Future of the EU Capital Markets Union

Post-Trading Spotlight: How the Integration of the Central Securities Depositories (CSDs) Landscape can become a Success Story

Executive Summary

- With the EU facing a challenging geopolitical and economic reality, the Capital Markets Union agenda is revitalised and prioritised as a critical key element for the years ahead.
- A number of key reports (Eurogroup, Letta, Draghi, Noyer and ESMA) entail important elements to lay the foundation for the next EU legislative agenda.
- The post-trading landscape plays an integral role when it comes to creating a more integrated, efficient and competitive EU capital market.
- Central Securities Depositories (CSDs) as the core post-trade infrastructure are already efficient and competitive today – key elements: companies receive funding due to an fast-track issuance process of only 5 minutes, CSDs allow for same day settlement and access to a growing number of international markets.
- However, while the Noyer Report suggested CSD fragmentation as an issue, it is important to note that there is no conclusive evidence that this fragmentation is related to the post-trade landscape. In fact, while 27 CSDs exist in the EU's post-trading environment, a majority of 95% of settlement value is already processed by 3 groups of CSDs today.
- Key elements that continue to act as material barriers to market integration and European capital markets growth: diverging national rule books, individual tax regimes and processes, contrasting handling of rules by national regulators and supervisors, varying standards for securities issuance and national corporate action processes.
- Additionally, we see investment restriction rules (e.g. insurance companies to invest in equity; debt versus equity taxation bias) also for retail which prevent deep liquid markets.
- While certain voices have supported public intervention via a stronger role and buildout of the ECB's T2S system, it is important to note that the underlying fragmentation issues at national level need to be solved. T2S should truly be used, enhanced and simplified in a timely manner with functional changes to allow further seamless cross-border flows. The speed of change is currently far too slow.
- The EU should therefore rather improve the current realities to empower private sector CSDs to drive natural integration and consolidation via fair cross-border competition.
- As part of this, the newly agreed CSDR passporting regime[1] should be explored, while a new roadmap should be developed to concretely reduce national barriers. The new CSD supervisory college could facilitate such processes.
- In addition, the EU should continue its work around settlement internalisation, bolster its digital thought-leadership, build on the success of the Eurobonds segment and facilitate the debt issuance process as well as strengthen the ELTIF 2.0 segment as interesting funding alternatives for European companies.

[1] To be phased-in during 2025, following CSDR Refit

The future CMU Agenda in Post-Trading: What to tackle in the CSD Landscape?

With the new EU legislative period, there has been a surge in debates and different ideas around how to make European capital markets more competitive and attractive.

To this end, a number of important reports and statements have been developed and published, ranging from the Eurogroup statement, over the Letta and Draghi reports, to the Noyer and ESMA reports.

These published reports mention a variety of different policy recommendations for the next EU legislative period, aiming to achieve tangible progress. This paper, however, focuses predominantly on the post-trade related aspects and the conversation around the future EU landscape around Central Securities Depositories (CSDs).

The Letta report stresses that "*there is no apparent need for competition in the clearing and settlement markets, as long as there is fair and open access for all actors, proper governance and sufficient incentives for innovation*." The report also highlights the benefits of economies of scale and lower costs that future consolidation would bring and warns that, despite the establishment of T2S, many barriers remain in the way of further harmonisation and integration in the post-trading landscape in the EU.

By contrast, the Noyer report outlines in its analysis: "*Europe seems to have far too many CSDs for the size of its markets. 28 CSDs operate in the EU – all active in the equity markets. In the US – with a stock market more than four times the size of the European market in terms of capitalisation – all settlement goes through one agency, the Depositary Trust Company (DTC). The plethora of central securities depositories in the EU is nothing new and there has been no substantial change in this complexity, despite some consolidation efforts in recent years […].*"

Also, the ESMA report stresses that "*the EU's capital market landscape also remains fragmented and complex. 27 different Central Securities Depositories (CSDs) and 14 different Central Counterparties (CCPs) are authorised and provide services in the EU, in comparison to 1 CSD and 8 CCPs in the US. […] While recognising that EU market infrastructures have evolved in this way to serve different purposes, such as the needs to multiple local markets that may be at different levels of development, nevertheless this has an impact in terms of inefficiencies and higher costs.*"

Finally, the Eurogroup highlights the need to address *"obstacles that could hinder mergers and acquisitions or other forms of integration of market infrastructure"*, while stressing the importance of further integration and cross-border realities in parallel.

As a general theme, it can be observed that fragmentation and the importance of reducing the number of CSDs across the EU has been a reoccurring topic, often comparing the EU market to the market structure in the US despite very different realities.

Myths and reality on fragmentation:

National laws: underlying divergent national laws as a root cause/drivers of fragmentation

FMIs work consistently to support the removal of barriers to capital market integration

When looking at the key reasons that act as barriers to further cross-border integration and the overall consolidation of CSDs, it is important to realise that the EU settlement landscape largely remains fragmented across long-standing and well-known national laws.

With its 27 Member States, the EU is still lacking harmonised national laws and is dealing with diverging rule books, individual tax regimes/processes, differences in market specificities/practices, different regulators and supervisors, different standards for securities issuance, settlement and corporate action processes. Further, there are differences in transaction taxes as well as withholding tax procedures or different registration versus non-registration processes. All in all, this extensive list of obstacles hinders the offering of real cross-border services.

This reality is also underlined by the fact that mergers of different national CSDs into one single company would not automatically lead to a functional consolidation of the systems:
The Clearstream merger back in 2000 is until today resulting in different settlement platforms and licences due to different national laws. The same can be observed for Euroclear, where various national CSDs have not been integrated operationally into one single post-trade infrastructure. Thus, a “copying” of the US model would not automatically lead to increased efficiency and reduced costs, as the fragmentation amongst Member States would still continue to exist. Mergers would not change the realities around local securities laws in each European Member State.

The CMU 3.0 should ideally tackle those hard-to-harmonise CMU-related differences well-identified in the Giovannini and EPTF reports and in the recently published AMI-SeCo report by the Advisory Group on Market Infrastructures for Securities and Collateral, and let fair cross-border competition drive integration and consolidation.

However, it would also be beneficial for the EU to go a step further and to establish a new roadmap focused on national differences across Member States and to effectively work across EU institutions and Member States to reduce such barriers.

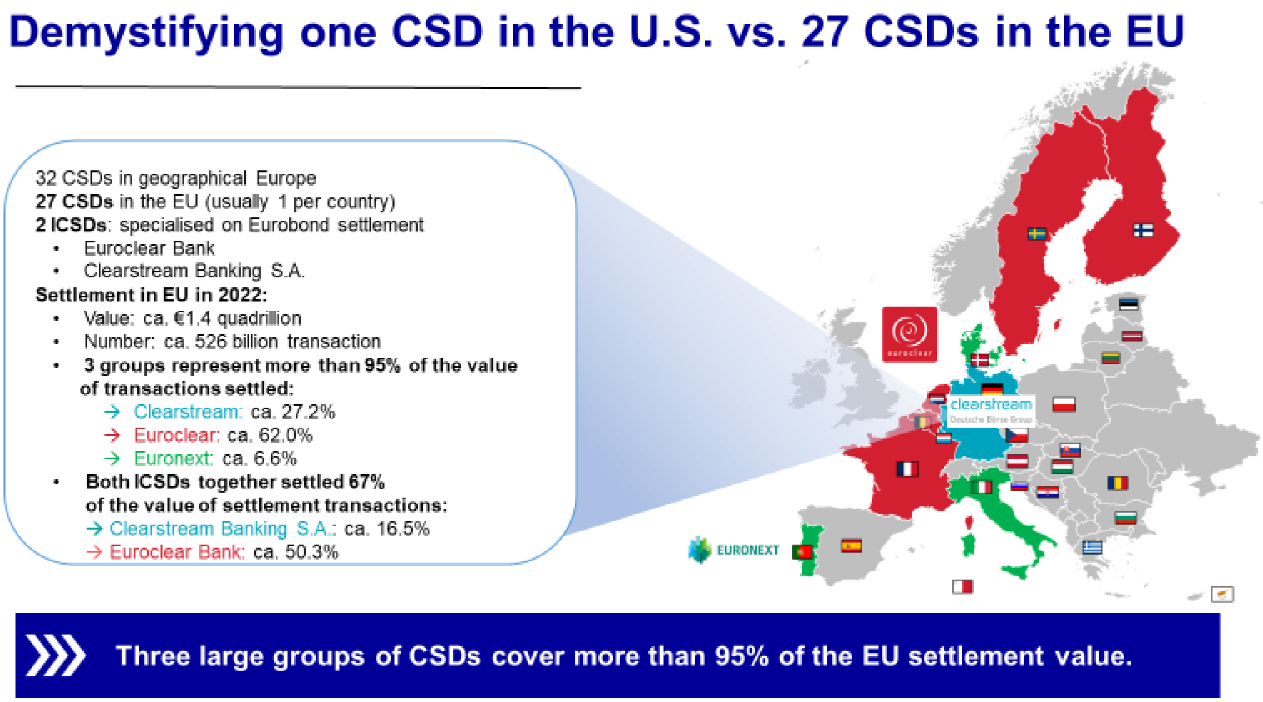
CSDs work consistently to support the removal of barriers to post-trade integration and more efficient and deep markets for issuers and investors. The number of European CSDs is the natural consequence of the current European environment. As a result, more harmonisation in the EU would enable more cross-border services of CSDs’ that are confronted to respect each relevant Member State’s different laws.

Consolidation: One CSD in the U.S. versus 27 CSDs in the European Union?

Taking stock of EU settlement values – more than 95% of settlement value is with 3 operators

When analysing the market realities in more detail, it can indeed be observed that the EU is home to 27 CSDs that are authorised to operate in the internal market. However, beyond the number of legal entities, a focus on the actual values provides a very different picture.

In fact, more than 95% of the value of all settled transactions is with 3 operators. The further integration of the remaining values would hence only bring marginal efficiencies in the context of the EU's CMU agenda.



Source: https://ecsda.eu/ecsda-members-database-2022

From an infrastructure perspective, alongside with exchanges and CCPs – Central Securities Depositories (CSDs) as the core post-trade infrastructure are already efficient and competitive today. Key to this is the fact that companies receive funding through a fast-track issuance process of only 5 minutes, and CSDs allow for same day settlement and access to a growing number of international markets.

Furthermore, we would question whether there is any objective evidence that more CSDs increase costs or reduce efficiency for the individual customer. Is DTCC settlement efficiency really materially higher than in the EU?

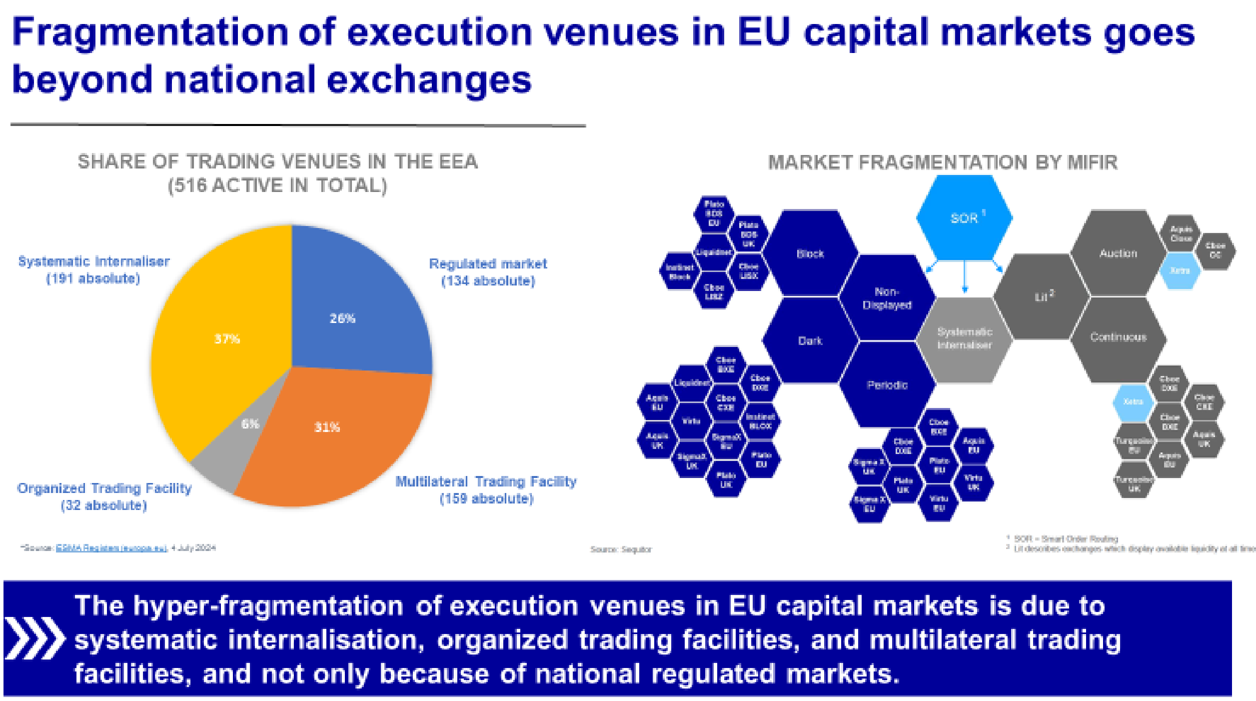
Fragmentation along national Member States and even beyond

European market structures are complex

Currently, 16 exchange groups account for 40% of total equities turnover, with about 90% of these volumes handled by three systems:

- Euronext (49%),
- Deutsche Börse (27%) and
- Nasdaq (16%)

This shows a certain level of consolidation on the so-called ‘regulated market’. Nevertheless, MiFID has introduced further competition in the market, and ‘regulated markets’ now account for only ca. 26% of the share of trading venues in the EEA. Hence, there is a level of complexity and fragmentation on this pre-issuance framework that goes beyond the realm of national regulated markets.



T2S as a solution to overcome fragmentation

T2S as a great starting point

Currently, T2S does not cover all EU Member States, and presents a number of technical barriers that render cross-border settlement less efficient across the EU. Working on improving these bottlenecks could already provide a path towards achieving less fragmentation in the post-trade landscape. Clearstream already provides state-of-the-art infrastructure, when it comes to T2S connectivity, with links to 23 EU Member States.

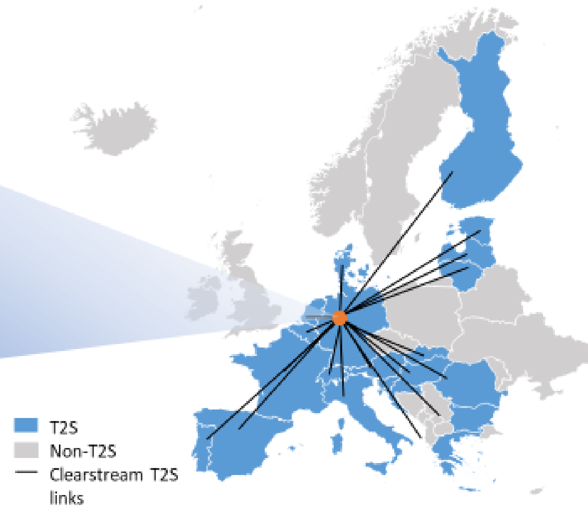
T2S resolved some cross-border barriers to settlement, but its potential is still not fully used

EU Member States that have not joined T2S

- **Sweden**
- **Ireland**
- **Cyprus**
- **Poland**
- **Czech Republic**
- **Greece (for non-government debt)**

→ Only settlement against Euro in CeBM

→ Many non-Euro denominated instruments still out of T2S (where the country has not yet adopted the Euro)



T2S resolved some cross-border barriers to settlement, but its potential is still not fully used. Not all Member States are linked, only Euro is available for settlement, and not all securities are in T2S. Clearstream, via its 23 T2S links, makes practically all T2S securities available to its participants.

1 https://www.ecb.europa.eu/paym/target/target-professional-use-documents-links/t2s/shared/pdf/List_of_CSDs_connected_to_T2S.pdf
2 https://www.clearstream.com/clearstream-en/securities-services/market-coverage/europe-t2s

It would be important to encourage market counterparties to embrace T2S. Today, many counterparties (especially in the area of securities lending) are technically incapable of supporting Investor-CSD cross-border settlement, as their systems are hard-coded to the place of settlement being the place of issuance/depositary.

T2S – Introduction of incentives such as rebate schemes based on volumes

While the EU's T2S system has significantly contributed to the context of cross-border flows, it has not yet had the expected effects in terms of transaction and other settlement costs.

In light of the parallel discussion on CSD consolidation and the creation of the so-called European Unified Ledger (EUL), the Noyer report elaborates on how to improve the operability of T2S.

It recommends "*improving the convergence in national securities laws and working in two cumulative reforms of T2S: first, T2S' objective of European integration should be reprioritised by fostering its efficiency and attractivity for market participants and potentially extending its remit to additional CSD functions. Second, longer-term work could be initiated to enable T2S to support the settlement of financial instruments on DLT (blockchain).*"

T2S is still not used in its full capacity and by every European CSDs, as the recently published AMI-SeCo report states: "*All CSDs should support continued settlement, and T2S should be implemented in all CSDs...extending T2S coverage*".

Importantly, the attractiveness of T2S could be significantly enhanced by introducing incentives via targeted fee rebates based on volume contributions. This would incentivise participation and reward those entities that contribute most, thereby creating a race to the top. In turn, volumes guided through T2S would also increase cross-border settlement activities.

Proposed solutions in the area of public sector initiatives

Taxation - going beyond the improvements with FASTER

The latest political agreement on FASTER reached by the Council on 14 May 2024 is an important milestone, making withholding tax procedures in the EU more efficient and secure for investors, financial intermediaries, and Member State tax administrations. However, further harmonisation should be achieved over the course of the next EU legislative period.

First, there still exists a difference between bonds and equity taxation processes. The current reality now confers an option for Member States to maintain their current procedures regarding bonds – but a harmonisation along all securities documentation would be beneficial.

Second, according to the AMI-SeCo report, "*withholding tax (WHT) requirements are seen as a significant barrier to cross-CSD activity and the establishment of CSD links, especially national differences in tax reporting and handling. The lack of alignment between tax processing and corporate actions standards further complicates matters. Tax reporting is too complex and lacks clear guidance*." Also on this end, additional action is important to boost integration.

Third, there is a bucket of additional barriers that the EU should tackle in the years ahead. For example, some markets still require a Certified Financial Intermediary (CFI) to send or receive tax related documents in paper-based form, whereby digitalisation would facilitate and streamline the processes. In other countries, the lack of English versions of tax-related documents poses an unnecessary administrative burden that needs to be addressed. Additionally, the process for Relief at Source and Reclaims is not standardised yet, varying based on each country's requirements.

Exploring 28th regimes and more regulations to overcome inconsistencies across Member States

The EU should consider revisiting discussions around potential 28th regimes to overcome certain inconsistencies across Member States. By not replacing Member States' own national rules but acting as a complementary alternative to them, a 28th regime could significantly boost efficiencies in post-trading and bridge some barriers where harmonisation efforts have proven challenging.[2]

ESMA underlined that: "*In the next political cycle, the European Commission and co-legislators should focus on reaching practical and effective agreements on the proposed directive on insolvency proceedings and the proposed directive on the debt–equity bias reduction allowance (DEBRA), and the Shareholder Rights Directive. Further harmonisation of corporate law at EU level on matters affecting the whole investment chain should also continue to be assessed and progressed to enhance the single market for capital.*"

In addition to exploring the 28th regime, there is also merit in "*continuing to propose legislation in the form of regulations rather than directives, to improve consistency of implementation and interpretation, and agility in making changes*." Further, it would also help to harmonise "local" interpretations – as an example, EU sanctions still leave room to Member States to interpret certain parts, which leads to diverging outcomes.

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[2] Examples include the European Company Statute, proposed European contract law, European insurance contract law, a unitary patent, and Union authorisation.

Proposed solutions in the area of private post-trade initiatives

Eurobonds: Building on a success story to leverage the future CMU agenda

As part of the endeavor to build a successful EU CMU reality in the post-trading landscape, it is also important to ensure that existing case studies are leveraged and promoted.

The EU's Eurobonds market is the third biggest bond market in the world, coming in just after the US and China. Over the past decades, the Eurobonds market has grown to a large and diversified, multi-currency and multi-instrument international securities market. This market is a success story for the European Union: It is operated out of the EU, regulated by European regulators and it offers competitive advantages to European issuers and investors.

The European Eurobonds market is recognised by international investors for its flexibility, allowing issuers to reach a broad global investor base. Therefore, the Eurobonds market contributes to the integration of EU capital markets, fostering cross-border investment flows and attracting capital inflows.

Concretely, there are three elements that should be considered to build on the success story of the Eurobonds segment for the future CMU:

First, fragmentation should be avoided. The Letta report, for example, included a notion around the idea to issue EU sovereign debt instruments (by the EU, supranationals, governments, etc.) outside the Eurobonds segment, leading to fragmentation and inefficiencies.

Second, to facilitate the use of Eurobonds while reducing regulatory burden and complexity, the de minimis thresholds that exempt issuers from the requirement to provide a prospectus could be increased (currently at €12m).

Third, to foster SME financing, the thresholds for SMEs should be raised further to meet the sizes of issuance which are rather closer to €20-50m. nominal.

European standardisation to facilitate cross-border issuance and digital thought-leadership

To allow (instant) issuance, settlement and investment of more products (especially also in the context of digital evolution) the EU should increase its focus on complete processes for the future CMU agenda – from the start to the end of their life cycle. This means that, if more efficient, digital, and scalable processes in the post-trade area are desired, there should also be a stronger focus on the creation of the product itself in a digital way.

Hence standardisation of the terms and conditions is crucial, as well as an overall harmonisation of the products and classes of products (e.g. via an EU ISIN code, common definitions on "Force Majeure", standardisation on what features/datapoints a "bond" needs to have, etc.) and a more harmonised EU framework for securities – or if too difficult to achieve, at least a new EU framework to standardise the elements of issuance.

Today, around 70% of international securities are based on UK executable law, even if the securities are traded, cleared and settled on EU market infrastructure. Therefore, EU-wide harmonised standards for legal terms and conditions would bring more legal certainty, as a security following the EU standard could be easily issued in various Member States – instead of having to follow a number of different national Member State laws.

This would also help to increase more competition in the post-trade area, by advancing cross-border business realities and fostering a level playing field intra-EU. Furthermore, this would help market participants to bring down costs and to leverage the technological possibilities, as it would be easier to create smart contracts.

One example of more standardised rules and regulatory treatment (besides insolvency, securities and tax laws) would be in the area of digital assets, i.e. by allowing to build smart contracts on basic common definitions of a bond – independent of its location of issuance. Standardisation of securities could also make other securities-related services more efficient (like securities lending or securitisation for instance).

To further improve issuance practices and asset servicing, machine-readable and standardised announcements of issuers are needed, which are to be sent directly or via issuer agents to the respective issuer CSDs[3]. In that respect, if all issuers and their agents were to fully adopt the AMI-SeCo's SCORE Corporate Actions Standards (in particular using the standardised templates for corporate events notifications provided therein) to announce the corporate actions to the issuer CSDs, meaningful progress towards harmonisation of issuance practices and straight-through-processing (STP) of asset servicing across the EU Member States could be achieved.

To further enhance the visibility to investors, the issuer CSDs may, in addition to informing the holders of relevant securities as today, provide this information also to a common digital space such as ESMA's existing European Single Access Point for financial information. Such an approach would require the actors (issuer/issuer agents) to resolve the existing problem at the correct place in the custody chain and, if adopted, it would involve minimal developments down the custody chain.

It is important to improve the current situation in which announcements are published in non-structured ways in national official journals with various providers scrubbing and adding pieces of information, which ultimately creates high costs and room for different interpretations. According to estimates, around 50% of the cost to process corporate events is spent today by custodians to source the correct information – while liability risks and costs remain high.

Further harmonisation of KYC and AML processes: driving efficiency

Another element that could help to advance cross-border services also of the banking sector overall, concerns the Know Your Customer (KYC) and Anti-Money Laundering (AML) processes, which should be further streamlined.

One important step would be harmonising KYC/AML processes across the EU to allow e.g. for the re-use of once verified data by one regulated entity for others to rely on this data. This way, market participants could perform their activities more easily and efficiently between countries.

In many other jurisdictions this is already a given standard and provides lower costs and higher efficiency levels in relation to processes, operations, etc.

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[3] Which, according to the CSDR, exercise the notary function and must be the first intermediary in the custody chain to receive this information as many national specificities remain to be taken into account

CSDR Refit brings a new passporting regime and establishes supervisory colleges

In addition, it is important to note that the CSDR Refit (Art. 23) has included a revamped and streamlined CSD passporting regime, which is expected to be phased-in in 2025. This will further strengthen cross-border business activities for CSDs.

Generally, the EU should ensure that the common rule, i.e. that financial services passporting regimes allow businesses authorised in one Member State to provide their services throughout the EU Single Market, also effectively functions in the CSD space.

In that context, it is also important to observe that the EU will establish new CSD supervisory colleges. These could help CSD operators to tackle challenging practices by certain national competent authorities by providing a true European supervisory forum. CSD operators could hence work in a better cooperative spirit with the full college to improve cross-border activities.

In turn, however, it is also important to realise that any public intervention via a bigger role for the ECB's T2S system (as proposed in the Noyer report) will not overcome the actual existing national barriers and therefore not lead to a more integrated CSD landscape.

Instead, the overarching approach should be focused on empowering CSD operators to drive natural integration and consolidation via enhanced cross-border activities, including reduced national barriers, the new CSD passporting regime, and a better supervisory dialogue on cross-border endeavours via the new CSD college.

Improving settlement efficiency: The necessary conversation on settlement internalisation

Another important element as part of the future CMU conversations on the EU's settlement landscape concern the realities around "settlement internalisation", i.e. executing transfer orders on behalf of clients or on one's own account other than through a securities settlement system (CSDs).
Due to the high fragmentation of EU securities markets and a high level of internalisation of the trading flows, the EU's post-trading landscape is also marked by a high level of settlement internalisation. These flows do not contribute to the ideas around cross-border business and also do not go through the T2S system – thereby increasing implicit costs and driving fragmentation.

In addition, the settlement fail rates in CSDs are significantly lower than in the settlement internalisation environment. As per a report by ESMA already published in November 2020, national competent authorities have identified risks associated with this practice of "settlement internalisation", the most common being operational risk and custody risk.

Such risks and inefficiencies should be mitigated by reassessing the extent to which settlement internalisation should be allowed. Settlement internalization further causes an unequal application of penalties, as fails with no penalties are also causing penalties in the chain. A possible solution could be to restrict the maximum amount of fail rates in settlement internalisation, based on instrument.

Where the settlement fail rate (e.g. in a certain UCITS product) is significantly higher than in the CSD environment, a mandatory settlement rule with CSDs should apply, meaning that failing settlement volumes from the internaliser would have to be sent to EU CSDs. This would reduce fail rates, improve market integrity, and contribute to cross-border and T2S flows while fostering consolidation.

European Long-term Investment Funds (ELTIFs)

Different kinds of asset classes (e.g. UCITS, AIFMD funds, ETFs) offer investment options, with different levels of liquidity and restrictions depending on the level of sophistication required from the investor.

On the more liquid side, there are long-only funds such as stocks and bonds and ETFs, which are publicly traded in stock markets. Conversely, on the less liquid side, there are alternative investment funds, which also comprise ELTIFs (European Long-term Investment Funds). ELTIFs are a new type for long-term collective investments that allow investors to finance companies and projects that need long-term capital. With ELTIFs, investment fund managers may offer long-term investment opportunities to institutional and private investors.

In recent years, there has been growth in private equity financing for companies wishing to raise capital – more and more companies are deciding to stay private, often due to different reasons. This has led to an increased interest of investors to invest into such companies.

Investors into ELTIFs, for instance, may invest in private equity (i.e. investments in non-listed enterprises), private debt (alternative debt financing) or in long-term infrastructure projects, such as projects from the renewable energies area. Therefore, ELTIFs represent an alternative to banks as a means of financing infrastructure projects, non-listed enterprises or listed small and medium-sized enterprises (SMEs).

Clearstream, through its fund services arm, is strategically placed to streamline the intermediation process between investors and asset managers. In a nutshell, Clearstream has built a DLT-based tool that aggregates investors and gives a greater number of different investors, access to ELTIF funds – by also allowing for smaller “ticket sizes”. Expanding the use of ELTIFs as an investment tool can strongly contribute to achieving CMU goals and provide financing for the EU strategic agenda, such as green transition, infrastructure projects, and digitalisation.

Digital finance and the next wave of digital evolution in EU capital markets

The case for a wholesale CBDC Euro

The EU should also harness the benefits and the competitive advantage of the next wave of digital evolution in capital markets to render the EU landscape more attractive while also promoting the Euro currency internationally.

After having laid the basis with a number of regulatory initiatives (e.g. Markets in Crypto Regulation, Digital Operational Resilience Act, etc.), the EU should continue with its thought-leadership as a global pioneer notably with a digital currency.

The Digital Euro should be understood as a logical element in the repertoire of EU instruments in this sphere, especially on the wholesale front. With the ECB working group to develop a wholesale Digital Euro (wCBDC) and the discussion amongst three alternative models (Bundesbank Trigger solution, Italian TIPS solution, Banque de France DLT), the corner stone has been established.

Given the (geo-)political challenges ahead, it seems imperative to ensure that the most advanced technological model of the wholesale Digital Euro prevails. Putting national interests or industry policy aside, there should be a preference for the technologically superior model of a genuinely European wholesale CBDC, which can compete effectively on the international stage and maintain a European competitive edge on a global scale.

Different applications include conducting euro-denominated issuances and delivery-versus-payment (DvP) transactions across different use-cases and payment models. To optimally support the goal of the exploration, CSDs promote digital post-trade platforms with DLT capabilities.

Clear rules, continued coordination between the ECB, central banks and the industry, as well as know-how and flexibility, will be key to make the Euro wCBDC a success story. It will also be important to ensure interconnectivity with existing systems such as Target2 as well as T2S to foster an integrated and consolidated approach across the EU.

Finally, the EU as well as the individual central banks should actively drive the reflection as to how the timeline beyond the currently envisaged cut-off date for the wCBDC trials in November could look like – to retain its globally leading position but also to successfully transition into a permanent set-up that boosts usage.