



TARGET Newsletter

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The **objective** of the TARGET Newsletter is to inform the user community and the general public about relevant issues surrounding the TARGET2 system in operation.¹ The Newsletter contains articles of special interest, and provides insights and opinions from relevant system participants.

Introduction

The seventh issue of the TARGET Newsletter was published in December 2013. Since then the TARGET2 system has continued to run smoothly, with the TARGET2 Single Shared Platform (SSP) achieving 100% availability. In the first half of 2014, TARGET2 settled a daily average of 364,127 transactions, with an average daily value of €2,012 billion. With a market share of 61% in terms of volume and 91% in terms of value, TARGET2 maintained its dominant position in the market for large-value payments in euro. The stability of TARGET2's market share confirms the strong interest among banks in settling in central bank money. In total, 24 central banks in the European Union and their respective user communities are connected to TARGET2, including the 19 central banks in the euro area (including the ECB)² and five central banks in non-euro area countries.³

About the TARGET Newsletter

This issue of the TARGET Newsletter contains two special interest articles, "Tiered participation in TARGET2" and "Renew and innovate to keep pace with market changes: the challenges and opportunities of T2S". There are also two boxes presenting a list of items recently published on the TARGET2 website and providing information on the main TARGET2 indicators in the first half of 2014. In addition to the boxes, two charts depict TARGET2 traffic trends in detail. The final part of the Newsletter includes a calendar of events and details of additional sources of information on TARGET2.

The next issue of the TARGET2 Newsletter, the ninth, is scheduled for publication in the second half of 2015.

¹ In the following paragraphs, the references made to the first-generation TARGET system (which was in operation from January 1999 to May 2008) are also applicable to its second-generation successor, TARGET2 (which has been in operation since November 2007). Indeed, the second-generation system continues to provide euro RTGS services, but with significant improvements. This is the reason for both the first and second-generation systems being referred to as "TARGET" in many instances in this Newsletter, i.e. without any distinction being made between TARGET and TARGET2.

² The ECB and the central banks of Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Portugal, Slovenia, Spain and the Netherlands, as well as those of Malta and Cyprus, which joined the euro area in January 2008, Slovakia, which joined the euro area in January 2009, Estonia, which joined the euro area in January 2011, and Latvia, which joined the euro area in January 2014.

³ The central banks of Denmark, Poland, Lithuania, Bulgaria and Romania.



Recently published on the TARGET2 website

<http://www.target2.eu>

- 18/11/2014 - Information Guide for TARGET2 users (version 8.0)
- 12/11/2014 - Go-live of the SSP release 8.0 on 17 November 2014 in production
- 11/11/2014 - Updated User Guide for Collection of Static Data
- 28/10/2014 - Quarterly update of the TARGET2 performance indicators
- 13/10/2014 - Updated User manual internet access for the public key certification service (Version 1.2)
- 13/10/2014 - Outcome Joint meeting September 2014 of the TWG and the WGT2
- 07/10/2014 - List of TARGET2 participants
- 01/10/2014 - ICM user handbook for SSP release 8.0
- 01/10/2014 - Definition of Authorisation and Interoperability testing for the TARGET2/T2S interface for TARGET2 participants
- 08/09/2014 - Communication to users on availability of SSP release 8.0 for testing
- 04/08/2014 - Revised table with settlement times of ancillary systems
- 04/08/2014 - New AS profile for "EBA CLEARING – STEP2"
- 30/07/2014 - Qualified indicators for Internet access (August 2014) – to be used from release 8.0
- 24/07/2014 - Quarterly update of the TARGET2 performance indicators
- 14/07/2014 - A Discussion Paper on Cash and Collateral Aspects related to TARGET2-Securities
- 07/04/2014 - List of TARGET2 participants
- 01/07/2014 - Communication on testing activities for SSP release 8.0
- 30/05/2014 - Revised table with settlement times of ancillary systems
- 30/05/2014 - Updated country profile for NL and updated AS profile for IBERPAY SNCE
- 14/05/2014 - Removal of AS "Euronext Paris s.a."
- 08/05/2014 - New AS profile for JCC SEPA SDD and updated country profile of Cyprus
- 30/04/2014 - Quarterly update of the TARGET2 performance indicators
- 10/04/2014 - Minutes Joint meeting February 2014 of the TWG and the WGT2
- 07/04/2014 - List of TARGET2 participants
- 20/03/2014 - Delivery of UDFS v. 8.0
- 14/03/2014 - Revised table with settlement times of ancillary systems
- 14/03/2014 - New AS profile for Hellenic Central Securities Depository S.A. (replacing HELEX)
- 10/03/2014 - Content of SSP Release 7.01 – Bug fix
- 24/02/2014 - Revised table with settlement times of ancillary systems
- 24/02/2014 - Updates of AS profiles
- 24/02/2014 - Communication to the user community on SSP release 9.0 - First user consultation and main milestones
- 24/02/2014 - Outcome of the second user consultation of the ISO 20022 strategy for TARGET2
- 24/02/2014 - General Functional Specification of the MX/ISO 20022 migration – V1.2
- 03/02/2014 - Revised table with settlement times of ancillary systems
- 03/02/2014 - Removal of "Settlement System of Ordinary Payments (ESTA)"
- 03/02/2014 - Quarterly update of the TARGET2 performance indicators
- 29/01/2014 - Updated User manual internet access for the public key certification service
- 28/01/2014 - Updated AS profile for BISERA7-EUR
- 17/01/2014 - Updated AS profile for LCH.CLEARNET SA (CCP)
- 14/01/2014 - Updated Country profile for FI and removal of AS profile PMJ-AS
- 06/01/2014 - List of TARGET2 participants

Special interest article

Tiered participation in TARGET2

By Peter Rosenkranz and Sara Testi, ECB

Tiering and its relevance to TARGET2

Tiered participation arrangements occur in a payment system when a direct participant in such a system provides services that allow other participants to access the system indirectly. The tiered (or indirect) participant⁴ thus benefits from access to the clearing and settlement facilities offered by the direct participant.

Tiered participation arrangements may occur for various reasons. For example, certain entities may be legally prevented from becoming a direct participant due to their residency, or they may choose to remain connected indirectly for economic reasons. While indirect participants can still benefit from the settlement facilities offered by the system, this type of arrangement also entails certain risks. Indeed, tiered participation arrangements create dependencies that may lead to risks for the payment system, its participants and the stability of the financial system as a whole.

The existence of such risks is reflected in the CPSS-IOSCO Principles for financial market infrastructures with the introduction of Principle 19: “**An FMI should identify, monitor, and manage the material risks to the FMI arising from tiered participation arrangements**”.

While direct and indirect participants are responsible for managing the risks arising from the exposure of interdependencies, Principle 19 requires a financial market infrastructure (FMI) to be able to access information on material dependencies and concentration of risks arising from a tiered structure which may have an effect on itself or its participants. This should be done by identifying those indirect participants that generate a significant share of transactions or whose values/volumes are large relative to those of the direct participant through which they access the FMI. The risks arising from tiered participation arrangements should be reviewed regularly and are three-fold:

- **Credit risk** may arise when a direct participant, acting as a settlement bank, grants a credit line to an indirect participant or when an indirect participant places a deposit with a settlement bank to pre-fund its payments. Credit risk would materialise if one party fails while owing money to the other party.
- **Liquidity risk** may arise if a settlement bank uses its own liquidity to make payments on behalf of an indirect participant, and relies on scarce offsetting incoming payments to the indirect participant. Conversely, an indirect participant may also be exposed to liquidity risk if the settlement bank decides to cut its credit lines at short notice and it is reliant on funding from the settlement bank to meet its payments.
- **Operational risk** may arise because indirect participants are dependent on direct participants to make payments on their behalf. Any operational incident preventing payments from/to the settlement bank from being processed would affect their indirect participants and, ultimately, may spill over to other participants and the financial system.

Owing to the magnitude of their turnovers, such risks are relevant in particular to high-value payment systems. Until recently, no precise quantification of the level of tiered participation in TARGET2 had been carried out for the system as a whole;⁵ the reason being that the level was perceived as low and not regarded as a critical issue. However, in order to improve knowledge of the system and its interdependencies, and with a view to ensuring compliance with the CPSS-IOSCO Principles, the TARGET2 operator has now carried out a study on the level of tiering in TARGET2.

⁴ In this article, the term “indirect participant” is used to designate participants that are connected indirectly, using the services of a direct participant. This term should not be confused with “indirect participant” as defined in the TARGET2 Guideline, which is a legal concept stemming from the Settlement Finality Directive (SFD).

⁵ Some analyses have, however, been carried out at the level of national components.

Methodology used and challenges encountered

The prerequisites for such an analysis are (i) a precise definition of a “tiered payment” in TARGET2, (ii) a complete banking group directory, and (iii) a representative sample of transaction-level data. As this is the first time that such study has been carried out for TARGET2, several methodological challenges were encountered.

Regarding the definition of a “tiered payment”, it was important to agree which payments should be identified as tiered and which set of indicators should be used to depict the risk stemming from tiered participation in TARGET2. Starting from the more general definition of a tiered participation arrangement, it was decided to include as tiered payments only those payments that are sent or received by a direct participant on behalf of another bank that does not belong to the same banking group. To select the appropriate risk indicators for tiered payments, several questions needed to be answered.

- The first question was whether they should be based on “sent” tiered payments, “received” tiered payments or both. Focussing on the “sending” side seemed to be more appropriate. Indeed any problems occurring on the “sending” side, e.g. a technical failure of the indirect participant or bankruptcy of the direct participant, would prevent the payment reaching TARGET2. As a consequence, the central bank money would not be transferred to the account of the “receiving” direct participant and thus to its tiered participant. Conversely, if the problem occurs on the “receiving” side, while the final beneficiary may not be able to access the funds in its account with the “receiving” direct participant, central bank money would at least have been correctly booked in the TARGET2 platform. For that reason, and from the perspective of TARGET2 and central bank money allocation, the risk stemming from tiered participation arises mainly on the “sending” side. A payment is tiered on the sending side if the originator and the sending settlement bank belong to two different banking groups.
- The second question concerned the distinction between the number of transactions (i.e. volume) and the value. As the main focus should be on the mitigation of systemic risk, the value-based indicators appear to be more relevant, especially for large-value payments that generate large amounts of turnover.
- The analysis has also been complemented by some additional statistics, including the number of direct participants used by an indirect participant or the number of tiered participants per direct participant.

Problems arose in connection with the prerequisite of a banking group directory owing to lack of information in the TARGET2 directory. An attempt to use the TARGET2 directory to pin down tiered payments led to several problems. First, a substantial proportion of the institutions involved in the payment activities could not be found in the directory. While almost all direct participants could be identified, this was not the case for many indirect participants. Second, it was not straightforward to determine the underlying banking group composition, since the participation type definition for the TARGET2 directory is not tailored to a detailed banking group analysis. Consequently, the TARGET2 directory turned out to be rather inadequate for an analysis of tiered payments in TARGET2. Therefore, the exercise was eventually carried out using a banking group directory of an external provider, which allowed a more complete and more accurate banking group differentiation thanks to the presence of a group parent key identifier.⁶ A description of how the payment chain was reconstructed and eventually populated using the banking group identifier is given below.

⁶ Thanks to the completeness of the database, it was possible to identify the participants involved in the payment chain and to assign them to a banking group for more than 99% of the transactions considered.

⁷ See the special interest article “The TARGET2 simulator” in TARGET Newsletter issue number 7 (16 December 2013).

The third prerequisite was met with the aid of the TARGET2 simulator environment,⁷ which includes a TARGET2 database at transaction level. This database has recently been enhanced with information on the originator bank and final beneficiary bank for each payment. This is of great importance for the analysis of tiered payments since it allows the whole payment chain to be reconstructed. To thoroughly assess the degree of tiered participation in TARGET2, it was also important to use a representative data sample and to ensure that the results were not driven by seasonal patterns or single day events. For this reason, June, which is usually a month of high traffic, was chosen to be part of the sample. Moreover, in order to have a longer, and therefore richer, time series, May and July were also included in the sample. As a result, the complete sample consists of data from May to July 2013.

Finally, a choice had to be made as to which payment categories to include. It was decided to focus on customer payments, interbank payments and ancillary system payments. Central bank operations, technical operations,⁸ and intra-group transfers were excluded for the following reasons: central bank transactions are normally undertaken directly with the counterparty and not through intermediaries; technical transactions do not have real underlying business content; and intragroup transactions are conceptually different from tiered transactions, as the actors belong to the same entity.

Reconstructing the full payment chain

For an analysis of tiered participation, it is crucial to identify not only the settlement banks involved in each payment, but also the originating and final receiving institution. The TARGET2 simulator data allows the reconstruction of such a payment chain in a straightforward manner.⁹ It is, of course, important that the fields are properly populated by the direct participants when submitting the payments to TARGET2. While there is no easy way to check, it is reasonable to assume that all fields were properly populated by participants because this is both recommended in the standards used for payments (in particular the SWIFT standards) and an anti-money laundering requirement (in particular in the AML Directive). In Table 1, which outlines the concept, the four (potentially) different parties involved in a payment are represented by different example BIC11s.

Table 1: Example of a payment chain

<i>Sending side</i>		<i>Receiving side</i>	
<i>Originator</i>	<i>Sending settlement bank</i>	<i>Receiving settlement bank</i>	<i>Beneficiary</i>
<i>PARTXXYYIZZ</i>	<i>PARTXXYY2ZZ</i>	<i>PARTXXYY3ZZ</i>	<i>PARTXXYY4ZZ</i>

Identification of tiered payments

As a next step, it is crucial to assign each institution involved in the payment chain to a banking group. This allows intra-group and extra-group transactions to be distinguished, the latter then being identified as “tiered payments”. For this purpose, the information on banking groups available in the banking directory has been used, and each BIC11 involved in the payment chain has been populated with the unique banking group parent key. Table 2 outlines this additional step.

⁸ E.g. internal transfers between a participant’s main account and a sub-account.

⁹ For the reconstruction of the payment chain, the fields *t_BIC52/56/57/58*, *t_asdebt* and *t_ascred* are used.

Table 2: Example of a payment chain populated with banking group information

Sending side				Receiving side			
Originator	Key	Sending settlement bank	Key	Receiving settlement bank	Key	Beneficiary	Key
PARTXXYYIZZ	1	PARTXXYY2ZZ	2	PARTXXYY3ZZ	3	PARTXXYY4ZZ	4

As a consequence, the following categories of tiered payments have been identified:

- A. a payment is tiered on **the sending side only** if (i) the originator and the sending settlement bank have different group parent keys and (ii) the beneficiary and the receiving settlement bank have the same group parent key;
- B. a payment is tiered on **the receiving side only** if (i) the beneficiary and the receiving settlement bank have different group parent keys and (ii) the originator and the sending settlement bank have the same group parent key;
- C. a payment is tiered on **both the sending and receiving side** if (i) the originator and the sending settlement bank have different group parent keys and (ii) the beneficiary and the receiving settlement bank have different group parent keys.

The applied methodology allowed more than 99% of all payments to be identified, i.e. allowed a group parent key to be assigned to almost every direct or indirect participant so almost every payment could be categorised as tiered or not tiered.

The level of tiering in TARGET2

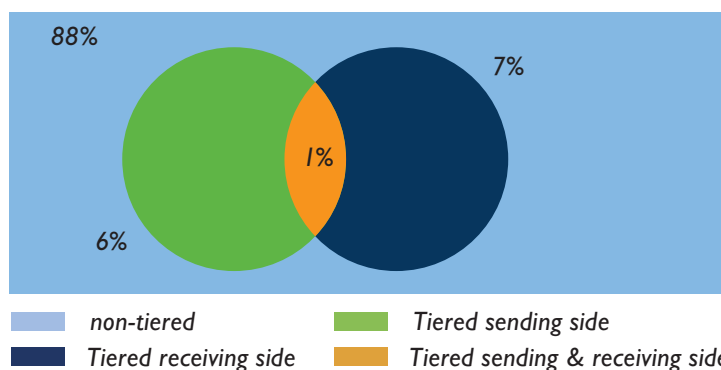
Tiered turnover

The results of the study confirmed the expectation that the level of tiering in TARGET2 is fairly limited and should therefore currently not be regarded as a source of material risk. Chart 1 shows the overall level of tiering in the TARGET2 turnover under analysis¹⁰ and can be read as follows:

- 6% of the value processed in TARGET2 is tiered on the sending side;
- 7% of the value is tiered on the receiving side;
- 1% of the value is tiered on both the sending and the receiving side;
- 88% of the value processed is not tiered.

As indicated in the previous section, the focus is put mainly on the sending side where only 6% of the total value of TARGET2 payments is tiered. Unfortunately, as similar measurements of tiered participation in other LVPS worldwide are not available, it was not possible to make any benchmark comparisons.¹¹

Chart 1: Overall level of tiering by value



¹⁰ As previously mentioned, customer payments, interbank payments and ancillary system payments are analysed.

¹¹ The CPSS Red Book only provides information about the number of direct/indirect participants and concentration ratios.

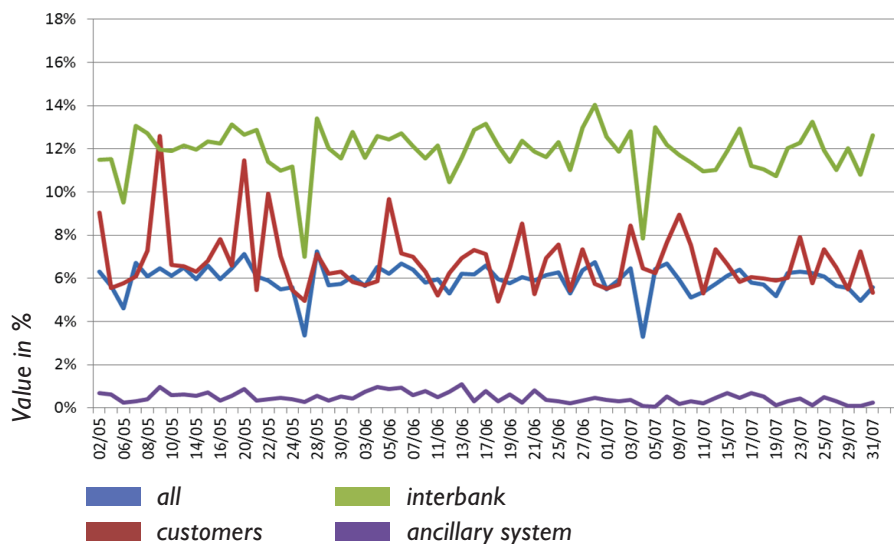
Chart 2 shows the daily decomposition of tiered payments by payment category for the period under analysis. The picture for the different categories is rather diverse. The category with the highest percentage of tiered payments is interbank payments, with an average share of 12% of value, while customer payments and ancillary system transactions have 7% and 0.5% of tiered transactions respectively. As already indicated, for all categories combined, 6% of transactions (by value) are tiered in TARGET2 (Chart 1). The fact that the degree of tiering in ancillary system payments, which account for a large part of the system's turnover, is very limited drags down the overall level.

The following explanations could be proposed for the different levels of tiering across the three categories.

- The low level of tiering in the ancillary system business is linked to the fact that many systems incentivise their settlement members to become direct participants in TARGET2.
- The limited level of tiering in customer payments may be explained by the fact that these are typically low-value transactions characterised by lower levels of criticality, so tiered participants may prefer to route this traffic via other payment channels.
- In contrast, interbank payments are more naturally routed via TARGET2 given their high value and criticality. This may explain, at least partly, the higher proportion of tiered payments in this category.

Finally, Chart 2 shows that the level of tiering is fairly stable over time across categories, clearly demonstrating the absence of any major seasonal effects.

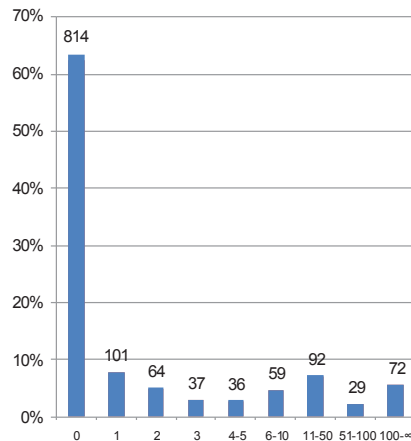
Chart 2: Share of tiered payments on the sending side by value



Distribution of tiering activities

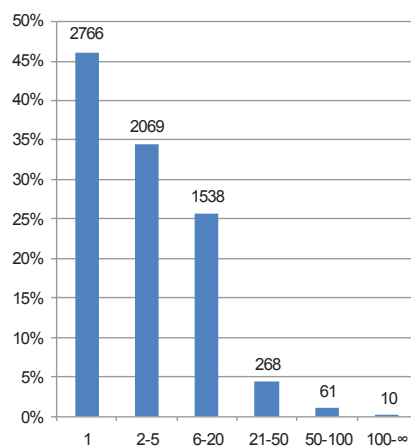
A further interesting aspect to look at is the number of tiered banking groups per direct participant. In the TARGET2 jargon, these correspond to the indirect participants and addressable BICs that use the services offered by the direct participants to settle in the system, aggregated by banking group. Chart 3 shows that, while 814 direct participants do not send or receive any tiered payments, 101 send or receive payments on behalf of only one tiered banking group and, on the other end of the distribution, 72 direct participants act as a settlement bank for more than 100 tiered banking groups.

Chart 3: Number of tiered banking groups per direct participant



The latter number indicates a certain level of dependency of several tiered participants on one single direct participant and could indicate the presence of concentration risks. Indeed, many tiered participants would not be able to send or receive payments if their corresponding direct participant would encounter technical problems or default.

Chart 4: Number of direct participants per tiered banking group



Changing perspective, Chart 4 shows the number of direct participants per tiered banking group. The chart indicates that almost 2,800 tiered banking groups use the settlement service of one single direct participant, whereas the other indirect banking groups are connected via more than one direct participant. Usually, one of these connections is the preferred one, while other channels are used for residual business.¹² This finding is somewhat reassuring and mitigates the risks identified in previous paragraph through the establishment of multiple correspondent banking relationships that can be used to settle in TARGET2. Having several tiered participation arrangements reduces the concentration risk on one single participant.

Top ten tiered participants

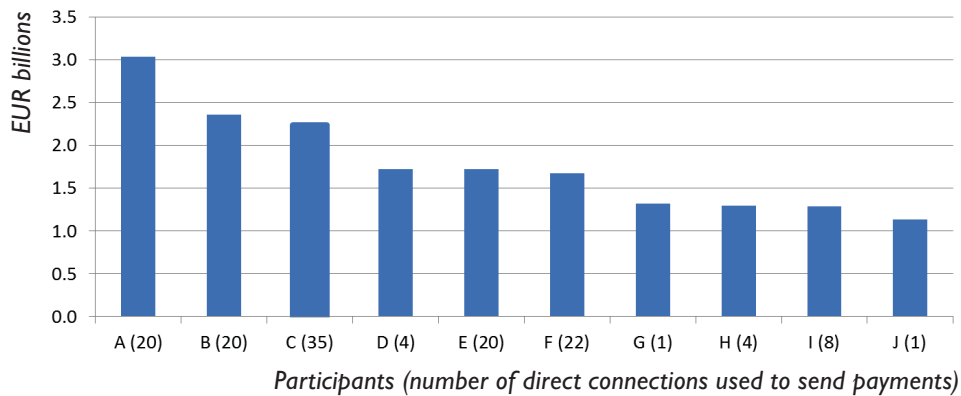
Chart 5 singles out the ten largest tiered participants by turnover and shows the number of connections they use. The top tiered participant in TARGET2 settles on average around €3 billion per day and resides within the European Economic Area (EEA), which means it is also eligible for a direct participation.

As it sends payments via 20 different participants in TARGET2, its dependence on the direct participants it is using is mitigated. However, if that top tiered participant were to become a direct participant in TARGET2, it would only have the 75th highest turnover in the system.

This level is far below the value processed by the smallest of the critical participants (€19 billion in the first quarter of 2013). Critical participants are those participants identified as systemically relevant. This finding indicates that there is very limited exposure to systemic risk stemming from tiered participation in TARGET2. Nonetheless, to prevent the emergence of risks in the future, it is important to keep monitoring the turnover of top tiered participants, to ensure that it does not get close to the level of critical participants.

It is worth pointing out that most of the top tiered participants are investment banks, which are not published in the TARGET2 directory and, with one exception, use multiple connections. Only one of them is a non-EEA bank.

¹² In a very limited number of cases, direct participants also operate indirectly, using another direct participant to settle transactions.

Chart 5 : Average daily tiered value (EUR billions) – top ten tiered participants**Conclusion**

The first analysis of the degree of tiered payments in TARGET2 was made possible by the availability of high quality transaction level data on the TARGET2 simulator platform and the possibility of reconstructing the group structure of the participants using a complete bank directory of an external provider. By combining these data sources it was possible to reconstruct the whole payment chain of each TARGET2 transaction and to identify whether or not it was tiered.

The study revealed that the level of tiering in TARGET2 is rather low, and does not pose serious risks to financial stability. This is true both for the system in general, with an overall share of tiered payments of 6% in value on the sending side, and for the top tiered participants, whose average daily turnovers are far smaller than those of critical participants in TARGET2 (i.e. banks that are considered to be systemically important for the system). The number of tiered participants per direct participant shows that a certain level of concentration risk may exist due to the dependency of several indirect participants on one direct participant. However, this risk is or can be mitigated by the existence of multiple connections between a tiered participant and TARGET2 direct participants.

In order to monitor compliance with CPSS-IOSCO Principle 19, this exercise will be repeated on a regular basis, using the same approach and methodology.

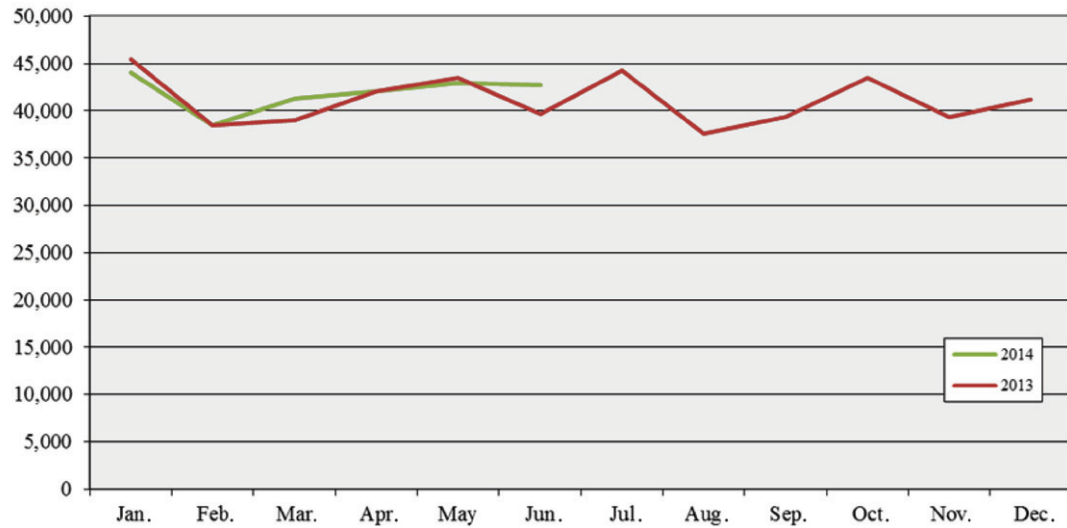
Main TARGET2 indicators in the first half of 2014

In the first half of 2014:

- TARGET2 processed a daily average of 364,127 payments, representing an average daily value of €2,012 trillion;
- the average value of a TARGET2 transaction was €5.5 million;
- 67% of TARGET2 payments had a value of less than €50,000;
- the peak day was 30 June (568,060 payments);
- TARGET2's share of total large-value payment system traffic in euro was 91% in value terms and 61% in volume terms;
- the availability of the system was 100%;
- 100% of TARGET2 payments were processed in less than five minutes.

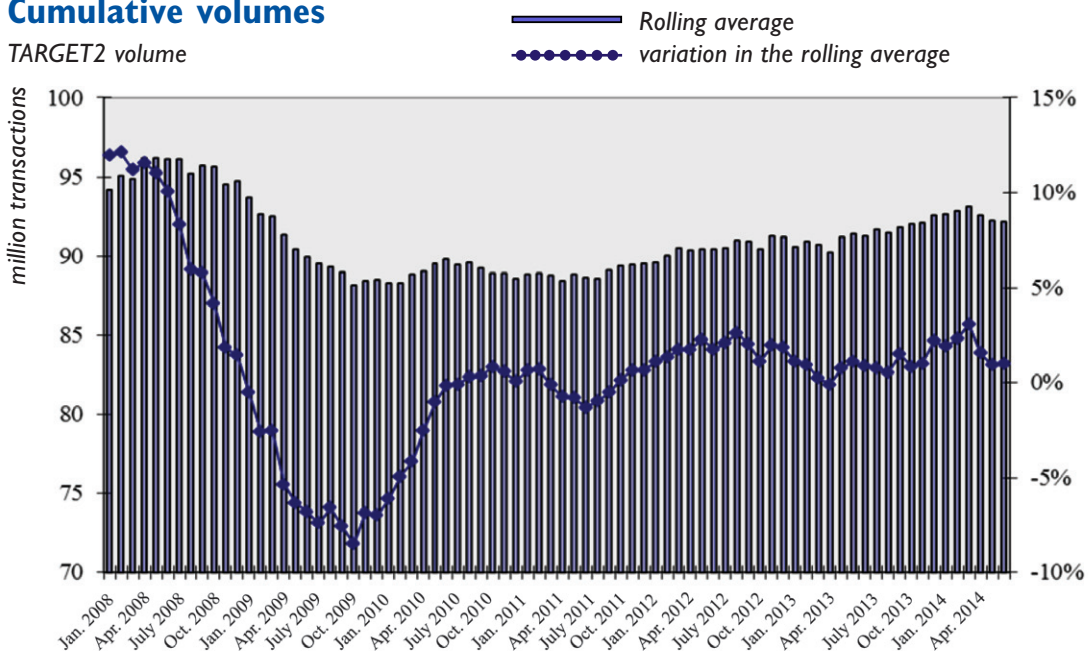
TARGET2 traffic

TARGET2 turnover (total value exchanged on a monthly basis in EUR billions)



Cumulative volumes

TARGET2 volume



Special interest article

Renew and innovate to keep pace with market changes: the challenges and opportunities of T2S

By Mario Domenico Recchia, Head of Local Custody, Intesa Sanpaolo – Milan, Corporate & Investment Banking, Global Banking & Transaction, member of the T2S Advisory Group



The past

An ever decreasing number of us still remember the phasing out of the old “monthly account” settlement system in Italy, which was replaced by a then innovative rolling settlement system almost two decades ago. Back in those days, both buy-side and sell-side counterparties relied on global custodians and their trusted local agent banks, using different forms and instruction formats, to figure out on the phone who were the ultimate counterparties involved, ensure that the trade details were always correct, and, at the same time, absorb all of the operational, credit, funding and settlement risks and associated costs of handling a month’s tally of trades volumes. Processing inefficiencies, manual processes and risks abounded, allowing agents to charge the type of fees now only seen in a very few emerging markets.

Ten years ago, an early European push for cross border harmonisation in the industry led to the introduction of a new domestic central securities depository (CSD)-managed settlement platform, designed with generally accepted, fully compliant, modern delivery-versus-payment (DVP) characteristics. After some initial teething issues, it was widely agreed that the market had become much more “secure” and significantly more efficient. At the same time, however, the new DVP system introduced a series of new challenges: all of a sudden trades began to fail, something that had never happened in the Italian market before! A whole new range of questions were asked: who was at fault? was it the agent? was it the counterparty? was it a matching issue? was it a securities availability issue? was it a cash issue?

With DVP rolling settlement, the importance of intraday liquidity and streamlined daily funding management was always central to assuring that, at the end of each day, all transactions settled as expected, without having to bear any extra cash management costs either for the agent or for the client. Some banks were more flexible than others, having very dynamic treasury departments. This was especially true if they had developed the tools to create internal links between on-line “real-time” securities processing platforms and the bank’s treasury applications. The need to always push for the highest degree of organisational efficiency led some banks to centralise their activities in global or regional liquidity hubs. This in turn affected the flexibility required to handle and successfully settle late trades in their other non-home markets, which was critical in order to achieve the ultimate goal of “perfect” settlement for that day’s book of trades. Today – apart from negative interest rates – discussions in treasury departments tend to revolve more around collateral driven by counterparty risks, and current and future regulatory and supervisory requirements. The questions now tend to be: where does the collateral need to be? is it the right type? how should it be priced? how much of it is required today? how much collateral is needed next year? how much is needed five years from now? and, most importantly, how efficiently can we move it and can we get it to where it is needed on time?

Recently, domestic market and collaborative agent bank initiatives have led to a high level of trade processing efficiency during the various matching and settlement cycles. Given that most agent banks have been deemed to be “systemically important” in their roles, a heightened focus has been placed on operational risk mitigation, process controls and adequate organisational and technological capacity. This has led to a high level of general sector-wide stability in the domestic market. While the occasional processing disruptions do occur, they are rare and sporadic and there is a strong focus on quick remedy management to minimise operational impacts. From a service perspective, providers with clients are now more focused on delivering quick, flexible connectivity and reporting solutions which deviate from the automated standards, and in making readily available local market intelligence and domestic competencies to customers with all of the required explanatory support. All of these factors have led to a steady reduction in processing fees, reflecting the very mature and efficient domestic market of today.

Change

Why is change still necessary?

The answer to this question could be a simple one. Basically, things around you change, whether you like it or not. You can decide to keep up with change or stay as you are. But the two options usually lead to different outcomes.

Let me give an example: in our family we still have a car which we acquired more or less back when our domestic CSD introduced its “modern” DVP system. We only use it occasionally, it has extremely low running costs, and we have paid off its financing costs many years ago. Generally, we consider the vehicle extremely reliable. It never gives us any problems and, for our current needs, it is a perfectly good and trustworthy means of getting from point A to point B. However, the fact is the car is classified as Euro I for emission purposes, so we can't use it to travel to the centre of any large Italian or European city given today's anti-pollution regulations, which will only become more restrictive in future. We also have gradually realised that if we experience a mechanical problem with the car, the cost of repairing it, assuming we can still find the right parts and the right skilled mechanic, would probably be rather significant. This would all add indirectly to the running costs of the car in the future. Last but not least, our current car does not have all of the latest, state of the art features for protecting passengers that are available on the market today. This sometimes worries me when we are on the motorway.

Therefore, in the near future, our family will probably have to face a decision: if we don't change our car, reliable as it is, we will most likely have to forego a whole range of travel opportunities. Ultimately, we will have to rely on other means of transport: taxis, rentals, trains, planes. All of these alternatives attract higher running costs as well as limiting our freedom by obliging us to rely on third parties. Our family expects to travel a lot in the next few years. We are planning trips to Paris, Frankfurt, and maybe Madrid. In addition, my daughter just started driving. All of this has to be taken into account.

Coming back to our business: why do things have to change? Once again, the answer is simple: as business and regulatory environments change (whether you like it or not), you can decide either to embrace and capitalise on these changes or to try to limit their impact.

TARGET2-Securities – a driver of change

One of the main drivers of change in the securities industry is TARGET2-Securities (T2S), which is set to go live in June 2015. Clearly, even if on the surface it doesn't seem that way to non-experts, T2S will profoundly change the way banks manage their securities settlement processes, with a major impact on liquidity management. As many of us know, T2S will consolidate and harmonise across all countries in Europe the most fundamental part of the securities processing infrastructure as CSDs outsource to the ECB in a harmonised way their respective settlement functions. The main characteristic of T2S will be that it will make cross-border settlement identical to domestic settlement in terms of core cost, technical processing, efficiency, and safety in the light of the fact that transactions will be settled DVP in central banking money. T2S will remove barriers across countries and eliminate differences between domestic and cross-border settlement, offering a solution to the drawbacks of the current fragmentation. T2S is a key driver for the harmonisation of post-trade services and standards, and will contribute to achieving stronger financial integration and a true European single market. The ultimate objective is to foster interoperability through harmonisation and simplification, allowing greater competition which will result in economic benefits that will trickle down to end-investors and issuers.

If a bank wants to stay in the securities industry, it needs to comply with all of the organisational and operational standards of T2S, requiring significant investments to be made up-front, especially if it wants to maintain the same levels of efficiency reached today.

Intesa Sanpaolo intends to maximise the opportunity for innovation presented by T2S, and has decided to access T2S as a directly connected participant (DCP) from Wave I. This has led to the decision to make significant investments in renovating and improving our global custody processing platforms, not only to comply with the new T2S new standards, but, most importantly, to position ourselves properly to be able to deliver an enhanced value proposition as the industry and business evolve in the future.

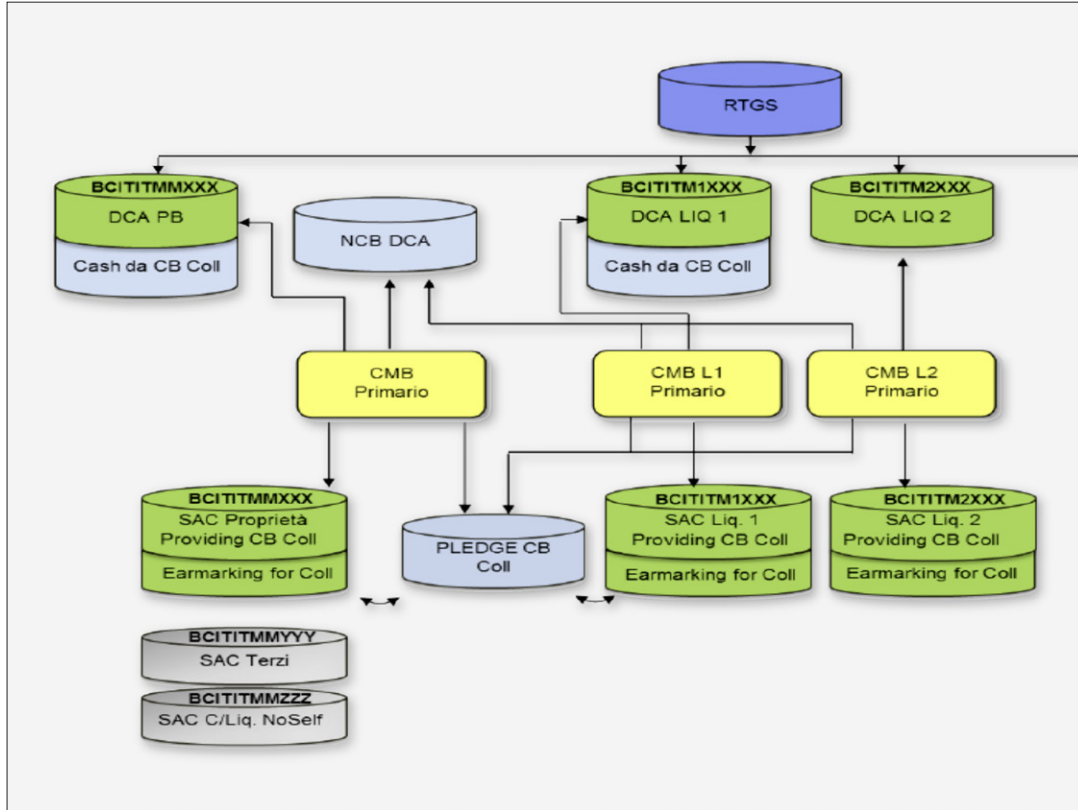
T2S also introduces new complexities for liquidity management. Dedicated cash accounts (DCAs) and real-time gross settlement (RTGS) accounts will interrelate. This will, in turn, be complemented by the auto-collateral functionalities available in the system. Moreover, all of this will have to be coordinated with the collateral management strategies required by each individual participant, who, in the next few years, will have to deal with increased complexity and future demands. The new environment requires a well-integrated and all-encompassing approach that takes into account optimisation of liquidity movements and positions, efficient handling of collateral and reliable real-time forecasting and monitoring tools for settled and unsettled transactions. This is especially true if multiple markets are involved, so as to allow for full exploitation of the notion of pan-European settlement in central bank money. Within the context of the investments being made by Intesa Sanpaolo for T2S, these solutions are being developed as illustrated in Figure I below. The design approach of these solutions also appears to be able to offer the same level of monitoring and forecasting tools to potential clients who hold their own DCA accounts but at the same time, for instance, have opted to allow Intesa Sanpaolo to operate their securities accounts in the domestic CSD.

Another example of possible innovative future business models may be, for example, multi-country intermediaries which decide to access the T2S platform directly as DCPs, taking advantage of the same liquidity management facilities offered on segregated DCA accounts with auto-collateralisation mechanisms which can be triggered on request, and leveraging collateral centralisation opportunities offered by the new system. These players may want to limit the investment and operational risks involved in managing securities administration tasks, especially for more complex markets which have not been fully “harmonised” or which are very unique in other certain respects. This is particularly true for those tasks which may involve such intricacies as domestic tax collection or, for instance, the timely and accurate reporting to issuers who are the effective underlying beneficiaries of the securities held in custody. Intesa Sanpaolo’s range of T2S services also include an asset service only (ASO) model in which we are able offer “custody-like” solutions for clients holding accounts with the domestic CSD, with the exception pure settlement services that the DCP handles on its own, covering the complexities mentioned above.

Finally, for those clients who don’t expect to “travel a lot” in the future, Intesa Sanpaolo will continue to offer traditional settlement and custody solutions, taking advantage of all of the new securities processing and liquidity management efficiencies introduced by the new T2S platform. Of course, these traditional institutional clients, whether internal or external, including our retail clients, will also indirectly receive the same benefits.

As for our family car? After much in house debate and lengthy discussion, over the last few weeks we have more or less narrowed our selection process down to one model. We expect to place the order before the year-end, and we expect the new Euro 6 class vehicle to be delivered towards the start of next year’s holiday period – right around June 2015.

Figure 1



Source: Intesa Sanpaolo – T2S Internal Program Working Group

The Eurosystem at Sibos 2014

This year's Sibos took place from 29 September to 2 October in Boston. It was attended by over 7,300 people. As in previous years, the Eurosystem was there to present all of its financial market infrastructure projects and products, namely T2S, TARGET2 and the current initiatives in the fields of retail payments and collateral management.

All products and initiatives were presented under the common slogan "Making integration possible", which was also the motto of a Eurosystem session held on 1 October under the title "Making integration possible – the ECB and Eurosystem perspective on the evolution of market infrastructures". Mr Marc Bayle, Director General of the ECB's Directorate General Market Infrastructure and Payments (DG/MIP) and Mr Jean-Michel Godeffroy, Chairman of the T2S Board and Co-Chair of the Payments and Settlement Systems Committee (PSSC), discussed the future of financial market infrastructures and payments in Europe. The session focused on the importance of delivering integrated, safe and efficient infrastructures that will make market integration possible in Europe. The questions, posed by moderator Ms Liz Lumley, editor at Finextra, were based on the input provided by stakeholders via an online survey that was run on the ECB website and via Twitter.

The questions covered the following topics: the future of T2S in Europe and its possible extension to other areas of the world; collateral management challenges; the contribution of TARGET2 to integration and its move to ISO20022; the status of SEPA and instant payments; the ECB's views on Bitcoin; and the next challenges relating to regulation and oversight. The session was filmed and the full record is available on the YouTube channel of the ECB.¹³ A new ECB video entitled "Integration of market infrastructure"¹⁴ was also shown during the session and is available on the YouTube channel of the ECB.

TARGET2, in particular the planned adoption of ISO20022 standards, was broadly covered and discussed in several sessions at Sibos. They showed that TARGET2 is well advanced in the adoption of the new industry standards. Some key messages that were passed on by the ECB stressed the efforts made by the Eurosystem to closely involve market participants in all discussions, to ensure backward compatibility with legacy standards (in particular with correspondent banking standards) and to adopt a common approach and timing with the other high-value payment systems in euro, namely EURO1. Further topics that related to TARGET2 were, for example, how RTGS systems can support instant payments initiatives, intraday reporting requirements of banks, and business continuity strategies of RTGS systems.

For the ECB and the Eurosystem, the presence at Sibos 2014 was a success and the interest in TARGET2 was high. The information provided by the Eurosystem on TARGET2 was well received and is available via the ECB's website. Next year's Sibos will be held in Singapore from 12 to 15 October, and we are already looking forward to having TARGET2 represented at that event.

¹³ See: <http://youtu.be/Z0dBdryLEro>

¹⁴ The video is available at:

<http://www.youtube.com/watch?v=hc9ntZmB0i8&index=1&list=PLnVAEZuF9FZmKDAshfzX8k2hNJAtA2rEJ>

Calendar of events

Meetings with user representatives

The Eurosystem maintains close relations with TARGET2 users through regular meetings held at the national level between the national central banks (NCBs) connected to the system and the respective national user groups. In addition to the cooperation at the national level, joint meetings of the Working Group on TARGET2 (WGT2) and the TARGET Working Group (TWG), which comprise representatives of the European banking industry, regularly take place at a pan-European level. In 2014 there were two joint meetings (on 19 February and on 4 September). Summaries of the joint meetings are available on the TARGET2 website.¹⁵ The dates of the joint meetings have been arranged to fit in with the planning of the annual system releases. Besides the regular joint meetings, additional opportunities for cooperation with the TWG may occur on an ad hoc basis.

Further information

More detailed information on TARGET2 can be found in the “Information guide for TARGET2 users” (http://www.ecb.europa.eu/paym/t2/shared/pdf/professionals/nov_2011/infoguide_V5_1.pdf) and in the most recent TARGET Annual Report, covering the year 2013, which was published on 22 May 2014. All relevant documents and reports can be found on the TARGET2 website at <http://www.target2.eu>, as well as on the websites of the participating NCBs.¹⁶ For further information, please e-mail target.hotline@ecb.europa.eu

¹⁵ <http://www.target2.eu>

¹⁶ <http://www.ecb.europa.eu/home/html/links.en.html>