

1. Opening Remarks

Josef Landolt welcomed 52 ISSA members and select guests representing 16 European markets plus the USA and Hong Kong. The timing and venue for this year's meeting was chosen to coincide with the largest annual conference for the European asset management industry, the European Funds Forum. The background to that decision is an increased focus by ISSA on issues posing operational challenges to institutional fund managers, but also affecting their custodians and the underlying market infrastructures. The majority of ISSA's member firms are central securities depositories or custodian banks. From their perspective, a fund manager can be a custody client, an issuer of a security, an interested party in the communications triangle between fund manager, broker and custodian – sometimes performing all of those functions at the same time. The agenda of this year's European meeting reflected that focus.

2. ISSA Information Items

The full text and slides used in Mr Landolt's presentation are available separately. Main points with regard to ISSA working items include the following:

G30 Interoperability Group

In the 2006 ISSA Symposium, members supported a push to advance G30 Recommendations 1, 2, 3 and 8 which have become known as the "interoperability recommendations". ISSA had offered, and was mandated, to take the role of a facilitator amongst a group of major stakeholders that had indicated a strong interest in working together to advance those recommendations in a concerted fashion. However, in the subsequent months, it became very clear that the global players' project resources are fully absorbed by market initiatives having a European focus: Removal of the Giovannini Barriers, the Code of Conduct, TARGET2-Securities, MiFID, the ESCB-CESR Standards, and others. The global G30 Recommendations lag far behind on the priority list. As a consequence, 18 months after the informal set-up of the G30 Interoperability Group, there is still no agreed action plan for a concerted way forward. The ISSA board scheduled an assessment of the situation for its July 3, 2007 board meeting.

ISSA Funds Working Group

The mandate of the Funds Working Group is to make recommendations for an improved processing environment for cross-border mutual funds transactions in Europe. The group met several times in 2006 to define the main obstacles to efficient processing. Those discussions became difficult very soon because the perception of an obstacle varies greatly, depending on the business segment serviced by each stakeholder. What one party sees as an obstacle is another party's indispensable requirement to properly fulfill its role in the value chain. The group produced an interim report describing ten barriers to be addressed. The challenge to agree on meaningful recommendations to overcome, or by-pass, those barriers still lies ahead. The working group lost momentum in a critical phase and needs to be revived. A promising concept to that effect is on the table, and the re-launch can be expected in the next few weeks. Parallel to advancing its own work, ISSA will maintain its constructive dialogue with the EFAMA Funds Processing Standardisation Group.

3. Alternative Investments

Introduction to the topic – "Operational Efficiency Enhances Alpha"

Markus Ruetimann, Schroders

Alpha: a quantitative technique which measures a stock's or fund's outperformance – risk adjusted - of its benchmark. Alpha is a common measure of assessing a fund manager's performance in excess of a benchmark index or a risk-free investment.

Operational efficiency is at the heart of creating value (Alpha) for the end investors and for all firms filling a role along the intermediary chain.

The hedge fund industry is roughly 60 years old. It experienced massive growth rates in the past few years. Currently, some 9,000 hedge funds are active world-wide. Around 65% of institutional investors place an estimated 5% of their assets in hedge funds. Hedge funds use a variety of investment strategies, some of which use leverage and derivatives to accentuate the impact of market moves. Many seek to reduce market risk specifically by short selling investment instruments, and by using swaps and derivatives.

Those strategies have substantially increased the operational challenges custodians are faced with. They place huge demands on the availability and accuracy of relevant data, on operational expertise across a broad instrument range, and on technology to support the lifecycle of a transaction which can span many years.

To illustrate the operational challenge, Markus Ruetimann briefly explained the main features of a number of exotic and complex yet frequently used options. Two examples:

- Chooser options (a "compound" option that has an underlying instrument which is itself an option, a strike price, a "chooser" date and an expiration date. At the chooser date, the buyer has the right to choose whether the underlying option is a call or a put option for its remaining lifetime.
- Sports derivatives: after every game, the value of the stock of a particular sports team (if it is a traded company) rises or falls depending on the result of the game. Investors trade these stocks and a number of derivatives using sports events as "underlyings".

Conclusion:

To cope with ever increasing volumes and instrument innovation, the asset servicing industry must find credible ways to **reduce** risks, costs, operational complexity, manual interventions, a multitude of different system applications to process an instrument end-to-end, resource requirements, and time to market to come up with automated solutions. At the same time, it must **increase** processing capacity and efficiency through scalable technology, the definition and promotion of industry standards, and making much more use of shared data services.

The next three speakers presented in greater detail some particular challenges from their perspective.

Broker's view (Bill Thum, Morgan Stanley)

The trend highlighted in the 2006 ISSA Symposium that the global capital market landscape is transforming from a vertically oriented, product and market based silo structure into a horizontally oriented structure along the layers transaction processing / risk management / data management, is quickly becoming reality.

What are the dealers doing to digest the enormously rising trade volumes and product innovation in the OTC derivative field?

New client on-boarding

The due diligence process applied by dealers in onboarding new clients for OTC trades becomes ever more important and more complex. Laws, rules and regulations and best practice standards require ever more assessments to be conducted to ensure that clients are properly identified, contracts are enforceable and minimum capital and risk containment obligations towards regulators are satisfied. Amongst others, the framework includes:

- KYC rules (Know Your Customer)
- Anti-Money Laundering rules
- CSE rules (Consolidated Supervised Entity)
- Basel II
- US GAAP (United States Generally Accepted Accounting Principles)
- Legal domicile and tax status
- Risk profile, credit assessment and applicable credit terms
- Capacity and authorization of the client to deal as intended

Client documentation and control is a crucial function. Morgan Stanley uses a large database to assess the enforceability of contracts entered into with counterparties.

Trade execution, trade life cycle, margin and risk management

The goal is to track all activity of a client on a single, consistent operational "map". Each transaction should be captured, managed and monitored from trade initiation through to final close-out. Such map should identify each point where risks can arise, the type of risk and the options to mitigate or eliminate it. OTC derivative contracts can remain open for up to thirty years. Such transactions involve a broad range of risk types to be monitored beyond the obvious counterparty risk.

With regard to margin management, a dynamic and holistic approach across all services and asset classes is required. Prime brokerage and similarly sophisticated clients demand it as their business strategies and depend on it, and service providers are no longer able to run their own business effectively and prudently without developing that capacity.

Documentation

Proper documentation of all transactions is a must. Morgan Stanley drives a number of inhouse initiatives to make the documentation process more robust and more efficient. Master confirmations and industry standards, and electronic means such as electronic trade confirmations, web-based confirmations and central databases play a key role.

Custodian's view (Jon Lloyd, JP Morgan)***Assumptions versus reality in the OTC derivatives world***

1. *"Processing derivatives is just like processing bonds or equities, and my custodian will take care of all my needs"*

For conventional assets the value chain of Fund Manager - Broker-Dealer - Global Custodian - Fund Administrator is very well established. It incorporates key controls and has proven to be scalable. A "prime record" is created at trade capture which is passed on for further processing. The same cannot be

said of the alternative investments space, where processing is based on spreadsheets without a prime record as the source reference. The processes are not robust, not scalable, risky and error prone.

The cost of managing OTC derivatives is estimated to be 50 times that of conventional assets.

The terms of OTC contracts are spelled out in so called Long Form Confirmations ("= the full Legalese"). In practice, no fund administrator has the legal resources to fully analyze the long contracts in each and every case. The industry relies on a short form, which entails risk.

2. "There is one correct value for a specific OTC derivative"

There is no absolute truth in OTC valuation. There is currently an obsession about exact values, but there are only approximations. The industry needs consistent pricing methodologies, not absolute precision. We need a good compromise between the full truth, and what makes economic sense in order to achieve a sustainable business model.

A great deal of debate in the industry is the regulatory position on the use of independent valuations versus counterparty prices or fund manager prices. This ties into the issue of operational efficiency as it is a key driver of the value chain. This issue needs to be addressed urgently.

3. "My Fund Accountant will source independent valuations for my OTC derivatives"

Price verification is a major challenge. Prices for conventional instruments can easily be compared against two or three alternative sources. In the field of alternative instruments there is no such consistency of pricing. Multiple fund administrators will come up with very different prices for the same instrument, depending on the methodology and source data used. It can take several months' time following a deal, until the fund administrator has an agreed-on and robust pricing methodology for a complex product. While there is a clear trend in the industry toward independent pricing, a lot of pricing data are still taken from the counterparty. From a client's point of view this not an acceptable situation.

4. "I don't need to worry about interfacing to derivative industry utilities"

Today's alternative investments landscape shows the typical characteristics of an emerging industry. Central infrastructures, industry standards, automation and industry-strength processes are largely absent. Processing costs are high. Workflows do not fit into the systems of a global custodian. Obtaining quality data and getting them into the custodian's system to enable smooth processing and accurate valuation is difficult.

Solutions

Consultation exercises are underway to help improve the state of the industry. For instance, IOSCO recently issued principles for the valuation of Hedge Fund portfolios (see appendix to slides).

Market infrastructures have started to provide solutions: for instance Swapswire and DTCC's Deriv/SERV.

For valuations, the focus should be on consistency versus the quest for the absolute truth. Valuation methodologies should be:

- practical
- scalable
- able to mitigate the key risks
- accepted to represent industry standards or at least emerging "best practice"
- clear about what a price actually represents.

The market buy side and the global custodians/fund administrators are beginning to discover now what the sell side has already known for 15 years. The awareness of the full extent of the challenges has only now reached the backoffice and the regulators!

Fund Manager's view (Markus Ruetimann, Schroders)

Market trends since mid-2006 show a rapid growth in the use credit default swaps, solid growth in interest rate products, lower growth in foreign exchange derivatives, and a decline in "simple" equity and commodity derivatives. These trends are expected to continue. New and ever more sophisticated investment strategies, such as LDI (Liability Driven Investments) or the "130/30" pattern (put 100% of a given investment amount into an index; sell short an equivalent of 30% of the invested amount in stocks expected to perform worse than the index; use the sales proceeds to buy stocks expected to beat the index) pose great challenges to the processing and custody side of the business. They stretch existing support systems and staff know-how to the limit, and often beyond:

- With every OTC contract being tailor-made, it is very difficult to standardize the various data components.
- Obtaining fair and independent valuations of OTC positions is critical to both investors and market regulators (the custodian view focuses on this issue).
- Collateral management and ensuring timely mark-to-market requires highly skilled staffs who understand the processes, legal expertise, and extensive technology support.
- Fund managers' accounting systems typically do not support today's complex dealing strategies, data flows and investment instruments. Many systems in place today were installed around twenty years ago.
- Global Custodians are all struggling to deliver scalable support solutions for derivatives without creating yet another IT-platform or operating environment.

To illustrate the dimensions: Schroders currently has some 95,000 open positions in Exchange Traded Derivatives (ETD) and some 1,200 open positions in OTC derivative contracts. OTC transactions at Schroders rose 120% between December 2006 and May 2007.

From a fund manager's perspective, there are no efficient, tested and proven operating models. Firms are all trying to leverage existing systems and processes while avoiding to create dedicated processing environments "just" for derivatives.

There are outsourcing opportunities with respect to valuations and collateral management, but this fragments the process, hindering operational efficiency if not making it impossible.

There is an ongoing war for talent and substantial resources are spent in each firm to run internal training and education courses on derivatives, to raise the awareness and technical understanding across fund management, operations, sales and marketing.

Schroders intend to centralize all aspects of derivatives post trade processing in one unit while leveraging existing order and transaction life cycle management systems. An internal assessment concluded that there is no appropriately integrated technology solution available in the market that could sufficiently cover the entire lifecycle of a derivatives transaction from trade capture to collateral management and close-out. There are still too few industry utilities that can provide solutions to fund managers, brokers, and/or custodians. DTCC is a notable exception with their confirmation service for credit derivatives, Deriv/SERV.

Taking an industry-wide perspective, the key challenges and optimal solutions look as follows:

| CHALLENGE | PRIORITY | OPTIMAL SOLUTION |
|-----------------|-----------------------|--|
| Price capture | Ease of access | Electronic use of broker's pricing model |
| Trade capture | Low cost | Integral to fund manager's order management system |
| Compliance | Timeliness | Integral to fund manager's order management system |
| Confirmations | Scalability, low cost | Electronic interfaces, use of industry standards |
| Accounting | Integration, low cost | Integral to accounting platform, else outsource |
| Valuation | Risk reduction | Independent valuation agent, outsource, use of standards |
| Payment | Scalability, low cost | Integral to accounting platform, else outsource |
| Collateral mgmt | Risk reduction | Integrated system, incl. workflow tools and reconciliation |

Conclusions:

- The industry must find a way of promoting standards in the fields of legal documentation, collateral management, valuations, and data management.
- Industry utilities such as ICSDs, CSDs and global custodians are encouraged to develop outsourcing solutions which span the entire lifecycle of derivatives, from trade capture to close-out.
- The war for talent to attract skilled operations and IT staff will heat up.
- Above all, the industry must find ways to reduce operational risk in the derivatives arena.

Panel and audience discussion (moderated by Jimmy Gambill, Franklin Templeton)

Some select questions and discussion points:

Where are the low hanging fruits in the next few years?

Suggestions:

- Improvements to the client onboarding process. Dealers must be sure they know exactly who their counterparty is.
- Improvements to documentation, in consideration that the typical OTC transaction lifecycle spans several years.
- Improvements to the pricing of OTC instruments. Today's Net Asset Values are not always reliable. The product originators, however, do not necessarily have an interest in making their pricing mechanisms transparent! From a dealer perspective, prices fall into three buckets:
 - Objective prices – taken from neutral data vendors' screens
 - Subjective prices – taken from the counterparty or based on own calculations in a market which is deep and liquid. In this situation, valuation does not pose much of a problem
 - Subjective prices – taken from a counterparty in an illiquid or even non-existing market. This is the true problem zone. Dealers generally are not willing to disclose their pricing methodology to a third party.

Investors increasingly see it as a problem that there are no reliable prices in the market for certain instruments. There is a perception that spreads tend to widen as soon as an instrument is bought... In some markets, the regulators are now beginning to look into this phenomenon.

Relevant industry associations should do more to improve the stability and reliability of pricing. The industry needs guidance in this area, and models giving end-investors the assurance that the pricing of their investments is fair and reliable.

- Improvements to data flows: All stakeholders need better accuracy of the relevant data, and quicker and easier access to them.

DTCC's Deriv/SERV and Trade Information Warehouse already provide partial solutions. 900 market participants are using it, including the top 25 broker-dealers. These offerings are different from a standard equity CSD, yet they are a valuable contribution towards a common industry infrastructure (see slides supplied after the conference).

What are the long term implications on the industry if complexity keeps rising at the present rates? The true cost of processing complex products does not seem to be reflected adequately in the pricing of those products.

MiFID may increase the unbundling of complex products and bring about more price transparency in Europe. The industry however needs a greater awareness of the processing costs, and of the fact that processing is a function that does need to be paid.

Price and cost transparency is a major issue. The pressure to explain "every buck earned, lost or not earned" is rising fast. The industry will face further drives to reduce operating costs. The trend towards higher margin products may slow down, as a consequence of the growing awareness of the operational complexity and the associated handling cost.

There has been much discussion about the ongoing transformation of the industry from a vertical to a horizontal orientation. What is the tipping point for the industry to take a significant leap forward? Does it require a crisis?

A crisis such as the default of a public sector pension fund, or a major broker-dealer, could indeed trigger a quantum leap. However, nobody wants that to happen. The industry needs ongoing discussion involving all stakeholders, and it needs discipline. With today's meeting, ISSA has provided a discussion platform. ISSA could contribute further by drafting a roadmap for the next two years, identifying the low hanging fruits more precisely and making suggestions on how to harvest them.

4. Impact of MiFID on the Fund Management Industry

Following the introduction of the Euro in 1999, the provision of cross-border financial services has grown by an estimated 25% every year. MiFID (Market in Financial Instruments Directive) replaces and extends the old legal basis for cross-border investment services, the Investment Services Directive from 1993.

MiFID will enter into force throughout the European Union on November 1, 2007. MiFID represents another crucial step on the road to an integrated capital market in the EU. The directive has three major objectives: to improve market transparency, to foster competition, and to strengthen investor protection. All businesses involved with trading in financial instruments, or with providing financial advisory services are affected by MiFID. Today's market structure is expected to change over time as the directive abolishes certain market principles and encourages new competitors to enter the market.

Mr Lucas focused on the impact of MiFID on fund managers and fund distributors. As far as that industry segment is concerned, MiFID deals with two main areas:

- Fund management companies, their internal organization and rules of conduct as regards
 - how they organize the client facing side of their business
 - how they interact with "eligible counterparties" and how those are defined
 - how client orders are filled – the "best execution" requirement;

and

- the funds distribution process, in particular
 - the provision of investment advice, tailored to the client's level of professional knowledge and experience;
 - the payment of distribution commissions, retrocessions, and similar forms of remuneration by fund promoters to fund distributors, as this is a highly sensitive area which could potentially bias the advisory and fund selection process;
 - the marketing of financial instruments – it must be "clear, fair and not misleading".

For each of these areas, Mr Lucas introduced the key principles, followed by practical issues and consequences that fund managers must have dealt with by November 1, 2007. Refer to the slides for more details.

The floor discussion focused on issues of concern and remaining uncertainty, such as

- The interpretation of "compliance with MiFID" in the different EU member states. The prospect that the directive may not be interpreted uniformly across the entire European Union is a very big threat for fund companies and distributors operating internationally.
- The interpretation of "giving investment advice" and associated responsibilities, in relation to a distributor selling its financial group's own products.
- The potential consequences if the industry is not fully compliant by November 1, 2007 – in particular in areas where the industry still expects more regulatory guidance and interpretation to complete its preparatory work. Will regulators grant a grace period in certain situations?

In June 2007, the SWIFT annual general meeting approved the addition of financial market regulators as a new SWIFT participant category. The intention is to enable SWIFT users to meet regulatory reporting obligations more efficiently, while facilitating the development of global regulatory reporting solutions. Currently however, there is very little standardization on the side of the regulators in the way they prescribe reporting formats.

The precise impact of MiFID cannot be anticipated yet. It is certain that more and new types of competitors will enter the capital market. It is likely that there will be a short phase of disruption, from which winners and losers will emerge.

5. TARGET2-Securities

ISSA's membership is divided roughly equally between providers of market infrastructure, and market participants using those infrastructures – mainly custodian agent banks and global custodians. All are directly or indirectly affected by TARGET2-Securities.

TARGET2-Securities (T2S) is a key initiative to eliminate the notion of "cross border" for securities trades between counterparties anywhere in Europe. It however raised controversy from the moment it was announced.

Jean-Michel Godeffroy (European Central Bank)

Jean-Michel Godeffroy recapitulated where the project stands: In July 2006, the Governing Council of the European Central Bank announced that the Eurosystem would evaluate opportunities to provide settlement services for securities transactions. Reactions from banks were generally positive, while CSDs were cautious. In March 2007, the Governing Council considered the project feasible and asked for the user requirements to be prepared. Banks and CSDs agreed to work with the Eurosystem to define those requirements. The final decision to go forward is expected early 2008.

Mr Godeffroy addressed the most frequent reservations voiced against the initiative to date. He noted that the TARGET money transfer system was initially also criticized as a market interference. Large market players announced that they might use it at end of day only, to settle net cash obligations between themselves. They changed their mind and today, 85% of all Euro payments flow through TARGET.

In some instances, public sector intervention helped the European industry to become more competitive, e.g. in aerospace or high speed train technology. There is however no "grand master plan to build the new Europe". Many European initiatives are driven in parallel. Ideally, all are complementary and reinforce each other.

T2S is not a purely European issue. It will be open to users anywhere in the world, for as long as they settle trades in Euro. Extension to other currencies is a possibility for a later phase.

T2S aims at the macro-economic benefits for Europe. Europe as a whole will benefit – which does not necessarily mean that every single institution having a stake in the business will win, but successfully adapting to change has always been the precondition for survival.

The ECB maintains full transparency in the T2S project. All relevant documentation is published immediately on the ECB website.

Frederic Hannequart (Euroclear)

If the single market in Europe is to be achieved, the industry must to more jointly. Euroclear contributes to many industry initiatives. Euroclear fully shares the T2S objective of reducing settlement costs - something Euroclear is very adamant of as a user-governed institution.

Euroclear supports the T2S initiative and participates in the consultation process. Some concerns must be raised, however:

- Time frames to comment on proposals are very tight. The industry would very much welcome more time to react, and sometimes to think of alternative approaches.
- In the end, the decisive factor is not the length of the consultation process, but the quality of the decisions actually taken.
- The consultation process should not only cover the design and user requirements phase. It should include participation in the business case formulation and in the cost/benefits analysis from the viewpoint of the market players. Obviously, the final go/no go decision remains with the ECB.

- There is the danger of wanting to load ever more functionality on T2S (securities financing, automatic collateralization, "optional" service modules, and more). This will increase complexity and hike costs immensely. How much of the original intention will still be there once the T2S live date is reached in 2013?
- At this time, important legal questions are open, such as: What is the governing law of the system? Will legal records documenting transactions have to be kept in the country of origin, or can they be kept centrally (Euroclear was forced to do the former)? How will the European Central Bank discharge its liability to CSDs and CSD users? Will users be "lost in the middle" between entities passing liability to each other?

Euroclear's largest concern is the assumption that CSDs can decommission their settlement platforms once T2S is operational. Euroclear and other infrastructure providers are convinced that settlement data generated and maintained in T2S must be mirrored by the CSDs, for instance for the following reasons:

- to meet intraday cut-off times to determine eligibility to entitlements on corporate actions
- for client and regulatory reporting purposes, e.g. transaction taxes
- to answer client inquiries
- to achieve real-time registration of securities

(I)CSDs operating in multiple currencies cannot expect to ever decommission any part of their settlement platform, unless T2S were expanded accordingly. This is extremely significant: if CSDs cannot decommission systems or at least components, then the cost of participating in T2S comes on top of today's operating cost.

Katja Rosenkranz (Clearstream)

Clearstream shares the assessment that nobody can disagree with the objectives of T2S and sees itself as a constructive partner. Similar to Euroclear, there are open questions. Some specific points include:

- Project governance: All decision rights are with the ECB Governing Council. The Advisory Group Members would like to be more closely involved in the decision process.
- User requirements: In the current phase, user requirements are discussed intensively. There is however an over-emphasis on the requirements of the CSD clients, while the needs of the CSDs themselves are rather underweighted.
- Business case and projected cost savings: Like Euroclear, Clearstream does not yet see the feasibility of decommissioning any significant parts of its own systems, either due to functional or to legal constraints. Also, an outline of contractual arrangements with CSDs allowing them to outsource business was announced for the end of the year in a high level version. This is a crucial issue for the CSDs which requires more detailed information as soon as possible.
- Implementation timeline: 2013 is very far in the future. Too many variables can alter the operating environment significantly by then.

Jacques-Philippe Marson (BNP Paribas Securities Services)

BNP Paribas Securities Services is a strong supporter of TARGET-2 Securities. It considers T2S as having the potential to deliver a missing core piece of the European financial market integration. JP Marson conveyed three key messages:

1. Europe needs TARGET2-Securities to meet its integration objectives

Europe needs further integration in the securities environment. With the introduction of the Euro, eight years ago, a major step towards financial integration was achieved, and the Euro has undoubtedly contributed to the development of Europe's financial market. But the competitiveness of a financial center relies on a complete set of efficient market infrastructure. In the cash world this is well under way. In the securities world, the environment is still too fragmented. In the Euro area, there are currently 19 securities settlement systems, and in Europe overall 30, whereas in the US there are only two – one for equities and corporate fixed income issues and the other one for government bonds.

The current "for-profit" infrastructure models are an obstacle to integration and consolidation. Therefore, industry-led initiatives are likely to remain limited in geographical scope, focusing on large markets for economical reasons.

TARGET2-Securities is a unique opportunity to deliver an efficient settlement infrastructure for the whole of the Euro area, by providing a single outsourcing solution for the 19 securities settlement systems, while being inclusive for large and small markets even beyond the Eurozone.

2. TARGET2-Securities is the right initiative to increase efficiency and reduce costs

The benefits of T2S for the market are fourfold:

- Cross-border settlements within the Euro zone will become as easy and efficient as domestic settlement.
- By fostering harmonization, T2S should generate savings for the market participants, at the level of their back-offices but also their treasury management.
- T2S will provide settlement in central bank money only. It will be a risk free, pan-European infrastructure without the risk of commingling central bank money and commercial bank money on the same platform. This set-up should largely contribute to limiting systemic risk in the market even with a large concentration of settlement volumes on the same platform.
- The involvement of the Eurosystem is a benefit because, as a public entity, not for profit, it is a neutral body inclusive of small and large markets and able to facilitate harmonization.

3. TARGET2-Securities will encourage competition in many ways

Competition in the field of securities services will increase at various levels:

- between custodians, by extending competition from local markets to the Eurozone
- between CSDs, who will be able to extend their CSD services to non-domestic securities
- and for some market participants, by extending the choice of possible set-ups between direct access and the use of local custodians.

All players will need to adapt to change. However, the custodians expect the Eurosystem to respect its mandate of market neutrality by providing the custodians the chance to compete on a fair basis.

T2S should also be seen in the context of the upcoming regulatory changes at trading and clearing level. MiFID is likely to lead to more market fragmentation. New trading venues are developing, either US platforms seeking European expansion, or new European projects trying to challenge incumbent exchanges. Incumbent European CCPs are also facing new entrants, for example with NSCC (Euro CCP) offering clearing services to the Turquoise trading platform.

This fragmentation reinforces the need for a single settlement solution. If we continue to compare with the US, competition at trading level has been very effective thanks to high settlement efficiency achieved by a single infrastructure. We expect T2S to provide the same benefit for the European market.

Ruud Sleenhoff (European Banking Federation)

The European Banking Federation (EBF), representing the interests of over 5000 European banks, supports the T2S initiative. It provides a unique opportunity to harmonize the settlement process in Europe. Its objectives are to increase efficiency, to promote competition and to enable cost savings. Who could object against any of these?

But, at this point in time, the EBF support is not unconditional yet. There are a number of points and principles that give rise to discussion:

Governance structure for the user requirements phase: In the Advisory Group – the highest body within the project structure where the future T2S users are represented – the national central banks and the CSDs have more weight than the banks. The users are actually in a minority position as far as voting rights are concerned. EBF had requested that the users should be given a 50% representation. The EBF itself has an observer status only in the T2S Advisory Group. While it is true that minority views can be brought to the level of the ECB Governing Council, the users are excluded from the ultimate decision making process.

Business case: The EBF takes the position that the fees charged by T2S for its settlement service should be lower than a competitive current fee for a domestic settlement, otherwise the business case is not viable. The ECB has announced that a new economic impact assessment will be done, which will be focused on savings to the users. Those are however difficult to quantify as an "average", as staff and IT savings very much depend on the individual level of process automation and STP that is in place in each firm.

The largest single success factor is the number of CSDs respectively markets that participate in T2S. An incomplete T2S market coverage, whereby a number of CSDs would decide not to join T2S, will result in much less savings than in the situation where all Eurozone CSDs are participating.

Competition issues: T2S should deliver competition between the CSDs, but also between the custodian banks and the CSDs. European banks are used to competition, whereas the market infrastructures are not. Let's make that competition real!

Banks will request direct access to the T2S environment. This will lead to competition between banks and CSDs and will provide price transparency for settlement services. In the T2S environment, banks could also opt for the settlement services of one or more CSDs as entry point(s) to T2S. This should lead to competition on settlement fees between CSDs. The resulting scale advantage for the CSD of choice could lead to lower costs and fees.

Consultation process: The consultation process foresees an extremely heavy load of issues to be commented on, whereby the time frames are very tight. The strain on the users' capacities is considerable, especially given that the same resources are typically tapped to work on other market initiatives as well (MiFID, TARGET2-Cash, others) besides having a full time job to do in their daily business role. It is unfortunate that the users are involved very heavily to do consulting jobs on detailed proposals but have almost no voice in deciding on the overall principles of T2S. Finally, industry feedback from 13 markets across the Eurozone will have to be assessed and brought to conclusion in record time frames. It is likely that this can be achieved only with enforced solutions and standards, or else discussions for compromise might take that long, that entirely different solutions (US driven?) might emerge in the meantime. Moreover, at this stage, there are intentions to load ever more functionality on T2S. If the scope is not kept simple, then making the boat swim within reasonable time will be very difficult indeed. Besides, if extras are loaded on the boat, who is going to pay for them?

The European banking community should see to it that T2S will be beneficial for it and this means that T2S must deliver more efficiency, more competition and lower cost.

Audience Discussion

Some select questions and discussion points:

The announced Turquoise trading platform is scheduled to go live later this year. Its main drivers are seven investment banks which are said to control 50% of the European equity order flows and volumes. If a large portion of that volume did not flow into T2S for settlement, how would that impact the T2S business case?

If that were true, it would certainly have a negative impact. But the same negative impact would hit the CSDs too, with or without T2S. Whatever the size and cost level of the pan-European market, it is better off with T2S than without it.

The ECB will issue a revised business case with a more detailed economic impact analysis. The ECB is determined to deliver settlement at a price lower than the lowest domestic settlement price today!

Turquoise and similar trading venues are a subset of all market *participants*. They are not market *infrastructures*, and they command too small a subset of the market to make a real impact. With regard to infrastructure: on the clearing level, Europe has not been able to build a single central counterparty. The US market was successful in achieving that and it will now bring its solution to Europe. On the settlement level, settlement is the process which achieves the finality of exchanging ownership between cash and securities. Without the ECB having a stake in it, it is an illusion to expect the same degree of safety from any other provider. If there is one place in the Eurozone that is appropriate and able to provide the highest settlement safety at low cost, it is the ECB.

Is "No Go" a scenario at all?

We first must try to understand what T2S is, what it delivers and what it does not deliver, before such concerns are raised. There *are* many open questions at this time, and we are charting new waters, but let's do it constructively!

A few years ago, the Scandinavian "S4" project tried to achieve something very similar like T2S, for four markets only. S4 never lifted off. The cost to handle the complexity exceeded the benefits. Shouldn't that be a warning?

T2S must be lean. Legal constraints must be addressed. We need to strive for standardization and the harmonization of market practice. Less and less specific national market practices will be justified as we achieve more market integration. Those markets insisting on proprietary practices should pay for the extra cost.

Who will lead the way to more standardization and harmonization? The Advisory Group? Given the very tight timeframes, it will hardly be able to reach consensus.

Making this process fully "democratic" is difficult indeed. Some enforcement rules will be necessary and indeed preferable, otherwise the goal will never be reached. Why should the ECB be gentler with the industry with regard to T2S, than a regulator with regard to enforcing MiFID?

Simplicity and a lean scope are essential. Keep T2S simple to make it fast, cheap and efficient. The heavier the load, the greater the danger that the boat will sink!

If it is true that CSDs participating in T2S cannot decommission anything, where would savings then come from?

This question should be revisited later. When the time comes for many CSDs to enter another investment cycle to renew their systems thoroughly, TS2 will be there and the situation will look different.

On the need (or not) to mirror accounts: T2S will hold the accounts, and the CSDs will view and access them. The need for account duplication or mirroring seems not clear, but this is obviously an issue requiring more analysis and clarification.

Major custodian banks already looked into the feasibility of separating securities settlement from asset services and found it impossible to do. The T2S business case must not only look at the settlement function, it should also assess the impact on the residual CSD business and on other infrastructure functions. Feasibility is not a question of writing off investments. It is a business issue with far greater implications than we are aware of at this time.

6. Closing Remark

Josef Landolt closed the conference by observing that the agenda had obviously managed to capture the audience's interest, evidenced by the lively participation in all discussions. The meeting demonstrated that ISSA still generates value and has a reason to continue. But like in the industry initiatives addressed during the day, success depends on the commitment and active participation of the community. In that sense, all ISSA members are encouraged to continue contributing to the success of ISSA going forward.
