



RealTime

BNY Mellon's Newsletter on TARGET2-Securities and Market Infrastructures

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Dear Reader,

Welcome to the fifth edition of BNY Mellon 'RealTime', our newsletter designed to keep you up to date with changes to the European market infrastructure and provide information relating to our T2S strategy and how BNY Mellon is positioning itself in the post T2S European infrastructure landscape.

In this edition we provide an update in relation to the T2S Wave 2 migrations in Belgium and Portugal which took place in March and look at BNY Mellon's plans for 2016, when we will become direct to the CSDs on T2S in Italy and the Netherlands.

The amended T2S timetable (recently ratified by the ECB) is a direct result of the decision taken by Euroclear to postpone migration of their ESES CSDs to the T2S platform. As a consequence, BNY Mellon's migration plans have also changed as we align ourselves with this new timetable.

2016 is an important and exciting year for the BNY Mellon T2S project. We will be direct to the CSDs on T2S in two of the six markets which we've identified as being crucial to our T2S strategy (full details can be found in the 'BNY Mellon 2016 Migrations' article).

Furthermore, we have an article on two important recent documents from AFME and from the European Central Bank, which contain recommendations on how market participants should use the T2S system.

In his regular THE REAL IMPACT column, James Cunningham looks at the subject of CSD Regulation and its impact on T2S and on market participants, in particular the work ESMA has been doing in relation to settlement discipline.

Lastly, we have an interview with Mark Higgins, Managing Director working within BNY Mellon Markets. Mark shares his thoughts on T2S and the changing regulatory landscape and their impact on collateral, which has already proved to be a crucial part of the new post T2S European market infrastructure.

As ever, should you wish to receive further information concerning the BNY Mellon T2S programme, or subscribe to future BNY Mellon T2S publications, please do not hesitate to email us on T2S@bnymellon.com.

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BNY MELLON

Wave 2 Update: Belgium (NBB-SSS) and Portugal

Wave 2 recently saw the successful migration of Interbolsa in Portugal and the NBB-SSS in Belgium to T2S with the first live day of settlement for these CSDs using the T2S platform on Tuesday 29 March.

Portugal as a market has now fully migrated to T2S. In Belgium, only the NBB-SSS fixed income CSD has migrated. Euroclear Belgium, the CSD for settling equities, will not migrate until Wave 3 which is scheduled for September 12th this year.

BNY Mellon's T2S strategy for the NBB-SSS in Belgium is to retain our sub-custodian model in the short term before migrating to direct accounts with the NBB-SSS in 2017. For Portugal, we will retain our sub-custodian model.

The impact to our clients has been minimal as they have continued to instruct BNY Mellon as their Global Custodian in the usual way. The only significant change to client instructions is the requirement for clients to use 11 digit BICs to identify their counterparties, whereas prior to the migration of the CSDs in these markets, counterparties could be identified using the 8 digit BIC format.

Further to this point, for any clients who may not be able to provide 11 digit BICs, BNY Mellon offers an enrichment service where we can transform client's instructions for you, so if you wish to find out more about this service, please don't hesitate to contact us for further details.

Lastly, BNY Mellon recommends that in order to achieve a greater rate of settlement efficiency, clients should use secondary level matching fields as well as the mandatory matching fields (as discussed in the 'T2S Market Practices' article following).

BNY Mellon 2016 T2S Migrations: Italy and the Netherlands

Beginning in Q3 2016, BNY Mellon will start the process of moving client assets onto our accounts with CSDs on the T2S platform so that by the end of 2016, we will be live in two of the six markets in which we will ultimately be direct: Italy and the Netherlands.

ITALY

In 2015, BNY Mellon's sub-custodians migrated to T2S in the Italian market. From Q3 2016 we will begin the process

of migrating clients away from their accounts with our sub-custodian to BNY Mellon's direct accounts with Monte Titoli. This process will be completed for the majority of clients by early Q4 2016.

Clients will receive specific communications advising of our exact migration plans and where they fit into them. Clients should pay particular attention to any BNY Mellon T2S related NetInfos they receive.

One of the key conversion activities to prepare for the switch to direct accounts with Monte Titoli is the completion and submission of new tax documentation. Clients will have already received a NetInfo from our Tax department in March containing detailed instructions advising what they need to do to ensure they have the correct documentation filed with the Italian tax authorities.

THE NETHERLANDS

The migration process in the Netherlands is more straightforward as BNY Mellon are already direct to Euroclear Netherlands, BNY Mellon will therefore migrate all client assets onto the T2S platform on the scheduled Wave 3 migration date of 12th September.

There will be a client impact for the Dutch migration, although it will not be as significant as the impact of the Italian migration, due to the existence of the current direct model with Euroclear Netherlands. As per the Italian market, further correspondence will follow on this in due course,

Please be aware that the timeframes discussed here for both the Italian and Dutch migrations apply, in the main, to BNY Mellon clients of our Asset Servicing and Broker Dealer Services businesses. Clients using the BNY Mellon Tri-Party Repo programme as operated by our Global Collateral Management (GCM) team should be aware that plans to migrate GCM clients from current sub-custodians to the BNY Mellon direct CSD network are being finalised and will be communicated separately once we are in a position to do so.

T2S Market Practices – AFME Recommendations / Client of CSD Participant

As settlement activity migrates on to T2S, there is inevitably a greater focus by all parties on the practical operation of T2S, and how market participants use the T2S system.

Two important T2S market practice documents were issued in March 2016. These documents aim to enhance settlement efficiency on T2S by improving the way in which market participants interact with T2S.

BNY Mellon supports both documents, and believes that if their recommendations are widely followed then this will make an important contribution to improving settlement efficiency on T2S.

AFME Recommendations for TARGET2-Securities Settlement

On 23 March 2016, the Association for Financial Markets in Europe (AFME) published a set of recommendations encompassing both the migration of a CSD on to T2S, and ongoing settlement activity on T2S.

The document sets out four high-level principles and 14 sets of specific recommendations on how to send settlement instructions to T2S.

- The principles include the suggestion that when a CSD migrates on to T2S, market participants advise their counterparties of changes to their standard settlement instructions (SSIs) no later than one month before the migration date.
- The sets of specific recommendations include a recommendation that the T2S matching field "Client of CSD Participant" be populated in line with the approach agreed by the T2S Advisory Group at its meeting in February 2016.

The AFME Recommendations are available at: <http://www.afme.eu/Divisions/Post-Trade/>

Client of the CSD Participant – A T2S Best Market Practice

On 30 March 2016, the European Central Bank (ECB) published on its website both a Best Market Practice document (endorsed by the T2S Advisory Group in February 2016) on the use of the field "Client of the CSD Participant", and a high-level explanatory presentation.

The ECB has subsequently circulated the document and the presentation to all the T2S National User Groups and has urged that both be widely distributed.

- The main recommendation of the document is that the field "Client of the CSD Participant" in a T2S settlement instruction be completed in order of priority by (i) a BIC11, (ii) a Legal Entity Identifier (LEI), and (iii) any other content, including "blank".

The ECB document and presentation are available at: <http://www.ecb.europa.eu/paym/t2s/harmonisation/activities/html/index.en.html>

Tom Casteleyn interviews Mark Higgins about T2S, Collateral and the Regulatory Landscape

TC: Hi Mark, we've heard a lot about T2S and the impact it will have on collateral pools and liquidity management, so would you like to share with us your thoughts on how the new market infrastructure of T2S will tie into the evolving collateral story?

MH: 'Collateral' is expected to be under increasing pressure in terms of demand and supply in the future, so the need for it to be 'the right collateral, in the right place, at the right time' remains key in achieving business efficiency. What this means in practical terms is that collateral is in greater demand as new regulations and commercial developments require the financial industry to be secured or backed by assets around transactions, much of which is covered by 'HQLA' or High Quality Liquid Assets by definition. That means there is an increased focus on assets such as Cash, G10 Government Debt, main Index Equity and highly rated Corporate paper. These are all valid forms of collateral seen and applied in areas such as Cleared and Non Cleared Derivatives, Repo and Securities Lending to name just a few. So, the right collateral may be defined by Regulatory guidance or market demands but it still leaves the individual players to largely deal with getting it to the right place at the right time and I think T2S can add value in this regard.

Often the term 'velocity' is used in association with Collateral, in relation to the circulation and use of market assets. For me though, this also implies the speed of delivery and settlement. Under the 'new world' of collateral management, speed and settlement finality has become increasingly of importance. Having oversight on your collateral pool, understanding what is available and best suited to covering any given need is the first step. Then you can take action and define what has to go where and when. Executing that action requires an understanding of what is possible in the market against what you can achieve alongside your counterparties own abilities.

Cash remains king in many regards as collateral, especially in the OTC and Cleared Derivatives market, given its historic abundance and ease of settlement. However in certain cases Cash has become an expensive collateral type due to capital calculations or simply the effect of negative interest rates in Europe. The use of Non-Cash assets has been on the rise for use as Initial Margin when placed with a CCP and it's certainly become more common in EMEA as collateral taken against Securities Lending transactions.

While some of this business can be collateralised within a Triparty books and records style solution at BNY Mellon, a significant amount of collateral still moves bilaterally between two parties in the market using Custodians to help process the movements. These open market transactions with collateral moving between parties FOP/Free of Payment are where I see T2S really helping.

When I used to work as a collateral manager in the 1990's and 2000's we usually moved collateral on a T+2 basis, factoring the two day settlement lag into our calculations. Now, with the added Regs and market risk demands, many will want to get settlement down as short as possible, with same day being the target. T2S as a platform offers the opportunity for same day bond settlement with reduced risk of settlement failure and if this can be made to work in the market, then we have really made a difference.

TC: Given that most of the T2S volume will be migrated to the platform during waves three and four when we see the ESES markets and Germany join, could we expect to see any additional changes as cross border settlement becomes more prevalent on T2S?

MH: When it comes to Government Debt as collateral, the market tends to be driven by the main top credits such as the US, UK, Germany and France. These tend to be the preferred collateral types, certainly in the ISDA world of OTC Derivative related collateral management. Italy, Spain and other Euro markets also get called into use but often to a lesser extent, so anything related to these markets has the most impact.

TC: The benefits of T2S are more obvious to a sell side market participant, such as a broker dealer client, but what about the benefits for the traditional buy side clients, can we expect to see EMIR and other upcoming regulatory changes have any impact for the buy side and how clients would look to make use of collateral?

MH: You mention EMIR but it is just one of a range of new regulations in EMEA that have an impact on both sell and buy side participants. I really don't think of regulation as just having impact on a single segment of the market as they all seem to have both direct and indirect consequence. For example, is it fair to say that Basel III just impacts banks or Solvency II matters only to Insurance companies? I don't think so as in both cases these regs have a major behavioural impact on those directly governed by them whilst clients and counterparties feel the change in terms of business.

In the case of collateral management, Basel III has significant implications for many given that it has changed the way the larger banks have to run their books and operational processing. The buy side clients have to react to that and mirror what becomes a new operating norm. We've seen this in the way that some larger buy side firms have started to look into self-sufficiency around collateral and liquidity management. By that, I mean, setting up a process to support them when the larger dealers can't manage the supply anymore and an alternative peer to peer market needs to step in. That would require the buy side firm to tap into much of the very same infrastructure that is open to the sell side, effectively running as one themselves.

TC: What would you suggest should be the considerations for clients active in the European markets, what should clients be looking to do to prepare themselves for T2S and the impact T2S will have on the collateral market as well as the regulatory challenges that they are facing?

MH: Wow, that's a tough one to get right given there seems to be such a long list of things to do and get right. I guess this comes down to education and understanding of the issues at hand and also the tools available to help solve them. Then it becomes a case of placing these in line for impact assessment and implementation over time. We've seen in the past few years what many have coined a 'regulatory Tsunami' with one wave hitting and often overlapping against another. Getting these all lined up and then recognising how T2S can fit in as part of the 'tool kit' is part of the process and given that T2S is a gradual roll out across Europe it does perhaps allow the user to factor it in and change over time. In this case, not being another 'Big Bang' release and change is perhaps to its advantage.

Read about Mark Higgins: <https://www.bnymellon.com/us/en/our-thinking/experts/mark-higgins.jsp>

THE REAL IMPACT

T2S and CSD Regulation – an update

In the March 2015 edition of RealTime, I wrote an article about ESMA's work in drafting detailed technical rules (so-called Level 2 legislation) for the European Union's Regulation on Central Securities Depositories (CSDR).

I made the point that CSDR complements T2S; T2S is the technical infrastructure, while CSDR provides the legal and regulatory environment in which T2S operates.

I also made the point that ESMA (the European Securities and Markets Authority) was taking a very ambitious approach in drafting the detailed CSDR rules.

On 1 February 2016, ESMA issued its Final Report on draft regulatory technical standards on settlement discipline under CSDR. This report completes the full package of CSDR-related technical advice from both ESMA and the European Banking Authority, and means that the European Commission is now in a position to issue its legislative proposals for CSDR Level 2 rules. It is expected that the final versions of the Level 2 rules will be published in the EU Official Journal during the second half of 2016.

Although we do not yet have definitive texts, it is unlikely that the ESMA proposals will be changed radically during the remaining part of the legislative process (namely, the approvals from the European Commission, Council and Parliament), so that we can now usefully evaluate ESMA's work.

Since ESMA issued in December 2014 the first version of its proposals, the

attention of industry has focused on the settlement discipline rules, and in particular on the buy-in rules. In my March 2015 article, I offered the suggestion that ESMA's original proposals for buy-in rules were unworkable, and needed to be changed. The very good news from the Final Report dated 1 February 2016 is that ESMA has now radically changed its buy-in proposals.

Industry reactions to the Final Report have been overwhelmingly favourable. Industry participants view the new proposed buy-in process as being largely compatible with existing market practice, so that the risk of major market disruption has been averted. With respect to some of the other rules, ESMA has also modified some of the more problematic proposals.

But it would be dangerous to conclude that the ESMA proposals are a non-event.

If we look at the CSDR settlement and settlement discipline measures and proposals in their entirety (from obligations to immobilise securities, obligations to confirm and allocate securities trades on trade date, obligations for enhanced settlement functionalities (such as hold/release mechanisms) at the CSD, to far-reaching obligations for late settlement fines and for buy-ins), we do indeed see an ambitious agenda to improve settlement processes and settlement rates in Europe.

As the industry collectively works its way through the full set of proposals, I think that we should keep two thoughts in mind.

One is that the objectives are important and desirable, and indeed many of the individual regulatory measures (such as obligations relating to confirmation/allocation and to hold/release mechanisms) are based on proposals put forward by industry bodies.

The second is that nonetheless there will have to be a major effort to adapt processes, systems and legal agreements. This will involve all parties in the settlement chain, from the end investor all the way to the CSD, and indeed to T2S. This will certainly be difficult, and sometimes frustrating, as some of the settlement discipline requirements (such as requirements for CSDs to receive and store buy-in information, and obligations on intermediaries to include buy-in requirements in their contracts with their clients) are burdensome, without having any obvious benefits.

A dedicated T2S task force has been set up in order to identify the changes to T2S processes and functionalities that will be needed to allow CSDs to be able to meet their CSDR-related obligations. It is expected that the task force will report on its conclusions in June in a meeting of the T2S CSD Steering Group, and that the necessary changes in the design of T2S will be approved in September 2016.

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