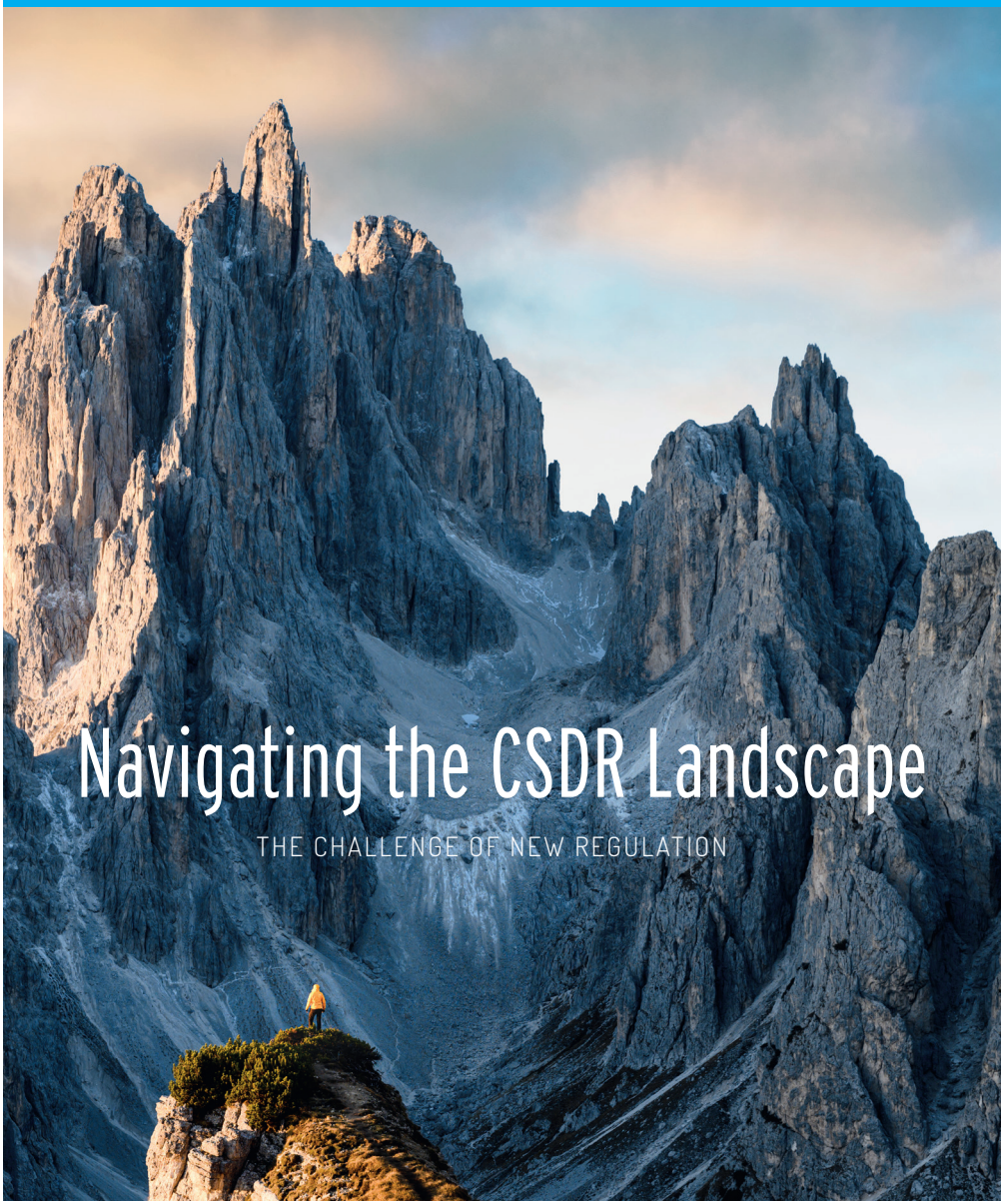
funds europe

A Funds Europe survey in partnership with RBC Investor & Treasury Services



Navigating the CSDR Landscape

THE CHALLENGE OF NEW REGULATION

Contents

CSDR: An unsettled regime?

WHAT THIS SURVEY REVEALS

Highlights

In 2021, €178.30 trillion worth of securities were settled across the EU's 'TARGET2-Securities platform.' T2S, as it is known, was introduced in 2015 to harmonise the EU's fragmented settlement system.

The platform has made progress in integrating and streamlining Europe's post-trade functions, which were once siloed by country. There are now more efficiencies.

Yet despite this progress, settlement fails – when a buyer or seller in a securities transaction does not get what they expected – are still a feature of the landscape. Earlier this year, a system of punitive measures for settlement delays was introduced as part of the Central Securities Depositories Regulation (CSDR). In other words, there are now daily fines for unsettled securities trades.

Although the CSDR aims for further harmonisation of the settlement system, its primary objective is to increase safety and efficiency for investors by forcing market actors – such as fund managers – to adopt greater settlement discipline to mitigate failure risk.

The so-called Settlement Discipline Regime affects firms right across the world if they trade securities that are settled in an EU-domiciled central securities depository.

So, how can firms navigate this CSDR landscape – a landscape that could become even more difficult as CSDR implementation evolves?

Funds Europe's survey, in association with RBC Investor & Treasury Services, highlights an increasing need for technology among respondents as they seek greater ability to comply with the regulation. Legacy technology employed by one market actor in a whole chain of counterparties subject to a trade could impact everyone in that chain.

Investing in technology appears more important to asset managers than ever. The expense of this, however, could lead to an increase in larger-scale middle-office outsourcing as a means of gaining more value.

CSDR may have come as a bigger shock to market actors than was expected. But at least we glean one positive aspect from our research: platforms supporting 'standard settlement instructions' have reduced booking errors, which were once a common cause of failure.

Our survey and expert commentary also offer insights into what market actors think about UK divergence.

CONNECTING YOU

Funds Europe is the leading journal for the cross-border funds business. Each month you will find detailed coverage of the funds industry, spanning Ucits, alternative investment funds and ETFs. We are unique in covering the full life-cycle of funds, from investment strategy and economics, through to regulation, asset servicing and post-trade services.

Funds Europe is read by CEOs, CTOs and COOs working within institutional, wholesale and retail investment. It is also read by professionals working in areas such as family office, private banking and fund services companies across 43 countries in Europe. It is published in print 10 times a year with a daily e-newsletter seen by more than 12,000 recipients. All content is available to view free of charge on our website and accessible via social media.

Whether you are concerned with investing, asset allocation, distribution, regulation, technology or outsourcing, Funds Europe connects the funds industry with thought leaders.

Providing Thought Leadership for Thought Leaders

www.funds-europe.com

FUNDS EUROPE PUBLISHED BY
CAMRADATA ANALYTICAL SERVICES LIMITED
5TH FLOOR, 80 LEADENHALL STREET, LONDON EC3A 3DH
TEL: +44 (0)20 3327 5679 FAX: +44 (0)20 3327 5693
EMAIL: CONTACT@FUNDS-EUROPE.COM

Foreword

KNOWLEDGE GLEANED NOW, IN THE EARLY DAYS OF THE CSDR PENALTY REGIME, WILL HELP FIRMS TO MAKE SENSE OF A COMPLEX REGULATION JOURNEY.

RBC Investor & Treasury Services is pleased to be a partner in this *Funds Europe* survey report, *Navigating the CSDR Landscape*. The CSDR penalty regime has been in effect for more than six months and we are seeing early indications of how it has been implemented, such as lack of market readiness and technology challenges and limitations.

It is evident that the penalty regime under CSDR poses a financial impact if both buy and sell side firms do not handle requirements in a timely and efficient manner. However, early learnings show that it is a complex regulation with many layers – which this report explores.

The industry is also dealing with current market trends such as margin compressions due to inflation and rising costs, rapidly evolving technology and the transition to T+1.

An outsourced middle-office transaction management service is allowing some market participants to leverage scale and expertise with these operating models and to better navigate market/regulatory change, including CSDR and future changes.

By being well prepared, firms continue to increase operational efficiencies, avoid CSDR-related penalties and focus on their core competencies – increasing returns for their underlying investors.

As both a thought leader and solutions provider in the asset servicing space, RBC Investor & Treasury Services understands the potential hesitation and challenges firms may experience, and that choosing the right partner can make all the difference in their regulation journey.

Ben Pumfrett
Head of Middle Office Product at
RBC Investor & Treasury Services

Dean Rook
Head of Middle Office Operations at
RBC Investor & Treasury Services

Navigating the CSDR landscape

GLOBAL SECURITY SETTLEMENT MARKETS ARE UNDERGOING SIGNIFICANT CHANGES AS THEY LOOK TO STREAMLINE AND OPTIMISE MARKETS. THIS OF COURSE BRINGS CHALLENGES. *FUNDS EUROPE* AND RBC INVESTOR & TREASURY SERVICES RECENTLY CONDUCTED A SURVEY OF OVER 100 MARKET PARTICIPANTS, WITH RESULTS SUGGESTING THE NEED FOR CORE TECHNOLOGY UPGRADES ACROSS THE INDUSTRY TO MANAGE THIS CHANGE. WRITTEN BY **MADELEINE SAGHIR**.

SINCE THE 2008 GLOBAL financial crisis, a swathe of new regulation – the European Market Infrastructure Regulation (EMIR) and the Markets in Financial Instruments Directive (MiFID II), to name two – has come into effect with the aim of creating a more transparent market, driving market efficiencies and lowering market risk.

The Central Securities Depositories Regulation (CSDR) penalty regime is the EU's latest push.

CSDR's Settlement Discipline Regime (SDR) requires European CSDs to automatically apply penalties against participants that fail to complete transactions on contractual settlement date. Asset managers, asset owners, service providers, investment banks and brokers are among those impacted.

Funds Europe and RBC Investor & Treasury Services (RBC I&TS) recently surveyed market participants on the buy and sell sides about CSDR readiness and the impact of the new regulation. We are pleased to present the survey results.

The new regime

Originally scheduled to go live in September 2020, the implementation of SDR suffered numerous delays – an acknowledgement by EU regulators that the new regulation was not in its optimal form and that extra time was needed to reopen the CSDR rulebook amid the disruption of Covid-19.

While the new regime finally went live on February 1 this year, initial reaction indicates that the market has a way to go before realising the desired results of more efficient European markets. Several teething problems have become apparent over the months following launch with many on the buy side incurring more fines than their pre-launch analysis had anticipated. Nevertheless, over the medium to long term, the opportunities to eliminate inefficiencies and risks are expected to become evident as the regulation continues to drive greater settlement certainty.

It is against this backdrop that our CSDR Survey 2022, conducted between February 14 and April 14, highlights the challenges, opportunities and trends that the regulation presents from the viewpoint of the buy side – predominantly asset managers, asset owners and service providers – and the

HARD WORK – Early reactions to CSDR suggest that achieving more efficient markets will be no easy task in the short term.

sell side, primarily investment banks and brokers.

Lessons learned from CSDR

"Lead time" was the most popular response from buy side (24%) and sell side (23%) respondents when asked to indicate what they had learned from the CSDR implementation (see Fig 1). Operational readiness was in second spot for the buy side (20%), while "risk" took on #2 spot for the sell side (19%). "Risk" took on third spot for the buy side (13%). A further 15% of buy side (#4 spot) and 17% of sell side responses (tied for #3 in terms of popularity) indicated that lessons learned from "technology requirements" would assist with other settlement regime changes.

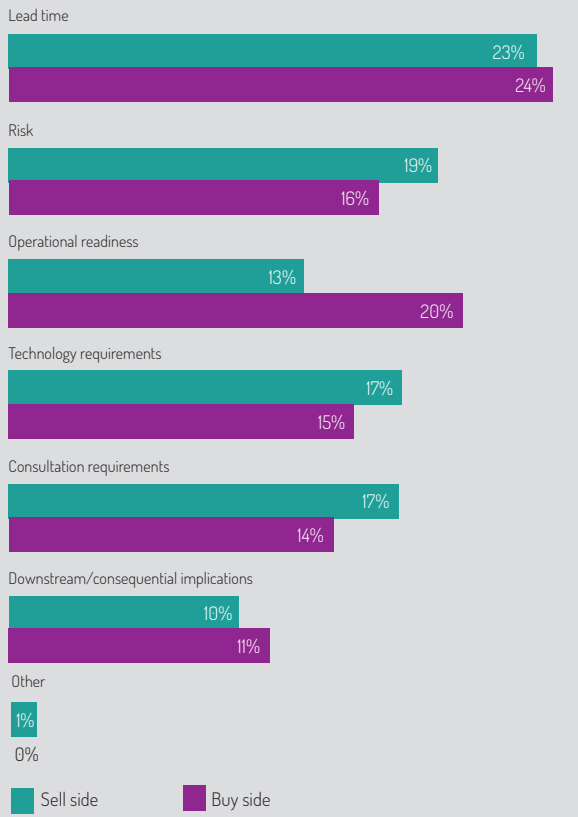
Dean Rook, Head of Middle Office Operations at RBC I&TS, agrees that CSDR's implementation can offer valuable lessons for other settlement regime changes, such as the move to T+1 in the US and Canada.

"It's not surprising that lead time and operational readiness are deemed to be key lessons learned given the implementation delays," says Rook. "Participants generally didn't have a sufficient window to make operational changes that were required once the practical day-to-day workings of the penalty regime had been published by the CSDs."

"Risk" is also among the top lessons learned. "One of the reasons for the move from T+2 to T+1 is to reduce settlement risk. The reduction in the timeframe means that investments into technology and exception-based operating models are required to meet T+1, which ultimately reduces this risk," Rook says.

Moving on to lessons learned

Fig 1: Are there lessons from the CSDR implementation that would assist with other settlement regime changes e.g. US/ Canada T+1? Select all that apply.



around "technology", Ben Pumfrett, Head of Middle Office Product at RBC I&TS, emphasises the interconnectivity of the various players within the settlement process. "Implementing a technology solution that works for you doesn't mean that you will get the full benefit if other parts of the chain are still on legacy systems."

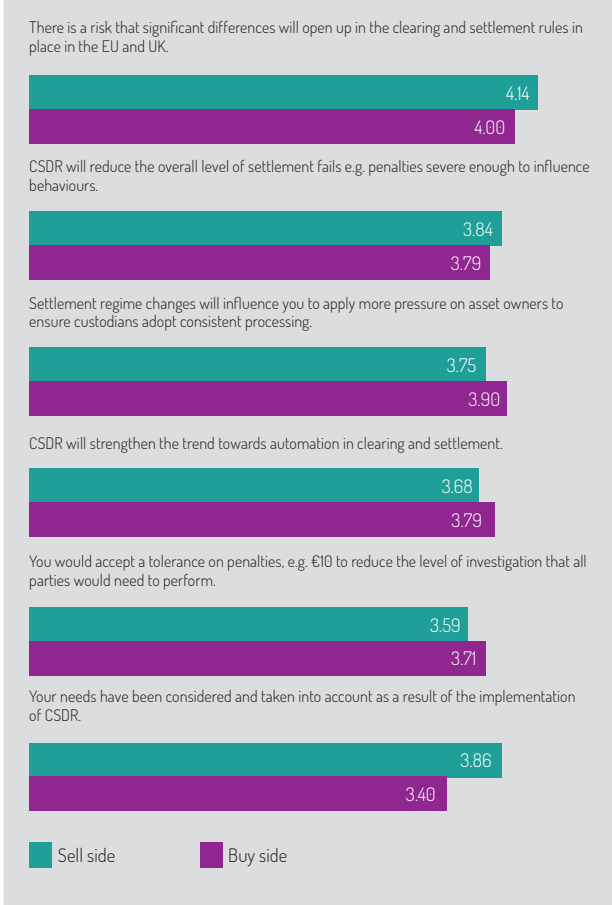
He adds: "You are only as strong as your weakest link. For example, a custodian may have enhanced their technology to accept real-time trade updates but, if there is a lack of timeliness in receiving this information, then the full benefits of the technology will not be realised".

So, CSDR will inform T+1 projects that the technology component of all the participants in the trade lifecycle is critical. But getting the various players within the trade lifecycle chain to enhance their technology cannot be achieved overnight. "This requires all participants to be willing and capable of implementing the required technology," Pumfrett affirms.

A universal technology stack through market utilities could help ensure that participants are compliant with CSDR and equally efficient. Ultimately, the fewer providers and technology variations, the less complexity there will be in the market. Open architecture is enabling greater integration through the technology lifecycle, and this also drives greater efficiency.

For CSDR, it is about getting clear industry standards out to the market as early as possible to ensure participant alignment, says Rook. "Unlike individual markets, such as the US and Canada, European regulation covers 27 jurisdictions

Fig 2: On 1-5 scale, please agree or disagree with the following. *1 – strongly disagree, 5 – strongly agree. Weighted averages.



so there is greater complexity in establishing these new regulations, with local variations, as well as multiple CSDs and impacted parties."

Wider impacts

T+1 could create additional divergence and complexity if implementation goes ahead in North America at the exclusion of Europe. Likewise, CSDR has the potential to create significant divergence in clearing and settlement rules between the EU and UK, should the UK decide to develop an alternative way of achieving settlement efficiency. The survey found 77% of buy side and 79% of sell side entities strongly agree or agree that this is a risk (see Fig 2).

"For the moment, the UK is able to sit back and watch. If the UK authorities see significant improvement in market efficiency resulting from the penalty regime in Europe, they may follow suit, but at the moment it's too early to draw any conclusions," says Rook.

"In the meantime, there will likely be an element of complexity with assets settling in both CREST, the settlement system for markets in the UK and Ireland, and Euroclear, which settles and clears securities trades executed on European exchanges."

Rook explains: "Where assets are dual-listed on the UK and European exchanges, the impact of transactions settling late on Crest and EEA Domestic markets will be different. This in itself may be an insufficient driving force to align the different markets but is a further example of complexity that, over time, could influence market convergence."

Settlement failures

"Economic mismatch" is cited as the most common cause of settlement failure by both the buy side (27% of responses) and the sell side (32% of responses) (see Fig 3). Only 15% of survey responses from the buy side and 12% from the sell side cite standard settlement instructions (SSIs)/asset static as a common cause of settlement failure.

According to Rook: "This relatively low rating was a bit of a surprise since SSIs have traditionally been a significant cause of fails. This obviously demonstrates the success of efforts to improve the efficiency of SSIs – centralise SSI storage, automate instruction updates, make the market more consistent and transparent in terms of SSI availability, and thereby reduce SSI-related fails."

Trade booking errors by the asset manager or broker are also a common reason for settlement fails – 20% of buy side and 13% of sell side responses. Theoretically, this should be easy to address as enhanced technology will help remove manual intervention and improve integration between platforms.

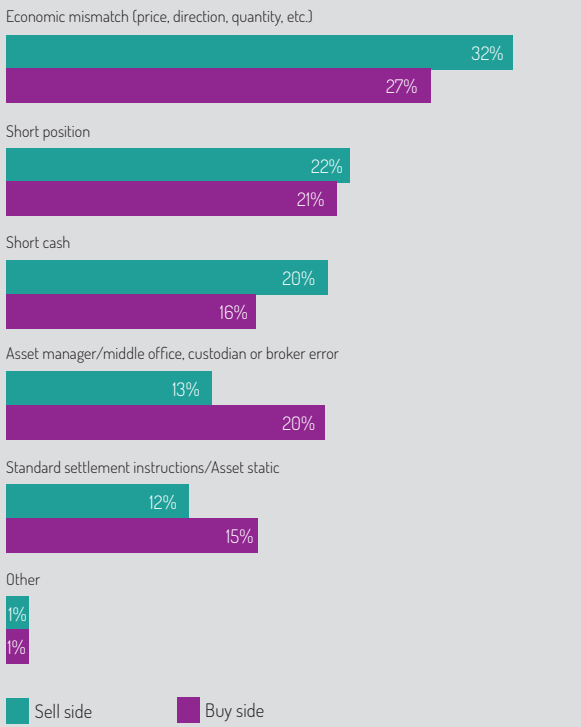
"We are also seeing a greater focus on market charges, such as stamp duty, taxes, exchange fees and the like, which are becoming much more difficult to manage. A number of front-office systems have an enrichment capability around these charges. But for some markets, this involves complex rules and a tiering process that require analysis of different data points to understand the charge – an area where there is room for improvement," says Rook.

CSDR creates a settlement discipline framework that is designed to enhance transaction settlement rates and transparency. Firms concerned about settlement failures due to inadequate operating models could consider collaboration with proven outsourcing partners, Rook concludes.

Outsourcing

The survey findings indicate that "operations" is the most frequently outsourced

Fig 3: What do you see as the most common or impactful cause of settlement failure? Select all that apply.



function for the buy side (30%), while technology is the most outsourced activity for the sell side (26%) (see Fig 4). These results reflect the scale of sell side firms, which continue to run many of their operations in-house.

Firms with a large number of high-volume settlement failures are more at risk from CSDR's mandatory cash penalties and upcoming buy-ins for settlement failures. This is where outsourcing could be advantageous, including a third-party provider with a robust platform that facilitates regulatory compliance and mitigates regulatory risk.

"The pandemic shone a light on inefficient operating models, creating an impetus to make changes designed to increase efficiency and resiliency," says Pumfrett. "A resilient operating model is key. And this is driving buy side firms to find new ways of managing their operating models, with outsourcing as an option. Retaining reputable service providers, with a pool of experts and a global footprint, allows buy side entities to respond to the market more quickly."

The buy side may choose to enhance their internal systems, but challenges remain around the capital costs of this option and the time required to implement new technology. This is one of the main benefits of outsourcing, says Rook. "Much of the technology is outsourced by default. As a middle-office provider, we offer a service that is underpinned by a modern technology platform."

Internal system changes

Market participants require enhanced internal systems or significant manual effort to monitor compliance with CSDR and help prevent settlement failures. The survey results suggest this is more important to the sell side, with over two-thirds of respondents (68%) stating they have enhanced their

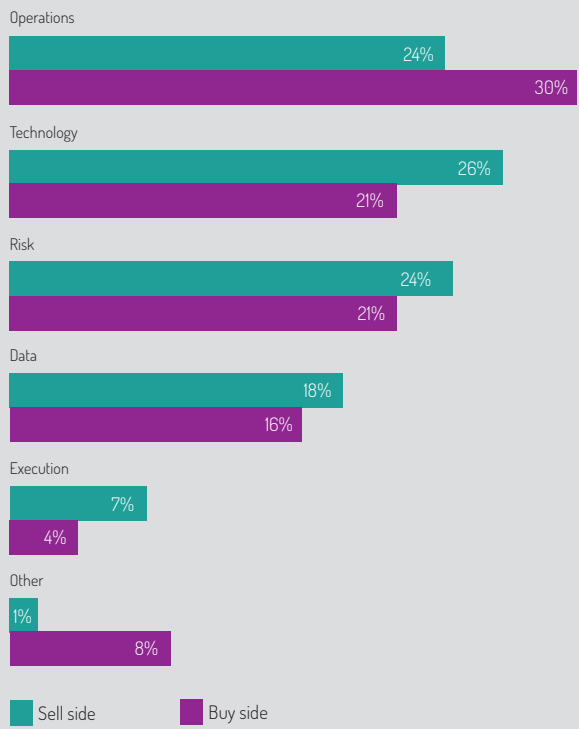
systems as a result of CSDR, compared to half on the buy side (see Fig 5).

The sell side tends to have more trade volume than the buy side, which means there is limited opportunity for firms to manage penalties manually or offline. The buy side tends to have less trade volume, and is often unable to justify spending time and money on technology enhancements, according to Pumfrett. Indeed, in the lead up to go-live in February, he says that RBC I&TS' buy side clients, based on their pre-regulation analysis, determined that they would not incur significant penalties and took the decision not to implement changes to their technology. "However, following implementation of CSDR, penalties seem to have been higher than expected."

One of the reasons for higher-than-anticipated penalties on the buy side revolves around the broker's request to update trade details and facilitate settlement. "As a result, participants on the buy side are often the last to instruct, which generally results in CSDR penalties being applied to the buy side by the CSD," says Pumfrett.

The scale of CSDR and the impact of its penalties have come as a surprise to many market participants. Consequently, the buy side is now looking to invest in technology designed to support CSDR workflow, assist in proactively managing the end-to-end lifecycle and ultimately reduce settlement failures.

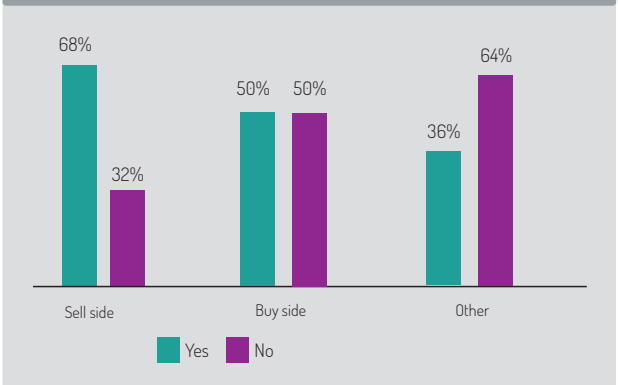
Fig 4: Have you begun/increased outsourcing of the following functions as result of CSDR? Select all that apply.



An evolutionary process

CSDR should be relatively easy to understand: if you fail, you get fined. However, this is a complex regulation, posing a number of challenges that may ultimately result in change. As mentioned, there has been a higher than expected impact on the buy side, where they amend a trade at the request of the sell side and subsequently receive a penalty due to their instruction being received last at the CSD. Over

Fig 5: Have you increased investment in your internal systems as a result of CSDR?



"The pandemic shone a light on inefficient operating models, creating an impetus to make changes. A resilient operating model is key."

Ben Pumfrett, RBC Investor & Treasury Services

time, these small penalties could, collectively, become unpalatable to the buy side and drive efforts to lower the current Association of Financial Markets Europe (AFME) penalty guideline, of which penalties under €500 incorrectly assigned are not claimed against the counterparty.

As margins tighten, asset managers are looking to minimise technology development in support of trading. The outsourcing of operations-related activities may be an option to control technology costs and move to a variable cost model.

Asset servicers are creating post-execution and trade lifecycle management services that help clients reduce settlement fails, says Rook. "At RBC I&TS, we have an automatic settlement tracking platform on the back end of our trade management service, which is custodian-agnostic. We can pull information from underlying custodians and then monitor the information to prevent failures. By acting as a proxy for asset managers and asset owners, we insulate them from custodians and brokers as much as possible."

Ultimately, the goal of CSDR is to create an efficient settlement model by improving settlement processes and reducing the number of failed trades. Some industry participants believe this can be achieved by penalising fails, while others support a shorter settlement cycle. And while different markets will use different tools, the objective is the same globally – improved settlement efficiency.

So far, CSDR and its penalty regime have not had a hugely positive impact on settlement rates. Rook and Pumfrett say they are starting to see improvement but only time will tell if the regulation is having the intended impact.

In 2024, Canada and the US are expected to move to T+1. Other countries may potentially make this move, too. Many market participants still employ legacy technology that must be enhanced to comply with CSDR. Technology has evolved enough to make some of the required changes relatively simple to implement. However, everyone in the chain must look to invest in technology or the operating model to meet CSDR's challenges and achieve improved settlement efficiency. **f**e

funds global **ASIA**

CONNECTING YOU

Funds Global Asia is the leading journal for the cross-border funds business. Each month you will find detailed coverage of the funds industry, spanning Ucits, alternative investment funds and ETFs. We are unique in covering the full life-cycle of funds, from investment strategy and economics, through to regulation, asset servicing and post-trade services.

Funds Global Asia is read by CEOs, CTOs and COOs working within institutional, wholesale and retail investment. It is also read by professionals working in areas such as family office, private banking and fund services companies around the world. It is published in print four times a year with a daily e-newsletter seen by more than 2,000+ recipients. All content is available to view free of charge on our website and accessible via social media.

Whether you are concerned with investing, asset allocation, distribution, regulation, technology or outsourcing, Funds Global Asia connects the funds industry with thought leaders.

Providing Thought Leadership for Thought Leaders

www.fundsglobalasia.com

FUNDS GLOBAL ASIA PUBLISHED BY
CAMRADATA ANALYTICAL SERVICES LIMITED
5TH FLOOR, 11 STRAND, LONDON, WC2N 5HR
TEL: +44 (0)20 3327 5679 FAX: +44 (0)20 3327 5693
EMAIL: CONTACT@FUNDS-EUROPE.COM

BEN PUMFRETT

Head of Middle Office Product
RBC Investor & Treasury Services

Ben is Head of Middle Office Product within RBC Investor & Treasury Services, where he is responsible for the middle-office modular services, including transaction management, corporate actions, investment book of records and collateral management.

Based in the UK, Ben joined RBC Investor & Treasury Services in 2006 and has spent the last seven years in the product team covering middle-office and derivative services. Prior to this, Ben held multiple roles across client solutions and middle-office operations, which included designing and delivering integrated solutions to support new and existing client business and establish the middle-office offering in the UK.

Prior to joining RBC Investor & Treasury Services, Ben was with J.P. Morgan where he held numerous roles within the Derivatives Middle Office Operations team.

Ben is a regular thought leader and holds a Bachelor of Science in International Securities and Investment Banking from the ISMA Centre, University of Reading in the UK.

DEAN ROOK

Head of Middle Office Operations
RBC Investor & Treasury Services

Dean is Head of Middle Office Operations within RBC Investor & Treasury Services, where he is responsible for solution design and operational implementation of the firm's middle-office modular services, including transaction management, corporate actions, investment book of record and collateral management.

Based in the UK, Dean joined RBC Investor & Treasury Services in 2018 within Middle Office Product with primary responsibilties for operational readiness of core middle-office modules. Dean brings a wealth of industry experience and, prior to this, was Head of Middle Office Operations at J.P. Morgan for six years, managing a global team of 100+ across London, Bournemouth, Mumbai, Manila, New York and Hong Kong.

Dean holds a BA Honours degree in Business Studies and an MBA certification.

Survey methodology

A total of 107 securities professionals completed the survey, conducted online during Q2 2022. Respondents were asked to say which type of organisation they represented.

- **Sell side (investment banks, brokers): 41% (44 respondents)**
- **Buy side (asset managers, asset owners, service providers): 49% (52 respondents)**
- **Other (centres of influence, fund platforms, technology providers): 10% (11 respondents)**