Radar

Q1 2016

If it's out there, it's in here

down the road

Welcome to the first edition of Radar for this year. Many of the issues we were grappling with last year have accompanied us into 2016 and this is evident in our editorial coverage in this edition.

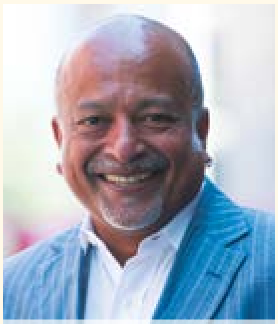
The expression 'elephant in the room' is commonly used to refer to a glaring issue that no one is addressing. I'm wracking my brains to think of the opposite – a glaring issue that everyone is addressing – and while I can't pin down the exact expression, the idea is epitomised by blockchain. The issue of distributed ledgers was inescapable in 2015 and we take stock in this issue of how much has been achieved so far (apart from column inches in the press).

Also joining us for further deliberation is the question of collateral mobility: regulation and technology are both through to the play-offs in this particular challenge and we explore the likely impact of the SFTR, inter alia, on the state of the playing field.

With providers and customers along the value chain facing new technological, regulatory and operational decisions that will impact strategy in the years ahead, it is not surprising that traditional client/provider relationships are coming in for review from both sides. We report on a discussion that took place at Sibos in Singapore 'far from the madding crowd', where intermediaries at different points along the value chain compared notes on how their commercial relationships are changing.

Enjoy this edition of Radar and please give us your feedback. (Oh, and if it's not too late, Happy New Year!)

Avi Ghosh



Avi Ghosh | Editor

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Riding the regulatory wave

Securities lending is already being reshaped by post-crisis reform, but future changes could alter the economics of the market still further.

Regulatory and macro-economic trends bolstered securities lending activity in 2015, but there are concerns that the weight of multiple reforms could provide disincentives to market participants in the medium term.

Demand for high-quality liquid assets (HQLA) from the sell-side, pursuit of additional income from asset owners in a low-interest rate environment, and a general rise in the importance of collateral all played a role in keeping securities lending volumes buoyant.

The most recent half-year report from the International Securities Lending Association (ISLA), published in August 2015 (based on January-June data), noted that institutional investors are lending out more government debt

Mutual and retail funds accounted for only 18% of securities on loan in the first half of 2015, a level attributed to recent European restrictions on fixed-term securities lending by UCITS funds.

securities, accepting non-cash instruments more frequently, including ETFs, as collateral. Government debt accounted for 39% of securities on loan (representing €718 billion of the total €1.8 trillion lent out in the period; up from €1.7 trillion six months earlier), compared with 35% 12 months previously. In return, collateral delivered to lenders of government securities in the form of non-cash instruments rose to 72% from 61% a year ago. Overall, securities loans were collateralised by non-cash assets in 60% of transactions (up from 55% six months earlier). Moreover, non-cash collateral exceeded cash for the first time in the lending of North American government bonds, overturning a long-established preference on that side of the Atlantic.

The report also highlights the trend toward longer-term transactions, notably on the sell-side. According to ISLA, 24% of all government bond loans were for three months or more, in the period covered by the survey, while fully 50% of all deals between banks and broker-dealers were for 90 days and beyond.

Derivatives and capital reforms

Regulation is driving both these developments, specifically the liquidity coverage ratio (LCR), introduced as part of the Basel III capital and liquidity framework. The LCR requires banks to hold sufficient HQLAs (typically cash and government bonds) to cover their net cash needs over a 30-day period in the event of liquidity disruption. As such, banks are keen to guarantee their access to HQLAs, preferring to provide equity as collateral to lenders, or indeed ETFs, rather than cash or government stock, not least because shifting equities off their balance sheets reduces capital charges.

Demand for HQLAs by banks is accompanied by a growing need for eligible collateral by both sell-side and buy-side firms which must collateralise OTC derivatives exposures, both centrally-cleared deals, as mandated by regulations such as the US Dodd-Frank Act and the European Market Infrastructure Regulation (EMIR), and bilateral transactions, which fall under a regime drawn up by the Basel Committee on Banking Supervision and the International Organization of Securities Commissions, from September 2016.

Last year's rise in government bond loans suggests stock lenders are responding to opportunities created by regulatory change. However, ISLA's latest report notes regulatory →

impediments to securities lending activity by UCITS funds. Mutual and retail funds accounted for only 18% of securities on loan in the first half of 2015, a level attributed to recent European restrictions on fixed-term securities lending by UCITS funds, which are further cramped by the fact they may only enter into repo and reverse repo deals if they can recall assets or cash or assets at any time.

recommendations on buy-ins until Q1 2016 (other regulatory technical standards were finalised in September 2015), meaning new rules will not apply until 2018. The aim is to cut trade fails and improve settlement discipline – if necessary by fines for non-compliance – but industry bodies warn of disruption, higher costs and risks, and a reduction in liquidity. "Existing participants

> Capital adequacy and OTC derivatives reforms will continue to influence securities lending activity in 2016, but other regulatory initiatives will also play their part.

Capital adequacy and OTC derivatives reforms will continue to influence securities lending activity in 2016, but other regulatory initiatives will also play their part, including the Central Securities Depositories Regulation (CSDR), the Securities Financing Transparency Regulation (SFTR), the Bank Recovery and Resolution Directive (BRRD) and its international equivalents, and the Transparency Directive Amending Directive (TDAD).

CSDR buy-in

The proposed introduction of mandatory buy-in provisions in CSDR has caused alarm among fixed income, repo and securities lending market participants. In response to its Q3 2015 consultation, the European Securities and Markets Authority (ESMA) delayed issuing its final

that supply liquidity by making their securities available for lending may reconsider to what extent they will continue to do so," said ISLA.

CSDR's Level 1 text turns the existing 'right' to a buy-in (on the part of a purchasing counterparty in the event of a failure to deliver securities), as established in market practice and underpinned by legal agreements between counterparties, into a mandated obligation, thereby altering the responsibilities, scope and cash flows of the process. None of the three approaches drafted by ESMA for implementing mandatory buy-ins are considered trouble-free, with two dismissed because "trading counterparties to the original transaction may not be involved in the buy-in or cash compensation process", according to the International Capital Markets Association (ICMA).

The proposed buy-in regime covers all securities transactions but poses a number of issues in the securities lending market. ISLA has asserted mandatory buy-ins could leave lenders at a loss in the event of a buy-in being triggered by failure of delivery due to a securities recall, recommending instead that a failing securities loan or return be remedied by a replacement loan. The association has also pointed out the potential of a financial transaction tax in 10 EU countries to sap the supply of securities needed to enforce mandatory buy-ins, by reducing returns to asset owners.

Elsewhere, the proposed partial exemption of short-term securities financing transactions (i.e. for near-legs) could lead to a two-tier market in which the interests of buyers and sellers may meet less frequently

Photo: tpholland

than at present. The ICMA has pointed out that while lenders will want to loan for short periods to avoid the buy-in risk that would arise if they failed to deliver the near-leg of a longer-dated trade, borrowers would prefer to borrow for term (i.e. a non-exempt transaction) to hedge their buy-in risk. The timeline for the buy-in process remains pending, with industry bodies hoping for sufficient flexibility to enable replacement stock to be sourced cost-effectively.

Resolution and reporting

Another change to the regulatory landscape for securities lending that has raised concerns on the supply-side has been the introduction of measures that allow for a suspension of counterparties' termination rights in the event of a systematically important bank entering a resolution regime. Post-crisis recovery and resolution regimes give regulators the power to impose a temporary stay on counterparty early termination rights in order to effect an orderly wind-down. Following the development of a Universal Resolution Stays Protocol by the International Swaps and Derivatives Association, which brings ISDA Master Agreements for OTC bilateral derivatives transactions in line with new resolution regimes, a number of industry associations – including ICMA and ISLA – created a Securities Financing Transaction (SFT) Annex, incorporated into the ISDA protocol in November 2015. THE SFT Annex enables firms that use securities financing master agreements to comply with various bank resolution regimes, but inevitably limits their existing contractual rights – and ability to protect investor interests – in the event of a default by a sell-side counterpart. The increased market risk represented by the regulatory stay could reduce buy-side appetite.

The European Commission's pursuit of greater transparency may also alter the economics of the securities financing market. Political agreement on the Securities Financing Transaction Regulation (SFTR) was reached in June 2015 and work on technical standards is expected to be finalised during 2016 (see page 9). In line with the requirements for derivatives enshrined in EMIR and equity and fixed income securities in MiFID II, SFTR will require detailed reporting to trade repositories, providing greater transparency of securities financing transactions, albeit on a next-day basis.

SFTR exempts securities financing transactions with central banks, but these currently fall within the scope of MiFID II / MiFIR's transaction reporting requirements (central banks will not have to report these transactions, but their counterparts will). These transactions notwithstanding, MiFIR specifically excludes from its reporting requirements any transactions that fall within the scope of SFTR. Securities financing transactions with either equity or non-equity collateral will be subject to both pre- and post-trade transparency requirements under MiFID II if traded on trading venues, but will be flagged as non-pricing forming trades in venue reporting. Because of their larger size than most transactions in underlying instruments, many repo and other securities financing transactions may be afforded exemption via 'large in scale' and 'size specific to instrument' transparency waivers. In addition, the TDAD, which amends the Transparency Directive of 2004, updates disclosure and transparency rules for stock lenders and borrowers, including disclosure of transactions and notification of vote holdings.

New reporting requirements increase costs, especially if they entail additional overhauls of post-trade processes, but there may be longer term efficiency benefits. Trade bodies are responding to demands for enhanced transparency and standardisation of transactions by working with market participants to develop common formats. For example, the ICMA's European Repo and Collateral Council Operations Group is developing a standardised template for trade matching and affirmation, leading to agreement on harmonised matching fields that would help users meet evolving reporting requirements.

SFTR and collateral re-use

Securities finance lies at the core of financial markets. According to Nerin Demir, Head of Securities Finance at SIX Securities Services, it provides "a crucial backbone to the smooth functioning of capital markets as a whole."

Despite the waves of securities market regulation, it has, says Demir, held up a lot better than expected, though overall volumes have not yet recovered to pre-crisis levels in either repo or securities lending.

Authorities in each member state are responsible for enforcing the SFTR and can impose a range of sanctions for breaches of reporting and transparency requirements.

Particular attention is therefore likely to be paid by market participants to the implications of the EU Securities Financing Transactions Regulation (SFTR), which came into effect on 12 January 2016.

According to international law firm, Eversheds, the SFTR is similar to the European Market Infrastructure Regulation (EMIR), "extending many of the obligations found in EMIR to SFTs, which are not otherwise caught by EMIR."

The SFTR sets out rules for the transparency and reuse of collateral in repos, securities or commodities lending and borrowing, buy-sell backs and sell-buy backs, and margin lending transactions.

Collateral re-use

The rules on collateral reuse are due to apply from mid-July. The right of counterparties to reuse financial instruments received as collateral is at a minimum subject to the following conditions: the collateral provider must have been informed in writing by the receiver of the risks and consequences of the potential collateral reuse; the provider must have granted prior express consent; and must also have expressly agreed to provide collateral by way of a title transfer collateral arrangement.

Authorities in each member state are responsible for enforcing the SFTR and can impose a range of sanctions for breaches of reporting and transparency requirements. These include cease and desist orders, censures and fines. •

Trying to keep the customer satisfied

Are the regulatory and commercial pressures facing custody clients affecting the way they approach provider relationships?

How have customer service priorities changed over the past few years? In October, SIX Securities Services took part in a private roundtable at Sibos hosted by Global Custodian magazine. The discussion ranged across the diverse challenges for agent banks globally and included the perspectives of both clients and providers. The question of priorities, however, elicited a degree of consensus among panellists.

Robert Almanas, Head, Strategic Alliances, SIX Securities Services, identified three principal client concerns in today's economic and regulatory climate: collateral management; compliance; and resource optimisation, including, of course, financial resources. The first two both involve improved control and visibility of end-to-end processes, particularly for clients engaged in cross-border business. In other ways, though, the challenges are quite distinct. New systems and procedures are required to meet growing regulatory reporting requirements. Collateral management at a global level can, in principle, make better use of existing processes. "There are mechanisms available that can transport collateral from one place to another as well as


Rob Scott | Commerzbank

"If you're a central treasury unit now, the ability to optimise your collateral is key, because that's a difference in P&L."

Rob Scott, Commerzbank

the ICSD solution around book-entry," says Rob Scott, Head of Custody and Collateral Solutions, Commerzbank. "The processes have been there, but I don't think the focus has been there. If you're a central treasury unit now, the ability to optimise your collateral is key, because that's a difference in P&L."

Collateral networks

A global collateral shortfall has long been predicted, but has yet to materialise. Has this led to complacency in preparing for it? "Obviously there's going to be a bigger demand for collateral as we move to a cleared world and as we go through sovereign crises; there are going to be stretches and limitations in the quality of collateral, but I'm not convinced myself that there will be a collateral shortfall," says Scott. "What I do know is that in the industry as a whole collateral is not mobile enough. Mobility is the important issue."

Essentially the collateral challenge is threefold, says Scott. "You need to have good visibility of your collateral first of all; you then need to optimise it and mobilise it across the various jurisdictions you work in. It amazes me that still today a number of big banks are somewhat inefficient with their collateral. They have a centralised treasury, but they don't optimise it very well."

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"There are three principal client concerns in today's economic and regulatory climate: collateral management; compliance; and resource optimisation, including, of course, financial resources."

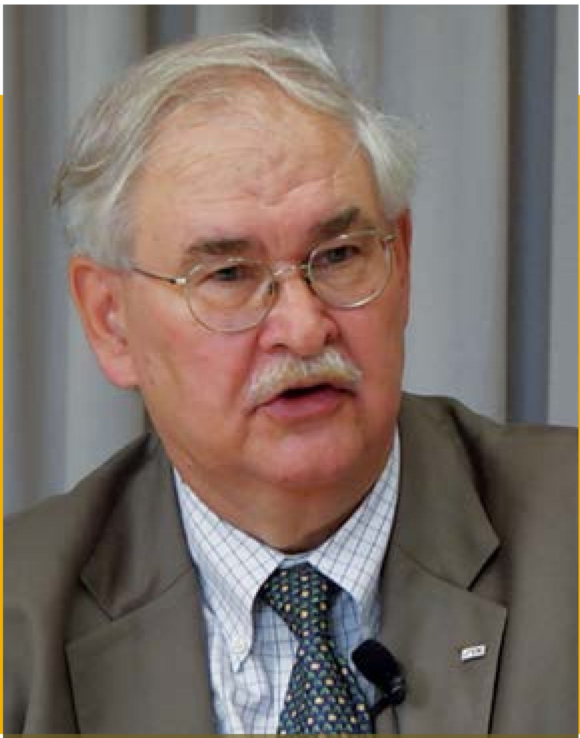
Robert Almanas, Head, Strategic Alliances, SIX Securities Services

Almanas agrees. "Remember we are still in a cheap cash world," he says. "There's so much cash floating around the system. We've also found collateral shortfalls within companies. If they're developing their collateral-consuming products in silos, they're not getting the general view of what's available. The question for us is how can we give them that wholesale view."

Scarce resources

As deadlines for successive mandatory changes loom, the issue of resource optimisation moves up the scale of priorities. Events such as the live launch of T2S may act as catalysts to revisit broader issues of operations and process efficiency. Where, for example, customers are engaged in non-competitive processes that are replicated by their service providers, there may be room to rationalise. "We have had customers come to us and say, 'We're doing the same thing. Is there something we can do together so you can take this process over for us?'" Almanas notes.

This is different from the classic outsourcing model, he stresses; rather, it is an effort to remove redundancy from a common process. "Their argument to us is, 'You're the



Robert Almanas | SIX Securities Services

"If [customers] are developing their collateral-consuming products in silos, they're not getting the general view of what's available."

Robert Almanas, SIX Securities Services

infrastructure. You operate at scale safely and cheaply. Why should we be doing the same thing?'" says Almanas. We're in an advanced pilot stage with one bank, where we take over the entire settlement process from time of execution. We're engaged in the matching, we maintain their SSIs [standing settlement instructions], because

There is a wide diversity of metrics employed to assess the efficiency of networks, says Almanas. For some firms, their key target is a reduction in external costs. In other firms, total cost of ownership (TCO) is more the issue. "The conversations are very different," says Almanas. "Metrics change behaviour."


Shrinath Bolloju | Deutsche Bank

> "[Clients] expect us to provide a flexible platform that will adapt to their internal systems so they don't end up customising at their end just to fit their pipes into our pipes."
>
> ***Shrinath Bolloju, Deutsche Bank***

we do it anyway. We're looking at other areas where customers say, 'Could you just do this for us'?

According to Shrinath Bolloju, Head of Investor Services, Asia Pacific, Deutsche Bank, customer appetite for technologically complex solutions has clearly diminished. "They expect us to provide a flexible platform that will adapt to their internal systems so they don't end up customising at their end just to fit their pipes into our pipes," he says. "That is clearly becoming an expectation, especially with larger customers. They also expect to collaborate with us, where they believe we have particular expertise to share with them."

This approach is facilitated by growing commercial interconnections between the parties. "We have a complex relationship with a lot of our customers," says Bolloju. "Sometimes we're their provider, sometimes they're our provider. Sometimes we work together and sometimes we compete in certain markets. We have a very transparent partnership approach."

The move from client-provider to partnership and collaboration is gaining traction. "I often don't go to client meetings with a pitch book," says Scott. "I just listen and we explore how we can work together. It's more solution-oriented. The dynamic has transformed."

The transformation has, however, required a shift in mindset on both sides of the table. "Speaking from a buyer's perspective, if, a few years ago, we had approached a number of our sub-custodians and said we wanted to expand our linkages with CSDs and we didn't want to buy everything they were offering, the reception might have been a little frosty. Now it's part of the conversation. Commercial institutions recognise reality. Ten years ago, they might have felt we were encroaching on their space. Now it's part of the conversation. That same dialogue is going on up the value chain and that's healthy for the industry."•

Living with delay

A postponement in the implementation of MiFID II will simply delay the inevitable, says Tomas Kindler, in charge of strategy implementation for SIX Securities Services.

The decision in mid-December by the US Federal Reserve to begin the process of raising interest rates has been hailed in the press as the start of a change of mindset, situating the 2008 financial crisis and the reaction to it as a past event.

Both market infrastructures and participants are, however, still in the midst of grappling with the regulatory aftermath of that crisis. In that context, the recent delay to the implementation of MiFID II is not really a game changer. It does, however, have a number


Tomas Kindler | SIX Securities Services

"Given the process surrounding [MiFID 2's] implementation, the announcement of a year's delay has not really come as a shock."
Tomas Kindler, SIX Securities Services

of short-to medium-term implications for the securities services industry.

While MiFID pre-crisis mainly targeted the trading layer, the aftermath of the financial crisis saw regulators taking a more direct approach to encouraging the use of central clearing in a broader range of asset classes and in financial market risk mitigation in particular.

Once in effect, MiFID II will have a material impact on where and how securities and derivatives are traded and cleared as well as levels of volatility and liquidity. Some of the mechanisms by which it will affect the markets are relatively straightforward; others less so. Given the process surrounding its implementation, however, the announcement of a year's delay has not really come as a shock.

The final version of the Directive itself was the result of two years of negotiation. It was approved by national governments and the EU parliament in early 2014, with a start date of January 2017. The key enabler, as with many other EU directives, is the release of technical implementation standards, which set out the practical details →

of what the various stakeholders actually need to do.

The end of September 2015, for example, saw the release by the European Securities and Markets Authority (ESMA) of its Technical Standards (TS) relating to the implementation of both the CSD Regulation (CSDR) and MiFID II. However, these are subject to another round of approvals and it is here that the delay has been brought about while certain differences between the European Parliament and ESMA are ironed out. The Parliament is likely to seek certain changes to the standards proposed. At the same time, participants will need sufficient lead-in time to make the necessary systems changes to comply with the implementation requirements.

What could this latest delay mean for the market as a whole? As far as the post-trade landscape is concerned, MiFID II has provided the main regulatory pressure for vertically integrated markets to open up to competitive clearing as well as for asset classes other than equities and derivatives to move towards electronic trading, and, in due course, centralised clearing. This pressure will now possibly be eased, though not removed, by a later start date.

More concretely, there will be a delay in providing CCPs with a tool to request access to the data feed of these currently closed exchanges. There will be less urgency for vertically integrated groups to open up to other non-group CCPs and to allow international banks to further consolidate their clearing business. Some delay in this process, however, was already anticipated, even had the implementation date not be postponed.

Vertical models allow participants to trade, clear and settle in a single infrastructure, and are operated by some of Europe's major derivatives players. SIX operates a horizontal clearing house in Europe and has long been an advocate of open access. However, a political agreement at the start of 2015 meant that open access to CCPs that are part of a vertically integrated model would be phased in.

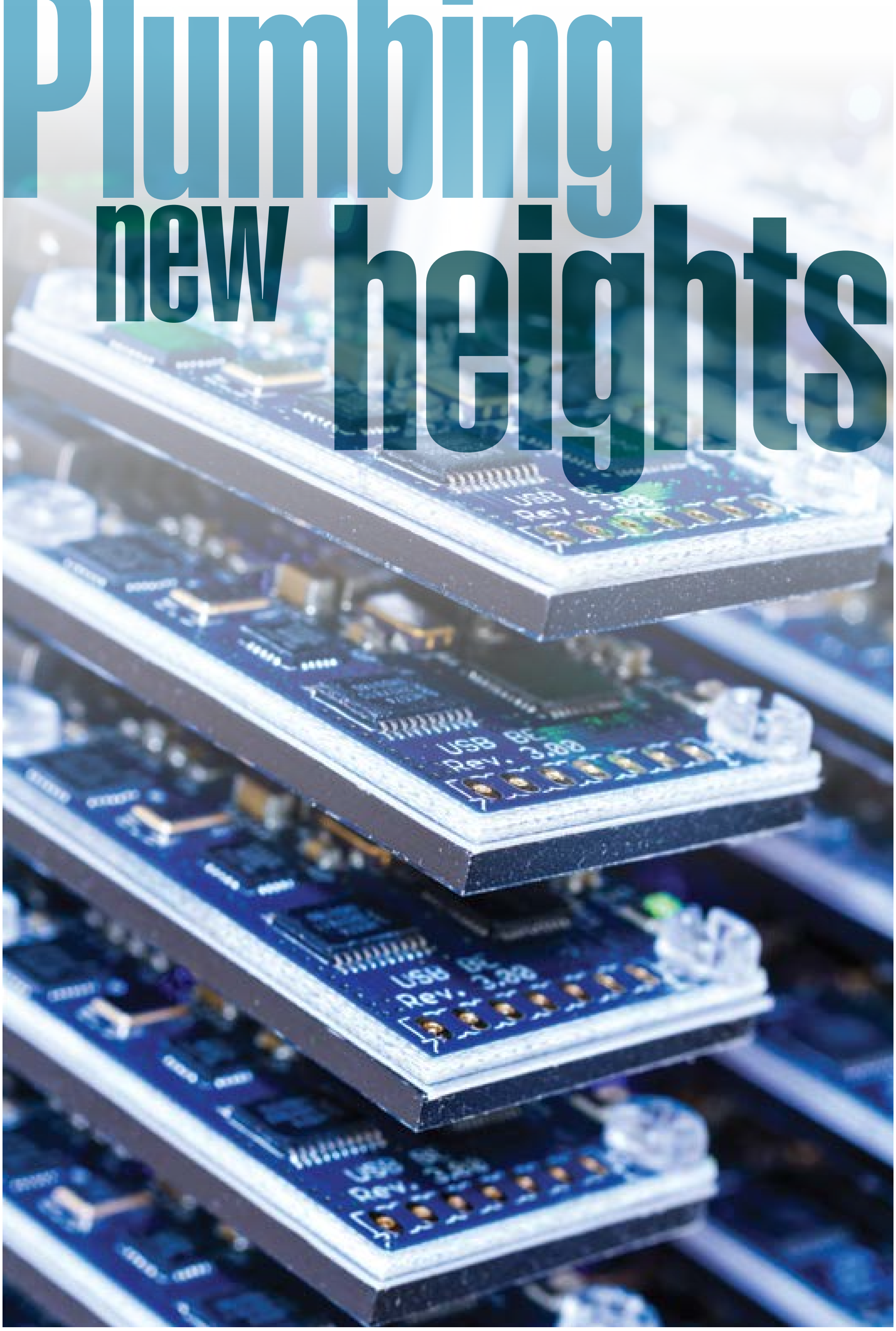
It is also possible that there will be a further delay in the shift to electronic trading in the bond markets, with bilateral structures still dominating. A multitude of ventures to foster electronic trading of bonds have been launched, but as a regulatory imperative, they have so far been slow to displace traditional market practices.

As far as the business models of CCPs, are concerned, we do not expect the delay to have any major additional impact. CCPs depending on and fighting for further access to European equities markets as well as those aiming to diversify into other asset classes, mainly bonds, will regard the delay as a setback from a timing perspective, but are unlikely to rewrite their business strategies.

While the long-term impact of MiFID II on the market landscape might indeed be transformative, we at SIX Securities Services do not expect the latest delay to have any dramatic impact on the ultimate shape of that landscape. It will simply restrain the pace of change. Given the multiple regulatory challenges facing participants along the value chain, no one will yet be taking their eye off the ball. •

This article first appeared in Futures and Options World (FOW)

Plumbing new heights



While 2015 may not have been the year of blockchain, it was certainly the year of talking about blockchain.

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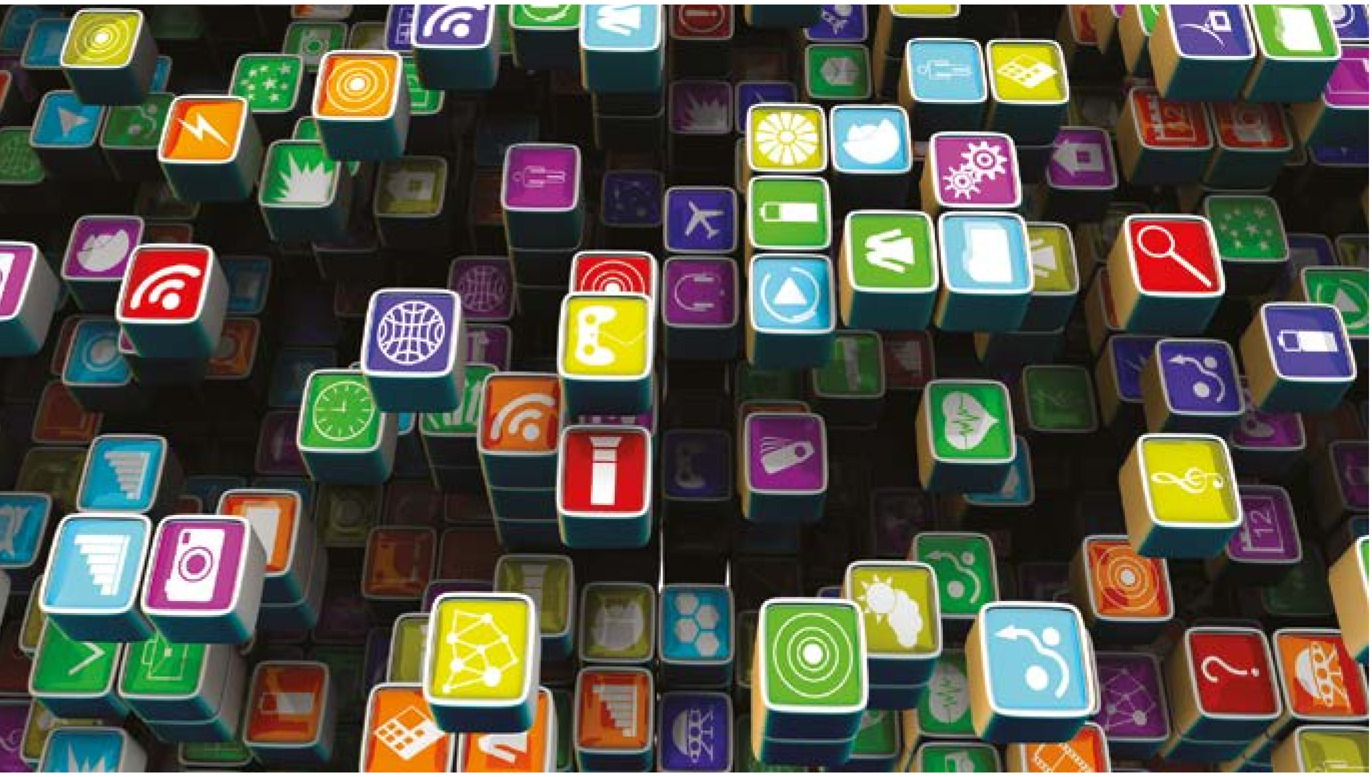


Every year, SWIFT hosts a global conference and exhibition, known as Sibos, exploring issues confronting the global financial services industry with an emphasis on operational and processing efficiency. Anyone who claims they were there in 2015, but did not hear the word 'blockchain' uttered at least twice an hour needs to be treated with suspicion.

Given that Sibos tends to focus on the post-trade arena, it was telling that the concept of distributed ledgers/blockchain, shorn of its more racy Bitcoin connotations, had managed over the course of the year to infuse discussion at the more prudent and conservative end of the transaction chain.

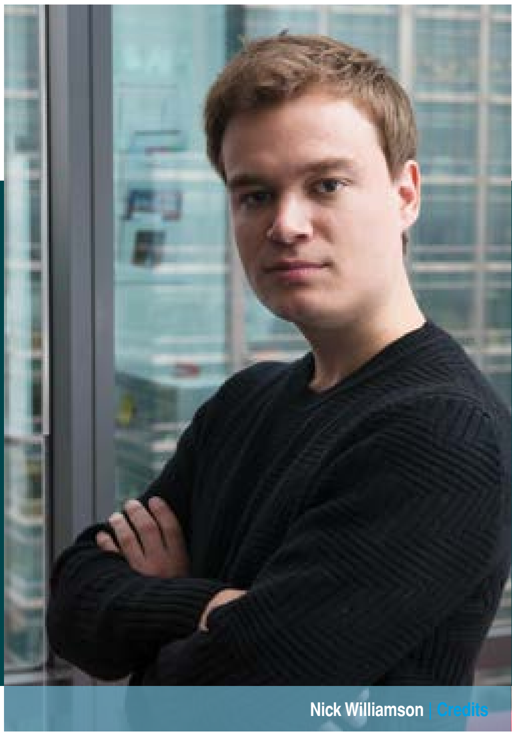
Most of the discussion, however, amounted to little more than strong expressions of interest. Many in the financial services industry are happy to predict a disruptive role for distributed ledger technology, but there are few firm predictions of how it will play out.

Practical advances

What was actually achieved in 2015? At least two settlement initiatives were announced to the market. In mid-December, Sir David Walker, a former executive director of the Bank of England, joined settlement infrastructure startup SETL as chairman. SETL is an institutional payment and settlement system based on blockchain technology. The company says is in the process of completing its fundraising and is in discussion with more than 40 financial institutions, including leading banks and infrastructure providers, to create a cross-industry platform.

In mid-November meanwhile, the US Patent and Trademark Office published a patent application from Goldman Sachs for "a virtual multi-asset wallet as a traditional securities and cash account for an individual, investor, and/or trader (`trader`)." The wallet includes technology to generate, manipulate, and store a new cryptographic currency, referred to as SETLcoins, "for exchanging assets, such as securities, cash, and/or cash equivalents via a peer-to-peer network."

At least two securities transactions were completed using distributed ledger



> "If a project turns into design-by-committee then progress might move more slowly than a new and dynamic technology needs in order to flourish."
>
> ***Nick Williamson, Credits***

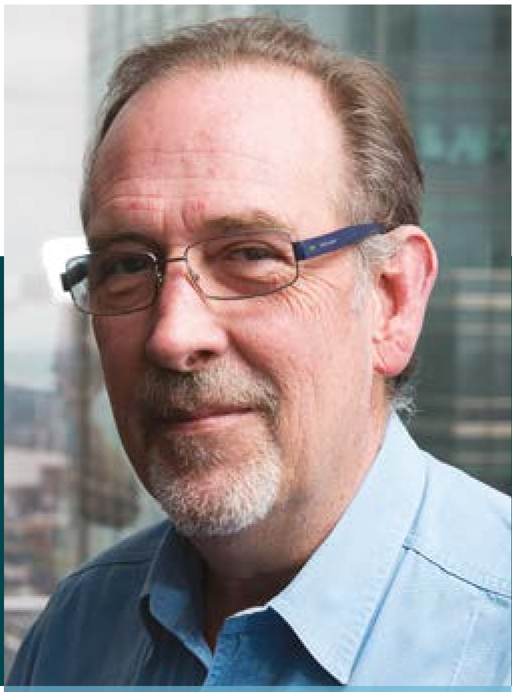
technology in 2015. In late December, NASDAQ announced a private securities issuance documented with blockchain technology. Nasdaq enabled the issuer, Chain.com, a blockchain developer, to digitally represent a record of ownership using its Linq subsidiary. "Through this initial application of blockchain technology, we begin a process that could revolutionise the core of capital markets infrastructure systems," said Bob Greifeld, CEO, Nasdaq. "The implications for settlement and outdated administrative functions are profound." NASDAQ's pioneering claim was disputed by Symbiont, a start up claiming to have issued its own shares on the Bitcoin blockchain in August. In September meanwhile, US company Pivit, which describes itself as an interactive marketplace combining public opinion, news and data to produce live odds on global event outcomes, issued a portion of a $5 million investment round using distributed ledger technology from Digital Asset Holdings, a company run by former J.P. Morgan executive Blythe Masters.

Early 2016 will see the execution of a plan approved by the SEC from online retailer Overstock.com to issue company stock by way of the blockchain. In June, Overstock used the blockchain for a private bond issuance.

Way ahead

While these transactions have certainly aroused industry enthusiasm and attracted media attention, there is growing recognition that the distance to be covered before the financial services industry as a whole can benefit from blockchain technology is still vast.

To bridge the gap, several consortia have been formed to harness the necessary skillsets. Financial innovation company R3's distributed ledger initiative is probably the largest with a total of 42 bank members. The initiative is now looking to attract non-bank institutions. "Partnering with a broad range of institutions has always been central to our strategy of developing distributed ledger technologies that will truly benefit the financial services industry as a whole," says David Rutter, CEO, R3. Interestingly, Overstock CEO Patrick Byrne →



Michael King | Credits

> "Clearly, it is the securities industry that is leading the experimentation with blockchain technology, from reference data to smart contracts."
>
> *Michael King, Credits*

has expressed misgivings about the potential for the R3 initiative to stifle innovation in this area of FinTech by allowing "Wall Street" to dominate developments.

Open Ledger Project

R3 is itself participating in the Open Ledger Project, which includes members as diverse as IBM, Wells Fargo, London Stock Exchange Group, Accenture, Digital Asset and Linux Foundation. Another founding member of the project is Credits, best known for its work with the Isle of Man government and several central securities depositories (CSDs). "Bringing expertise from different industries enables the creation of innovative and relevant solutions," says Nick Williamson, CEO & founder, Credits. The firm's collaboration with the Isle of Man Government and MICTA (Manx ICT Association) has resulted in the world's first government service running on a blockchain.

The Open Ledger Project is expected to help identify and address features and requirements for a cross-industry open standard for distributed ledgers. "Distributed Ledger Technology (DLT) will unlock the full 'digital' potential of capital markets and the wider financial services industry by enabling a shift away from the current reconciliation-based systems that are very expensive and highly inefficient," says David Treat, Managing Director, Financial Services at Accenture. "Key to that journey is to have standards and shared platforms that are utilised across industry participants." Beyond standards, Arvind Krishna, Senior Vice President and Director, IBM Research, suggests that creating common code will allow organisations to focus on industry-specific applications.

While lauding the aims of the Open Ledger Project, Williamson nevertheless warns that, "Collaborative initiatives can also bring a double-edged sword dynamic. They have the potential to establish a standardised way forward for industry, but if the project turns into design-by-committee then progress might move more slowly than a new and dynamic technology needs in order to flourish – and this is what all participants should carefully consider."

Regulators

Financial institutions handling mainstream transactions are likely to be cautious in embracing distributed ledger technology until their respective regulators and central banks have at least given tacit approval to such engagement. Indications so far are that central banks, while not necessary keen on digital currencies per se, are more open to the benefits of distributed ledger technology. The Bank of England published a detailed paper in 2014, making clear the distinction between the two. In December 2015, The Bank invited students to pitch new uses for the technology, offering the prize of an internship with the bank.

From a position of distrust of crypto-currencies two years ago, the Reserve Bank of India has now spoken positively of the underlying technology while querying the value of the currencies themselves. In its December Financial Stability Report, the RBI recognised that, "With its potential to fight counterfeiting, the 'blockchain' is likely to bring about a major transformation in the functioning of financial markets, collateral identification (land records for instance) and payments systems."

Benoît Cœuré, Member of the Executive Board of the ECB and Chairman of the Committee on Payments and Market Infrastructures (CPMI) of the BIS, representing central banks as a whole, notes that, "Even if today's schemes do not endure in their present form, it is likely that other products, services and business models based on the same underlying technology will continue to emerge and develop."

Underpinning the argument for blockchain from the initial paper by the pseudonymous Satoshi Nakamoto is the ability to transact without the need for counterparties to trust each other or rely on a mutually trusted third party. Lack of trust is, however, a non-starter for the financial services industry. Without trust, either in one's counterparty or in the intermediation process, any innovation is likely to stall. This is not lost on some FinTech entrepreneurs. "Clearly, it is the securities industry that is leading the experimentation with blockchain technology, from reference data to smart contracts, says Michael King, Chairman, Credits and, prior to that, a SWIFT veteran. "Blockchain is about trust and non-repudiation and we will see many applications being developed over the next five years both for private and public chains," he says. "The internet changed the way that we consume information, the mobile put our desk in our pocket and blockchain puts trust back into interactions, which is especially applicable in financial markets transactions." •

"Even if today's schemes do not endure in their present form, it is likely that other products, services and business models based on the same underlying technology will continue to emerge and develop."

Benoît Cœuré, ECB

Are we virtually there yet?

Can existing technologies be used to accelerate international securities-related payments?

Richard Schwartz, Senior Contributing Editor, Global Custodian

When delivery versus payment (DvP) settlement fails in an international securities transaction, it is often the P rather than the D that is responsible. As Thomas Zeeb CEO, SIX Securities Services, has observed the securities involved in a DvP environment are rarely a problem for successful completion of a transaction. They are usually held in dematerialised form in the jurisdiction where they need to be delivered, regardless of where their beneficial owner or instructing broker is located.

A foreign investor will, however, need to transfer the cash for their purchase to the relevant sub-custodian in time for settlement. This involves the extra step of waiting for a foreign exchange transaction to settle and the funds to hit the requisite account before the transaction can be completed. There are of course workarounds – some more cost-effective than others, involving credit lines and securities financing – but the process of organising these is not stress-free.

Last year, Zeeb mooted the idea of applying the technologies of virtualisation to restructure the cash component of international securities transactions. While much of the industry has been focusing over the past year on the potential of distributed ledger technologies to reshape securities operations, there are existing processes that could be harnessed to address the problem Zeeb identifies. Cloud technologies, for example, could allow for the 'virtualisation' of existing good currencies.

A cloud structure could be considered where both commercial and central banks hold mirror accounts. Funds credited in one central bank could be blocked for immediate use in another participating jurisdiction. This would not displace existing foreign exchange clearing mechanisms, but the underlying transfers would be a simple back-office function after the event.

The concept of mirror accounts is already ingrained in correspondent banking. If the Fed, the ECB, Bank of England and SNB were connected to the new cloud facility, a significant percentage of global cross-border transactions would be covered.

As with any cross-border arrangement of strategic importance, there would be regulatory, operational and security issues to iron out as well as the need for a thorough review of potential unintended consequences. However, none of the technical challenges appear insurmountable.

The promise of blockchain has been eagerly embraced despite the distance to travel before its impact on securities services becomes tangible. I suspect that less effort would be needed to accelerate cross-border securities-related payments in the cloud, while still preparing for the blockchain revolution. •

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