

TARGET2-SECURITIES – A CENTRAL SETTLEMENT HUB FOR THE EURO

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1. Purpose and expectations of the TARGET2 – SECURITIES

T2S is a technical platform to support CSDs by providing core, borderless and neutral settlement services. The objective is to achieve harmonised and commoditised delivery-versus payment settlement in central bank money in euro (and possibly other currencies) in substantially all securities in Europe. T2S thereby supports the Lisbon agenda in securities markets.

This management summary addresses *high-level executives* of financial market participants, issuers and CSDs. These institutions were invited to assess the impact of T2S at a very senior level, considering all aspects of their securities business (lifecycle management, custody operations, funding and collateral, retail and wholesale client servicing, market-making, new issues, etc.) in order to determine the extent of their support for this potentially transformational change.

The user requirements posted on the ECB's website¹ define the features required by CSDs and financial market participants for core, borderless and neutral settlement of securities in Europe. They are the result of six months of very intensive cooperation involving hundreds of experts from CSDs, banks and central banks with the ECB coordinating the work and drafting the results.

The requirements were published on 18 December 2007 and were subject to consultation until 2 April 2008. During these three months the T2S team at the ECB actively facilitated discussion so that all financial market participants and CSDs had the opportunity to gauge the impact of, and opportunities offered by, T2S.

The Eurosystem invited CSDs, issuers and financial market participants to provide in-depth analysis of the user requirements, all of which were open for review during the consultation period. After the consultation period, the ECB Project Team analysed the responses and revised requirements where appropriate. The requirements have been reviewed within the framework of the current governance structure, involving the Technical Groups, the Advisory Group and, ultimately, the Governing Council. The ECB Project Team has actively provided feedback to respondents, including stakeholders not represented in these groups.

The final user requirements - together with an updated economic and business case analysis, a legal analysis, an action plan for harmonisation, an evaluation of the market support for the project and the governance structure for the next project phase – form the supporting documentation for the ECB Governing Council decision, were finished in summer 2008.

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<http://www.ecb.europa.eu/paym/t2s/html/index.en.html>

2. General Principles of the TARGET2 – SECURITIES

The general principles constitute the main cornerstones of T2S. They were approved by the Governing Council of the ECB on 26 April 2007. Though it was not asked to endorse the principles, the Advisory Group agreed in its meeting of 31 July – 1 August 2007 to suggest some clarifications of the principles to the ECB Governing Council. The revisions mainly affected the supplementary text on the principle. The modification of the principle itself was the exception. The Governing Council has agreed to the clarifications suggested by the Advisory Group. According to the **T2S User Requirements** - Version: 4.0, the principles of the T2S are:

1. The Eurosystem shall take on the responsibility of developing and operating T2S by assuming full ownership. In line with the Governing Council's decision of July 2006, the proposed platform will be fully owned and operated by the Eurosystem. A governance structure has been set up to define user requirements. It allows for a wide involvement of market participants. The Eurosystem is committed to keeping market participants closely involved in the different phases of the project.

2. T2S shall be based on the TARGET2 platform and will hence provide the same levels of availability, resilience, recovery time and security as TARGET2. The Governing Council decided that T2S will be developed and operated on the TARGET2 platform. Four Eurosystem central banks (the Deutsche Bundesbank, the Banco de España, the Banque de France and the Banca d'Italia, otherwise known as the 3CB+) are ready to develop and operate T2S on TARGET2 via the Single Shared Platform. Use will be made of the valuable experience and knowledge that is available in the market. The intention is to exploit synergies and provide an efficient solution to central securities depositories (CSDs) and users. In addition, enhanced liquidity management

mechanisms will be provided as a result of the proximity between T2S and T2. The existing operational structures and support organisation, telecommunications infrastructure, business continuity and disaster recovery arrangements shall be reused to the maximum extent possible. "T2S on T2" must be understood as an open concept that will not impose constraints on the user requirements.

3. T2S shall not involve the setting-up and operation of a CSD, but instead will serve only as a technical platform for providing settlement services to CSDs. T2S is purely an IT settlement service operated by the Eurosystem and provided to CSDs for the benefit of their customers. Therefore, it neither constitutes a CSD in itself, nor is it intended to become one in the future. The scope of T2S is restricted to settlement, including settlement instructions resulting from corporate actions or portfolio transfer, for example. This therefore excludes the possibility of T2S engaging in any asset-servicing businesses (such as event set-up, computation of benefits and response management of corporate actions).

4. The respective CSD users' securities accounts shall remain legally attributed to each CSD. Each CSD will continue to be legally responsible (under their applicable laws) for opening, maintaining and closing the securities accounts of its users in T2S and, where relevant, those of the clients of these users as well. The securities account balances will be stored within the T2S platform and will be available to CSDs and their users on a real-time basis.

5. The T2S settlement service will allow CSDs to offer their participants at least the same level of settlement functionality and coverage of assets in a harmonised way. The aim of developing a common settlement platform is to enable CSDs to use T2S to perform their entire settlement processing in a harmonised way. The centralised platform should cover the full

functionality needed for such a harmonised service and should enable enhanced liquidity management. If this is not achieved, CSDs will be forced to maintain duplicate settlement infrastructures, with a cost impact through both duplication and reduced economies of scale. The objective of T2S is to provide a level of functionality that frees CSDs from maintaining securities balances on a separate platform or from duplicating processes. The scope of instruments eligible for T2S shall be all securities that have an International Securities Identifying Number (ISIN) and are held by a CSD operating in T2S.

6. Securities account balances shall only be changed in T2S. T2S will process all changes on securities account balances that relate to settlement activities of CSDs on the basis of the instructions it receives. Examples of this are settlement instructions generated via primary and secondary market transactions, corporate actions, and lending and collateral management activities.

7. T2S shall require participating CSDs to be designated under the Settlement Finality Directive (SFD) in their respective jurisdiction. Participating CSDs will have to be designated as securities settlement systems under the SFD and notified by the competent national authority to the European Commission in order to benefit from protection under the SFD. Consequently, transfer orders processed in T2S will acquire adequate protection under the relevant laws and rules of the individual CSDs that are designated under the SFD. Furthermore, the proprietary aspects and the finality of transfers of securities will be determined in accordance with the laws of the country in which the CSD that has opened the securities accounts is located.

8. T2S shall settle exclusively in central bank money. As stated above, T2S is a service for enhancing the efficiency of securities settlement across Europe while at the same time keeping

central banks' cash account management within the central banks. Its scope is therefore limited exclusively to central bank money and does not extend to the settlement of commercial bank money.

9. The primary focus of T2S shall be settlement services in euro. The primary focus of the Eurosystem is to ensure efficient and sound settlement services in euro. As a result, the focus of T2S is to provide settlement services in euro central bank money. The extension of T2S to other currencies is possible.

10. T2S shall be technically capable of settling currencies other than the euro. T2S will be technically capable of providing settlement not only in euro central bank money but also in non-euro central bank money. An explicit request by the relevant non-Eurosystem central bank(s) in coordination with the local market community is required to activate this service. Non-Eurosystem central banks would be expected to adapt to a harmonised, standardised interface.

11. T2S shall allow users to have direct connectivity to its platform. CSDs will retain the business and legal relationship with their participants. All securities account balances will be stored in T2S, irrespective of the choice of connectivity. From a T2S point of view, the connectivity choice refers solely to the way in which users will interface with T2S in order to send and maintain settlement instructions and access reporting facilities. Irrespective of the way in which they connect to T2S, users' instructions will be subject to equal processes within T2S. The connectivity choice will also be neutral to CSDs, since all the necessary information, even from directly connected users, will be available to CSDs.

12. CSDs' participation in T2S shall not be mandatory. CSDs' participation in T2S is a business decision on the part of the CSDs and their local market community. When deciding whether or not to join T2S,

CSDs are expected to follow the interests of their shareholders and users.

13. All CSDs settling in euro central bank money shall be eligible to participate in T2S. All CSDs settling in euro central bank money and designated under the SFD are invited to join T2S, regardless of their location inside or outside the euro area.

14. All CSDs connecting to T2S shall have equal access conditions. The criteria for CSDs to access T2S will be public and non-discriminatory. All participating CSDs will have access to all T2S services. A single, transparent and publicly available fee schedule will be applied. In line with European principles of competition, the Eurosystem will provide its services to connected CSDs on a non-discriminatory pricing basis (in a similar manner as for other existing Eurosystem infrastructures, such as TARGET2).

15. All CSDs connecting to T2S shall do so under a harmonised contractual arrangement. With reference to their contractual relationship with T2S, all CSDs receiving the same service level will be subject to a harmonised contractual arrangement. This means that all CSDs willing to participate in T2S will adhere to the same harmonised conditions for the platform's core functions. For specific optional services to be provided to a CSD, they would need to be covered by a specific contractual arrangement. Any other CSD willing to use such specific services would also be eligible to apply under the same harmonised conditions for the specific optional services.

16. All CSDs connecting to T2S shall have a single calendar of opening days and harmonised opening and closing times for settlement business. The participating CSDs shall adopt the T2S calendar. This will be the same as the TARGET2 calendar. Settlement (delivery versus payment (DvP) as well as free of payment (FoP)) via T2S shall not be possible outside this calendar. Within the T2S calendar, a CSD which closes due

to a national holiday would need to provide a minimum level of service (e.g. to allow the realignment of settlement carried out in other CSDs). The opening and closing times will cover daytime and night-time settlement. They will be compatible with, though perhaps not identical to, TARGET2 operating hours. Further consultation will be conducted on the exact cut-off times within the single T2S operating timetable – different cut-off thresholds might for instance be required for specific operations (DvP notification submission, automatic lending operations, etc.).

17. T2S settlement rules and procedures shall be common to all participating CSDs. To minimise costs and simplify processes, T2S will aim to harmonise all rules and procedures related to the services it provides. For example, T2S will provide a single set of harmonised matching rules and procedures which must be observed by instructing parties. These will be based on the European Central Securities Depositories Association (ECSDA) report on matching standards. In addition to these harmonised rules, CSDs may maintain additional domestic rules, provided that such rules do not conflict with those of T2S.

18. T2S shall operate on a full cost-recovery and not-for-profit basis. The Eurosystem will price the development and operation of T2S on a full cost-recovery and not-for-profit basis. While delivering a very high level of service in terms of quality, security and availability, T2S will also seek to be as cost-efficient as possible.

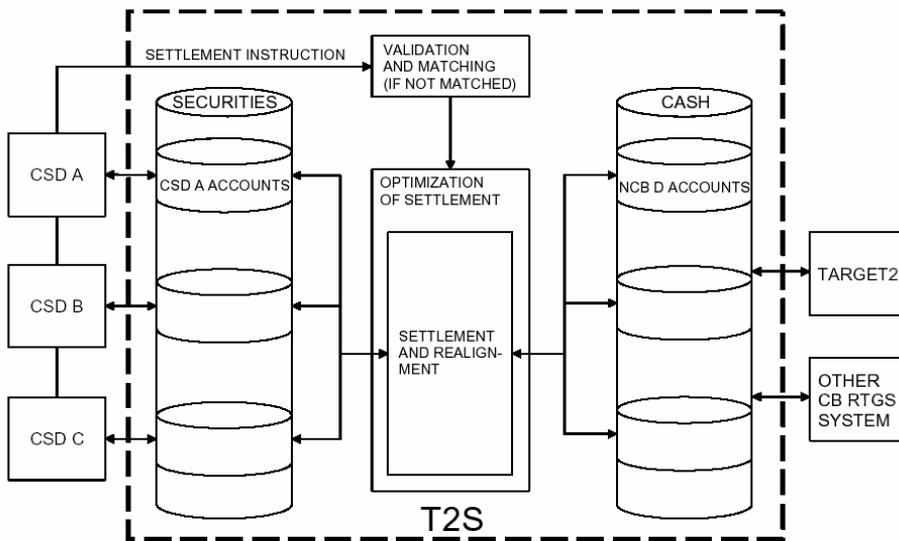
19. T2S services shall be compatible with the principles of the European Code of Conduct for Clearing and Settlement. T2S will be compatible with the principles of the European Code of Conduct for Clearing and Settlement with regard to price transparency, the unbundling of services and accounting separation. Compatibility with the Code of Conduct will enable CSDs also to remain compliant.

20. T2S shall support the participating CSDs in complying with oversight, regulatory and supervisory requirements. T2S will be set up in such a way as to allow participating CSDs to comply with the relevant regulatory, supervisory and oversight requirements, as well as to strive for a high degree of harmonisation in meeting those requirements.

3. The technical platform of the TARGET2 – SECURITIES

T2S is a platform for core, neutral and borderless securities settlement to support the Lisbon agenda. It will provide harmonised and commoditised delivery-versus-payment settlement in central

bank money in euro (and possibly other currencies) in more or less all securities circulating in Europe. Settlement will be extremely safe, because it will involve payment in central bank money. Reliability, scalability and robustness (as provided by TARGET2) are also vital, in view of the huge volumes of transactions to be settled even in today's fragmented markets (with two million settlement instructions being processed every day), and will become more vital still as volumes increase. Much of the growth will be in cash trading and in collateral markets, which contribute greatly to liquidity but are low-margin activities. Such trades are only viable in risk/return terms if settlement is both timely and reliable.



The structure of the TARGET2 – Securities

Settlement also needs a sound legal basis. T2S will build on a set of European initiatives in this area (following the implementation of the Settlement Finality Directive, the Financial Collateral Directive, MiFID and other measures), and the Eurosystem will seek to foster further harmonisation. *CSDs are the gateways* through which market participants can access T2S services. Participants will continue to contract with

one or more CSDs for the settlement (across the accounts of those CSDs) of securities eligible for such settlement. Moreover, it will be the CSDs – not market participants – that contract with the Eurosystem for T2S services.

Each CSD is invited to agree to move its settlement to T2S and offer its clients borderless settlement of trading and collateral operations. Most CSDs should be able, over time, to reduce their

internal costs by restructuring and downsizing their own settlement processes. CSDs will continue to operate, provide and improve efficient and safe services – particularly in relation to national requirements in areas such as registration, taxes, regulatory reporting, and some aspects of direct holdings by retail investors – at prices which are (as required by the Code of Conduct) a transparent and fair reflection of the cost of providing those services.

T2S will create opportunities for CSDs and market participants to develop their businesses in new ways in order to exploit efficiencies or to offer new services. As core, neutral infrastructure, T2S will support the different business models adopted by CSDs and market participants without discrimination. Some CSDs may wish to consider *investing in asset servicing* in order to support their clients' growing operations in securities Europe-wide. This may imply significant changes to their current business model.

While T2S provides the core functionality to make cross-border settlement as simple as domestic settlement, access to European securities via any individual CSD is dependent on that CSD being able and willing to accept securities issued in other CSDs. To use a railway analogy, T2S provides the "tracks" for cross-border settlement, but requires changes to the "trains" (i.e. the CSDs) to meet the demands of their "passengers" as regards this service. While T2S is, in itself, not sufficient to meet these passengers' demands, it creates incentives for train companies to make these changes. Such incentives barely exist today, since the necessary shared tracks have not been created by a neutral player.

As the diagram indicates, CSDs will keep all of their clients' securities positions in T2S, which will map to each CSD's *account structure* (including direct holdings), without accommodating all of the ancillary account information maintained by CSDs for their clients. Thus, each securities account held in

T2S will be attributable to only one CSD. Similarly, T2S will maintain *dedicated central bank money* accounts representing a CSD client's claims in central bank money on that client's chosen national central bank. Each account may be used to settle transactions relating to the client's security accounts in one or more CSDs. This cash account structure will foster efficiency improvements for clients that use more than one CSD.

When a CSD client does not have access to central bank money, it may be authorised by a payment bank to operate a dedicated cash account in T2S. This will provide CSD clients with a choice of payment bank. T2S will provide *DvP settlement in real time* with auto-collateralisation and optimisation procedures, irrespective of which CSD and NCB provide the respective underlying securities and central bank money accounts. It will be able to do so by providing realignment in real time when securities issued in one CSD are settled in another CSD. CSDs joining T2S will thus be able to offer their clients cross-border settlement in central bank money – a service that is hardly available today.

T2S will enable *direct connectivity* by CSDs' clients. These will be able to input settlement instructions directly into the T2S platform and receive information on the results where the relevant CSD allows such a connection under its general terms and conditions. For other services that are not available in T2S, they will connect to the relevant CSDs. Direct connectivity can make it easier for market participants to operate direct memberships of multiple CSDs and for CSDs to reach a wider set of international clients. The decision on direct or indirect connectivity will depend, inter alia, on the pricing of such services by the CSDs and on whether or not the user finds it possible to concentrate its activities in fewer CSDs as the market develops. Offering both direct and indirect options provides maximum flexibility for financial market participants

entails no significant additional cost for T2S and may well be a driver towards harmonisation.

T2S will *match settlement instructions* relating to cross-CSD settlement, as well as those input directly into T2S. It will also accept matched instructions from other infrastructures which apply the same matching rules. Since multiple matching facilities might exist, there needs to be a rule to determine the location of matching. Where CSDs cannot match both sides of the trade, the matching will take place in T2S.

T2S will deliver settlement at *low cost*, reflecting the very significant economies of scale in such services. Once T2S is serving all EU countries, these economies of scale should make the unit cost considerably lower than the lowest price charged by a European CSD at current volumes. If volumes rise (stimulated by the reform programme set out above) to US levels, the cost is expected to fall very significantly, towards US levels. The low projected unit cost applies to both cross-border and domestic settlement. There are no borders within T2S.

T2S will be a Europe-wide core securities settlement platform, since its design will accommodate settlement in *central bank money in other currencies* where the relevant central bank and the market wish to support such services. The sooner these central banks and markets make such decisions, the better the prospects of accommodating them in the build phase. Where non-euro currencies join, T2S will interact with the RTGS system of the relevant central bank in the same way as it will with TARGET2. T2S is expected, in time, to become the *single provider* of core securities settlement platform for CSDs. This model of a single provider of “backbone” services is one that some countries have adopted for distribution networks in other industries (e.g. telecoms). Such core infrastructure is tightly controlled as regards reliability and pricing, and is available to all producers

on equal terms. Provision of core settlement services by the Eurosystem fits with this model.

Moreover, competition between CSDs (and the resulting benefits) has been very limited. For many securities there are hardly any alternatives to the local market CSDs. CSDs were set up not to compete with one another, but to be the central infrastructure within each country, with tight regulation so as to keep a low risk profile. A shift to competition with other CSDs in order to be the preferred gateway to T2S may thus require changes in the mandates and/or regulatory structures of some CSDs. The provision of core services by T2S, by lowering the barriers to entry to new markets, has the potential to create new opportunities for competition. The Eurosystem has decided that T2S will be run on a full cost recovery and not-for-profit basis. T2S will ensure the full accountability and transparency of costs and prices, in full compliance with the industry Code of Conduct, so that the market can scrutinise operating and investment efficiency.

These factors support the Eurosystem's decision to *control T2S via its ownership* rights. It will, of course, continue to keep the market involved, building on the open and cooperative culture developed in preparing the current user requirements. The ownership decision also establishes clear accountability for the important task of managing the risks inherent in the creation of systemically important infrastructure that could become a single Europe-wide point of failure. These risks are not new: every current CSD is a systemically important single point of failure for its own market.

Nevertheless, there is no doubt that the scale of the risks will be larger in T2S. It is important that the Eurosystem should not be constrained in its ability to manage those risks, alongside those relating to the equally important TARGET2 system, which will be operationally coupled to T2S.

4. Conclusions

The launch of the T2S project on the 17 July 2008 was the result of the feedback received to the invitation expressed by the Governing Council of the ECB on 23 May 2008 to all European central securities depositories (CSDs) to join the T2S initiative. The proposal conveyed to the CSDs consisted of an outline of the economic benefits, a legal assessment, the T2S User Requirements, a description of the governance for the specification phase and details of the harmonisation efforts to be undertaken in the context of T2S. Subject to certain conditions expressed in their replies, almost all euro area CSDs, representing a very large share of settlement activity in the euro area, are in favour of the continuation of the T2S initiative, are prepared to enter into a legally binding contractual arrangement by the end of the first quarter of 2009 and intend to use the service once it is in operation.

CSDs outside the euro area have been invited to express their opinion until the end of 2008 in order to have sufficient time to establish whether or not their central bank is prepared to make its

currency available in T2S. However, the Danish CSD has already agreed to participate in T2S for Danish krone settlement and euro settlement, and the Swedish and Swiss CSDs have indicated that they intend to participate for euro settlement but that a formal decision on their national currency has not yet been taken.

T2S constitutes a major step forward in the delivery of a single integrated securities market for financial services, thus reinforcing the Lisbon strategy, and in particular the Code of Conduct on Clearing and Settlement and the harmonisation efforts through the Giovannini process. T2S will provide a single, borderless pool of pan-European securities, as well as a core, neutral, state-of-the-art settlement process. Market users will be able to access these assets through CSDs in a way which can accommodate, rather than perpetuate, national and regional differences, and which already embodies agreed harmonisation measures in several key areas.

The Eurosystem will continue to cooperate closely and transparently with CSDs, their users and other relevant stakeholders.

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