«Speech Javier Hernani»
« WFC» - 30 May 2022

Welcome and Introduction

Good afternoon, ladies and gentlemen, thanks you very much for attending the Congress and being here today. I would like to thank ECSDA for inviting me to participate.

The world is going through a period of unprecedented change, and post-trade is no exception. Over the last two years CSDs have seen transactional volumes and volatility reach levels few imagined were possible. All of this has taken place against a backdrop of intense regulatory scrutiny and technological disruption.

In the case of post-trade, regulation has always been a prominent feature of the industry. However, in the last decade, rule makers have produced a paradigm change across financial markets in their entirety, and as part of it, post-trade will be not only be impacted but, perhaps, re-designed by these reforms.

The same is true for digitalisation, whether it be the adoption of new technologies such as Distributed Ledger technology (DLT) or Artificial intelligence (AI), or the growing investor appetite for all things digital assets – comprising of instruments including crypto-currencies, Stablecoins, security tokens or Central Bank Digital Currencies (CBDCs).

After what is happening during last weeks in the crypto sphere, measures shouldn't be postponed.

Regulation is all around

Let's begin with regulation. Having introduced a standardised rolling t+2 settlement cycle across the 27 EU member states and established a common supervisory framework for CSDs. The final leg of the EU's CSDR – principally the Settlement Discipline Regime (SDR) which was partially implemented earlier this year – having been repeatedly delayed by the pandemic.

Settlement discipline should of course be seen as a positive development for the wider industry. Under SDR, cash penalties will be levied by CSDs on the market participants responsible for those failed trades taking place within the European Economic Area (EEA).

The threat of the additional costs arising from penalties should help improve settlement discipline among trading counterparties, thereby generating market efficiencies, and reducing risk. This initiative should therefore be applauded.

Much to the relief of the industry, the European Commission (EC) listened to the market's concerns and opted against imposing mandatory buy-ins. Had mandatory buy-ins been enacted as planned, it would have had a destabilising impact on liquidity.

Moving forward, needs for greater communication and clarity from regulators when implementing rule changes, especially as they continue to progress with their Capital Markets Union (CMU) agenda.

So, what further changes could we see to post-trade in the EU? This is an open question, and one which stimulates a lot of debate. Some believe a further shortening of the trade settlement cycle should be enacted in the EU just as it is being done in several other leading markets.

However, critics contest this, warning that time-zone differences could exacerbate operational problems not least around FX management. It could also spark a flurry of penalties for trade settlement fails.

Within the EU, experts stress that having just adopted T+2 and with it Target2Securities, the appetite to shorten the trade settlement cycle to T+1 is simply not there. That said, the EU is not afraid of changing settlement processes. Through its Regulation on Markets in Crypto-Assets (MICA), the EU is creating a DLT Pilot Regime, which could pave the way for market infrastructures to use DLT to support trading and settlement.

As we shift away from present day regulations such as CSDR, I am now going to look at what the future may hold, and where further oversight is warranted.

Crypto and its relation to post trade processing show

Nowhere is regulation needed more than in the burgeoning crypto-asset marketplace. Let’s start with crypto-currencies – the digital asset class with the largest market capitalisation, estimated to be in the region of $2.3 trillion. Though, as you know, last months have brought extreme volatility in those assets.

Dominated by the likes of Bitcoin and Ethereum, institutional and retail participation in the crypto-currency market has accelerated despite the recent market turmoil. According to a recent study by Fidelity Digital Assets, over half (52%) of investors globally have exposure to digital assets, while 9 in 10 said they found digital assets to be attractive. Appetite for crypto is clearly on the ascent.

The growth is exponential and constant. Bitcoin has increased its market value to overtake some commodities like palladium and platinum. However, the volatility wave from the last weeks has had an impact on the crypto currencies as well and significant decreases can be observed.

At a time when subdued interest rates and looming inflationary risk is spooking investors, the uncorrelated nature of crypto currencies remains to be seen as a lucrative source of returns or at a least sensible hedge against interest rate risk or rising inflation. But crypto currencies are not a risk-free asset. Price volatility aside, some investors highlight the absence of proper fundamentals as being off-putting, as is the lack of transparency in terms of the valuation methodologies for many crypto currencies.

Increasingly, some investors are disposing of their crypto-currency holdings on ESG grounds because a lot of the underlying technology facilitating trading in crypto is powered by coal and other carbon intensive commodities.

There is clearly a prerogative for regulation in what has been a hitherto unsupervised corner of the market, and one that is becoming increasingly sizeable and potentially one day systemic.

So, what is happening?

Whereas some countries have introduced blanket bans on crypto-currency mining and trading, the EU is taking a more nuanced approach through the Markets in Crypto-assets (MiCA) Regulation.

Right now, MICA negotiations are ongoing between different branches of the EU, but the rules will aim to bring about a pan-EU regulatory framework overseeing crypto-assets not currently covered by existing securities rules – namely crypto-currencies and Stablecoins.

The rules will apply to those issuing and servicing crypto assets, in what should hopefully bolster investor protection and safeguard market integrity.

But last weeks have been quite dramatic for these assets. There has been a massive loss in confidence. The Terra Luna debacle has knocked investor confidence in bitcoin and the broader crypto market, which has collectively lost roughly $600 billion in value in the past month alone.

Regulators are becoming concerned, with the likes of Federal Reserve Chair Janet Yellen and European Central Bank President Christine Lagarde calling for urgent regulation of crypto — especially stablecoins. I can't agree more.

The future is in digitalisation

But digital assets are not just crypto-currencies and StableCoins.

Asset fractionalisation or tokenisation is gaining traction too. Through tokenisation, the investment process will be democratised by creating digital, divisible tokens representing tangible assets. In addition to listed equities and bonds, tokenisation can be applied to nearly any asset class including mutual funds or even illiquid private assets such as private equity, real estate, and commodities.

Through tokenisation, it will be cheaper for people – namely retail investors - to gain exposure to assets which were previously unavailable to them on cost grounds. If successful, this will have a profound impact on liquidity in these assets, including those which have historically been highly illiquid.

The need for custody in case of digital assets is also increasing significantly. The presented data shows a constant increase and a positive trend when it comes to the forecast. New players are entering the market to answer this need and large traditional players are now entering the digital custody market through agreements with leading technology providers. As you can see, the number of new players in the sector increased 6 times in the past 6 years.

Elsewhere, we are seeing a lot of activity in the field of Central Digital Bank Currencies (CBDCs), or digital issuances of fiat money. Unlike crypto-currencies, which are issued by private institutions – CBDCs – as the name suggests are issued by Central Banks.

If utilised correctly – and perhaps in tandem with other technologies such as DLT and self-executing smart contracts, CBDCs could be used to facilitate instant settlement. For this to happen, however, the payment leg of the transaction would also need to be instantaneous, and this has yet to materialise. As such, instant settlements might take a while to become reality.

The truth is that neither CBDCs nor security tokens will usurp traditional securities overnight. In fact, they will most likely co-exist with each other for a prolonged period as investors gradually become more comfortable trading these new asset classes. In short, there will not be a sudden big bang adoption.

Nonetheless, post-trade providers cannot afford to ignore these new digital trends. A failure to plan ultimately opens incumbents up to disintermediation or at best, a loss of market share.

Accordingly, providers need to start allocating budget and resources to change management, as it relates to digital assets. Simply doing POCs is not sufficient- but rather firms need to invest into systems and technology to support the eventual trading of digital assets.

Those firms which lead the way on digitalisation will ultimately be the net winners moving forward, in what is likely to become a very competitive post-trade ecosystem.

It is here where SIX– through the establishment of SIX Digital Exchange – is truly leading the way. In 2021, SDX received regulatory approval from FINMA to launch a stock exchange and CSD for digital assets in Switzerland. This authorisation enables SDX to go live with a fully regulated, integrated trading, settlement, and custody infrastructure based on DLT for digital securities.

This innovative approach ensures that the link between the digital and traditional financial ecosystem is maintained.

Thank you vey much for your attention.