



# TARGET2-Securities Project Design: some key questions

**Jean-Michel Godeffroy**, Chairman of the TARGET2-Securities (T2S) Programme Board at the European Central Bank, talks to Bob Currie about the progress of the T2S consultation process and key steps towards the first phase of the project implementation planned for September 2014

## Framework Agreement

The ECB indicates that key milestones in the development of T2S during the next 24 months will be the adoption of the Framework Agreement by the Governing Council in Jan 2011 and then by CSDs in April 2011. Another major activity for 2010 is negotiation of the Currency Participation Agreement with non-euro area central banks that anticipate allowing their currencies to be settled in T2S.

**What are the principal issues that need to be resolved in tabling the Framework Agreement in line with this timeframe?**

We continue to negotiate the programme governance with key stakeholders, including central securities depositories, central banks, national regulators and potential users of the system. This project presents some complex legal challenges, given that there have been few previous examples of situations where private sector companies have outsourced processing functions to a public authority. In finalising contractual arrangements, it is clear that we need to find common ground between the CSDs and the Eurosystem. Some CSDs have maintained that the outsourcing contract should be a standard outsourcing agreement under private company law. The Eurosystem leans more towards a public task model. We will need to find a solution in the centre ground between these two positions, drawing on the strongest elements of each of these models. All parties to the consultation have been open in sharing their priorities and concerns and we are confident that such a solution can be established in the timeframe we have proposed, whereby the Framework Agreement is scheduled for approval by the Governing Council in January 2011 and then put to the CSDs in April 2011.

## Project timeline

**You have specified in recent presentations that T2S will be open for testing with CSDs in January 2014 and will**

**be open for production with the first wave of CSDs in September 2014. You indicate that this timetable will not slip further. However, you have voiced concern that some CSDs may not be making the preparations necessary to be ready for T2S according to this timetable.**

**Are CSDs in a position to proceed more rapidly with their preparations until they have seen the terms of the Framework Agreement and have greater clarity around what the outsourcing agreement and pricing schedule will look like?**

Inevitably, this situation will differ slightly from CSD to CSD. In preparing for T2S, CSDs will be expected to make changes to their IT infrastructure that will clearly require investment. Some CSDs have indicated that it is hard for them to attain approval from their management boards until they have a legal contract in place with the Eurosystem, delivering clarity around the project governance and price structure. Though we are sympathetic to this position, we believe it important to avoid any further slippage in the project timeframe. The danger is that any delay from CSDs in signing the contract would translate into possible further delays from CSDs in committing investment to their technical restructuring in preparation for T2S.

In turn, we are aware that there may be some CSDs that wish to change their existing IT infrastructure and operational models as little as possible in preparing for T2S. We are concerned that, in trying to protect their existing revenue sources, these CSDs may attempt to resist the project implementation, rather than committing to the internal changes necessary to connect to the T2S platform. This, we believe, would be a mistake. We identify a number of European CSDs that have embraced T2S as a trigger for a more efficient securities processing environment – and they are working to be at the forefront of the project implementation in order to reap early mover advantage from the opportunities that T2S will present. Undoubtedly, T2S will create a more competitive landscape in

which CSDs that prepare early will be the first to pass on substantial price improvements to their users. In turn, those CSDs that do not evolve, that do not adapt to this new environment, will lose business to the CSDs that can already deliver an attractive T2S offering.

## Currency Participation Agreement

### How much progress has been made in preparing the Currency Participation Agreement for T2S?

From early July, we will be in a position to firm up the contractual arrangements that will underpin the Currency Participation Agreement (CPA) with non-euro central banks. Consultation with these central banks has been ongoing for some time.

the Swiss National Bank and a number of central banks in the Nordic region, for example, the question is principally whether or not they will bring their currency on board to support CeBM settlement in T2S. Other central banks (including central banks in Poland, Hungary, Romania and the Baltic states among others) face the additional challenge that they are preparing for adoption of the euro as their official currency and, in parallel with this, they are reviewing whether they will link to the T2S platform. In light of this, we expect to host two distinct sets of discussions with the central banks that fall into these respective categories.

We are confident that preparatory discussions in each of these categories have been progressing well. Central banks are weighing up the implications for the domestic and international banking industry

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However, in preparing the project schedule we recognised that negotiations around the Framework Agreement would require considerable time, given that the Eurosystem would need to negotiate terms of the Framework Agreement with the CSDs and the CSDs would then require time to secure approval from their national regulators and to ensure they have the support of CSD participants. With this in mind, we were eager to expedite work on the Framework Agreement and, when this was well on track, to accelerate our work on the CPA.

In preparing the Currency Participation Agreement, we are negotiating with non-euro central banks that fall broadly into two categories. For the Bank of England,

of seeing settlement of euro-denominated and non-euro securities in the T2S platform.

In many cases, banks with an international outlook have embraced T2S in recognition of the major boost to cross-border settlement efficiency that this facility will deliver. However, some banks that have a predominantly national focus – for example those specialising in local sub-custody that might be subject to greater competitive pressures in a T2S Europe – have been sceptical owing to the threat that change may pose to their existing revenue streams.

Ultimately, we are confident that central banks will not attempt to protect national banking interests that rely on local idiosyn-

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crasies in market practice, legal and tax regimes in order to charge high settlement and/or asset servicing fees to their customers. T2S will encourage harmonisation, removing avenues for generating rental income through imperfect competition, and it will make for a more efficient domestic and cross-border securities processing environment.

### **Competitive landscape**

**Network managers have raised the question of whether T2S may deliver a zero-sum outcome in terms of sub-custodian pricing. Facing a decline in settlement-based revenue in a T2S environment, sub-custodians may be forced to revise upwards what they charge for asset servicing functions?**

Firms may react to a decline in revenue in several ways. One is to diversify or realign their service expertise in order to access new sources of revenue. Another is to exit the market, such that a squeeze on revenue triggers a consolidation of service providers

in that market segment. We anticipate that both trends will prevail following T2S implementation. Some agent banks and CSDs are already preparing for life in a T2S Europe and are refining their service delivery accordingly. We expect also to see consolidation within both the agent bank and CSD communities. If the market is working efficiently, it is likely to be those providers that have been slow to adapt – and those that are trying to preserve revenues by opposing innovation in the market – that are likely to be the first to disappear.

We are confident that T2S will bring more than a zero-sum outcome because we believe it will deliver significant general benefit for the market in terms of pricing and efficiency. However, we recognise that T2S will not benefit all stakeholders equally. Those that embrace T2S as a business opportunity will gain competitive benefit when T2S goes live. However, we recognise that in the name of operational efficiency and market harmonisation, inevitably some market participants will be better placed than others to commit the investment and expertise needed to thrive in this new environment.

## Full cost recovery

**T2S is being designed and built on a “full cost recovery” basis. What is the estimated timeframe through which costs of the platform build and implementation will be recovered after the T2S platform goes live?**

As Chairman of the Programme Board, I have insisted that we do things in the correct order. We are addressing the issue of how T2S should be paid for and how this investment should be recovered. We have been in negotiation with the market regarding which items we should charge for and at what tariff. We are now well advanced with this process and expect to have a price list ready for presentation at the Advisory Group (AG) meeting in September. Some AG representatives have raised the possibility that the Eurosystem will offer a price guarantee for the first two years of T2S operation, but no firm proposals have been agreed at this stage.

**Do you intend to extend the cost recovery period?**

We believe strongly that there is need to recover project costs at an early stage. Any potential delay in our efforts to recover costs may result in price increases on the platform at a later time. This is likely to be unpalatable to T2S users.

## Separate legal entity

**The T2S Advisory Group has evaluated the potential benefits and disadvantages of establishing a separate legal entity in shaping a governance model for T2S. Some stakeholders favour this possible arrangement whereby decisions relating to infrastructure will be taken by the Governing Council whereas strategic decisions relating to operation and future development of the platform will be taken by a broader range of stakeholders. Is there still a possibility that a separate legal entity will be established to guide the day-to-day operation and development of T2S?**

Marye Humphery presented the results of her investigation to the Advisory Group in March, providing a well balanced report that summarised key positions regarding the creation of a separate legal entity (SLE). From this discussion, we noted that some non-euro central banks supported an SLE, believing that this framework would allow them greater influence over the future direction of the T2S project. In turn, some users of the system appeared to support an SLE on the grounds that this would provide the best means through which they could persuade non-euro central banks to commit to T2S. In contrast, a number of euro-currency central banks were firmly opposed to the creation of an SLE, perceiving that the Eurosystem is taking on considerable responsibility as owner and operator of the T2S project and wishing to ensure that the ECB Governing Council retains full responsibility for services provision.

On balance, we concluded within the AG that there was little unconditional support for the creation of a separate legal entity. In its April 2010 meeting, the Governing Council requested the Programme Board will continue the elaboration of the T2S governance in the running phase without contemplating the setting up of a separate legal entity, but with the intention to find appropriate ways to involve CSDs and non-euro central banks. We are confident that the views of non-euro central banks will be well heard under the framework we are proposing to them.

Significantly, the management framework that is likely to evolve for T2S will have some characteristics in common with a separate legal entity. An SLE, if created, would be 100 per cent owned by the Eurosystem, as per the existing design under Principle 1 of the T2S General Principles. Moreover, an SLE would fall under the ultimate authority of the ECB Governing Council with a board structure similar to the Programme Board that we have in place currently.

## Direct holding account structure

**Several Nordic markets operate a direct holding account system which is a**

**central tenet of their capital market infrastructure. To what degree does the T2S design offer effective provision to settle securities transactions via omnibus accounts at this centralised T2S settlement platform, while retaining compatibility with direct holding accounts at the CSD platform?**

The challenge of accommodating direct holding account structures was an issue when T2S was first proposed, but subsequently the T2S design has advanced in a way that can support direct holding accounts. In turn, markets that embrace direct holding account arrangements are themselves adapting such that they may interface with T2S through mechanisms such as a layered model: CSDs will retain

Our position at the ECB is that we will be entirely flexible in this area, leaving the ultimate decision regarding account management to the local market. What we do not accept, however, is a CSD that may be tempted to free-ride on T2S. This would happen if a CSD used T2S to access securities issued by other CSDs, but did not make its balances available to these other CSDs. To address this concern, the ECB Governing Council has issued a set of five CSD eligibility criteria, detailing the terms on which a CSD can and cannot participate in T2S.

**Closing thoughts**

In conclusion, efforts to finalise details of the Framework Agreement will remain the most important task of the ECB and other

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administration of beneficial owner accounts locally, even though we offer the facility to manage individual accounts on T2S if required.

Indeed, we have seen a gradual evolution. Initially, we were asked on the Programme Board to ensure that T2S could care for the needs of countries that operate a retail model at the CSD. Subsequently, the direct holding account countries have tailored their own operational models, such that they have flexibility to manage administration of individual accounts locally, with the interface with T2S being via an omnibus account in the name of the account operator.

T2S stakeholders during the remaining part of 2010. We continue to seek a balance between the need to secure consensus between interested parties and the need to preserve momentum in the project design and implementation process. In April 2010, the ECB Governing Council adopted the T2S Guideline, which provides the foundation for the legal framework for T2S. Through open consultation, we are confident that we can deliver a T2S governance structure and pricing framework that aligns with the expectations of core stakeholders and which will enable us to meet our proposed timeline through which T2S will be ready to be used by the first group of CSDs by September 2014. ■