

## EPFSF Briefing: TARGET2 Securities

On 7 July 2006, the European Central Bank announced that “the Eurosystem is evaluating opportunities to provide efficient settlement services for securities settlement in central bank money, leading to the processing of both securities and cash settlements on a single platform through common procedures”.

### Why T2S?

Eight years after the introduction of the single currency, the Euro area still lacks an efficient, integrated securities infrastructure that would support the operations of a more efficient financial market. The ECB believes that the most efficient model for securities settlement is an ‘integrated’ model where cash and securities are settled on the same platform and such integrated settlement must occur on the books of a central bank. However, under the current arrangements, settlement and related processes - but not the cash side - take place on the same technical platform. Current systems, which use a dedicated pool of central bank money in an ‘interfaced’ model, are in a position to achieve the same level of efficiency as the ‘integrated’ model.

Secondly, the ECB emphasises the potential economies of scale in the connection between TARGET2 and T2S, in terms of liquidity management and operational consistency for users, technical expertise, project development and management on the side of the developers. The ESCB has operated the TARGET payments system since the introduction of the Euro in 1999 and the successor system, TARGET2 (-Cash) is scheduled to go live in November 2007. T2S for securities is projected to make use of (or at least to closely link with) TARGET2 (-Cash) to settle the cash leg of securities transactions. It is important to note in this context that the three Central Banks that developed TARGET2 (the Bundesbank, Banque de France, and Banca d’Italia), “are ready to develop and operate the new service on the joint platform together with the Banco de España on behalf of the Eurosystem”. Finally, T2S is expected to contribute to removing at least some of the 15 Giovannini barriers, (barriers 1 (differences in information technology and interfaces) 2 (restriction on location of C&S), 3 (corporate actions) 4 (intra-day settlement) and 7 (settlement deadlines and operating hours/days) ).

### What is T2S?

- T2S is a **technical solution** whereby the settlement process is outsourced by the eurozone CSDs on a voluntary basis. It will provide delivery versus payment (DvP) settlement in central bank money in Euros for all securities (with ISIN numbers) **denominated in Euro** (including equities, debt instruments, investment funds, warrants, and potentially more) that are held through the accounts of the participating CSDs; with the consent of the relevant central bank, it can provide DvP settlement in central bank money in other EU currencies for which there is demand. Securities, which are denominated in **foreign currency but settled in Euro**, can also be settled by T2S, provided they are held through a T2S-connected CSD.
- T2S is designed to provide the settlement process – and only the **settlement process** – and custody functions like asset servicing, corporate actions etc will remain with the national CSDs.
- Structurally, **access** to the T2S settlement engine will be **provided through the national CSDs**; as a consequence, the legal situation of the end-users (banks and investment firms) and the securities accounts on the national level will not change. The ECB is also proposing direct technical access to T2S for those end-users who want it. In any case, the CSD retains legal responsibility.
- T2S will offer “**DvP Model 1 settlement**”<sup>1</sup> with several optimisation mechanisms (e.g. for situations where participants lack liquidity, or for complex transactions). T2S will also offer FoP (Free-of-Payment) settlement and other types of securities settlement needed for the

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<sup>1</sup> Model 1 is a settlement model providing real-time gross settlement in central bank money. Transfer instructions for both securities and cash are settled on a trade-by-trade basis, with final transfer of the securities from the seller to the buyer (delivery) occurring at the same time as final transfer of the cash from the buyer to the seller (payment)

functioning of CSDs. The ECB is assuming that the provision of “DvP Model 1” settlement in combination with optimisation makes the need for other netting settlement models redundant.

- The ECB have said that the design of T2S will allow for the provision of securities settlement in other EU currencies, provided that there is a market demand and the relevant national central bank is prepared to enable settlement in its currency in T2S.

### TARGET2-Securities in the European institutional context

- T2S was first presented only a few days before Commissioner McCreevy’s landmark speech before the ECON Committee announcing the Commission’s abstention from direct legislative intervention in European clearing and settlement structures and processes.
- Although the Code of Conduct does not apply directly to T2S (as it is a technical solution, not a “new” CSD), the ECB has expressed their intention to comply fully with the Code and, moreover, with EU competition policy in general. Issuer CSDs still remain responsible for fulfilling the Code of Conduct’s principles.
- One of the earliest points of express criticism with the Eurosystem project was the question of whether developing a securities settlement system falls within the competence of the ECB as defined in the EU Treaty and the ECB Statute. The ECB firmly asserts that Articles 17, 18 and 22, together with Article 3.1 of its Statute constitute the legal basis for establishing and operating T2S, so long as it is limited to settlement. The ECB is expected to publish a detailed external legal opinion supporting the assertions by ECB for public discussion.
- On 27 February 2007, the ECOFIN Council welcomed in principle that the ECB shared the Council’s aim to enhance the efficiency and soundness of European post-trade services, and invited the ECB to proceed step by step, conducting in particular a full feasibility study based on widespread consultation. The ECOFIN reminded the ECB that T2S should not be compulsory, that alternative mechanisms for settling in central bank money must be made available by the National Central Banks to those CSDs who decide not to join, and that the project would have to fully comply with EU competition policy. Emphasis was also given in the Council conclusions to an appropriate governance structure which should provide for accountability, transparency, and adequate mechanisms to handle conflicts of interest as well as ensure responsiveness to market needs.
- The ECON Committee has been kept informed by the ECB about the T2S project. A special workshop on clearing and settlement was held by the Parliament on 12 April 2007 at which, inter alia, the ECB presented the status of the T2S. In her draft report on the Commission’s Financial Services Policy Paper, Mrs. van den Burg MEP underlines the intention of the EP to “... closely scrutinise the developments surrounding the ... TARGET2-Securities project”, reiterating the need for improvements in the post-trading infrastructure both with a view to price transparency and competition.

### What are the risks for T2S?

While a number of industry participants have spoken of strong support for T2S, concerns relating to *scope*, *cost* and *governance* have been expressed during the discussion and consultation process over the past nine months. It seems that the ECB is confident of being able to address these. In order to build confidence in the T2S project, details of how the concerns will be addressed will have to be published for consultation.

- Can the settlement process be separated from related services as proposed? There is a risk that this separation may lead to additional complexity and therefore cost. User scrutiny will be essential.
- The ECB has promised to deliver cross-border settlement in the Eurozone more cheaply than domestic settlement today. How will this be achieved?  
One of the ECB’s central commitments is to deliver (cross-border) settlement at a cost per transaction which is lower than the cost of any national (domestic) transaction today. Such fees would be charged by T2S to its direct users, the CSDs. Only if these CSDs will be able to reduce their overall costs significantly through the outsourcing process, can the project be seen as commercially favourable by the CSDs and their end-users. The economic feasibility calculations presented so far indicate that costs below the lowest level of today’s national costs may be achievable only if (almost) all major European national CSDs join and link up. For them,

participation will be voluntary, as mentioned earlier. It is worth noting that the ECB is intending to facilitate direct connectivity to T2S for banks and is willing to extend the T2S platform to other non-euro currencies (with the agreement of the relevant national central bank).

- Will the views of market users be taken into account in the governance structure?  
Governance has been a particular concern for many stakeholders, including banks and settlement systems. Banks have been concerned to ensure that their views on the development of T2S are adequately heard and represented within the T2S governance structure. Settlement systems have expressed concerns about the strict requirements that local regulators place on them when outsourcing core functions, such as settlement; they believe that they must retain responsibility for such services. This may have implications for the governance of T2S.

Since the start of the project in July 2006, the ECB has embarked on a comprehensive and intensive consultation process with all stakeholders. A key feature of this process is that the ECB's Governing Council decided in March 2007 to proceed only with a further phase of the project, namely the definition of user requirements on the basis of market contributions in 2007. During this phase, which has just begun, the scope of the project will be determined by taking into account the results of public consultation. The Governing Council will only then decide on the subsequent development phase. This decision is expected in early 2008.

#### **What is the timetable? What happens next?**

The consultation process on the user requirements has now started. The ECB Governing Council has decided on a governance structure comprising a large Advisory Group (AG) chaired by the ECB, and six Technical Groups (TGs) of which two are to be chaired by central banks, two by CSDs and two are to be chaired by user representatives. The AG includes representatives from all of the euro zone National Central Banks, all of the euro zone CSDs, as well as end-users, i.e. banks, securities firms and a clearing house as well as observers. The AG will submit its advice directly to the ECB's Governing Council and Executive Board for their consideration. Each TG will assist in developing one specific aspect of the user requirements. The preparation of the user requirements will mainly be carried out by an ECB Project Team including experts from central banks, CSDs, and end-users, headed by an ECB manager as T2S Programme Manager. All documentation will in principle be published in the dedicated area of the ECB's web site:

<http://www.ecb.int/paym/market/secmar/integr/html/index.en.html>

The final user requirements are scheduled to be published towards the end of 2007 with a final consultation phase of three months. After the completion of this phase (scheduled for the first quarter of 2008), and in conjunction with any commitments given by national CSDs to join the project, the Governing Council will decide on the development phase.

The ECB Governing Council also decided in March 2007 to review the current Eurosystem collateral management handling procedures, particularly, the Correspondent Central Banking Model (CCBM). It opted to develop a single platform, CCBM2, which would allow the Eurosystem to manage collateral for both domestic and cross-border operations based on existing systems, such as those operated by the National Central Banks of Belgium and the Netherlands. Work is scheduled to be conducted in parallel with the T2S project in order to exploit all possible synergies and to avoid any overlaps.

The ECB has committed to inform all interested parties through regular information sessions and to provide regular presentations on the progress of T2S to the European institutions, including the EP.

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Briefing notes are prepared by the Financial Industry Committee to the European Parliamentary Financial Services Forum. For further information on the subjects raised in the briefs please contact the Chairman, Members or Secretariat of the Financial Industry Committee.

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