Report back on the outcome of the breakaway session 10 April 2019

It was my pleasure to moderate the first breakaway session.

This was not on the unknowable future -I gladly left that to Vivek – but on the challenges of running a CSD business in the world of today.

I would like to thank Juliette Kennel for keeping a record of our discussion on the white board.

A lot of our discussion revolved around the question of links.

That was in large part because we were lucky to have at least once glimpse at a possible future through a presentation from Boris Cherkasskiy of INFINITUM Asser Services.

Boris has a vision.

It is, in its final form, a network of networks of CSDs that spans the world.

In effect, a truly global securities settlement network, based on regional clusters.

And Boris explained in his presentation that he thinks we should begin that journey in Asia – through the creation of an Asian Settlement Depository, or ASD

Our group was able to recall more than one failed initiative of this kind in Asia, where collaborative ventures tend to founder on competition between financial centres.

In fact, there were similar stories of failed regional initiatives from Africa.

And on the global scale.

Some of us could recall the GSTPA of the late 1990s.

Rather more of us could remember LinkUp Markets, which also failed.

Political will – government support – seemed to be the main missing ingredient.

But there was also a recognition – based on experience – that aligning regulatory regimes and operational processes is a necessary precursor to success.

That is of course one of the lessons of the one existing example of success in this field: T2S.

That took a great deal of political will, and even more time and money, and it is still not complete yet, as CSDR shows.

But, as Boris sad – echoing our chairman, Mr Mohamed- every journey starts with a first step.

But CSD people are nothing if not practical – and Boris certainly got some advice -whether he wanted it or not.

A concrete suggestion as that he map the operational frameworks and regulatory regimes of each of the countries in his proposed network – to decide the scale of the gaps that need to be bridged.

Right at the end of our session we took a vote by show of hands on whether we thought Boris's Asian Settlement Depository would become a reality within five years.

I have to say this did not attract a lot of votes – in fact, I think Boris was the only one.

However, there was a lot more support for it becoming a reality within 10 years.

And I think Boris would be – indeed was -the first to accept that the obstacles are great – but they can be overcome.

Once Boris had sat down, we began to explore the question of whether links work and, if not, why not.

Every CSD in our session had links, so we could draw on a lot of experience.

At one level, what makes a link successful is blindingly obvious: if your link offers access to a fast growing economy everybody wants to invest in, it almost doesn't matter if the link is expensive or has operational mismatches: people want access to the high returns.

Stock Connect is the classic example.

The bridge between the ICSDs – Euroclear and Cleerstream – has some of the same characteristics: it is troublesome, but it works because it gets used.

In fact, most links fail or become dormant simply because they attract too little traffic.

We discovered some clear patterns in what determines success or failure.

Investment flows create traffic.

Dual listings do not.

One very interesting reason for that is a factor we don't often think about: namely, national political protectionism: the fact governments don't want liquidity or revenues to be exported to another jurisdiction.

That can stop links being built, let alone failing to succeed.

Curiously, though, outbound links can work better for smaller CSDs than inbound links – again, a function of where the investment opportunities are, but it does require a government with a liberal attitude to overseas investment.

As was pointed out to Boris, bringing operational, legal, regulatory and fiscal regimes at either end of a link into alignment will increase the chances of success if the investment opportunities are actually there.

In fact, we learned that one reason links fails is lack of understanding of operational processes and procedures by the people at either end.

Another actor in failure is that investors continue to use the alternative: the global custodian-sub-custodian networks.

Custodian banks can offer settlement in commercial bank money.

They can advance credit.

They offer a full one-stop shop service that includes asset servicing.

Their relationships with clients are usually much deeper and more complex than those with CSDs, so they have many levers to pull other than price.

They can overcome operational incompatibilities and obstacles – at a price.

In short, custodians are formidable competitors to CSD-to-CSD links.

One possible solution to this competitive disadvantage was to refurbish links with new technologies such as Blockchain and AI.

It implied links could start to service new investors, new asset classes

I have to say our group was not impressed by this idea.

For a start, they didn't think they had the money to turn links into nodes on a blockchain, or add an AI monkey to the mix.

They also thought technology alone could not address the legal, regulatory and operational incompatibilities identified.

Only standardisation could do that, they thought.

Standards before technology – Juliette liked that one.

There was also one thoughtful observation about enriching links with new asset classes: that crypto-asset tokens actually <u>increase</u> counterparty risk.

And one other observation which we would we would do well to remember as we point to all the difficulties in creating a more efficient global clearing, custody and settlement infrastructure: namely, the fact that the Millennial generation will not be interested in reasons why it cannot be done: they will just expect it to be there.

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We then turned to more genera issues, an asked what kept people awake at night.

There were of course some facetious answers.

Coffee.

Children.

Noisy neighbours.

The real reasons were in some cases depressingly familiar.

Incessant regulation.

Complex regulatory implementations.

Inadvertent compliance errors or omissions.

Cyber-security.

Cyber-attacks.

Data protection.

Business continuity.

Migrations to new systems.

Falling down on investor protection.

But there were some novelties too.

Inefficient or lackadaisical customers was one.

But I particularly liked the Fear of Stagnation: the idea that there is nothing more worrying than having nothing to worry about

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However, it got really interesting when we began to talk about revenues and profits.

Everybody's fee income is static or suppressed.

This is an industry which lives off ad valorem fees and, in depressed stock markets, the valorem is lower.

Margins are being crushed by rising costs even when revenues are stable.

Everybody s under pressure to be more transparent about their charges – which increases pressure on prices.

Consolidating clients don't help revenues or earnings.

Operating with regulated prices forces you to diversify into unregulated areas.

Being part of a vertically integrated trading, clearing and settlement silo reduces your ability to set your prices.

It is hard to diversify when you don't have capital, and can't raise it.

Almost all diversifications in the securities markets force you to compete with your customers and often your owners – usually custodian banks.

Even if it is into services- such as e-voting or corporate actions – that can allow custodians to widen their own margins.

But we can pass on one useful tip in this regard: it is much easier to compete with custodians if you offer end-investor accounts than if you offer omnibus accounts only.

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That was it.

Any questions?