Julia: **Hello and welcome to a DerivSource podcast. I'm Julia Schieffer, the founder and editor of DerivSource.com**

The European Market Infrastructure Regulation or EMIR was launched in 2012 but there are still loose ends to be tied up in terms of the CCP clearing obligation, frontloading, and other regulatory rules this new regulation introduces.

Meanwhile, the Central Securities Depositories Regulation or CSDR only came into force in 2014 to help harmonise settlement in Europe alongside T2S or Target-2 Securities.

In this DerivSource podcast Ran Pieris, an analyst with Celent's Capital Markets practice and author of a new report on this very topic, discusses the different impact these two regulations will have on the technology and operations of CSDs and CCPs.

Here is DerivSource reporter, Lynn Strongin Dodds speaking to Ran Pieris.

Lynn: **Thank you very much for making the time to speak to us. The questions I will be asking will be based on the research and your report. The first question is: What impact will EMIR and the CSDR regulations have on the services delivered by CCPs and CSDs?**

Ran: Hi Lynn, thank you very much for inviting me here. To understand the impact we need to understand a few things about the new regulations, EMIR has been in motion since 2012 and what we are seeing now are the last few provisions linked to EMIR. The first is the clearing obligation with regards to the mandatory clearing of OTC asset classes such as IRS, CDS, FX and commodities via a CCP, and linked to this is a requirement for front loading where existing OTC contracts would need to be centrally cleared.

This is only going apply to Category I and Category II firms. Category I firms are firms that are directly linked to CCPs, while Category II firms are firms that are clients of Category I firms. The second provision is the bilateral margining of non-centrally cleared OTC derivatives. In this case it becomes necessary for any OTC instrument that can't be standardised or has to be cleared via a CCP to be margined by a third party. At first this may be based on variation margins, followed by the introduction of initial margin at later stages.

Now CCPs who have already been authorised and can clear IRS and CDS instruments won't have to update many of their systems in respect of the clearing obligations, so effectively they are pretty much 'okay' right now and they can take in the new IRS and CDS instruments when they come in.

From what I have read, it seems that any extra demand arising from the clearing obligations (which is very likely to happen) and the related requirements for front loading could easily be dealt by the CCPs. CCPs who have not been authorised for these specific products, and there are quite a few out there, will naturally not have been providing a clearing function for them, so they would need to invest in systems and processes to clear these. The bilateral margining of non-centrally cleared trades is now outside the scope of CCPs, so effectively it isn't something they're going to cover.

But one of the requirements of this provision is to have a third party holding on to the collateral, and this might mean that third parties such as custodians and CSDs would be playing a role in holding on to this collateral.

The general sense I got was that EMIR's impact on CCPs has become historical, and CCPs have adapted to the changes and are now preparing to rationalise the services that they can provide. So this could be new account structures, for example, you might have fund accounts which are OSA or ISA accounts; you could have new products being introduced, so that you could actually clear them via CCPs.

Let's move on to CSDR. CSDR came into force in September 2014, with the consultation ending in February 2015, and the draft technical standard expected to be delivered by ESMA in June 2015, so it is this year basically.

It's a relatively new regulation, but already it has had an impact in that the settlement cycle has moved to T+2 in most of Europe. The two provisions that have an impact on post-trade services are the standards on settlement discipline and the penalty for settlement fails.

ESMA effectively is trying to harmonise the standards for settlement in Europe, when technically settlement will move into the T2S platform over the next three years. The standardisation of CSD services means that you could go to the various CSDs and find that what they're offering becomes generally the same. So the question for you, then, is: who will be the best partner in helping you achieve your particular goals?

The other requirement in terms of using Legal Entity Identifiers, which are short for LEIs, tries to record mandatory book entry across transferable securities, will require system changes on the part of CSDs, but will not change the services that are provided by the CSDs.

***Lynn*:** **Against that backdrop, what do firms need to do on an operational and technological level to prepare?**

Ran: Well, EMIR has required CCPs to introduce new account structures such as OSAs and ISAs. It's made them define their operational structures and to apply to become authorised as a CCP.

When looking at the remaining provisions for EMIR, those who already provide clearing services for any asset classes undergoing the clearing obligation won't have to do much, but CCPs who want to increase their asset coverage will have to introduce systems and processes to expand their services.

My understanding is that CCPs are through most of the changes for EMIR, and now it is a matter of rationalising the services that they are offering to their clients, such as account structures and increasing product ranges.

What I can see is that most of the work behind EMIR has been completed by CCPs, and it's a matter of just waiting for the clearing obligations, taking in the extra volume, which from what I can understand, from what they're saying, the CCPs they can easily handle, and any CCPs who want to actually expand their product range will have to apply for the ability and authorisation to actually cover those asset classes.

So there's not much really left when it comes to EMIR.

If we move to CSDR, there are six things that need to be covered by the CSDs:

- The first is there will be a new record keeping requirements, so CSDs will need to use legal entity identifiers, LEIs, for regulatory reporting and for their own record. Right now CSDs who do not have access to LEIs will have to adopt these into their system, so that's the first.

- The second is that CSDs will be asked to keep a record of the direct participants as well as their participant clients. Most CSDs keep records of direct participants, so introducing records of client participants and also updating this will require ongoing operational processes and systems.

- Third: late penalties are based on a prescriptive set of rules, and CSDs will need to maintain the database of instruments to know how to apply the late settlement charges. Also, CSDR requires that any settlement charge be wholly passed on to the counterparty. Right now, CSDs use this charge as a form of revenue, so this might impact their bottom line.

- Fourth: CSDs will have to get more involved in the buying process by collecting data on buy-ins, adopting a buy-in agent, and preventing multiple buy-ins. Buy-ins are something that have normally been carried out by CCPs and exchanges, so CSDs will have to introduce new procedures and systems to cope with this requirement.

- Fifth: CSDR is going to slowly introduce a book entry of all transferable securities. In reality this is far off, as all securities will have to be de-materialised by 2025, so it's quite a long way off, and from what I can see it's really the action of the national governments that are needed to make this possible.

- Sixth (and last), CSDR is going to introduce a non-discriminatory access to CCPs and trading venues. CSDs will have to decide on the cost and benefits of this, and I suspect that the most successful CSDs will not shirk away from expanding their networks.

So that's pretty much what I can see on the CCP and CSD side from these changes on technology and on procedures.

Lynn: **The next question focuses on the growing competition in the CSD space with new initiatives such as the LSEG globeSettle, the BNY Mellon CSD as well as Northern Trust joining forces with ABN AMRO Clearing to provide a clearing, custody, and collateral management solution. Do you think this will follow other market trends where there has been increased competition and then the eventual consolidation?**

Ran: That's a really interesting, because it seems that it's standard practice that change in the regulatory sphere, for example if you look at when MiFID came in, leads to a fragmentation of the system followed by consolidation. I remember all these other exchanges that came on, for example Turquoise, BATS, ChiX, came along, BATS ChiX those two got merged, and then you had Turquoise becoming part of the London Stock Exchange, so yes I think, you know, there is a possibility of that. But when I look at CCPs there's been a move for consolidation for quite some time, and if you look at the CCPs with the largest volume in Europe, they tend to be part of vertical silos. So, I think that's already been taking place, so there might be more consolidation over the next few years, but already they seem to be structured within these clear vertical silos, so unless there's going to be takeovers between them, who knows? I think they will continue as they are.

When I think about the introduction of new CSDs, I think it's more related to the T2S system where these new entrants are seeking to use the direct connection that's available through T2S to leverage their business. So effectively they're just trying to secure the existing business that they have, and they're trying to make sure that they can provide all the services that their clients need. For example, when you're looking at BNY Mellon CSD and LSEG globalSatellite, I think what they're trying to do is just make sure they keep hold of what they're doing, plus expand. But T2S basically allows it, and I don't think it's really much to do with CSDR right now. But saying that I think that CSDR has a role in the harmonisation and I can see three possible outcomes here from the harmonisation.

The first possibility I can see is that the smaller CSDs are going to consolidate with the larger CSDs, and ICSDs so they can share systems and they can leverage their local regulatory knowledge, and I find this to be the most likely outcome right now. There's quite a lot of very small CSDs out there and it would probably be in their interest to become part of a larger group and have access to those systems and so on.

The second possibility is that the smaller CSDs reduce the provision of any operationally expensive ancillary services while keeping their independence, and these services actually moving to the better resourced CSDs and custodians. This will mean that smaller CSDs might only exist due to national requirements, because they supply a local knowledge to larger CSDs and custodians.

The last possibility I can think of is the possible survival of the smaller CSDs by them sharing technology and infrastructure and data expertise, and I don't think that's very likely to actually happen.

Lynn: **How do you think the new rules will impact the services offered by post-trade service providers? Do you think there will the opportunities be for the custodians who are hoping to leverage their businesses to take advantage of the new rule?**

Ran: Yes, this is quite an interesting point. When it comes to post-trade providers and when you look at EMIR, I think there are two real possibilities here, and that will always depend on how big the participants are that connect up to CCP clearing services.

The larger participants as a group, they are going to actually require the use of multiple CCPs throughout Europe, and they might find the services of a post-trade provider to consolidate their positions are crucial to successfully manage their risk and regulatory requirements.

The smaller participants who are the second group, will require the use of a single CCP, and most CCPs actually give a good service anyway, and they will be able to use the services offered by that CCP rather than using the services of post-trade providers to manage their positions and risk.

The other thing I mentioned earlier on is the front loading. The front loading will mean that existing OTC trades will have to be moved to CCPs and that's going to require participants to analyse their positions and then to clear with the CCP.

We already have service providers who help with risk mitigation by way of compression, and there could be opportunities here to help clients analyse how they could reduce any basis risks that are related to the frontloading requirement.

If we move on to CSDR, I think there's already a need to make sure that the matching and reconciliation are carried out as soon as possible, now when you have fines what's going to be needed? With settlement discipline and fines being in the wings it becomes more important that issues with any transactions can be identified very quickly and then can then be solved as soon as possible.

The way I see it, CSDs are going to have a hard time. To answer your question on CSDs they are going to have to cope with T2S and CSDR, and the larger custodians are in a sweet spot to expand as they have a complete view of the market infrastructure and they won't be as heavily burdened by the regulatory changes. They are generally well resourced and also, I believe, closer to the end client. I think there are opportunities for custodians to choose their clearing and settlement partner, to offer buy- side services to optimise their portfolio, especially when collateral is becoming very important.

***Lynn*:** **As always with regulation. What do you think are the unintended consequences?**

Ran: The question is if either of these regulations will make either of these institutions too big to fail, and the way I see it, they already have for CCPs, and CSDs it's only a matter of time before they begin to consolidate and a few institutions come to play a central role in custody.

Also, we have to consider that collateral is becoming more important, as these two institutions will be providing and taking it, and CCPs don't re-hypotheticate, so liquidity will be removed from the market.

The way I see it, custodians might provide a useful way to get hold of collateral with their links to buy-side firms, so they might play an important role in bringing up this collateral. This might be beneficial when it comes to clearing non-centrally cleared trades as they become the intermediaries that find liquidity.

***Lynn*:** **Finally, looking farther down the road when all the post trade dust has settled, how do you think the European post trade landscape will unfold?**

Ran: That's hard to say. If I had a crystal ball… I think post trade will generally be undergoing some initial fragmentation. It seems to be just a standard model where you've got a bit of fragmentation and then the new players come in. You can already see that in the CSD landscape. Over time, you will have them actually consolidating.

To me, the impact of CSDR is to actually to basically harmonise the manner in which CSDs conduct business in Europe, so I think market participants will generally tend to drift to the service providers that provide the most joined-up solutions. This means that in the long term, obviously, there's going to be less CSDs and CCPs but that's quite an obvious answer.

The question is, who's going to be the most successful ones? What are the indicators of who are the successful ones? So, that's maybe something to look at later on in a further report.

Also, I have to mention one other thing actually, thinking about this, and someone actually introduced me to this idea, and it's about the new technologies that could actually make CSDs and CCPs redundant, maybe way off in time. I can see that Bitcoin, BlockChain are becoming sources of disruption, and if you look at the idea of smart contracts as well, I think these ideas actually have the potential of disrupting the whole business model of CCPs and CSDs, but right now it is at a very immature stage, so we can't say how long it might take. I think it will eventually get there, where these smart contracts and the BlockChain might have a big impact on the CSD and CCP business.

Lynn: **Thank you very much for such a comprehensive view of the regulations, it's been much appreciated.**

Julia: DerivSource listeners, if you would like more information on this topic you can find links to this report, and transcript of this podcast via the podcasts notes page available on DerivSource.com and via our app.

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