Yves Mersch: Advancing financial market integration

Speech by Mr Yves Mersch, Member of the Executive Board of the European Central Bank, at the Government Borrowers Forum, organised by the World Bank, Luxembourg, 18 May 2017.

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To foster European financial integration, the ECB has set sail under the European flag. And we will continue our journey towards European financial integration. Today, in this respect, I'd like to make three key points.

1. We need to better explore the potential of our integrated financial market infrastructure for securities. T2S has integrated the securities settlement business, bringing the economies of scale it needs. Therefore we welcome the **announcement of the international central securities depositories (ICSDs) to bring Eurobonds (not to be confused with EU sovereign debt bonds) to T2S for settlement.**
2. In the EU, issuance has remained a largely domestic business, often as a result of legacy structures and national rules. In a true single market, one could expect **a Europe-wide primary market for securities to develop in order to ensure equal and unrestricted access for economic actors. We stand ready to examine the need for and potential of such a European issuance service** together with potential users.
3. On central counterparty (CCP) clearing, we must consider whether recent geopolitical events require **the Eurosystem to take action to ensure that we continue to adequately control the impact of offshore clearing activities on the stability of our common currency**.

Single market for capital

To foster the smooth and effective transmission of monetary policy, an efficient and integrated financial system is key. Financial integration is essential for an effective monetary union and relevant to financial stability, to which we contribute. The Eurosystem's task of promoting well-functioning payment systems, as part of its monetary policy mandate, is also supported by financial integration. And it is not something we can take for granted: incomplete financial integration creates vulnerabilities. This is why, in the past few years, fundamental steps towards an integrated and developed capital market have been taken at European level. The banking union and the capital markets union are important initiatives which have the potential to change the structure of the euro area's financial architecture.

A single market for capital is needed primarily because it can improve the efficiency of credit allocation, it can enhance risk-sharing and it can foster diverse sources of financing. Indeed, it would strengthen the economic resilience of Economic and Monetary Union as a whole by providing the ECB with alternative channels for transmitting monetary policy and by enabling capital markets to play a role in cushioning asymmetric shocks.

However, to facilitate the mobility and free flow of capital and financial assets across Europe, it is essential that an efficient underlying infrastructure is in place. A lot has been achieved already, but still we need to ensure that we use the market infrastructure as effectively as possible.

TARGET2-Securities

Nine years ago this month (on 23 May 2008), the Governing Council issued a proposal to all European central securities depositories (CSDs) to join T2S. The project was backed by the European Parliament, but the ECOFIN Council specified three requirements: (i) the platform should be multicurrency; (ii) participation in T2S should not be compulsory; and (iii) access to

central bank money should not be restricted for non-participating CSDs.

Nine years on and the first roll-out phase of T2S is almost complete. The system is multicurrency and the Danish krone is set to join in October 2018. The majority of European markets will be connected, although participation remains voluntary. And some CSDs outside the European Union have even expressed an interest in joining T2S.

This February, the successful migration of six CSDs from Austria, Germany, Hungary, Luxembourg, Slovakia and Slovenia doubled the settlement volume in T2S. Today, a daily average of around 500,000 transactions is settled on the platform. This represents 90% of the transaction volume that is expected to be settled on the platform after the end of the full migration in September 2017. The volume is in line with the expected yearly forecast done by the Advisory Group on Market Infrastructures for Securities and Collateral. The most recent survey from March 2017 shows that the overall volume growth for the next two years is anticipated to be 5.3% on average. Additionally, when the Danish krone joins next year we expect the volume to increase by 5.5 million transactions per year.

With the introduction of T2S, the average cost at market infrastructure level per transaction has decreased significantly – in particular for cross-CSD transactions. Our initial cost estimations showed that the average fee per domestic CSD settlement in the euro area was 73 euro cent while cross-border transactions were up to ten times more expensive. The launch of T2S has brought the transaction fee per instruction down to 15 euro cent. However, T2S is built on a full-cost recovery principle and we continue to monitor the cost recovery prospects. Consequently, in the first half of 2016 a review of the T2S operating costs was launched. Despite the positive market trend, we cannot rule out that the price list will need to be adjusted after 2019 and/or the cost recovery period extended.

T2S also created the momentum for an extraordinary harmonisation agenda which, for many markets, has been the key benefit. T2S, together with the adoption of the Central Securities Depositories Regulation (CSDR), provided the push needed to drive the harmonisation process forwards. The market used the project to create a single rulebook and harmonise the post-trade rules and practices. The adoption of the ISO 20022 messaging standard, the single schedule for the settlement day, a harmonised settlement cycle of T+2 and a single intraday delivery-versus-payment settlement model in central bank money are but a few examples of the achieved harmonisation. But T2S has also contributed to issues that go beyond the core T2S settlement functionalities, such as the harmonisation of the processing of corporate actions and the harmonisation of the different settlement finality rules in T2S CSDs.

The large market players which have migrated to T2S have given us very positive feedback. T2S has not only harmonised the settlement of securities across Europe and brought forward post-trade harmonisation in at least nine out of the 15 Giovannini barriers, it has also optimised their liquidity and collateral management, which many regard as being the greatest benefit. We can conclude that the benefits brought by T2S are widely recognised.

Eurobonds

The single securities settlement platform has also led to greater freedom in the mobility of securities, in particular for the purpose of collateralisation: this is true for all securities used in Europe. An example of that is “Eurobonds” (i.e. issues made mostly through the ICSDs). Since the T2S launch, both Clearstream Group and Euroclear Group have publicly announced that their group (offering both CSD and ICSD services) will give their customers the possibility to settle all securities on the T2S platform. For market participants such as central banks, this is a key benefit, providing greater collateral mobility and greater liquidity efficiency (in particular in central bank money). In Europe the ICSDs are the main issuers of so-called Eurobonds or international securities. Today, over 250,000 outstanding ISINs (20% of these ISINs are euro-denominated) are issued through the two ICSDs, with a value of roughly €9.2 trillion. From a European capital

market perspective, these assets are important. They account for about 25% of all outstanding marketable assets eligible as collateral with the Eurosystem. I would like to see the announced strategy of the two groups to bring Eurobonds to be settled in T2S starting to take effect by 2018.

Issuance

As we see T2S roll out, it has become apparent that despite the progress towards a more integrated market, issuance has remained a largely national business across the EU, often as a result of legacy structures and national rules. Indeed, the issue was first identified in the T2S harmonisation agenda in 2011 and remains relevant today.

Recently adopted legislation, namely the CSDR level II, addresses certain aspects of the location of issuance. In particular, it covers the rights of issuers, allowing them to have their securities recorded in the CSD of their choice. However, despite both T2S and the CSDR, fragmentation endures and a domestic issuance process at European level does not exist at the moment.

There are several possible reasons why the market has failed to generate a more integrated and efficient securities issuance industry. These include legal constraints and, specifically, uncertainties arising from issuing in foreign jurisdictions, where some or all aspects of the issuer's domestic law no longer apply. In addition, regulatory restrictions or domestic market practices may prevent issuers from reaching out to the whole EU investor base. Take, for example, restrictions on the location of primary dealers in sovereign debt or national registration procedures.

The result is that – regardless of the launch of a single securities settlement engine (T2S) and the single legal framework (CSDR) – the market has remained national, from the perspective of securities issuance. Debt instruments, even supranational ones, are issued nationally and issuers and investors often fail to reach each other across Europe. Although ICSDs issue Eurobonds in a global environment, they remain in the context of specific market infrastructures (under the rules of the market where the ICSD is located). This status quo restricts the investor base, in particular the pan-European one, lowers the level of credit allocation and risk-sharing, and hampers cross-border investment.

In a true single market, a Europe-wide market for securities should exist to ensure equal and unrestricted access for economic actors. In this context, the establishment of a European issuance service, which would allow the emergence of a Europe-wide market, would be the next logical step to consider.

Central clearing

Central clearing is another area in which we should continue our efforts to promote European integration. Awareness has grown within the European Union of the critical importance of "where" and "how" these clearing houses operate and, as a result, these infrastructures have been under intense scrutiny recently.

Central clearing is a global financial activity, and major currencies such as the euro, US dollar and Japanese yen are traded and cleared worldwide. It is undoubtedly an important function within the global financial system, and ensures that investors can hedge their risks by accessing liquidity in multiple currencies across a variety of markets.

The euro is unique among major currencies, however, in that a significant number of systemically important classes of derivatives and securities are cleared to a large extent outside its currency area.

Looking at the centrally cleared euro-denominated derivatives market, the picture that emerges from the data reported by euro area banks under EMIR is that CCPs established in the UK clear

approximately:

- 95% of their interest rate derivatives transactions;
- 60% of their credit derivatives transactions;
- 30% of their commodity derivatives transactions;
- 25% of their equity derivatives transactions.

Overall, in terms of notional amounts, more than 90% of the euro-denominated derivatives business of euro area banks is cleared via UK CCPs.

The importance of UK CCPs is not limited to derivatives, as they are involved in approximately 50% of the cleared euro-denominated repo business of euro area banks.

As I have said in the past, the risks stemming from this situation are currently adequately covered: the European Market Infrastructure Regulation allows the Eurosystem to assess and monitor risks through active participation in cross-border supervisory colleges, whose role and prerogatives are guaranteed by the authority of the European Court of Justice. This framework is complemented by the dedicated Memorandum of Understanding signed by the Bank of England and the European Central Bank.

The UK's recent decision to leave the EU has called into question the ability of authorities such as the Eurosystem to ensure they can continue to adequately control the impact of offshore clearing activities while maintaining the stability of their currency.

The challenges arising from Brexit are still ahead of us, and authorities need to think carefully about how they can guarantee the stability of their respective currencies in the future. For example, in the coming years, a better balance may have to be found between the global nature of central clearing and the need for certain systemically important clearing activities to be under the oversight of the domestic currency areas. Naturally, the transition towards a new European and global clearing landscape could raise certain operational challenges. If poorly managed, it could increase the cost of central clearing. A clear timetable, good cooperation between regulators and careful preparation by market participants would be necessary to ensure a smooth transition. I believe that it is feasible.

The European Commission will shortly be making legislative proposals to address systemic risk related to CCPs. Naturally, we are willing to cooperate with the Commission within our areas of expertise.

Conclusion

In concluding, I want to reiterate the need to reflect on whether recent geopolitical events require **the Eurosystem to take action to ensure that we continue to adequately control the impact of offshore clearing activities on the stability of our currency**.

To deepen integration and complete the Single Market, ambitious goals need to be supported by specific proposals. We stand ready to facilitate a dialogue and take action on these specific proposals.

Thank you.