, be avoided. It is not necessary to harmonise all market practices across Member States, or to impose requirements that are too detailed, as this could hamper the development of markets.

For the development of the Finnish capital markets it is of key importance that competition between central securities depositories operating in the EU is open, and that securities trading, settlement and custody is not more expensive in Finland than on the other markets. The freedom of an issuer to choose the central securities depository for its securities issues must be ensured in the manner required by the Regulation. Free access to systems applies also to other parties and central securities depositories.

On the European level, the Regulation will introduce a compulsory penalty and buy-in regime to improve settlement discipline. This will be accompanied by the start of extensive monitoring and reporting of the stages of transactions. The Regulation applies first and foremost to central securities depositories, but the impacts of the requirements on settlement discipline will reflect on a wider range of entities in the securities transaction chain, and therefore also on securities trading. Central securities depositories must report anonymous and annual data on settlement fails by market participants.

Several types of responses[7] have been delivered on the draft technical standards of the Regulation, as the impact of regulation varies across market participants. Some participants fear that the requirements planned for improving settlement discipline will jeopardise the efficiency and liquidity of the markets. The implementation of the sometimes highly-detailed requirements will harmonise and change market practices, but at the same time, it may also e.g. increase the risks and costs of market-makers and investors.

Late settlement must be curbed in Helsinki

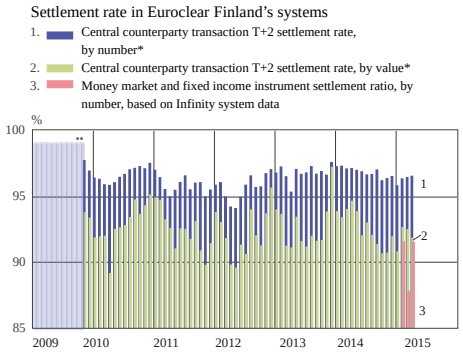
In Helsinki, settlement of a significant proportion of equities and fixed income instrument transactions take place later than the intended settlement date. This is mainly due to settlement taking place after the agreed settlement period, and not because settlement has failed completely. In such a case, an equity transaction becomes final on average 3–4 days after the contract has

been concluded, even though the current requirement is 2 days after the trade date. The costs of securities transactions rise because sellers do not deliver the funds to the buyer within the agreed period of time, and the settlement rate remains low as a result of late settlement. Only some of the reasons for the delays have been identified.

On the equities markets, the problems are partly due to communication problems between a foreign customer and a local entity providing services, but mainly they are the result of an inadequacy of incentives for remote brokers to avoid settlement fails. In Finland, the delivery of claims generated on the equities markets is often the responsibility of domestic agents providing services to foreign customers, and on a small local market the customer's incentives to deliver the claims within the settlement period are inadequate. The foreign parties that are causing the problem do not, for various reasons, utilise the securities lending markets and borrow the required assets. Moreover, fines imposed by the central counterparty or central securities depository have not helped to resolve the situation.

With the launch of the 'Infinity' system, the same problem of late settlement was also apparent in the settlement of fixed income instruments.[8][1] This is not due to new settlement deadlines, central counterparty clearing or lack of familiarity with the regulatory environment of the local markets, because the parties responsible for late settlement are local entities. The situation needs to be remedied rapidly.

Chart 1.



*Until 6 October 2014: T+3.
**Average T+3 settlement rate of transactions in the trading venue.
Source: Euroclear Finland.

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Notes

1. For more information, see http://www.suomenpankki.fi/fi/julkaisut/euro_ja_talous/rahoitusjarjestelman_vakaus/Documents/08Vakausraportti.pdf, p. 31–32. ↑

2. The first stageIn the first stage of the Euroclear Finland T2S programme, changes were introduced to the settlement and custody of fixed income instruments. ↑
3. See http://www.suomenpankki.fi/en/rahoitusjarjestelman_vakaus/infrastruktuuri_valvonta/Documents/Suomen%20Pankin%20yleisvalvonta-arvio%20Euroclear%20finland%20-yhti%c3%b6st%c3%a4%2c%202014.pdf. ↑
4. See https://www.ecb.europa.eu/press/pr/date/2013/html/pr130927_1.en.html. ↑
5. The plan ensures the continuity of a company's critical services in situations that threaten the company's viability and financial position. See http://www.bis.org/cpmi/publ/d121.pdf. ↑
6. See http://ec.europa.eu/finance/capital-markets-union/index_en.htm. ↑
7. See https://www.esma.europa.eu/page/Post-tradingSettlement-SFD-CSDR-T2S. ↑
8. It should be noted that in the settlement of fixed income instrument transactions, due to the small number of transactions, individual delays have a larger impact on the settlement rate than in the settlement of equity market transactions. ↑

Keywords

CDS Regulation, economies of scale, securities settlement, settlement discipline, T2S, technical advances