



EUROPEAN CENTRAL BANK

EUROSYSTEM

THIRD PROGRESS REPORT ON TARGET2

On 21 October 2005, the Eurosystem published the second progress report on TARGET2. The report provided details on the start date of the single shared platform (SSP) for TARGET2 (19 November 2007), the envisaged pricing scheme for the TARGET2 core service, the liquidity pooling service and ancillary system settlement, as well as the TARGET2 operational day. In addition, on 21 July 2006 the Eurosystem released the “Communication on TARGET2” with the details of the TARGET2 core pricing scheme and liquidity pooling service, the basic elements of the pricing scheme for ancillary system services and the different ways of participating in TARGET2.

The Eurosystem has continued to work extensively on the new TARGET system. The overall project is progressing as planned and the schedule for testing and migration has already been prepared and published. TARGET2 is well on track: the go-live date of the SSP for TARGET2 was set for 19 November 2007 and this can be confirmed, as well as the two subsequent migration waves, after which all central banks and TARGET users will have migrated to TARGET2.

The purpose of the third progress report on TARGET2 is to update market participants on the Eurosystem’s recent decisions on the outstanding issues on pricing (see Chapter 1) and legal issues (Chapter 2). In addition, the report describes the progress made with regard to contingency procedures (Chapter 3), and the forthcoming testing (Chapter 4) and migration activities (Chapter 5).

I PRICING ISSUES

I.1 PRICING OF ANCILLARY SYSTEMS

In October 2005 and July 2006, the Eurosystem laid down the principles establishing the pricing

of ancillary systems with a view to ensuring cost recovery, striking a balance between price and service, and establishing a level playing-field (between gross and net settlement systems). The pricing scheme will apply to ancillary systems interacting with TARGET2 irrespective of the method of settlement, i.e. through the payment module of the SSP or the proprietary home accounting module, and irrespective of the type of interface, i.e. the ancillary system interface¹ or the payment interface. Three elements of the ancillary system pricing scheme were already agreed upon by the Governing Council and published in the “Communication on TARGET2” of July 2006:

- A fixed fee of €12,000 per year will be charged to each ancillary system that settles in central bank money in the SSP or the NCB’s proprietary home accounting application. This reflects the fact that a certain part of the costs is homogeneous for all systems, irrespective of their importance (e.g. general costs for administration and monitoring);
- The second fixed fee will be different for large-size and small-size systems and falls in the range of €5,000 and €50,000 per year. The size of the system would be approximated to the underlying gross value of the ancillary system’s settlement (i.e. the value of settlement for gross systems, value of positions before clearing for net systems);
- A transaction fee based on a degressive scale applied per ancillary system.

¹ The ancillary system interface module has been defined in a way which ensures maximum security within the settlement process. The use of the ancillary system interface is not compulsory, but the pricing policy eliminates any price advantage for those systems which do not use it.

The transaction fee would be, at the choice of the ancillary system, one of the two options in the core pricing scheme, i.e. €0.80 (Option A) or a degressive structure (Option B). Where the ancillary system opts for the degressive scheme, the limits of the bands of the core pricing scheme would be divided by two to increase the degressive element of the mechanism.

The monthly fixed fees – €100 in the first option, and €1,250 in the second option – shall be paid on top of the two fixed fees mentioned above which are specific to ancillary systems.

In sum, the pricing scheme for the settlement of ancillary systems would be as follows:

| Pricing scheme | | | |
|---|--------------------|---------------------|-------------------------|
| 1 A) Monthly fee plus flat transaction fee | | | |
| Monthly fee: | | €100 | |
| Flat rate transaction fee: | | €0.80 | |
| 1 B) Monthly fee plus degressive transaction fee | | | |
| Monthly fee: | | €1,250 | |
| | Volume (monthly) | | |
| Band: | From: | To: | Transaction fee: |
| 1 | 0 | 5,000 | €0.60 |
| 2 | 5,001 | 12,500 | €0.50 |
| 3 | 12,501 | 25,000 | €0.40 |
| 4 | 25,001 | 50,000 | €0.20 |
| 5 | 50,001 | | €0.125 |
| 2) Fixed fee I: (flat rate) | | | |
| Monthly fee per ancillary system: | | €1,000 | |
| 3) Fixed fee II: (based on daily underlying gross value) | | | |
| (EUR million/day): | Annual fee: | Monthly fee: | |
| €0-1,000 | €5,000 | €417 | |
| €1,001-2,500 | €10,000 | €833 | |
| €2,501-5,000 | €20,000 | €1,667 | |
| €5,001-10,000 | €30,000 | €2,500 | |
| €10,001-50,000 | €40,000 | €3,333 | |
| Above €50,000 | €50,000 | €4,167 | |

The Eurosystem also investigated the issue of which party should be charged with the ancillary system fee. Under the TARGET2 core pricing scheme, every transaction received by the SSP from a direct participant is charged to the sender of the payment instruction. The Eurosystem considered it appropriate that, as a general rule,

any transaction sent or received by an ancillary system be considered an ancillary system-related transaction. As a consequence, in order to avoid charging a system twice, TARGET will not charge banks when they send a payment to an ancillary system.² The ancillary system would then charge its banks in accordance with its own pricing scheme outside of TARGET2.

The pricing aspects relating to the so-called “integrated model” are not covered in this progress report and will be elaborated over the coming months.

1.2 PRICING OF TRANSACTIONS ON HOME ACCOUNTS

The first progress report on TARGET2 of February 2005 stated that transactions between market participants, and transactions relating to ancillary system settlement and to open market operations had to be settled in the payment module.

However, in order to assist the migration of banks and central banks to TARGET2, the Governing Council allowed a maximum four-year transition period (from the moment the relevant central bank joined the SSP), during which time these transactions could be settled on proprietary home accounts in the central bank’s local application. The Governing Council also decided to charge these payments during the transitory period at a rate above the TARGET2 price in order to speed up the move of payment traffic to the SSP.

Hence, payments between market participants and payments relating to open market operations will be charged at a rate higher than “€100 per month and a flat rate of €0.80 per transaction” which corresponds to the fee for a low-volume direct participant in the payment module of the SSP (Option A of the core pricing scheme). The same pricing scheme will be applied to payments

² This implies that these transactions will not be included in the degressive fee charged to the banks, but in the degressive fee charged for the ancillary system’s transactions.

in which central banks connect indirect participants to TARGET2.³

For transactions related to ancillary systems, Fixed fee I, Fixed fee II, and a transaction fee higher than the ancillary system transaction price will be charged if they are settled in the propriety home account during the transition period.

For so-called “central bank customers” that do not meet the TARGET access criteria, NCBs will be free to determine their own pricing.

1.3 PRICING OF LIQUIDITY TRANSFERS

Liquidity transfers are used to shift liquidity between accounts held in the payment module of the SSP, the accounts of the SSP’s home accounting module, and the NCB’s proprietary home accounting application or within these home accounts. Since liquidity transfers do not necessarily fall under the home account pricing scheme, the Eurosystem defined their pricing separately.

Liquidity transfers are defined as all transactions transmitted via a simplified SWIFT MT202 message type (or the corresponding XML message for liquidity transfers)⁴ within/between home accounts and payment module accounts. The TARGET2 core fee will apply to liquidity transfers initiated in the payment module. The pricing of liquidity transfers initiated from the propriety home accounting application/home accounting module and processed within the propriety home accounting module/home accounting module is to be left to the discretion of local central banks.

The pricing scheme for liquidity transfers will be provisional for the first six months following the end of the migration period (i.e. May 2008). During this period, the Eurosystem will closely monitor the use/misuse of liquidity transfers and will thereafter, if deemed necessary, reconsider the pricing scheme.

2 LEGAL ISSUES

2.1 DEFINITION OF A GROUP

In TARGET2, “multi-addressee access” (also known as “technical BICs access”) and liquidity pooling require the definition of a group of participants eligible to use such services. From the point of view of market expectations, transparency and legal simplicity, a universal approach has been taken for the definition of this group in respect of both multi-addressee access needs and liquidity pooling. The definition also takes into account the business needs of the banking communities and is easy to verify.

After due consideration of several options, the Eurosystem agreed to make reference to the International Accounting Standards (IASs).⁵ IAS 27 defines a range of institutions that are bound to publish consolidated financial statements. These include all subsidiaries of a parent company that conform to the subordination rules delineated via a control notion.⁶

All TARGET participants, whose accounts are consolidated on the basis of IAS 27 by the parent company (the parent company does not

3 Such possibility exists during the transition period of four years.

4 In the simplified SWIFT MT202 message, there is a restriction in the format: only fields required for transfers of liquidity are permitted; it is not possible to specify a final beneficiary which is different from the receiver.

5 The application of the IASs was endorsed by the European Parliament and European Council Regulation 1606/2002 of 19 July and became mandatory from 2005 onwards for the financial statements of listed (publicly traded) EU companies.

6 Control is presumed to exist when the parent owns, directly or indirectly through subsidiaries, more than half of the voting power of an entity unless, in exceptional circumstances, it can be clearly demonstrated that such ownership does not constitute control. Control also exists when the parent owns half or less of the voting power of an entity when there is:

- (a) power over more than half of the voting rights by virtue of an agreement with other investors;
- (b) power to govern the financial and operating policies of the entity under a statute or an agreement;
- (c) power to appoint or remove the majority of the members of the board of directors or equivalent governing body and control of the entity is by that board or body;
- (d) power to cast the majority of votes at meetings of the board of directors or equivalent governing body and control of the entity is by that board or body.

necessarily have to be a credit institution), will be regarded as eligible to form a group for the purpose of liquidity pooling and multi-addressee access. For the majority of credit institutions, which already consolidate their group accounts in accordance with the IASs, this approach would provide legal certainty for the Eurosystem that those institutions do indeed form part of a group, since the accuracy is checked by auditors, shareholders, investors and securities' commissions and no additional verification would therefore be necessary.

In other cases where groups do not prepare their annual accounts in accordance with the IASs (e.g. non-listed companies, or groups of which parent undertakings are established outside the EEA), the Eurosystem will verify whether their group composition is equivalent to the definition provided under IAS 27.

Moreover, in its "Communication on TARGET2" of July 2006, the Governing Council acknowledged that networks of savings and cooperative banks could also form a group for the purpose of liquidity pooling, subject to the ex ante approval of the Governing Council. The Eurosystem has now accepted that multi-addressee access will also be beneficial to such networks. As far as the definition of these types of affiliation was concerned, the Eurosystem decided that some of the criteria should be established on the basis of which the Governing Council could take decisions. It is proposed that these bilateral or multilateral networks and associations of credit institutions be: (i) organised through the statutory law governing them (already determining such affiliation) with or without existence of a central institution; or (ii) characterised by self-organised mechanisms of cooperation (promoting, supporting and representing the business interests of their members) and/or economic solidarity going beyond the ordinary cooperation usual between commercial credit institutions whereby such cooperation and solidarity are, as a rule, permitted by their by-laws or statutes or established by virtue of separate agreements.

2.2 MINIMUM SERVICE LEVEL FOR INDIRECT PARTICIPANTS

On 20 July 2006, the Governing Council agreed on the legal framework for indirect participation. However, one relevant aspect of indirect participation is whether a minimum service level from the direct participant vis-à-vis its indirect participant would be required. Since the efficiency and attractiveness of indirect participation could depend on the terms and conditions agreed between the direct and the indirect participant, such a service level could have a positive impact on their business relationship.

The Eurosystem is of the opinion that a minimum service level for indirect participants should be recommended in TARGET2, and therefore expects direct participants to offer the following services in TARGET2 to indirect participants:

1. Confidentiality: to use the information contained in the payment instruction of the indirect participant exclusively for the proper execution of transactions;
2. Correct execution: to process the payment in accordance with the given instruction and exclusively via TARGET2;
3. Same-day execution (value dates): the obligation of the direct participant to execute the payment instruction on the day of its receipt from the indirect participant and to credit amounts received in favour of the indirect participant on the same day;
4. Notice period: the obligation for the direct participant to notify sufficiently in advance the indirect participant of the termination of the status of the direct participant;
5. Requirements for contingency processing: some payments from indirect participants (volumes and nature to be established by the Eurosystem) should be treated by the direct

participant as critical ones when TARGET2 is in contingency mode.

The service level provided should be agreed upon by the direct and its indirect participant(s).

3 CONTINGENCY PROCEDURES

The Eurosystem has made some progress on the concept of (very) critical payments in TARGET2, i.e. payments that should be processed in the event of a contingency. In such an event, TARGET2 will try to recover full processing capacity as soon as possible by means of business continuity (two regions/four sites concept). However, to avoid delayed processing of (very) critical payments causing systemic risk, TARGET2 contingency arrangements will ensure payment processing under all circumstances, for instance, even during the time required to failover from one region to the other.

The definition of (very) critical payments takes into account the technical, operational, liquidity and cost constraints of payment processing in a contingency, whilst exploiting the available processing capacity. A TARGET2 failure caused by a problem with the SSP – unlike TARGET1 – would affect the distribution of liquidity in the whole euro area. Hence, the concept aims at avoiding systemic risk, i.e. the spillover of a TARGET2 failure to other currencies and ancillary systems. As a result, the processing of CLS-related payments, end-of-day settlement of EURO1 and CCP margin calls will be regarded as mandatory in the event of a contingency. The definition of critical payments also allows some room for the central banks to decide, ad hoc, whether further payments should be processed.

A further issue is TARGET2's delayed/enforced closing. Unlike TARGET1, where the failure of a national component can be bridged or isolated,

a failure in the SSP at the end of the day would leave no other option than to wait until the failure were resolved. The work began with the identification of potential scenarios and with the launch of a fact-finding exercise to discover how central banks, banks and ancillary systems would cope with such scenarios.

4 TESTING ACTIVITIES

4.1 USER TESTING

The aim of user testing is to verify the readiness of the participants – at a technical and organisational level – to interact with the SSP of TARGET2. Structured and free tests will be organised at the institution level, at the country level and at the European level. User testing will follow the timetable of the migration waves, leaving six months for the users of the first country window and up to ten months for the users of the subsequent windows. A TARGET2 user test guide with general information on the testing procedures and detailed scenarios for connectivity and interoperability tests was published on 7 November 2006. More information on the following two sub-phases, country and business day testing, will be provided to the users in March 2007.

4.2 TARGET2 TEST RELATED INFORMATION SYSTEM

The TARGET2 Test Related Information System (T2TRIS) is a web-based application designed to facilitate the coordination and communication between all stakeholders during the testing phase. The T2TRIS will be available to all TARGET2 users via the TARGET2 website by the end of 2006, and will provide them with all information relevant for the preparation, planning, actual performance of and reporting on TARGET2 user testing activities.

5 MIGRATION ACTIVITIES

5.1 NATIONAL MIGRATION PROFILES

The Eurosystem developed the National Migration Profiles which provide a structured overview of the set-up of all central banks on their first day of operation in TARGET2. The National Migration Profiles are valuable tools for participants to decide on their future account structure in TARGET2. The first version was published in May 2005. Profiles have recently been enriched with further information on ancillary systems' settlement and on the national rules for account usage. Moreover, by the end of 2006, profiles will be amended to reflect longer-term information, e.g. changes that are expected until the end of the transition phase.

5.2 MULTI-COUNTRY BANKS

In November 2004, the Eurosystem opted for phased migration in order to limit the overall project risk. At the same time, the Eurosystem also committed itself to minimising the effect of such a migration strategy, in particular on multi-country institutions. In this context, the Eurosystem – in collaboration with the users – investigated mainly two aspects. First, the certification process should not lead to unjustified repetition of tests when banks from several central banks connect to TARGET2. Second, multi-country banking groups should have the means to limit the effect of the phased

migration, in particular if their Head Office is migrating in the second or third group. The Eurosystem will elaborate further the issue of multi-country banks with concrete proposals, which will be in line with the prevailing assumptions with regard to: i) the phased migration approach; ii) the traffic allocation to the migration windows; iii) the strategic consolidation efforts of a multi-country bank; and iv) the level playing-field principle.

5.3 REGISTRATION PROCESS

The registration of participants for the SSP will be performed by the Eurosystem. For the sake of neutrality in the migration period and in order to ensure a fair registration process, the SSP registration forms will be available to all TARGET2 direct participants (irrespective of which migration wave they belong to) in the first quarter of 2007. The SSP registration forms will enable all TARGET2 direct participants to provide, in detail, their participation data, services used, account usage details, etc. as well as to register indirect participants and “addressable BICs”, which will ultimately feed into the TARGET2 directory.

In a separate procedure, and based on an electronic form (e-ordering), participants will also need to register with SWIFT in order to obtain the appropriate SWIFT services for participation in TARGET2.

© European Central Bank 2006

Address: Kaiserstrasse 29, D-60311 Frankfurt am Main, Germany.

Postal address: Postfach 16 03 19 60066 Frankfurt am Main, Germany

Telephone: +49 69 1344 0; Website: <http://www.ecb.int>; Fax: +49 69 1344 6000; Telex: 411 144 ecb d

All rights reserved. Reproduction for educational and non-commercial purposes is permitted provided that the source is acknowledged.

ISBN 92-899-0036-9 (online)