LEGAL INSIGHT

Evaluation of the European Commission's Green Paper on Building a Capital Markets Union of 18.2.2015 with particular focus on the forthcoming Target2Securities (T2S) project.

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Target2Securities (T2S) project starting operations in June 2015 aims at achieving stronger financial integration and a true European single securities market, cutting settlement costs to one of the lowest levels in the world, improving financial stability, fostering competition and ultimately benefitting the European end-investors and issuers. Surrounded by other initiatives of the EU Commission's Capital Markets Union (CMU) plan it is reasonably expected to bolster European financial markets liquidity in favor of cash striving European companies and countries.

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One of European economy's major setbacks is definitely the heavy reliance of financing on bank lending. As Leonardo Gambacorta, Jing Yang and Kostas Tsatsaronis observe in their recent paper[1], bank oriented economies react in a much worse pattern than market financed economies in cases of financial crises. Furthermore there are some indications that market based financing plays a more stimulating role to economic growth than bank based, but in any case certainly securities markets have at least an equal effect on growth compared to banks and their efficiency should also be promoted in order to ensure the maximum possible financing of the economy. On the other hand high capital markets fragmentation in EU, due to differing rules and market practices for products like securitised instruments or private placements between Member States, place a barrier for market financing, so that shareholders and buyers of corporate debt rarely go beyond their national borders when they invest and small and medium enterprises (SME) still have limited access to finance. This situation definitely deprives EU economy of its maximum output capacity and reduces its international competitiveness. According to Commission's data[2] stock market capitalisation in the EU was just 64,5% of GDP in 2013, almost 20% lower than its before crisis highest point in 2007, and still by far the lowest

[1] Leonardo Gambacorta, Jing Yang and Kostas Tsatsaronis, Financial structure and growth, BIS Quarterly Review, March 2014, p. 21
[2] http://ec.europa.eu/finance/capital-markets-union/docs/capital-markets-in-eu_en.pdf

among EU's international competitors like USA (138%), Switzerland (228%), Japan (94%), Australia (87%). Inside EU, 35% of SME's were not fully financed in 2013 and especially in severely affected by the crisis countries like Greece and The Netherlands this percentage rose to almost 70 percent[3]. At the same time disposable capital is not able to be channeled through financial markets to those capital starving enterprises. Only 10% of family income goes to bonds and shares, whereas 94% of Europeans have never bought a financial product outside their own country[4].

Based on those facts EU Commission under Mr. Juncker decided to take action "Raising the Game" really high under Capital Markets Union (CMU) plan. CMU according to the Commission aims at developing a more diversified financial system complementing bank financing with deep and developed capital markets, unlocking the capital around Europe which is currently frozen and put it to work for the economy, giving savers more investment choices and offering businesses a greater choice of funding at lower costs and establishing a genuine single capital market in the EU where investors are able to invest their funds without hindrance across borders and businesses can raise the required funds from a diverse range of sources, irrespective of their location. In that background Commission issued a Green Paper on 18.2.2015, in order to initiate a public consultations procedure.

An important part of this Green Paper (4.3) describes the actions towards the improvement of market effectiveness, through improvements and harmonisation of the legal and operational framework of capital markets themselves, including mainly supervisory and infrastructure rules, but also of securities, including investor rights, company law, corporate governance insolvency and taxation rules. A critical component of market infrastructure improvement is definitely the forthcoming Target2Securities (T2S) mechanism, as it will eliminate "friction" created in the capital markets due to the high fragmentation of central counterparties (CCPs) and central securities depositories (CSDs) ecosystem, especially in comparison to the directly competitive US market.

Securities after the phases of immobilization at first and consequently dematerialization are held by central securities depositories (CSDs), so that ownership can be easily transferred through a book entry rather than the transfer of physical certificates. Securities intermediaries hold their securities at a CSD. Because the volume of transactions is huge, the transfer of the above mentioned ownership is organized through the clearing and settlement processes. As an intermediary or market participant makes hundreds or even thousands of transactions of let's say stock A or bond B in a day, those transfers of ownership are not registered at the CSD one by

[3] http://ec.europa.eu/finance/capital-markets-union/docs/capital-markets-and-sme-in-eu_en.pdf
[4] http://ec.europa.eu/finance/capital-markets-union/docs/financial-markets-for-investors_en.pdf

one, but rather they are all cleared at the end of the day. This means that buy and sell orders are set off (netted), usually with a central counterparty (CCP), in order to end up with the net result of those transactions, for example that x number of stocks A or z number of bonds B finally have to be transferred through the "books" of CSD. After that stage comes the settlement process, in which securities ownership is actually transferred (delivery) and the necessary payments are made to the counterpart.

In case of a cross border securities transaction, which means buying and selling securities on non-domestic markets and/or undertaking transactions with counterparties in other countries, there is a need for securities transfer and payment in different countries. Thus, the distinctive feature of a cross-border settlement relative to a domestic settlement is that it involves gaining access to a settlement system in another country and/or the interaction of different settlement systems[5]. This scheme has also no difference in Europe, so today cross European securities transactions are extremely complex involving at least two CSDs. With a simplified example, in order a German securities intermediary, which is normally member of the German CSD, to acquire stocks which are traded in a Greek market, e.g. ATHEX, and immobilized and dematerialized at the Greek CSD by a Greek market participant, there has to be a link between German and Greek CSDs, in order "book" registrations to be done at both depository systems for both market participants the German buyer and the e.g. Greek seller. Each European CSD settles according to its own technical set-up and respective national legal requirements, resulting in very high transaction costs due to the rise of legal risk and the need for compatibility adjustment. Furthermore, settlement practically results in being a national monopoly for local CSDs in Europe, as even cross border settlement requires, as above described, the involvement of the local CSDs.

After market consultations and a decision by the Governing Council of the European Central Bank (ECB), Target2Securities (T2S) project was launched in 2008 and the platform is scheduled to start operations in a few days. The main aim of this project is to achieve stronger financial integration and a true European single securities market, through the elimination of differences between domestic and cross-border settlement. According to the ECB T2S will cut settlement costs to one of the lowest levels in the world by fully exploiting the economies of scale resulting from the use of a single IT settlement platform, a single set of standards and a single operational framework. T2S will have a positive impact on financial stability, because will settle exclusively in central bank money and offer the most advanced standards of resiliency, availability, business continuity and security, thus reducing the risks that still affect cross-border settlement today.

[5] The Giovannini Group, Cross-Border Clearing and Settlement Arrangements in the European Union, Brussels, November 2001

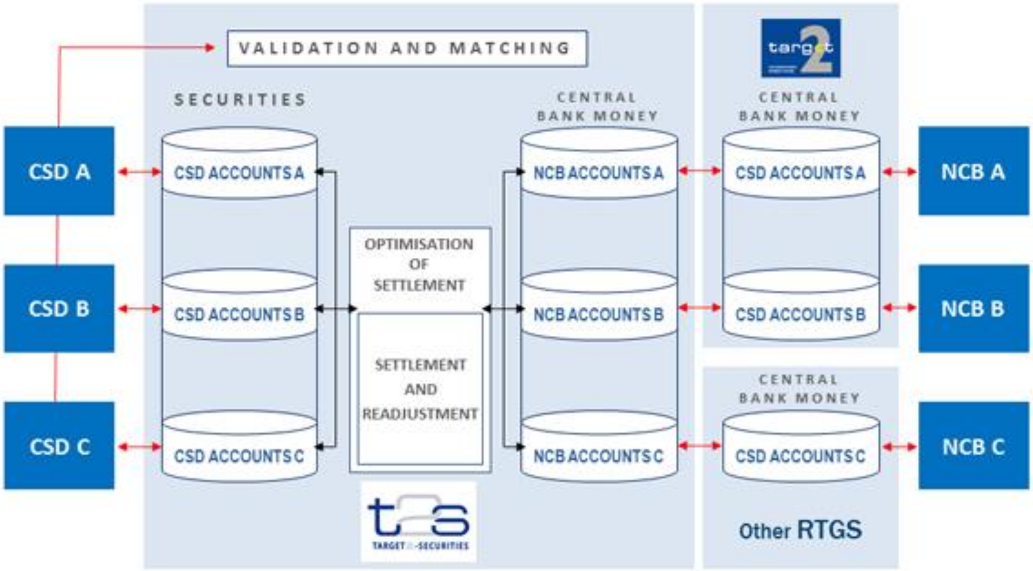
Finally, it will foster competition, open new business opportunities and ultimately benefit the European end-investors and issuers[6].

Target2Securities is a central European securities settlement engine offering delivery-versus-payment (DvP) settlement in central bank funds across all European securities markets. It is not a central securities depository (CSD) itself, but just a platform in which existing local CSDs will be provided with harmonized securities settlement services. Securities will continue to be held at local CSDs, but settlement of cross European transactions will be brought from bilateral mechanisms to T2S, which will apply a single set of rules, standards and tariffs to all transactions in Europe, creating this way an identical to domestic settlement situation. T2S will accommodate both the market participants' securities accounts, held at either one or multiple CSDs, and their dedicated central bank cash accounts, held with their respective national central bank.

According to T2S scheme the above given simple example alternates as following. The German securities intermediary will have an account at T2S, in which all its securities, held in one or more European CSDs, will be registered. At the same time the German intermediary, will have a dedicated cash account T2S, which will include money held at the Deutsche Bundesbank. In order to acquire stocks at ATHEX, held by the Greek CSD (Central Securities Depository S.A.) by a Greek market participant, after the trading and clearing procedures, those stocks will be directly registered, by the T2S IT platform, to its account at Central Securities Depository S.A., after its cash account at the Deutsche Bundesbank is charged and money is transferred to the Greek market participant cash account at Bank of Greece. At the same time (of registration of sold stocks to German market participant's account), Greek market participant's securities account at Central Securities Depository S.A. will be reduced by the number of stocks sold. This way contrary to the previous typical cross country transaction example, there is a common IT platform, thus eliminating the cost of different technical set-ups compatibility issues. There is also a certain and secure legal framework for settlement procedure common for all participants arising from an absolutely independent market institution. European Central Bank is generally well trusted for it's independency, as it has not any national interest in markets, and above all long tested in connection with it's other functions like the monetary role. Market participants are not in danger of any national legal alteration, which may affect transfer and holding of their securities, during the critical stage of settlement. Finally single and common tariffs will definitely decrease transaction costs.

Target2Securities scheme:

[6] https://www.ecb.europa.eu/paym/t2s/about/about/html/index.en.html



In conclusion, Target2Securities (T2S) project, although highly technical, will foster the much needed growth of European capital markets and is a crucial step towards a Capital Markets Union, as it creates a major component of capital markets, the common settlement mechanism. Surrounded by the other initiatives described under chapter 4.3 of the Green Paper it is reasonably expected for EU capital markets to cover the long distance that splits them from international competitors, in order liquidity to be attracted and channeled to cash striving European companies, but also European countries.

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