

## THE NATURE OF OUTSOURCING IN T2S

The purpose of this note is to clarify the nature of outsourcing in TARGET2-Securities (T2S) in response to various views that have been expressed in various fora.

T2S is a service based on a single technical platform, allowing for core, neutral and borderless pan-European securities settlement in central bank money, providing a settlement engine to support *the Central Securities Depositories (CSDs) that have been instructed (explicitly or implicitly) by their authorised participants in the form of transfer orders* in the processing of *these* transfer orders and a data base holding all relevant static data, including data related to the securities accounts maintained by CSDs and the cash accounts maintained by the Eurosystem Central Banks. T2S enables the Eurosystem to offer to CSDs an array of settlement services in order to enable them to provide to their customers harmonised and commoditised delivery-versus-payment settlement (DvP) in central bank money in an integrated technical environment across European markets.

The specificity of T2S lies in the fact that it fulfils statutory tasks of the outsourcee, i.e. the Eurosystem:

- to contribute to the efficient operation of clearing and payment systems (Article 22 of the Statute of the European System of Central Banks and of the European Central Bank, hereinafter the ‘Statute’), and
- to provide means and set the conditions for carrying out monetary policy operations and related cash transactions (Articles 17 and 18 of the Statute).

Reflecting these tasks, T2S will offer CSDs efficient processing of DvP settlement in central bank money, and will technically support credit operations against collateral in a harmonised, safe and efficient environment on a cross-border basis.

T2S will also contribute to the single market agenda by fostering the integration of the European financial markets and reducing costs for investors and issuers. Furthermore, T2S will enhance competition, both in CSD activities and in adjacent markets, and operate on a full cost recovery and not-for-profit basis.

From a regulatory perspective, T2S implies that a core part of CSD’s IT functions (the processing of transfer orders and the technical maintenance of securities account database) will be outsourced to the Eurosystem, acting in this respect as an IT service provider. They thus stress the need imposed by the regulatory framework in force to establish adequate control over the outsourcee.

T2S will be governed by a comprehensive legal framework, in particular, a framework agreement between the Eurosystem and all participating CSDs (that will include a service description and a change management procedure) and an ECB Guideline. These legal documents will reflect the general principles adopted by the ECB Governing Council (the T2S Principles), which are also the basis for this note.

## 1. T2S entails the outsourcing of CSDs' IT functions

T2S entails outsourcing of a core part of CSD's IT functions since they will use an external IT infrastructure for technical record keeping and processing of settlement, as reflected in the T2S Principles. Outsourcing of this core part is a necessary pre-condition for CSDs to obtain the services that T2S will provide them.

## 2. CSDs are fully responsible to their customers

In line with the T2S Principles, T2S will not constitute a CSD or a securities settlement system (SSS) in itself; thus the CSDs will remain fully responsible to their customers. The T2S Principles state that the CSDs continue to maintain legal relations with their customers, including the booking of securities on accounts and the (legal and operational) responsibility over the securities database supporting the settlement process. Legally, this remains true even though from a technical perspective securities account balances may only be changed in T2S.

## 3. Impact on the oversight, regulatory and supervisory requirements

The Eurosystem is aware that most CSDs have to comply with requirements related to outsourcing when using services to be provided by T2S. The T2S Programme Board (supported by the Eurosystem central banks) will take an active role so as to enable that CSDs demonstrate compliance to the competent regulators, supervisors and overseers in this respect.

As owner of T2S, the Eurosystem is acting as a service provider and will ensure a clear separation of its regulatory/oversight and service provision roles at all times.

In accordance with the rules contained in Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC<sup>1</sup>, in many regulatory regimes, a distinction is made between the outsourcing of operational functions that are considered critical, for which specified or more stringent conditions apply compared with the less stringent conditions applied in such regimes to the outsourcing of non-critical functions.

It is clear that since a defect in or malfunction of T2S could materially impact the CSD's ability to meet its obligations towards its clients and its regulators, supervisors and/or overseers, including its soundness and service levels, the technical functionalities provided by T2S are of a critical nature.

In any case, T2S will support and facilitate participating CSDs in complying with oversight, regulatory and supervisory requirements (as already stated in the T2S Principles). There have already been some precedents of outsourcing by CSDs in Europe (e.g Euroclear group, Monte Titoli, Clearstream, VP) which fall within the scope of the competent regulatory, supervisory and/or oversight authorities. Neither the powers of the competent regulators, supervisors and overseers in relation to the CSD's decision making process leading to their participation to T2S nor in relation to the activities of a CSD will be limited by the use of T2S.

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<sup>1</sup> Article 13.5 provides thereof that “[an] investment firm shall ensure, when relying on a third party for the performance of operational functions which are critical for the provision of continuous and satisfactory service to clients and the performance of investment activities on a continuous and satisfactory basis, that it takes reasonable steps to avoid undue additional operational risk. Outsourcing of important operational functions may not be undertaken in such a way as to impair materially the quality of its internal control and the ability of the supervisor to monitor the firm's compliance with all obligations.”

T2S will not result in any delegation of a CSD's senior management's responsibility, nor will it alter the CSD's contractual obligations *vis-à-vis* its clients.

T2S will not impact the powers of the regulators or other competent authorities as a result of the establishment of the shared platform and shall in no way affect the role of the Eurosystem in ensuring ongoing compliance by CSDs with relevant legal and regulatory requirements.

#### **4. T2S is a shared technical infrastructure service and thus necessitates an harmonised service provision to all CSDs**

T2S is intended to be a single provider of common "backbone" services to multiple CSDs, similar to other multilateral shared infrastructures and distribution networks in other industries (e.g. SWIFT or VISA in financial services, or many examples in the telecom, transport or energy sectors). Such core infrastructures are typically subject to oversight as regards soundness and are to act in compliance with EC competition rules.

The multilateral character of T2S is emphasized by some of the T2S Principles: the criteria to access T2S will be public and non-discriminatory; the fee structure will be transparent; the contracts with CSDs will be established and negotiated in a coordinated manner with the aim to provide for fully harmonised contractual arrangements. Also, all rules and procedures of T2S will be common to participating CSDs in order to reduce cost and simplify processes. Specific services may be tailor-made by T2S for particular CSDs, in accordance with the change management procedure under discussion and subject to separate documentation.

The use of a single shared infrastructure by CSDs has an unavoidable impact on the way in which CSDs exercise their management and control functions in respect of the operations outsourced to T2S. For example, the design of arrangements for system resilience has to be the same for all. Economies of scale in T2S should allow them to be more robust than those which exist today for individual CSDs.

Another consequence of sharing a single infrastructure is that an inadequate use of it by one or more CSDs and their respective customers may have an impact on other CSDs and their customers. This justifies *per se* the need for a harmonised service level avoiding therefore an undesirable fragmentation of the services according to each individual CSD demands. It is thus the responsibility of the Eurosystem, whilst outsourcee, to foster such harmonisation adequately, and eventually in certain defined cases to set incentives to prevent negative externalities in the use of T2S and to define the processes to address these negative externalities if and when they arise. Naturally, CSDs will have an influence over the service levels of T2S.

The governance and change management procedures of T2S will reflect the need to balance eventual individual CSD's obligations in terms of corporate law and regulatory requirements with the necessity to provide a standardised service for a multitude of CSDs. Any regulatory need that is specific to a given national market could be implemented in T2S, but the resulting costs should be borne by that market.

To sum up, it is inescapable that a CSD will have a different control than if it outsourced to a non-shared service, since T2S will be an open and shared infrastructure that promotes equal access to all CSDs. This model will necessitate efficient and comprehensive coordination with T2S by CSDs subject to the approval by their regulators, overseers and/or supervisors.

Therefore, CSDs should be invited to discuss together with the T2S Programme Board, supported by the relevant Eurosystem central bank, how to further comply with CSDs requirements, including regulatory, supervisory and oversight ones. The T2S Programme Board is also ready to enter into discussions with competent regulators and overseers.

## **5. T2S has wider objectives than the provision of IT outsourced services** **- Traditional concept of outsourcing does not sufficiently describe T2S**

Outsourcing is commonly defined as an entity's use of a third party (either an affiliated entity within a corporate group or an entity that is external to the corporate group) to perform activities on a continuing basis that would normally be undertaken by the entity, now or in the future<sup>2</sup>. In particular, it is defined as an arrangement between an authorised institution and another entity by means of which this latter, acting as outsourcing service supplier, supplies goods, services or facilities on a structural basis which would otherwise be undertaken by the institution itself<sup>3</sup>.

T2S entails the provision of a complex set of services for the benefit of CSDs, one of which being the provision of integrated settlement in central bank money. Therefore, since part of these services entails Eurosystem activities, which by no means would otherwise be undertaken by the CSDs, T2S goes beyond a mere IT outsourcing relationship.

Moreover, it should be noted that, differently from a conventional provider of IT services to multiple CSDs, which would, in principle, offer independent services tailor-made for the specific needs of each CSD, the T2S outsourcee would instead offer a single harmonised set of services to be used simultaneously by all CSDs (T2S). This said, it should be borne in mind that currently outsourcing in financial services comprehends already standardised interbank transaction services such as payment routing and processing (e.g. SWIFT) which may correspond to an harmonised service level by the outsourcing service provider. The foregoing analysis is without prejudice to the relevant conditions under applicable laws and regulations that must be met in relation to outsourcing by a CSD. By way of example, the local laws and regulations might require that control of the outsourcer (i.e., the CSD) is adequate; that the outsourcer remains liable vis-à-vis its customers; that the human technical and financial resources are adequate for the outsourcee (i.e., the Eurosystem) to carry out its functions; that proper continuity and security of the CSD and/or SSS is ensured.

These harmonised services have the specificity to be provided by the outsourcee, i.e. the Eurosystem, in the fulfilment of its statutory tasks. Indeed, the rationale underlying the outsourcing relationship between the Eurosystem, as service provider, and the CSDs, as authorised and regulated institutions, lies in the fact that such a relationship is intended to pursue and serve the fulfilment of the statutory tasks entrusted to the Eurosystem by Articles 17, 18 and 22 of the Statute. This amounts to a differentiation from a conventional outsourcing relationship in that it allows the outsourcing service to be constructed not exclusively by reference to the specific needs of the outsourcer (i.e. the CSDs) but also according to the public tasks entrusted to the outsourcee (i.e. Eurosystem).

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<sup>2</sup> The Joint Forum, *Outsourcing in Financial Services*, Basel Committee on Banking Supervision, February 2005, p. 3.

<sup>3</sup> Committee of European Banking Supervisors, *Consultation Paper on High Level Principles on Outsourcing*, April 2004, p. 3.