

European Central Bank
Secretariat Division
Kaiserstrasse 29

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Milan, 7th of May

Response of ECSDA to the TARGET2 consultation of ECB

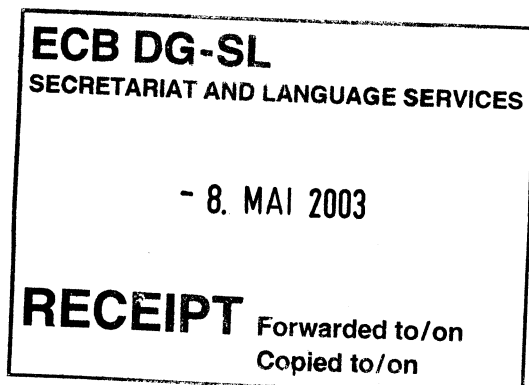
Dear Sirs,


I am pleased to send you the response of the European Central Securities Depositories Association (ECSDA) regarding the Consultation of the ECB on TARGET2; an electronic copy of the attached document has been sent to the email address mentioned in the consultation. The response was prepared by ECSDA Working Group 3 and reviewed by the members of the ECSDA Management Committee.

Payment and securities settlement systems are increasingly connected and the cash transfer is considered as one of the most important and critical issues in the area of cross border securities settlement, therefore we would like to thank ECB for the opportunity to comment on a such critical issue.

On this occasion, I would also like to confirm ECSDA availability to further discuss the attached document and any other related matter.

Warmest regards




Giovanni Sabatini
Chairman of ECSDA

Answer of ECSDA to the consultation of ECB concerning TARGET2 (dated 16.12.02)

Mai 2003

1 Introduction

ECSDA is in favor of the objective of the European Central Bank to harmonize the payment systems across Europe as this will further contribute to the integration of the European financial infrastructure and to the creation of a single EU financial market. We welcome the idea of the ECB to provide one shareable platform and to give the single national banks the choice of

- utilizing the shareable platform, giving up their own system
- sharing their own platform with other countries (e.g. regional polarization)
- continuing to use their own domestic platform.

A network approach or the polarization of the payment system infrastructures, i.e. on a regional basis and on the shareable platform of ECB, could be an important step towards greater European harmonization and integration. It should be mentioned that such a network approach can be considered a mere technical integration and standardization and that no legal consolidation of national banks will be required. This means that despite using a shared platform, accounts and relationships may be operated by the single national banks during a sufficiently long transition phase (this is considered important for changing the infrastructure and educating users).

Special attention should be paid to define the user requirements for TARGET2 and to analyse the interaction/ interfaces to ancillary systems like securities settlement systems (SSS). We would like to draw your attention to some of the most important requirements of TARGET2 regarding securities settlement systems. Please note that these requirements are only a subset and that a more detailed discussion and analysis has to be done together with ECB.

2 Requirements of SSS regarding TARGET2

2.1 Background

Most countries in the EU avail of safe and efficient DVP securities settlement systems (because no seller will deliver securities without receiving the counter-value in cash and vice versa). Additional safety is added by allowing for payment through central bank money. The payment in central bank money requires an exchange of information between the SSS and the system of the central bank. The exchange can be organised in different ways. Either the SSS initiates the payment in the system of the central bank or part of the balance of the central bank system is kept in accounts in the system of the SSS (cash memorandum accounts).

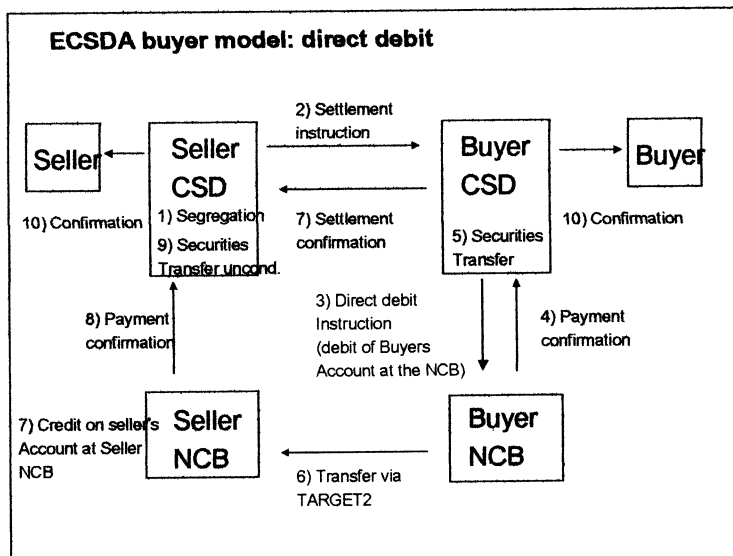
For the DVP settlement to be not only safe, but also efficient, the SSS needs certain control over the transfer of the money. It must be authorised to transfer cash from the buyer to the seller and it must be able to monitor the transfer.

2.2 Direct Debits

When it comes to DVP settlements between participants in different SSSs (cross-border settlement), the same principles of safety and efficiency are more difficult to implement. More systems have to interact with each other and the systems operate in different jurisdictions. One particular difficulty is the settlement of the cash leg of a securities transaction.

Under existing procedures, cross-border **direct debiting** would be expensive and not transparent due to different domestic schemes and national legal environments (common features of the various national schemes are e.g. the preauthorization and the debtor's right of revocation). It should, therefore, be ensured that there will be a European-wide standard for direct debits (including consistent rules of finality) and that direct debits will be supported by the technical infrastructures of TARGET2.

When regarding the Buyer Model developed by ECSDA, the Buyer SSSs¹ should be able (i) to debit the buyer in his national central bank (NCB), (ii) to make a transfer via TARGET to the seller's account in the NCB of the seller and (iii) to monitor the whole transaction (see graphic below).



¹ Seller CSD or Buyer CSD can be equally represented by a group of integrated CSDs operating on the same platform that permits settlement to take place intra-day by book-entry on a delivery-versus-payment basis (i.e. using the central banks' cash memorandum accounts on the platform).

With the updated Investment Services Directive (ISD) market participants and regulated markets would have the absolute right to choose the location of trading and settlement (single European passport).

Also in this case, e.g. with remote access of the intermediary to a trading system in another country, a direct debit scheme would be of advantage as regarding the cash leg of the transaction, the intermediary (buyer) would have the possibility to regulate the cash in its own country without involving an additional party in the chain. The transfer of the cash would be initiated by the SSS by sending a direct debit message via its own NCB and TARGET2 to the NCB the intermediary, where the account debit is done in the account of the intermediary. The CSD, in this case, has full control of matching, settlement and payments.

To conclude, for SSS, the direct debit offers the advantage that the money transfer could be initiated and controlled more easily by the CSD (and in close connection with the securities settlement), that the time required for the transfer of the cross border cash leg could be shortened and that the number of payment messages could be reduced.

2.3 Earmarking and transfer of reserves

Another alternative to be considered would be to allow intermediaries to **earmark reserves** of cash for ensuring the smooth securities settlement, not only in the domestic securities settlement system, but also within another SSS. In this case, on the one hand a domestic intermediary might instruct (for example daily in the evening or on a default basis) its domestic national central bank to attribute part of its total cap for securities settlement (e.g. 70%) to its domestic SSS and part (e.g. 30%) for settlement in another SSS. The domestic NCB would then pass on the information and the percentages to the foreign NCB where the reserve would be constituted. Vice versa, also the foreign investor could transfer intra-day reserves to the domestic NCB.

However, in order to carefully monitor the earmarked reserves and to observe any updates of the allocations and utilizations, a close cooperation within the Eurosystem will be needed.

2.4 Integrated and interfaced model

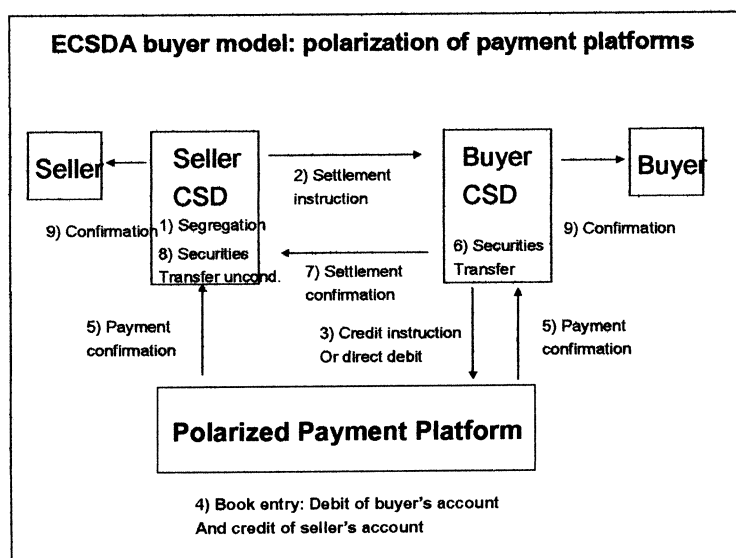
ECSDA welcomes the approach mentioned in the ECB's consultation to give the single national platforms the choice to keep their settlement models, e.g. the **interfaced or integrated model**. For the ECB's shareable platform, it is likely that only one settlement model can be supported in the future. For some countries, changing the settlement model may not be easy considering the specific domestic laws and the impact on the systems' users. Before deciding which settlement model will be supported, a business case would be required; the business case should include an analysis of the acceptance of both models by Western Europe and accession countries, the advantages and disadvantages of each settlement model and the costs for changing the single domestic infrastructures compared with the costs of supporting both models by the shared platform. Such analysis

should specifically take into account any existing outsourcing arrangements in place between central banks and SSS for book-entry DVP settlement in central bank money on the platform of the SSS.

3 Outlook: Benefits of a polarization of payment systems for SSS

Finally, as a further step, besides the above mentioned new functionalities required, a polarization of payment systems (i.e. the shared platform of the ECB and some regional poles) would offer further advantages for SSS.

If both SSS were participants in the same payment platform and if the necessary legal framework were in place, DVP settlement would be facilitated as the cash transfer will take place by a mere book transfer within one technical system (even if single NCB continue to operate accounts and relationships). As described in the graphic below, the ECSDA buyer model will be simplified as well:



As the cash will remain in the technical payment system where both intermediaries have their accounts (like a local payment), there will no longer be the need to transfer cash via TARGET cross border to the other domestic payment system. The transfer of cash could be done by a simple book entry on the cash accounts of the intermediaries held with the payment system, without the exchange of multiple payment messages. Also the chain of the parties involved in a cross border securities transaction will decrease, since there will no longer be the need to use cash clearers, which are currently providing access to foreign payment systems. Cross border DVP settlement will take place faster, the total costs of a transaction will decrease and risk will be significantly lower because the time gap between effecting and receiving the payment will be minimal and because less systems will be involved.²

² In line with the above model, it can be envisaged that such arrangement would also apply to those seller or buyer CSDs that have merged and/or that operate on a single platform. In this case, both the securities and cash leg of the securities transaction settle by book-entry on the single platform (i.e. using the central banks' cash memorandum accounts on this platform), with end-of-day positions being transferred through TARGET.