

2008-04-02

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T2S URD consultation feedback from NCSD Finland

NCSD welcomes the opportunity to express our view upon the T2S User Requirement documentation [T2S URD]. We recognise the great effort of producing the extensive documents in the relatively short amount of time. We see that the T2S URD to a large extent is in line with the functionality expressed in the white papers by NCSD [NCSD WP], together with the market participants, formulated in 2006 and 2007. However, there are some high-level differences compared to the NCSD white papers, both from a structural and functional point of view.

Furthermore, NCSDs view is that it is important to differentiate between the functional/technical specifications in the T2S URD and the T2S project from other aspects. Hence, agreeing/disagreeing with the functional specifications does not imply support/opposition to the T2S project in a wider context. In general, we see that additional information is needed in order for stakeholders, specifically CSDs, to express their degree of support for the T2S project, for example in areas such as:

- governance regarding scope, functionality, pricing, future development
- pricing and economic feasibility
- system provider service level, flexibility, cost and time-to-market for customised functionality
- legal and risk aspects

In this context, we would like to stress that this NCSD response to the T2S URD focuses on the functional aspects and must not be seen as any expression related to NCSDs potential interest to participate or not in T2S.

In addition to the specific T2S URD specifications, where NCSDs views have been expressed in the Excel file and where some of the items have been highlighted further down in this document under the section 'Comments to the T2S URD', NCSD sees that there are some general high level aspects that we would like to highlight.

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High level general comments related to T2S**T2S cannot be seen as a pure IT-outsourcing**

We see that a CSDs participation in T2S cannot be seen as a pure it-outsourcing, as has been suggested by the T2S project. NCSDs view is that it would have much more far reaching implications. The role, responsibility and business model of a CSD would change significantly in a T2S environment, something which also would affect other areas of the market infrastructure.

Effect upon systemic risk

It is well recognised that there are substantial savings to be made by centralising functionality to one, or fewer, CSD system/s, both from an operational point of view and when it comes to efficiency related to the use of participants' securities and liquidity. However, this centralisation also brings about new risks and dependencies that should be addressed. The settlement of securities in one market will be dependant upon market participants' performance in other markets. Hence, a failure or technical disturbance at an Italian or German participant may also have effects upon the settlement of Finnish or Swedish securities. The extended dependency upon the performance of other market participants may lead to lower settlement ratio, specifically for markets that are functioning very well in today's CSD structure. It will be important to have harmonised rules, penalties and central monitoring of the whole process, not just for the securities accounts administered by one specific CSD. Although centralisation brings about higher efficiency it may also increase the systemic risk.

Economic feasibility

The outcome of the economic feasibility study is expected to be delivered during the early summer 2008. There has been great attention in the Advisory Group and different other forums to potential savings at the CSD level, under the assumption that all, or part, of the current CSD systems are decommissioned. In this context we would like to underline that each CSD today is running several systems, where the same operation sites, computers and administration are shared between these in order to save costs. Hence, the outsourcing of the settlement functionality would, regardless if savings can be made in decommissioning the existing settlement system, lead to that other systems have to bear a greater proportion of the common fixed costs. In addition, the securities accounts constitute the core of CSD systems, with several dependencies to other systems on the same platform, which require extensive initial system development and limit possible savings related to IT operations. Theoretically, highest efficiency would be obtained if as many systems/functionality as possible were centralised. We recognise that such an extended project would be more complex and would, in addition, likely not fall under ECBs assignment 'to promote a smooth payment system' in accordance with article 105.2 in the Treaty of The European Union. However, due to cost of each CSD adopting existing systems to T2S and due to the necessity for each CSD to maintain other systems and to establish links with the other CSDs in order to handle corporate actions and asset services, T2S do not necessarily reduce the overall costs at the CSD level. Under the T2S vision, participants should be able to connect to one CSD and to have one central bank account and one securities account, enabling them to reduce their back-office cost and use of local agents. However, in order for this vision to materialise, the CSDs need to establish CSD links and related services hereto. Hence, any economic feasibility study including savings in accordance with the T2S vision must also include costs for establishing CSD links and other investments that are required at the CSD level in order for the CSD to be competitive. We also note that the discussions on economic feasibility to a large extent have been focused on the effects on the CSDs, whereas all other studies show that the greatest savings are found among the intermediaries. In this perspective, we believe that it is of greatest importance to also include effects among intermediaries, how much savings can be achieved, both in terms of more efficient and harmonised routines and in terms of short-cutting intermediaries, and how much of the savings will be passed on to investors.

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Investor accounts

NCSD view is that, most likely, not all investor accounts would be moved on to T2S. Any such decision is not only a question of cost but also a question of service level agreement, efficiency, flexibility, development of new customised functionality and time-to-market. NCSD view is that it is unlikely that ECB would be the most efficient supplier of such functionality, specifically since this functionality is not core settlement and in direct competition with other solutions based upon indirect holdings and depot accounts supplied by banks/brokers. In general, we see difficulties in having critical functionality, which is used by CSDs and banks to create competitive advantage, on a common platform provided by one system supplier. The task of deciding what should be developed when and how costs are to be shared would be difficult and have great effect upon the competitive situation. Of course, if T2S is proven to be the best, most flexible and efficient solution, then based upon a commercial decision in a competitive environment, investor accounts may, to a greater extent, be moved on to the T2S platform at a later stage.

Governance and system supplier

To NCSD, it is unclear who will be the intended system supplier of T2S. NCSDs view is that it would be inappropriate if ECB / Eurosystem would take on a role as both system supplier, provider of central bank money and related services and supervisory authority. The system supplier has to take difficult decisions that effect the competitive environment, both among CSDs and among market participants as well as between CSDs and market participants. In addition, NCSDs view is that T2S should be seen as one system, competing with other system alternatives. In this perspective, it is of vital importance to clarify the responsibility of the system supplier. Would it for example be possible to direct claims against ECB / Eurosystem as system supplier?

It is essential that other CSD platforms are given the same access and functionality related to settlement in central bank money, both from functional perspective and from a cost perspective. In relation to this, it is important that T2S is priced in such a way that it allows competition. Hence, it would be inappropriate with a large proportion of fixed cost, taking away most incentives of savings related to internalisation, netting and efficient processing of transactions.

Comments to the T2S URD

When it comes to the structure of the T2S URD, we see that it covers a mixture of both high level strategic matters as well as matters of more technical and detailed character. Most certainly, there are different target groups of readers for the different parts of the T2S URD. The wide scope of matters also results in a rather extensive document, which not all actors may have the resources to penetrate in detail, CSDs as well as market participants. Hence, we see a large risk that smaller players have not had the resources to analyse and respond to the T2S URD and, as a cause of this, that the responses to the T2S URD will be biased to mainly cover the interests of larger participants. We recognise that there are industry organisations that to some extent have the responsibility of securing the interest of the smaller participants. However, the extent of the T2S URD is such that not even these organisations have had the necessary internal staff of analysing the document, but rely upon experts from larger market participants. Hence, we see that also responses from industry organisations and the T2S National User Groups [NUGs] mainly reflect the interests of the larger market participants. Without doubt, T2S and the functionality expressed in the T2S URD would have a significant impact upon the competitive situation between different market participants, and to some extent between regional markets, and we insist on ECB to specifically take note of this. Although the aims of the T2S project are to increase efficiency and competition, the functionality expressed in T2S URD could just as well lead to the opposite.

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When it comes to functional matters of the T2S URD, the main difference between NCSD white papers and T2S URD are related to settlement model/account structure, central bank money model, settlement intraday schedule and scope of services.

The settlement model/account structure

In NCSD WP it is proposed that each security should be settled under the legislation of the Primary CSD, which in most cases would be the legislation of the issuer CSD. The reason for this is to:

- i. comply with existing legislations when it comes to registrations on CSD securities accounts
- ii. comply with existing legislation with regards to issuers and registers, companies acts etc.
- iii. avoid unnecessary complexity of CSD-links, although these can be set up as an internal part of the CSD system

The shortcoming of the NCSD model is that formally, account operators will have to be account operators in each jurisdiction under which they want to hold securities in their accounts. Hence, in order to administer securities accounts and perform registrations related to both Finnish and Swedish securities, participants formally have to be account operator both under Swedish and Finnish legislation. However, this was essential in order to comply with items i-iii) above.

The T2S model is based upon that securities accounts being held under the local legislation of the CSD and that cross border settlement in the system will be carried out between internal omnibus accounts held by the CSDs. The model is efficient for the account operators but raises a number of legal matters which need to be clarified. In addition, the T2S model is more complex in the sense that, although integrated on the same platform, it is still built up on a concept of CSD-links. These CSD-links have to be established by the investor CSD, to all issuer CSDs for the securities the participants require the CSD to handle, and these are between each CSD outside of the T2S scope. The establishment of these bilateral links between each CSD will require investments by all CSD for the cross border settlement in T2S to be possible.

In addition NCSDs view is that most likely the transparency regarding ownership information will be reduced, since these investor CSDs will nominee report their participants and not the clients which are currently reported by the participants.

Model for central bank money

NCSD WP propose a combination of two alternative models, the outsourcing of central bank money accounts to the CSD (the integrated model) and a model where the CSD holds a client account with the central bank where the CSD keeps track of the rightful owners in its internal system (the modified integrated model). The benefits of the latter are that clearing members can settle in central bank money, without having to be member of the central bank RTGS system.

The T2S model is based upon that participants need to be member of Target2 in order to avoid credit risks of settlement banks. This may be a barrier for smaller participants.

Since T2S, according to the principles, should not be mandatory for CSDs, it is important that other CSD-platforms are allowed the same functionality for settlement in central bank money. This also stresses the difficult role of ECB as a one alternative system supplier at the same time as ECB decides upon matters related to access to central bank money.

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Settlement intraday schedule

We recognise that, from a CSD system perspective, there are benefits of night time settlement. Batch processes can be allowed to lock accounts and settlement instructions for more efficient optimisations, the system is given more time to process instructions and there is currently excess collateral available at night, just to mention a few benefits. However, we also see that there are shortcomings with night time settlement, there are fundamental reasons why all market participants distinguish between intraday risk and overnight risk, something which is well known by traders and risk managers. One of the main reasons why intraday risk mandates in general are larger is that it is possible to take action when necessary, which reduces the risk exposures. Also in capital adequacy requirement calculations, intraday exposures are distinguished from overnight exposures. Although it has been agreed in Target2 to accept winding forward the clock and consider overnight exposures taking place 18:45 on S-1, we question the methodology from a fundamental point of view. If the same principle should be applied for T2S, then it should be allowed for all systems, whereby the whole concept of overnight risk can be questioned. Based upon this fact, when it comes to T2S, it was negotiated/discussed in the Advisory Group that it should be optional for participants to produce payment capacity already on S-1. However, NCSD believe that this is not feasible and that there will be a need for a common set of rules stating when payment capacity should be in place for all participants. Otherwise, the settlement processing will become very inefficient and it will be difficult for market participants to estimate how much payment capacity that they need to present in order to settle their securities. In general, such forecasts are produced based upon the assumption that all other market participants present their net payment obligations. Otherwise participants will have to present unnecessary large payment capacity, bringing about inefficiency. The implication of the T2S URD is that participants, as well as issuers with redemption and dividend payments, must have payment capacity in place already on the calendar day before settlement date. It is stated in the T2S URD that banks are not expected to charge their underlying clients for the resulting requirement of commercial bank limit / payment obligations, since the banks are not charged by the central banks for their use of central bank money liquidity on a certain value date. However, this argument is inconsistent since banks, will be exposed to overnight credit risk and will have a cost for that.

To conclude, due to the large number of settlement instructions, it may be necessary to start the processing as early as possible, but we believe that the T2S proposal have negative effects that have not yet been addressed properly.

Corporate actions

The model expressed in NCSD WP includes corporate actions as an essential part. After having formulated the NCSD white papers, NCSD consulted market participants on their preferences where to start to implement the new model. The view of the vast majority of participants was that the area of corporate actions was by far the area where the most potential for savings and risk reductions could be found.

We appreciate the constructive work in the T2S project, the well structured T2S URD, ECBs approach with an official consultation and we are looking forward to your considerations to the responses received.



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Feedback template T2S URD and annexes NCSD Finland