Beyond T2S:
Balancing collateral efficiency versus investor protection

Passion to Perform
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Introduction

The launch in June 2015 of TARGET2-Securities (T2S) – a single settlement platform for tradable euro-denominated assets – heralds the start of a process of rationalisation and consolidation of post-trade processes across the Eurozone that could lead to substantial cost savings and efficiency gains for investors. Amongst other benefits, the streamlining of service relationships as markets migrate to the T2S system over the next two years promises to simplify collateral management as asset pools are linked via the platform.

A series of regulatory initiatives at various stages of implementation is expected to increase the demand for quality collateral across the region. At the same time, with the aim of enhancing investor protection, regulators are considering the introduction of mandatory asset segregation at various points along the investment chain.

Deutsche Bank welcomes the introduction of greater investor choice in account structures. We believe that greater transparency and disclosure will help customers and service providers to structure their asset administration and collateral management arrangements in the interests of both safety and efficiency.

Ultimately, however, the choice of account structures should be the result of informed decision-making by the parties concerned rather than of regulatory requirement, which in focusing on one set of concerns, risks unintended consequences for the efficiency and safety of the transaction chain as a whole.

Two key issues for the financial services industry in this context are:

1. **How to reconcile operational efficiency with the growing regulatory push for greater transparency on asset ownership.**

2. **How to reinforce asset safety – a key concern of the regulators – without hampering collateral mobilisation – a key requirement of the market in meeting enhanced collateral demands from market infrastructures.**

Below, we examine key considerations in determining how best to achieve those ends.
Collateral management and liquidity

Today

Securities lending and financing activity allows buy-side firms to generate extra income from their asset portfolios and meet the associated collateral demands of their trading strategies, while enabling sell-side firms to secure their business by posting collateral to market infrastructures and covering short positions in time for settlement.

An efficient market structure allows assets and cash to flow among participants to where needed, by pooling assets available for lending and enabling collateral to be transformed where necessary.

Investors who choose to place their assets into a lending programme are looking for both incremental income and a way of offsetting asset administration costs. They may also have collateral obligations of their own from their participation in derivatives trades that under a range of new regulations need to be centrally cleared.

Access to an appropriate lending programme will in most cases be provided by their global custodian or dedicated lending agent, who will ensure distribution of the assets to pre-vetted participants seeking to borrow.
Tomorrow

Where appropriate collateral is not available within a participants existing pool, intermediaries may offer a collateral transformation service.

Each market infrastructure or counterparty to a securities financing transaction will set the type and grade of collateral they are willing to accept. The aim of collateral transformation is to allow market participants who need to post collateral for particular regulatory or transaction requirements to upgrade their available collateral, to the level mandated or requested for the purpose concerned.

In a collateral transformation, providers will, in return for a premium, accept certain forms of securities (debt & equities) as collateral and in return provide more liquid or higher quality assets (AAA, AA rated sovereign debt) that can then, for example, be placed at Central Counterparties (CCPs). Collateral pledges will entail haircuts that vary according to the perceived riskiness of the collateral, the context of the transaction and the nature of the collateral taker (for example, central bank, CCP or other counterparty under a particular regulatory framework)\(^1\)

Currently, mobility of the collateral required is made through the investment chain by omnibus and nominee account structures that allow intermediary institutions to manage their clients’ participation in such programmes on a book-entry basis.

Asset security in this context therefore needs to be viewed in terms of both legal protection of ownership and appropriately structured processes to minimise operational complexities that could also put the assets at risk.

\(^1\) Comparisons of haircuts applied in different circumstances are available in the ECB’s July 2014 Follow-up to the report on “collateral eligibility requirements – a comparative study across specific Frameworks”
Collateral efficiency in an age of regulation

Triparty collateral management is one of the common methods used to facilitate the movement of collateral from buy-side to sell-side and the onward distribution of those assets through to where the collateral needs to be placed.

Triparty administration

Triparty collateral arrangements allow institutions to manage their collateral assets via a “triparty agent”, who acts on behalf of both the collateral giver and collateral taker. The agent will maintain accounts for both parties.

Tri-party collateral management employs a combination of client omnibus accounts and books and records segregation at the triparty agent, to manage title transfer via book entry (See Diagram 1). The structure of these triparty arrangements allows agents to efficiently manage asset movements between the parties as well as substitutions.
Collateral demand and regulation

In the current market and regulatory environment, there is an increase in the quantum of collateral required, while at the same time, regulatory concerns for investor protection are feeding through to operational processes and account structure discussions. Securities service providers are working with a range of regulatory initiatives that are causing participants along the investment chain to revisit existing mechanisms for collateral transfer.

Diagram 2 – Dichotomy of regulation

Investor protection
- AIFMD
- UCITS V
- CSDR

Collateral mobility
- EMIR
- BASEL III
- Dodd Frank
- SFTR

MIFID II
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The original Markets in Financial Instruments Directive (MiFID) was implemented in November 2007. It introduced competition to the EU trading landscape along with various investor protection measures. On 20 October 2011, the European Commission (EC) adopted a legislative proposal for the revision of MiFID through a revised Directive and a new Regulation, which together are commonly referred to as ‘MiFID II’. Implementation of the new measures will take effect from 3 January 2017.

CSDR sets out the framework within which EU CSDs must operate and lists the functions they are approved to provide. It also for the first time defines what a CSD is. The regulation has two key objectives: ensuring that CSDs meet the requirements of critical market infrastructures, avoiding activities that accrue additional risk; and driving harmonisation across EU settlements, such as a T+2 settlement time frame and the introduction of a mandatory settlement discipline regime. It also provides for greater customer choice in account structures that offer varying degrees of segregation.

The Basel III framework – so named for the Basel Committee on Banking Supervision that developed it – is a set of reform measures covering bank capital and liquidity. It is designed to strengthen the regulation, supervision and risk management of the banking sector. A key aspect of Basel III is risk-weighted asset (RWA) increases on Over-The-Counter (OTC) and derivatives transactions and their introduction for centrally cleared transactions. This will raise the levels of capital and liquidity necessary to support credit-based commercial activities. It also sets out the weighting applied to different classes of assets in secured funding transactions.

Given the need for Basel III to be introduced by legislation in each applicable jurisdiction, implementation timeframes are not globally consistent.

The Alternative Investment Fund Managers Directive (AIFMD) came into force in July 2011 with an implementation deadline of July 2013. The directive covers the management, administration and marketing of alternative investment funds (AIFs): collective investment schemes that are not subject to the UCITS regime (See below). These include hedge funds, private equity funds, retail investment funds, investment companies and real estate funds, among others. There is a broad expectation that technical implementation of AIFMD will require the segregation of AIF assets from any other assets administered by the intermediary (including its own assets), though the exact form of this segregation has yet to be mandated.

The successive UCITS directives provide the principal regulatory framework in the EU for collective investment schemes that are suitable for retail distribution. UCITS V was adopted in September 2014, and is due to be implemented by member states by March 2016. It sets limits, inter alia, on the re-use of UCITS assets by a depositary.

The exact requirements for segregation of UCITS assets under custody remains to be determined.
EMIR

European Market Infrastructure Regulation (EMIR) covers over-the-counter (OTC) derivatives, CCPs and trade repositories. In principle, it provides for mandatory clearing of derivatives contracts through a CCP. EMIR affects the risk absorption role performed by custodians, since it requires assets to be concentrated at operators of a Securities Settlements System (SSS) and requires segregation of accounts to be offered.

Securities Financing Transactions Regulation (SFTR)

SFTR was adopted in January 2014, but has yet to be enacted. The Regulation aims to improve the transparency of SFTs by (i) requiring transactions other than with a central bank to be reported to a central database; (ii) requiring investment funds engaged in SFTs and total return swaps to provide detailed reporting on these operations to investors; and (iii) setting minimum conditions on collateral reuse to be met by the parties involved.

Also:

Target-2 Securities (T2S)

T2S is the Eurosystem’s new technical platform to support securities settlement across Europe in central bank money with EUR cash funding from TARGET2 (T2) accounts. Notary and safekeeping functions remain with the participating Central Securities Depositories (CSDs). By consolidating the number of post trade intermediaries and central bank relationships in the T2S participant markets, the opportunity for investors to create a single collateral pool should facilitate collateral movement once migration to the system is completed in 2017.
The potential impact of segregation

The regulations outlined above are in various stages of implementation and clarification, taken in aggregate, however, there appears to be a shift in the direction of greater asset segregation as a means of investor protection.

Whether or not this will involve physical segregation down through the custody chain is yet to be determined. At the very least, there is serious discussion among regulators and market participants about greater segregation as a potential contributor to enhanced safety for investors.

The book entry mechanism underpinning the triparty framework would become significantly more administratively complex and operationally costly to run if a “fully segregated account structure” (physical segregation of client assets from an intermediary’s own assets down through the chain of custody) were mandated. Where (and if) assets are required to be held in physically separate accounts at a sub-custodian level, for example, collateral movement would be complicated by an increase in the individual settlement instructions to the sub-custodian or even the CSD.

Similarly, the dynamic real-time intra-day allocations and substitutions that occur within the triparty environment to minimise client risk and optimise performance would be hampered. Resulting in increased collateral costs and risks and reduced market liquidity.

Current pricing models would be challenged where delegates are required to pay additional account fees, increasing the likelihood these will be passed on to investment funds and as a consequence to underlying investors.

Costs that would be incurred are hard to estimate, but would likely be significant, given the need to re-engineer pre- and post-trade infrastructures along with the associated implementation programmes.

In a triparty collateral management model, where data at the end-investor level changes frequently, a fully segregated account structure would make it difficult for market infrastructures with fixed settlement cycles to keep up with frequent changes of collateral at the end-investor level. A greater number of reconciliations and settlements may lead to an increased operational risk of errors and failed trades, given the much larger number of new settlement accounts.

As the cost of collateral programmes increases, the additional value they bring to potential contributors to the lending pool decreases. Fewer long asset holders would therefore be tempted to place their assets in lending programmes. This would make it more costly for borrowers to access assets. Paradoxically, therefore, two valid and legitimate regulatory concerns – investor protection and risk mitigation within market infrastructures – could begin to work against each other.
Ensuring investor protection

In refashioning the efficient market mechanisms we have today for collateral management and transformation, would fully segregated account structures actually offer greater investor protection?

The *sine qua non* for investor protection is definitive knowledge of who owns the assets concerned and acceptance of that record by all parties. Already with an omnibus account, intermediaries in the post-trade transaction chain must be able to show in their own books and records what assets belong to each participating client. Whether a fully segregated account structure at the level of the beneficial owner would provide greater overall protection for the investor is moot, given the additional operational complexity and risk that it would introduce. There is nevertheless a possibility that such full segregation through the chain of intermediaries will be mandated in the implementation of one or more of the regulatory initiatives outlined above.

Insolvency rules in a number of jurisdictions do not support the view that the physical segregation of assets is in itself sufficient to ensure the protection of those assets in the event of insolvency. Insolvency regimes can vary greatly in this regard. In certain jurisdictions physical segregation is seen as a contributing factor in the return of assets following an insolvency. In certain major markets such as the US, however, physical segregation of assets will have little or no bearing on the protection afforded to assets in the event of insolvency of the custodian.

If the opening of physically segregated accounts in a particular jurisdiction does not guarantee the return of client assets on insolvency then insisting on this level of segregation over the current market standard of books and records segregation does not appear to further the investor protection policy objective, despite significant cost and operational challenges that would arise for market participants.
The industry challenge

In the current environment, both sides of the collateral management business are regulated, quite rightly, with a specific aim in mind: the sell-side is required to secure its business through the placing of collateral to cover the eventuality of default, while the buy-side is required to demonstrate that it is safeguarding its clients’ assets, ensuring that they are easily identifiable as such. Going forward the industry needs to balance these goals in order to ensure that we do not risk introducing unintended consequences resulting from an imbalance.

The conundrum at the moment is what solutions are, and might be, available to allow intermediaries involved in facilitating collateral management and transformation to continue to pool client assets, while satisfying the regulator that the protection of the assets in those pools is secured and ultimate ownership of the assets in those pools is recognised?

One effective option for achieving the desired level of protection might be to mandate that a specific client’s assets be immediately identifiable in the books and records of third party intermediaries without necessarily insisting on full account segregation.

Another might be to leverage emerging distributed ledger (DL) technologies: effectively a decentralised record-keeping system based on the blockchain concept that was initially designed to underpin Bitcoin, supported by the use of public and private key infrastructure.

Recognition of the potential value of DL technologies is now relatively widespread, including by governments and public authorities. The Monetary Authority of Singapore, for example, uses a distributed ledger system to prevent duplicate invoicing in trade finance.

In the context of securities services, DL technologies could provide an alternative record in parallel to existing account structures that would serve as an instant and comprehensive transaction audit trail. Deutsche Bank has through its own research already identified uses for DL technologies in the following processes:

- Securities issuance and transfer – creation of unique identifiers, transaction tracking and asset segregation;
- Securities clearing and settlement – through delivery of more efficient post-trade processing; and
- Securities asset servicing – through automation of dividend/interest payments and corporate actions processing.

The use of such technologies in mainstream financial transactions is still being explored and would clearly need to integrate an identity management capability to address regulatory risk management concerns.

In addition, a number of unresolved questions still need to be addressed. Assuming that a distributed ledger can be operated in a permissioned environment, who will be responsible for the public key infrastructure underpinning it? Who would be the regulators’ central point of contact? Who would have visibility of the identity of the parties to a transaction and under what conditions?

Nor is it yet clear what the impact on exceptions handling and netting might be in a distributed ledger environment. Nevertheless, we believe the industry as a whole could benefit from finding the answers to these questions, preferably in dialogue with regulators.
WHERE A FULLY SEGREGATED ACCOUNT STRUCTURE FOR INVESTORS’ ASSETS THROUGH THE CHAIN OF ADMINISTRATION IS Viable, IT SHOULD BE LEGALLY PERMITTED ALONGSIDE OMNIBUS ACCOUNTS.
Conclusion

In an environment where the demand for high quality collateral is likely to exceed supply at some point for individual market participants, any additional operational burden that would inhibit collateral mobility could have a detrimental effect on market activity as a whole.

Various account structures are available in different markets. Where a fully segregated account structure for investors’ assets through the chain of administration is viable, it should be legally permitted alongside omnibus accounts.

However, the choice of account structures should be a matter between investors and intermediaries, provided the disclosure of risks and associated pricing is clear and regulators’ concerns about investor protection are explicitly addressed in each of the available frameworks.