

[Extract from overall summary of the ISSA Regional Meeting Europe 2007]

5. TARGET2-Securities

ISSA's membership is divided roughly equally between providers of market infrastructure, and market participants using those infrastructures – mainly custodian agent banks and global custodians. All are directly or indirectly affected by TARGET2-Securities.

TARGET2-Securities (T2S) is a key initiative to eliminate the notion of "cross border" for securities trades between counterparties anywhere in Europe. It however raised controversy from the moment it was announced.

Jean-Michel Godeffroy (European Central Bank)

Jean-Michel Godeffroy recapitulated where the project stands: In July 2006, the Governing Council of the European Central Bank announced that the Eurosystem would evaluate opportunities to provide settlement services for securities transactions. Reactions from banks were generally positive, while CSDs were cautious. In March 2007, the Governing Council considered the project feasible and asked for the user requirements to be prepared. Banks and CSDs agreed to work with the Eurosystem to define those requirements. The final decision to go forward is expected early 2008.

Mr Godeffroy addressed the most frequent reservations voiced against the initiative to date. He noted that the TARGET money transfer system was initially also criticized as a market interference. Large market players announced that they might use it at end of day only, to settle net cash obligations between themselves. They changed their mind and today, 85% of all Euro payments flow through TARGET.

In some instances, public sector intervention helped the European industry to become more competitive, e.g. in aerospace or high speed train technology. There is however no "grand master plan to build the new Europe". Many European initiatives are driven in parallel. Ideally, all are complementary and reinforce each other.

T2S is not a purely European issue. It will be open to users anywhere in the world, for as long as they settle trades in Euro. Extension to other currencies is a possibility for a later phase.

T2S aims at the macro-economic benefits for Europe. Europe as a whole will benefit – which does not necessarily mean that every single institution having a stake in the business will win, but successfully adapting to change has always been the precondition for survival.

The ECB maintains full transparency in the T2S project. All relevant documentation is published immediately on the ECB website.

Frederic Hannequart (Euroclear)

If the single market in Europe is to be achieved, the industry must to more jointly. Euroclear contributes to many industry initiatives. Euroclear fully shares the T2S objective of reducing settlement costs - something Euroclear is very adamant of as a user-governed institution.

Euroclear supports the T2S initiative and participates in the consultation process. Some concerns must be raised, however:

- Time frames to comment on proposals are very tight. The industry would very much welcome more time to react, and sometimes to think of alternative approaches.

- In the end, the decisive factor is not the length of the consultation process, but the quality of the decisions actually taken.
- The consultation process should not only cover the design and user requirements phase. It should include participation in the business case formulation and in the cost/benefits analysis from the viewpoint of the market players. Obviously, the final go/no go decision remains with the ECB.
- There is the danger of wanting to load ever more functionality on T2S (securities financing, automatic collateralization, "optional" service modules, and more). This will increase complexity and hike costs immensely. How much of the original intention will still be there once the T2S live date is reached in 2013?
- At this time, important legal questions are open, such as: What is the governing law of the system? Will legal records documenting transactions have to be kept in the country of origin, or can they be kept centrally (Euroclear was forced to do the former)? How will the European Central Bank discharge its liability to CSDs and CSD users? Will users be "lost in the middle" between entities passing liability to each other?

Euroclear's largest concern is the assumption that CSDs can decommission their settlement platforms once T2S is operational. Euroclear and other infrastructure providers are convinced that settlement data generated and maintained in T2S must be mirrored by the CSDs, for instance for the following reasons:

- to meet intraday cut-off times to determine eligibility to entitlements on corporate actions
- for client and regulatory reporting purposes, e.g. transaction taxes
- to answer client inquiries
- to achieve real-time registration of securities

(I)CSDs operating in multiple currencies cannot expect to ever decommission any part of their settlement platform, unless T2S were expanded accordingly. This is extremely significant: if CSDs cannot decommission systems or at least components, then the cost of participating in T2S comes on top of today's operating cost.

Katja Rosenkranz (Clearstream)

Clearstream shares the assessment that nobody can disagree with the objectives of T2S and sees itself as a constructive partner. Similar to Euroclear, there are open questions. Some specific points include:

- Project governance: All decision rights are with the ECB Governing Council. The Advisory Group Members would like to be more closely involved in the decision process.
- User requirements: In the current phase, user requirements are discussed intensively. There is however an over-emphasis on the requirements of the CSD clients, while the needs of the CSDs themselves are rather underweighted.
- Business case and projected cost savings: Like Euroclear, Clearstream does not yet see the feasibility of decommissioning any significant parts of its own systems, either due to functional or to legal constraints. Also, an outline of contractual arrangements with CSDs allowing them to outsource business was announced for the end of the year in a high level version. This is a crucial issue for the CSDs which requires more detailed information as soon as possible.
- Implementation timeline: 2013 is very far in the future. Too many variables can alter the operating environment significantly by then.

Jacques-Philippe Marson (BNP Paribas Securities Services)

BNP Paribas Securities Services is a strong supporter of TARGET-2 Securities. It considers T2S as having the potential to deliver a missing core piece of the European financial market integration. JP Marson conveyed three key messages:

1. Europe needs TARGET2-Securities to meet its integration objectives

Europe needs further integration in the securities environment. With the introduction of the Euro, eight years ago, a major step towards financial integration was achieved, and the Euro has undoubtedly contributed to the development of Europe's financial market. But the competitiveness of a financial center relies on a complete set of efficient market infrastructure. In the cash world this is well under way. In the securities world, the environment is still too fragmented. In the Euro area, there are currently 19 securities settlement systems, and in Europe overall 30, whereas in the US there are only two – one for equities and corporate fixed income issues and the other one for government bonds.

The current "for-profit" infrastructure models are an obstacle to integration and consolidation. Therefore, industry-led initiatives are likely to remain limited in geographical scope, focusing on large markets for economical reasons.

TARGET2-Securities is a unique opportunity to deliver an efficient settlement infrastructure for the whole of the Euro area, by providing a single outsourcing solution for the 19 securities settlement systems, while being inclusive for large and small markets even beyond the Eurozone.

2. TARGET2-Securities is the right initiative to increase efficiency and reduce costs

The benefits of T2S for the market are fourfold:

- Cross-border settlements within the Euro zone will become as easy and efficient as domestic settlement.
- By fostering harmonization, T2S should generate savings for the market participants, at the level of their back-offices but also their treasury management.
- T2S will provide settlement in central bank money only. It will be a risk free, pan-European infrastructure without the risk of commingling central bank money and commercial bank money on the same platform. This set-up should largely contribute to limiting systemic risk in the market even with a large concentration of settlement volumes on the same platform.
- The involvement of the Eurosystem is a benefit because, as a public entity, not for profit, it is a neutral body inclusive of small and large markets and able to facilitate harmonization.

3. TARGET2-Securities will encourage competition in many ways

Competition in the field of securities services will increase at various levels:

- between custodians, by extending competition from local markets to the Eurozone
- between CSDs, who will be able to extend their CSD services to non-domestic securities
- and for some market participants, by extending the choice of possible set-ups between direct access and the use of local custodians.

All players will need to adapt to change. However, the custodians expect the Eurosystem to respect its mandate of market neutrality by providing the custodians the chance to compete on a fair basis.

T2S should also be seen in the context of the upcoming regulatory changes at trading and clearing level. MiFID is likely to lead to more market fragmentation. New trading venues are developing, either US

platforms seeking European expansion, or new European projects trying to challenge incumbent exchanges. Incumbent European CCPs are also facing new entrants, for example with NSCC (Euro CCP) offering clearing services to the Turquoise trading platform.

This fragmentation reinforces the need for a single settlement solution. If we continue to compare with the US, competition at trading level has been very effective thanks to high settlement efficiency achieved by a single infrastructure. We expect T2S to provide the same benefit for the European market.

Ruud Sleenhoff (European Banking Federation)

The European Banking Federation (EBF), representing the interests of over 5000 European banks, supports the T2S initiative. It provides a unique opportunity to harmonize the settlement process in Europe. Its objectives are to increase efficiency, to promote competition and to enable cost savings. Who could object against any of these?

But, at this point in time, the EBF support is not unconditional yet. There are a number of points and principles that give rise to discussion:

Governance structure for the user requirements phase: In the Advisory Group – the highest body within the project structure where the future T2S users are represented – the national central banks and the CSDs have more weight than the banks. The users are actually in a minority position as far as voting rights are concerned. EBF had requested that the users should be given a 50% representation. The EBF itself has an observer status only in the T2S Advisory Group. While it is true that minority views can be brought to the level of the ECB Governing Council, the users are excluded from the ultimate decision making process.

Business case: The EBF takes the position that the fees charged by T2S for its settlement service should be lower than a competitive current fee for a domestic settlement, otherwise the business case is not viable. The ECB has announced that a new economic impact assessment will be done, which will be focused on savings to the users. Those are however difficult to quantify as an "average", as staff and IT savings very much depend on the individual level of process automation and STP that is in place in each firm.

The largest single success factor is the number of CSDs respectively markets that participate in T2S. An incomplete T2S market coverage, whereby a number of CSDs would decide not to join T2S, will result in much less savings than in the situation where all Eurozone CSDs are participating.

Competition issues: T2S should deliver competition between the CSDs, but also between the custodian banks and the CSDs. European banks are used to competition, whereas the market infrastructures are not. Let's make that competition real!

Banks will request direct access to the T2S environment. This will lead to competition between banks and CSDs and will provide price transparency for settlement services. In the T2S environment, banks could also opt for the settlement services of one or more CSDs as entry point(s) to T2S. This should lead to competition on settlement fees between CSDs. The resulting scale advantage for the CSD of choice could lead to lower costs and fees.

Consultation process: The consultation process foresees an extremely heavy load of issues to be commented on, whereby the time frames are very tight. The strain on the users' capacities is considerable, especially given that the same resources are typically tapped to work on other market initiatives as well (MiFID, TARGET2-Cash, others) besides having a full time job to do in their daily business role. It is unfortunate that the users are involved very heavily to do consulting jobs on detailed proposals but have almost no voice in deciding on the overall principles of T2S. Finally, industry feedback from 13 markets across the Eurozone will have to be assessed and brought to conclusion in record time frames. It is likely that this can be achieved only with enforced solutions and standards, or else discussions for compromise might take that long, that entirely different solutions (US driven?) might emerge in the meantime. Moreover, at this stage, there are intentions to load ever more functionality on

T2S. If the scope is not kept simple, then making the boat swim within reasonable time will be very difficult indeed. Besides, if extras are loaded on the boat, who is going to pay for them?

The European banking community should see to it that T2S will be beneficial for it and this means that T2S must deliver more efficiency, more competition and lower cost.

Audience Discussion

Some select questions and discussion points:

The announced Turquoise trading platform is scheduled to go live later this year. Its main drivers are seven investment banks which are said to control 50% of the European equity order flows and volumes. If a large portion of that volume did not flow into T2S for settlement, how would that impact the T2S business case?

If that were true, it would certainly have a negative impact. But the same negative impact would hit the CSDs too, with or without T2S. Whatever the size and cost level of the pan-European market, it is better off with T2S than without it.

The ECB will issue a revised business case with a more detailed economic impact analysis. The ECB is determined to deliver settlement at a price lower than the lowest domestic settlement price today!

Turquoise and similar trading venues are a subset of all market *participants*. They are not market *infrastructures*, and they command too small a subset of the market to make a real impact. With regard to infrastructure: on the clearing level, Europe has not been able to build a single central counterparty. The US market was successful in achieving that and it will now bring its solution to Europe. On the settlement level, settlement is the process which achieves the finality of exchanging ownership between cash and securities. Without the ECB having a stake in it, it is an illusion to expect the same degree of safety from any other provider. If there is one place in the Eurozone that is appropriate and able to provide the highest settlement safety at low cost, it is the ECB.

Is "No Go" a scenario at all?

We first must try to understand what T2S is, what it delivers and what it does not deliver, before such concerns are raised. There *are* many open questions at this time, and we are charting new waters, but let's do it constructively!

A few years ago, the Scandinavian "S4" project tried to achieve something very similar like T2S, for four markets only. S4 never lifted off. The cost to handle the complexity exceeded the benefits. Shouldn't that be a warning?

T2S must be lean. Legal constraints must be addressed. We need to strive for standardization and the harmonization of market practice. Less and less specific national market practices will be justified as we achieve more market integration. Those markets insisting on proprietary practices should pay for the extra cost.

Who will lead the way to more standardization and harmonization? The Advisory Group? Given the very tight timeframes, it will hardly be able to reach consensus.

Making this process fully "democratic" is difficult indeed. Some enforcement rules will be necessary and indeed preferable, otherwise the goal will never be reached. Why should the ECB be gentler with the industry with regard to T2S, than a regulator with regard to enforcing MiFID?

Simplicity and a lean scope are essential. Keep T2S simple to make it fast, cheap and efficient. The heavier the load, the greater the danger that the boat will sink!

If it is true that CSDs participating in T2S cannot decommission anything, where would savings then come from?

This question should be revisited later. When the time comes for many CSDs to enter another investment cycle to renew their systems thoroughly, TS2 will be there and the situation will look different.

On the need (or not) to mirror accounts: T2S will hold the accounts, and the CSDs will view and access them. The need for account duplication or mirroring seems not clear, but this is obviously an issue requiring more analysis and clarification.

Major custodian banks already looked into the feasibility of separating securities settlement from asset services and found it impossible to do. The T2S business case must not only look at the settlement function, it should also assess the impact on the residual CSD business and on other infrastructure functions. Feasibility is not a question of writing off investments. It is a business issue with far greater implications than we are aware of at this time.
