

T2S PROGRAMME BOARD

ECB-UNRESTRICTED

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Item 4.2

## CLARIFICATIONS ON THE T2S PRICING POLICY

### Introduction

During the ad-hoc meeting with CSDs on 16 February 2012, it was agreed that the T2S Programme Board provides detailed clarifications on the T2S Pricing Policy in writing in order to ensure that the CSDs and the Eurosystem have a uniform understanding of the provisions in the Framework Agreement (FA). *The present note provides such detailed clarifications following the CSDs' requests.*

### Clarifications related to Section 2 of Schedule 7

Section 2 of FA Schedule 7 states:

*The Governing Council of the European Central Bank (ECB) decided to set the Delivery versus Payment price for TARGET2-Securities (T2S) at 15 eurocent per instruction. This price will be fixed for the period from the T2S Go-Live Date until December 2018. In order to provide assurance to market participants about T2S prices after 2018, the Governing Council has made a commitment not to increase T2S fees by more than 10% per year between 2019 and the end of the cost recovery period.*

*This commitment to set the price at 15 eurocent is subject to the following conditions: (i) non-euro currencies add at least 20% to the euro settlement volume; (ii) the securities settlement volume in the EU is no more than 10% lower than the volumes projected by the T2S Programme Office, which are based on market advice; and (iii) tax authorities confirm that the Eurosystem will not be charged VAT for the T2S Services it provides.*

**1. Concerning condition (ii) above, what is the baseline volume against which the volume increase/reductions are measured?**

It has always been explained that the Eurosystem cannot provide an insurance against the general market risk, i.e. the risk that the market as a whole shrinks for whatever reason (e.g. market reactions to the financial crisis, increased use of CCPs, possible introduction of a transaction tax, ...). With or without T2S, CSDs and their clients are subject to these volume uncertainties which consequently may lead to an increase in unit settlement costs and prices. The Eurosystem has never intended to compensate for these risks which are decoupled from the T2S service offering.

The financial calculations underlying the T2S pricing policy were based on the data provided by the CSDs in response to the semi-annual T2S CSD settlement volume questionnaire by autumn 2010. As publicly explained in the September and December 2010 T2S Advisory Group (AG) meetings, these figures (covering the first half of 2010) were adjusted to take into account further information provided by CSDs on the expected netting effect of new CCPs in several European markets as well as reflecting the uncertainty regarding the adaptation of direct holding markets to T2S and then extrapolated for the full year 2010. They were combined with the expert advice of the T2S Advisory Group (AG) concerning future growth rates for 2011 onwards on the basis of a survey conducted during the March 2010 AG meeting.

The reported data resulted in a baseline figure for 2010 of 244.8 million securities settlement transactions of CSDs, excluding ICSDs, in the European Union<sup>1</sup>. Using the expected annual growth rates provided by the AG survey (3.2% for 2011, 4.7% until T2S goes live and 6.3% after T2S go-live), the following Table 1 provides the resulting benchmark volume against which the volume increase/reductions will be measured until 2024. The average settlement volume growth rate of 5.6% p.a. over this time period is well below historic average growth rates exceeding 15% p.a. between the mid-1990s and 2007.

**Table 1: Projected securities settlement volume of CSDs, excluding ICSDs, in the European Union<sup>2</sup>**

Year	2010	2011	2012	2013	2014	2015	2016	2017
Million transactions	244.8	252.6	264.5	276.9	289.9	303.6	322.7	343.0
Year	2018	2019	2020	2021	2022	2023	2024	
Million transactions	364.6	387.6	412.0	438.0	465.6	494.9	526.1	

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<sup>1</sup> Since the Bulgarian and Czech CSDs have not signed the Memorandum of Understanding with the Eurosystem, they do not participate in the regular questionnaire on CSD settlement volumes. Therefore, their reported Blue Book volume of 1.0 million transactions for 2010 is added to the projected 2010 volume based on the T2S CSD volume questionnaire for all other EU CSDs.

<sup>2</sup> See previous footnote.

## **2. How will actual figures be calculated? Where do we currently stand in terms of volumes?**

After 2010, actual market volumes are evaluated on the basis of the following principles:

- actual T2S data once they become available ;
- T2S CSD settlement volume questionnaire as a second best;
- ECB Blue Book<sup>3</sup> data as a third choice.

It should be noted that actual figures may deviate from the baseline not only because of market trends, but also because of reporting errors of CSDs. The Eurosystem cannot be accountable for these errors: the Eurosystem made its revenue calculations in good faith, on the basis of the figures provided by CSDs.

According to the latest data reported by CSDs to the Eurosystem – which is still to some extent preliminary – 225.0 million transactions were settled in the CSDs in the European Union<sup>4</sup> in 2011. This is equivalent to a shortfall of 10.9% compared with the projected volume of 252.6 million transactions. (However, the volume shortfall for the euro volume in 2011 is only 6.9%)

## **3. On condition i) above, how are euro/non-euro settlement volumes calculated?**

The projected securities settlement volume in the European Union (see Table 1 above) includes securities settlement volume in euro area and non-euro area CSDs, excluding ICSDs. In addition to these figures, three CSDs from countries outside the European Union have signed the MoU with the Eurosystem.

Euro settlement volume is defined as all securities settlement transactions (DvP and FoP) of CSDs in T2S which are operated by a legal entity based in the euro area and the euro-DvP settlement volume of all other European Union CSDs in T2S. Non-euro currencies volume is defined as securities settlement transactions (DvP and FoP) of CSDs in T2S operated by a legal entity located outside the euro area.

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<sup>3</sup> The ECB Blue Book data refers to the public securities settlement statistics in the ECB Statistical Data Warehouse, formerly published as “ECB Blue Book data”, available at <http://sdw.ecb.europa.eu/reports.do?node=1000001582>.

<sup>4</sup> See explanation under question 1 for the calculation of EU data.

#### **4. On condition iii) why is there still a reference to the VAT issue?**

Condition (iii) refers to the treatment of VAT in the relationship 4CB – Eurosystem. The tax authorities of the 4CB have confirmed that this relationship is not VAT-taxable. Although this was already publicly communicated, CSDs requested to keep this condition in Schedule 7.

As explained by the Eurosystem on several occasions, condition (iii) essentially relates to a T2S cost issue, as it was not fully clear yet at the time of the T2S pricing policy decision if VAT had to be added to the 4CB offer. If it had turned out that VAT had to be applied, this would have led to a T2S cost increase which would have impacted the common T2S prices included in the T2S price list. Since the relevant national tax authorities have meanwhile issued binding rulings that the relationship 4CB – Eurosystem is outside the scope of VAT, the condition has become obsolete.

#### **5. If condition i) and/or condition ii) is (are) met, would price revisions be automatic? Would the Eurosystem have full freedom to re-set fees?**

If one or both of these conditions are not met after one year of full operation of T2S, then there might be a need for a price adjustment. However, it has to be clear that this limited price increase is an option for the Governing Council rather than an automatic response. The Governing Council may decide not to use it at all, or to use it only partially, after taking the views of the market into account. If the option is used, the maximum increase would be proportional to the decline in the respective volumes.

#### **6. The opening of T2S has been postponed by nine months. Why did the Eurosystem not also postpone the fixed price period from December 2018 until September 2019? What happens if there are further postponements?**

The Governing Council offered the negotiated Framework Agreement to the CSDs in November 2011. The nine-month delay in the T2S go-live created additional costs for the Eurosystem although this delay was not entirely caused by the Eurosystem. Nevertheless, the Eurosystem did not change its price commitment and extended the cost recovery period (i.e. increased its financial risks) instead.

The only consequence of the end of the fixed price period in December 2018 is that the Eurosystem has the contractual possibility to change prices by a maximum of 10% per year after taking the views of the market into account and following the process for “Decision-making on relevant matters other than Change Requests” in Section 1.3 of Schedule 8. During this public review process, the reasons for potential changes would be openly discussed and referring to a delay might be a weak argument for changing the prices even if it was legally possible.

In case the Eurosystem is forced to delay the T2S go-live date again, after the signature of the Framework Agreement, it is unlikely that it could provide decisive arguments to convince the CSG and the AG to support a shortening of the cost guarantee period, especially if the Eurosystem is the origin of the delay.

## **7. Will there be price revisions before T2S opens?**

The Programme Board does not intend to propose any revision of the benchmark price of 15 eurocent per DvP settlement instruction until at the earliest one full year after the last migration wave in order to have a stable volume basis in T2S for assessing the conditions (i) and (ii) of the T2S Pricing policy

## **Other clarifications**

### **8. Will the 15 cent commitment be upheld? What will the Eurosystem do if in practice it cannot recover its costs as expected?**

The T2S Programme Board's clear ambition is to uphold the 15 eurocent fee. However, should there be unexpected events that would make reaching this objective impossible, the Eurosystem may increase the T2S fees, only where possible according to the Framework Agreement, if it is considered appropriate by the ECB Governing Council, and after consultation of the CSG and the AG. An alternative way to achieve full cost recovery could be to extend the cost recovery period. As last resort, and if neither was possible, the Eurosystem, like a private company in such a situation, would have to accept a loss. But this is not a likely situation from today's perspective; it could materialise only under very adverse conditions.

### **9. What happens if one or several major CSDs do not sign the Framework Agreement, i.e. who bears the CSD adoption risk?**

The Eurosystem has made it clear that it is ready to take and accept the "CSD adoption risk" which means that its pricing policy will not be affected if some existing CSDs in the euro area do not sign the Framework Agreement. The T2S Programme Board expects that such volumes will migrate to T2S over time irrespective of the local CSD's decision to migrate or not to T2S. CSDs which do not sign for T2S will face competition from other CSDs, acting as investor CSDs, which will try to expand their market share and bring indirectly the relevant volumes into T2S.

### **10. What happens if the Eurosystem significantly overruns the cost estimate, i.e. who takes the cost risk?**

Without prejudice to the cost ensuing from change requests, the Eurosystem takes the cost risk as it can only change pricing within the parameters of the Framework Agreement. There are two main sources of cost in the T2S project, the ECB and the 4CB. The ECB has a baseline against which it is annually scrutinized for cost consciousness (between 2008 and 2011, the ECB spent almost 4 million euro less than projected in the baseline).

The 4CB have agreed with the ECB on a conditional maximum price offer, so there is a cap to the 4CB expenses. This means that the 4CB cannot charge overruns to the Eurosystem if they are linked to mismanagement or estimation errors on their side. However their offer is conditional. If certain conditions materialise, the 4CB have the possibility to request additional funding from the Eurosystem. One important case is linked to possibly higher volumes than anticipated. In this case, the Eurosystem would also get additional revenues which would cover more than the 4CB cost increase.

### **11. What happens if the cost recovery needs to be extended again? What is the ultimate duration?**

The Eurosystem has to calculate its prices *ex ante*, on the basis of reasonable assumptions, aiming at full cost recovery and avoiding cross-subsidisation. In case of adverse market conditions, the Eurosystem may nevertheless not be able to cover its costs *ex post*, as any market participants in the private or in the public sector.

Some of the obligations of CSDs and of the Eurosystem in the Framework Agreement are linked to the cost recovery period. Without prejudice to the cost of future change requests, the cost recovery period refers to the “anticipated cost recovery period at the time of the signature of the Framework Agreement”, i.e. end March 2024, 8 years and 9 months after end June 2015. Should the extension of the cost recovery exclusively result from an omission of the Eurosystem, such extension would not negatively affect the rights of CSDs.

### **12. What are the consumption patterns which would lead to put prices for those services which are currently priced at zero?**

The expected consumption patterns can only be defined at the time of the final sizing of the T2S infrastructure 12 to 18 months before go-live. The primary reason for a price change during operations would not be revenue generation, but the avoidance of performance problems. This is in the interest of all CSDs and their customers. If there were indeed significant deviations to the consumption pattern during T2S operations, the Eurosystem would in any case discuss this with the market first and aim at finding a consensual solution to change the behavior of participants instead of charging for services currently priced at zero. It is anticipated that a price will only be applied if market participants do not change their behavior and resource consumption continues to be under stress.

### **13. How are compensation claims calculated in case of liability or termination applicable to non-euro area CSDs?**

The Framework Agreement foresees that compensation claims are calculated on the basis of the number of securities instructions in T2S during the preceding 12 months. If the respective CSD would not have settled for 12 months in T2S, the number of securities instructions in its legacy settlement infrastructure would become relevant. The formulas given in the Framework Agreement, in particular in Art. 32 (9) and in Schedule 13, Section 2, imply that both euro and non-euro volume have to be included in such

calculations. If the national currency of a CSD would not be in T2S, the situation would be as follows: Until migration, the volume in the legacy system will be considered. As of migration, the “preceding 12 months” will be considered. During the first year after migration this encompasses as many months as possible in T2S and the volumes before migration to T2S for the other months. As an example: 7 months after migration, the basis for calculation would be 7/12 of the volume in T2S and 5/12 the volume in the legacy system.

**14. Is the June deadline for signature mandatory? If several CSDs do not sign by June, will the Eurosystem be forced to waive the entry fee also for late signatories?**

The incentives to commit to T2S at an early point in time are not an ultimatum since CSDs may sign the Framework Agreement at a later point in time. Naturally, the conditions will differ over time. CSDs which have not signed before end of June cannot benefit from the waiving of the entry fee, which will be 25% of their annual fees.

The conditions for waiving the entry fee have been decided and formally offered by the ECB Governing Council as an incentive for CSDs to provide a high degree of certainty for market participants to help them plan their adaptation. They are part of the offer of the ECB President and therefore they cannot be changed.

**15. When possible under the FA, are price changes decided unilaterally by the Eurosystem without consulting CSDs?**

The FA explicitly states in Schedules 7 (Pricing) and 8 (Governance) that the Eurosystem will amend Schedule 7 (Pricing) only after taking the views of the market into account.

The process for changes to Schedule 7 is as follows: The T2S Board submits, on the basis of input from the ECB T2S Programme Office, its analysis and a proposal to the CSG, the NECSG and the AG. Alternatively, any Participating CSD, euro area NCB, non-euro area NCB, the ECB, the 4CB or User member in the AG could propose a change to Schedule 7 to the T2S Board. The T2S Board will then consult the CSG, the NECSG and the AG within a reasonable amount of time, taking into account the urgency of the matter. In case of divergence of views between different Governance bodies, the T2S Board shall aim at reconciling the different views. The CSG or the NECSG can, upon agreement with the T2S Board, ask for a non-binding external advice for relevant matters of T2S except for matters related to safeguarding the integrity of currencies in T2S or to financial stability. A decision on the proposal is taken by the ECB Governing Council or, for matters which have been delegated by the ECB Governing Council, by the T2S Board. This decision will have to respect the prior notice period of 180 calendar days according to FA Article 47 (6). The Contracting CSD and Participating CSDs have the right to challenge the final decision of the ECB Governing Council before the Court of Justice of the European Union.

**Disclaimer:**

The explanations in this document are provided exclusively for information purposes with the aim of clarifying certain provisions of the Framework Agreement in line with the outcome of the negotiations of the Eurosystem and CSDs having signed the T2S Memorandum of Understanding. Nothing in this explanatory note shall be interpreted as changing any of the provisions of the Framework Agreement or creating any additional rights or obligations of either of the Parties to the Framework Agreement as approved by the Governing Council and offered to CSDs on 21 November 2012. This explanatory note is not a legally binding document.