



EUROPEAN CENTRAL BANK

PROGRESS REPORT ON TARGET2

INTRODUCTION

On 24 October 2002, the Governing Council of the ECB decided on the long-term strategy for TARGET (TARGET2). The decision was outlined in a press release published on the same day and envisaged a technical consolidation of the TARGET system, a single Eurosystem-wide pricing structure for domestic and cross-border payments, and a harmonised service level. On 16 December 2002, a public consultation was launched on a document entitled “TARGET2: principles and structure” and a summary of the comments received was published on 13 July 2003.

On 28 July 2003, three central banks, namely the Banque de France, Banca d’Italia, and Deutsche Bundesbank, informed the President of the ECB of their readiness to jointly provide the basis for the Single Shared Platform (SSP) by using adapted parts of their existing TARGET1 infrastructures complemented with the necessary ad hoc developments (i.e. the so-called “building block” approach). By the end of 2003, the Eurosystem central banks had expressed their willingness, subject to further elaboration on governance, cost and financing issues, to join the SSP. Since then, the Eurosystem has based its further project work on the assumption that TARGET2 would be shaped as a single-platform system.

As regards its features and functionalities, the TARGET user community was invited to provide comments on a draft version of the General Functional Specifications (GFS) for the SSP, after which the document was finalised and approved by the Governing Council of the ECB on 22 July 2004.

The current report elaborates on a number of issues that needed to be settled in order to enable each central bank to finally decide on its participation in the SSP. Section 1 addresses open issues regarding the TARGET2 service, namely liquidity pooling, home accounts and ancillary systems settlement. Section 2 deals with the pricing of the TARGET2 service. Section 3 deals with migration issues. Finally, section 4 provides some further information on the TARGET2 project plan.

I TARGET2 SERVICE

I.1 POOLING OF INTRADAY LIQUIDITY

The pooling of intraday liquidity by means of a virtual account (hereafter referred to as liquidity pooling) will allow TARGET2 participants to group (some of) their RTGS accounts and to pool the available intraday liquidity for the benefit of all members of the group of accounts. Each member of a group of accounts can thus make payments from its own account, up to the sum of available intraday liquidity on the accounts in the group. Instead of shifting liquidity to the account where it is needed, a sound legal framework will ensure that a debit position on one account in the group is collateralised during the day by the cash available on the other accounts in the group. At the end of the day, a levelling-out procedure – either manually by the group-of-accounts’ manager, or, if need be, automatically by the system – will aim for a positive balance for all accounts in the group and ensure that account balances respect overdraft limits (if any).

The Eurosystem stresses that the provision of the intraday liquidity pooling feature is solely a payment systems matter which will not translate into the centralisation of the conduct of monetary policy operations.

I.1.1 LIQUIDITY MANAGEMENT

The liquidity pooling feature will contribute to the smooth functioning of TARGET2 and of ancillary systems that settle in TARGET2. Due to the availability of the entire liquidity on the accounts within the group, there may be less need for intraday credit. As a result, collateral needs and the risk of gridlock will diminish. This will facilitate, inter alia, the settlement of ancillary systems, whose participants will have access to the group of accounts’ total available liquidity (and overdraft limits).

Liquidity pooling partly disconnects liquidity management from collateral management, since the liquidity can be made available to the whole group of accounts without collateral movements,

which results in cost savings for the TARGET2 users. In addition, the feature will decrease the cost of managing several accounts with one or several central banks and will effectively “neutralise” the fragmentation of intraday liquidity experienced by multi-country banks that need to maintain accounts with several central banks.

I.1.2 LEGAL FEASIBILITY

Liquidity pooling by means of a virtual account would generally be legally feasible in the relevant jurisdictions of the euro area countries. Local law in the relevant jurisdictions of almost all the central banks could allow the use of cash accounts as collateral. Furthermore, the cash balances on these accounts in the books of one central bank could be used as collateral in favour of another central bank in almost all relevant jurisdictions.

As regards third party collateralisation, the conclusion of an adequate agreement between the collateral provider and the debtor whose debt is being collateralised can reduce the legal risk of non-enforceability of the collateral arrangement to an acceptable level, except, for the moment, for some jurisdictions located outside the euro area.

Further careful examination and legal work is required in order to establish a robust legal framework, which is a precondition for offering this feature. The Eurosystem will also analyse whether there should be restrictions, from a legal or policy viewpoint, with regard to the entities (e.g. branches, subsidiaries and separate legal entities) allowed to participate in a group of accounts.

I.1.3 ACCOUNTS ELIGIBLE FOR LIQUIDITY POOLING

Following a careful assessment (including legal feasibility), the Eurosystem decided that the intraday liquidity pooling feature will be provided in the SSP only for RTGS accounts¹

¹ Excluding, however, accounts of remote participants because remote participants are not entitled to receive intraday credit from the host central bank.

of euro area banks held with euro area central banks.

However, all banks, including those which will not be allowed to use the virtual account facility, will have access to consolidated account information.

1.1.4 INTEREST FROM THE TARGET USERS AND PRICING

The estimated annual total cost of the liquidity pooling feature of around EUR 900,000 was communicated to the TARGET users. Preliminary results of a survey of the market participants showed that, on this basis, between 60 and 120 accounts could be pooled, resulting in an annual fee per pooled account of between EUR 7,500 and EUR 15,000 in order to recover the costs of the liquidity pooling feature. The pricing of the consolidated information feature will be elaborated in the coming months.

1.2 HOME ACCOUNTING ISSUES

The Eurosystem considered the issue of so-called “home accounts” which can be kept outside the RTGS system (i.e. outside the Payment Module (PM) of the SSP). Such home accounts are today primarily used to manage minimum reserves, standing facilities and local collateral and to settle cash withdrawals. In addition, such accounts are used to record the transactions of central bank customers that are not (cannot be) participants in the RTGS system. In the TARGET2 environment, home accounts may be held in the standardised Home Accounting Module (HAM) of the SSP or in a “proprietary home accounting application” (PHA) of each central bank.

The Eurosystem agreed that transactions between market participants and transactions stemming from the settlement of ancillary systems, as well as payments related to open market operations should ultimately be settled in the PM of the SSP. However, for those types of transactions the domestic set-up in some countries may not allow for an immediate shift of these operations to the SSP at the start of its operations. As a

result, the Eurosystem agreed on a maximum transition period of four years (from the moment the relevant NCB joins the SSP) for settling these payments in the PM of the SSP. In the case of ancillary systems, it is expected that pan-European ancillary systems will move when, or soon after, all central banks have moved to the SSP. The situation would be reassessed one year after the start of TARGET2.

Certain operations with the local central bank (i.e. minimum reserve management operations and recourse to standing facilities as well as cash withdrawals) can, depending on the choice of each central bank, either be settled in the central bank’s local PHA or in the SSP (in the PM or in the HAM).

In order to support the policy line regarding the usage of home accounts, the payments made through home accounts will be priced at a higher level than the normal TARGET2 price. This will serve as an incentive to shorten the transition period and move to the PM of the SSP as quickly as possible.

1.3 ANCILLARY SYSTEMS SETTLEMENT

The Eurosystem consulted market participants, who confirmed that the six settlement models offered by the SSP for the settlement of ancillary systems (i.e. two real-time and four batch models), as defined in the General Functional Specifications, are necessary, because each of them serves one or more business purposes. These models already represent a substantial harmonisation of current practices. In addition, the settlement of cash positions coming through ancillary systems into TARGET2 will take place directly in the participant’s RTGS account in the SSP, independent of the location of the ancillary system. This represents a major step towards the integration and harmonisation of market practices.

As regards the issue of night-time settlement, there are no plans at present to open TARGET2 during the night. However, it is envisaged to start the next TARGET2 business day for a

predefined time window after the close of the TARGET2 business day and the finalisation of the end-of-day processing. During this time window, liquidity can be used specifically for the settlement of overnight cycles of ancillary systems. Subsequently, the PM of the SSP would re-open early and would process settlement requests from the ancillary systems before 7 a.m. Afterwards, the liquidity that was not used for overnight settlement would become available again.

Several other issues which have an impact on ancillary systems settlement (e.g. possible harmonisation of settlement times, analysis of the overall liquidity impact of the new arrangements in TARGET2, policy and strategic aspects that the different settlement models could raise, remote participants' access to liquidity, self-collateralisation, settlement finality, etc.) require further discussion and elaboration, which is scheduled for the first half of 2005. In particular, issues related to the co-existence of SSSs which have adopted different settlement models (integrated, interfaced or pre-funded), as well as the details of these individual models, must be further investigated.

2 PRICING

The Eurosystem has elaborated on a methodology for a possible dual pricing scheme for the TARGET2 core services which should allow participants to choose between a transaction fee only or a lower transaction fee plus a periodical fee. It envisages the following main principles:

- i. The scheme should permit recovery of a very large part of the total TARGET2 costs;
- ii. The highest transaction fee should not exceed EUR 0.80; and
- iii. The lowest (marginal) transaction fee should reach EUR 0.25 per transaction.

Some simulation exercises were carried out in order to verify that the above principles are compatible with the cost and volume estimates for TARGET2. The Eurosystem intends to work out a concrete fee structure for TARGET2 in the coming months.

It should be recalled that certain optional services (e.g. liquidity pooling and settlement of transactions of ancillary systems) will be priced separately.

3 MIGRATION

The objective of the TARGET2 migration is to enable a smooth transition from the current TARGET to the new TARGET2 system for all players (central banks, financial institutions and ancillary systems). It covers the coordination of all activities after the development of its technical components and until all central banks have moved to the SSP. In particular, it encompasses testing activities and the organisation of the changeover to TARGET2.

The Eurosystem assessed the advantages and disadvantages of a "big bang" migration compared with a phased migration by "country windows". In concrete terms, a big bang approach would mean that on the first day of operation of TARGET2, all central banks and TARGET users would have to migrate simultaneously to the SSP. From a "level playing field" perspective, it would be preferable for all TARGET2 features to be available to all participants at the same time. However, migrating all users from all countries to the SSP at the same time would create an enormous project risk and would provide no flexibility in the organisation of the changeover.

For this reason, the Eurosystem opted for a country window approach, allowing TARGET users to migrate to the SSP in different waves and on different pre-defined dates. Each wave will consist of a group of central banks and their respective national banking communities. The migration process will be spread over several months, during which both TARGET1

components and the SSP will co-exist. Such a phased migration will have to be organised in a way which minimises project risk. Within this framework, another important consideration will be to minimise level playing field problems and costs for central banks and TARGET users. The migration period will be limited to a maximum of one year, while the working assumption (see section 4) is that this time should be shorter. It should be noted that other payment systems-related projects of similar size (e.g. CLS, SWIFTNet) also employed a phased migration to the new infrastructure.

The Eurosystem will define the country windows according to business needs. The pricing policy during the migration period will be determined after the country windows have been defined and will aim at ensuring maximum neutrality vis-à-vis the users.

4 TARGET2 PROJECT PLAN

At the current stage of the project, the following main milestones are envisaged. Each is subject to the completion of the previous steps.

Table Milestones 2005-2007

1.	End of Q1 2005	Finalisation of the User Detailed Functional Specifications (UDFS) document
2.	April 2005 to December 2005	Completion of the development of the SSP
3.	January 2006 to March 2006	SSP internal testing
4.	April 2006 to May 2006 (tentative)	Acceptance testing by the central banks
5.	June 2006 – December 2006 (tentative)	Customer testing for the first country window (TARGET users migrating in later windows might also take part in these tests)
6.	December 2006	Live trials / activities in the production environment
7.	January 2007	Go-live for the first country window
8.	January 2007 – September 2007	Customer testing, live trials, etc. and go-live for the other country windows

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