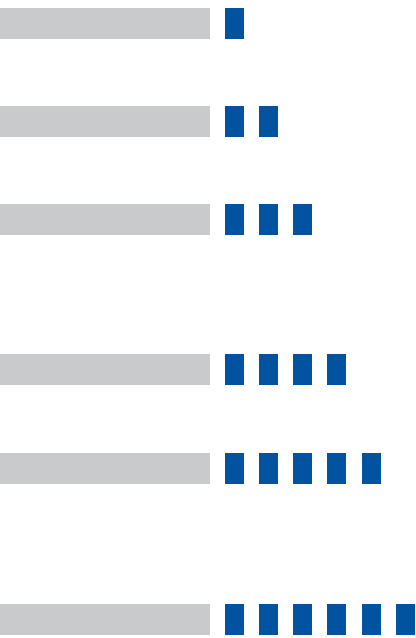




NEWSLETTER

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EUROPEAN CENTRAL BANK

EUROSYSTEM

BUILDING EUROPE WITH T2S



Hans-Gert Penzel
Director General Information Systems – ECB

EDITORIAL

What makes the TARGET 2 Securities (T2S) project so special?

Is it the technical challenge to settle the large number of euro zone trades in one place, with interfaces to all CSDs and directly connected participants? In today's world, systems routinely interact in real time with each other – efficiently, handling huge volumes, applying high security standards. This is no longer a leading edge of technology, and the available infrastructure solutions from Target2 (as provided for T2S by the 3CB+ - Banca d'Italia, Banco de España, Banque de France and Deutsche Bundesbank) can certainly help. Still, especially the management of huge volumes, networking issues and systems interactions, make the project technically challenging...

Is it the functionalities and data models that have to be defined carefully? Indeed, the discussions whether matching belongs to the settlement process, and the exchanges about the data structures that are needed for settlement show that these aspects of the project bring up a number of challenging questions...

Is it the revision of the roles and responsibilities of market players resulting from the potential re-allocation of certain functions? Clearly, these discussions go to the core of people's interests, and there may be quite some resistance to change. It is perfectly understandable and legitimate that current market players argue: "my system works, it suits my customers' needs, I invested in it, why should I change"? This aspect of the project is surely a big challenge.

Is it the significant impacts of the project on national legal frameworks, with possibly some adaptation to reflect the new European context? I would mention for instance the diverging national practices of considering matching as legally binding or not, or the case of direct holding countries, which have implemented a significantly different legal framework than the other countries. The future legal framework and the changes necessary to reach it constitute, without any doubt, a challenge in itself.

Is it, finally, the unusually transparent strategic approach which the T2S project has chosen in order to come up with answers to all of these questions and the organisation of completely open market consultation? Explaining the system features, reaching consensus on project issues, patiently convincing participants to adapt whilst keeping the strict published deadlines is certainly a further challenge...

All considered, my answer to the question what makes T2S so special is rather straightforward: This project is special because it comes up with a set of multiple challenges. We are collectively remodelling the European Securities settlement landscape in various dimensions. By doing so, we are creating a new important cornerstone of a joint Europe. Beyond national or corporate interests, T2S will be a significant step towards the European financial market integration, contributing to a European-wide access to securities for banks, companies and citizens and contribute to increasing efficiency and competitiveness of European financial markets.

The ECB in European Projects

Projects with a truly European vision have been – and will continue to be – the ECB vocation: to think of the future of European markets and facilitate their evolution. The ECB and the National Central banks of the Eurosystem are used to conducting such projects, first "thinking the unthinkable", understanding the required functionalities, demonstrating technical solutions, progressively convincing people, getting increasing support from the market and finally achieving significant European-wide changes. Remember, the Euro itself encountered some scepticisms at first. But through the Eurosystem efforts, an increasing buy-in was achieved. The Euro was successfully introduced in all euro countries and has become an unquestioned reality. With SEPA, we have a second example where the ECB in cooperation with the National Central Banks has played a pivotal role. And again, SEPA is in the process of becoming a widely accepted reality.

The key to success

Conducting major projects of such international dimension is definitely not an easy task. It requires a neutral European mind, experience and proven methods and techniques. Together with the partners of the Eurosystem, the ECB, as the Captain of the Team, has developed significant know-how and is very well equipped for running such projects. The Eurosystem is constantly improving in this respect and builds on market standards and on past experience to further develop its framework for the management of projects, the development of applications and for the hosting of system. For the ECB, most major projects were of an international nature.

The IT experts of the ECB, together with their Eurosystem colleagues are extremely active in improving their part of the project framework. I am particularly proud of the way ESCB IT-experts have worked with the Securities Experts to achieve the success of the early stage of the T2S project. Now is the time to detail our vision with market participants and convince them to share this vision.

To get the support of the market, the ECB has only one approach: open debate and discussion. This is certainly facilitated by its neutrality regarding the way to implement changes and by its understanding of the various cultures. The ECB is vigilant that everyone can be heard. Convincing market players to change working systems is possible when

there is a positive balance between the benefits and the costs of change. The benefits of changes are very often to be found in harmonisation, opening of new opportunities and reduction of overall costs. Experience shows that harmonisation of features is difficult to agree upon, but when applied efficiently it pays-off. Finding the right level of harmonisation and avoiding specific features just for selected participants is not only a cost saving exercise, it is also a matter of overall market efficiency. I consider harmonisation is a crucial issue for European projects. Indeed this imposes market players to agree on changing systems, which are most of the time well adapted to national specificities...

The issue is not to develop a system allowing 12 different ways to settle securities, but to get a common vision. The payment and securities markets encountered major changes in the past years since the introduction of the Euro. This is likely to continue in the near future. Possibly, building on T2S is a way to plan on stable ground for the next 10 years.

T2S will only be successful if all participants make an attempt to think "out of the box". Don't see TARGET 2 Securities in terms of today's functionalities and eventual short term losses, but in terms of long term opportunities. Once this common vision of the European market will be achieved, all other issues will become secondary, and "easy" to address.

BAYLE'S EYE VIEW



Marc Bayle
T2S Programme Manager – ECB

We have been working intensely in the TGs and the AG with many users of the market, as well as with the CSDs, since the last newsletter. And there has been increasing contact of a less formal kind. This has caused me to think it is time to restate – and in some cases remodel – our objectives for T2S.

The recent SIBOS conference was an important opportunity to meet people in an easy and informal way. The Project Team benefited from several panels where T2S was discussed in front of large audiences, as well as the large number of bilateral meetings to which many of you kindly agreed. This was an important influence on the conclusions and action points that I note below.

I detected a real conviction at SIBOS that “T2S is here to stay”. Most people we spoke with thought it probable that the ECB Governing Council will give the go-ahead next year.

I can however assure you that there is no complacency in the ECB Project Team. We know that you want to see the user requirements completed, review the economic case and see progress on governance before you make your final judgement.

Progress on the user requirements so far seems to have convinced most members of our groups that T2S is technically doable. The debate is thus now focused on whether T2S will be cost-efficient.

Much of this debate has been narrowed to whether, and if so when, CSDs can downsize their settlement engines – which may materially affect the size of the costs they need to recover by adding a mark up to the price T2S will charge the CSDs.

But perhaps this is not the most important question. I expect that by 2013 CSDs will be concentrating on providing attractive services to support clients' settlement efficiency in using the plain vanilla service provided by T2S. The market gains from this across the EU will far outweigh any losses from early write-offs of investment in platforms. Increasingly, and in particular as Giovannini

barriers are dismantled, users will have a real choice between different CSDs as their preferred point of access to T2S, thus reducing their interface costs in addition to getting better service. This in turn will benefit those CSDs which best adapt their offering the new T2S world.

But this does not exhaust the benefits. The ability to pool securities and central bank money in a single platform will reduce users' collateral/liquidity needs and funding costs. This is a clear expectation expressed by users repeatedly.

We have already published estimates (March, 2007) of annual savings for users ranging from €140M to €330M. We will revisit these figures, now that the user requirements are close to completion.

We also take your clear message that you – especially firms which already operate across borders - want more harmonisation. We agree – we continue to uphold the “lean T2S” concept. We have avoided modifying T2S to bring national specificities inside its functionality. Instead, we are encouraging harmonisation, while at the same time helping markets and CSDs to create process workarounds using our standard functionality. It may well be that the need to use these workarounds will have disappeared by 2013, under pressure from the wider market place.

We can do more to foster harmonisation in such areas as market processes relating to settlement, and extending into matching and reporting. Developing a common infrastructure is a very useful tool in creating pressure for harmonisation decisions, using the EU-wide community of users of the common settlement process in T2S.

We are often asked two related questions: “how can we benefit from the work performed so far, in particular by CSDs?” and “how does T2S relate to investments, recent or being currently undertaken, by CSDs?”. We think that building T2S is the best possible outcome for the market in re-using the ideas underlying the most efficient facilities currently available – while accepting that it may shorten the anticipated life of some investments in these ideas. Reflecting this, we have invited CSDs to plan their

investments given the strong probability that T2S is in operation no later than 2013. While the deadlines for preparing the user requirements are tight, they need to be tight to allow CSDs and their users to plan for the major changes ahead both in settlement and in the way that market users organise their post-trade operations. The team is very grateful to you for the considerable effort you have put into responding to the mini-consultations, in particular during the summer period.

On governance your message is also clear. You seem to be reasonably happy with the current governance approach, in particular with the transparency of the decision-making process and the progress achieved towards defining the user requirements. Once the user requirements are published, the Project Team will “tour” the various National User Groups and Associations to show how your input was taken into consideration and, when a different decision was taken, to argue why this was the case. For the future, and as individual firms deepen their engagement, you want to have a clear picture of how

the market’s needs will be recognised in the project. We understand the importance of this, and we have presented a first “sketch” of alternative approaches to the October Advisory Group.

Boston was an excellent occasion to understand the market’s view of the overall progress of the project, from the many of you we met there. We know that we need to deepen the contact, and extend it to the even more firms which do not attend SIBOS. Even so, we were pleased that in an electronic vote at a large panel session 69% out of 610 delegates supported the go-ahead for T2S.

As you know, the ECB Governing Council will only go ahead with adequate market support. This was a very encouraging first indicator of support. We know that we cannot take it for granted, and that it is not fully representative; but it strengthens our desire to work with you to deliver this vital element in completing the single market for financial services. I thank you for your support of this important work.

T2S: AN ESSENTIAL ELEMENT IN THE FUTURE FINANCIAL MARKETS



Riccardo Lamanna
Managing director responsible for the
Transaction Services – Intesa San Paolo

It is only six months since the Governing Council's decision to go ahead with the T2S project, and the level of involvement of the financial world has been already very high. It can be easily imagined that no one, involved in Securities Services as well as in treasury and collateral management, refrained from rethinking of the long term strategies issues in a T2S scenario. Although the reassessments of the securities industry, as a consequence of T2S, will take at least a decade, one may expect an early change in the choice of the services to clients.

Transforming matching and settlement into “commodities” will bring CSDs to concentrate on value added services, entering a field which has been so far the banks' and ICSDs' field. On their side, banks and ICSDs will shift to offer “ad hoc” services closer to the more sophisticated clients' needs (broker-dealers and asset managers). Broker-dealer and asset managers will be in the condition to access sophisticated products at lower costs with an ultimate benefit for the final investor.

The European Banking system is living a brand new situation these years. On the one hand, the European banks have reached for the first time a size which is now almost comparable with that of the major American and international banks in terms of assets, capitalization, geographical distribution and clients. The largest European investment banks may now envisage competing on international scale with the traditional American ones.

On the other hand, the dimension of the major European industries grew exponentially as a result of the mergers in all sectors within the last 10/15 years. Corporations, which are the main clients of the European banks, are requiring services with a global breath and size!

Even if a greater attention to the Capital Market comes from the European industry today, one should not underestimate the effect of the European demographic trend which will relay more and more in the Capital Markets, rather than Real Estate, for ensuring appropriate pension funds for the future.

It is in this scenario, nonetheless, that the higher “attrition” that the European securities market infrastructure presents in comparison with the American one represents a competitive disadvantage. Those who work in the treasury and finance department at any financial institution in Europe would prefer to deal with a unique infrastructure, like the American DTCC, rather than basing their activities on a complex network of CSDs using different rules: how simpler would be a pan European ETF in a T2S scenario! In addition, BASEL 2 is increasing the need for a more effective use of collateral and this will lead to even more sophisticated needs in term of “operations” with securities. The simplest way to manage these needs today is through the use of ICSDs, which currently shows constraints in the securities usage and some add on costs.

T2S will allow a simpler and cheaper use of cross border activities and, besides the more direct and still to quantify economical effect; it will also stimulate Regulatory Authorities to move towards harmonization of rules.

The debate in the international press on T2S has been loud and not all the comments have been positive. The reasons to be critical may be few, ranging from the uncertainty of the future governance of T2S, some technical aspects and to the measure of the effective economical result of the project.

Too often, not enough space is left in these debates, to the vision of the long term effect that the T2S project will bring to the entire European securities market. It is just few years ago that the euro became a reality and nowadays nobody remembers the vivid debate that was on newspapers about the monetary reserves and their transferring to the European Central Bank!

As already mentioned, implications and benefits of T2S will be at least of two different kinds: a first one will be the elimination of cross border transactions thus reducing their current price and a second one, and more important, the greater efficiency of the overall financial system; T2S will also help creating some common market practices at European level.

In addition, it can be envisaged that major structural changes are going to take place in the landscape of the securities services business thanks to T2S.

T2S will push for a new and welcome competition among CSDs. CSDs will not be anymore the domestic provider, but will have to evolve to a more international status and to improve, together with ICSDs, their capabilities to provide efficient and standardised custody and corporate actions services. A lot has to be made in these fields and still a lot of question marks are there to be answered. Asset servicing will require different models where the roles of the current providers might change and evolve. The consequence of those tendencies are that CSDs will look forward to become more like banks and banks will try to leverage on their current capabilities to provide outsourcing services. New business model will arise, among banks and CSDs and new way to serve assets will be implemented.

T2S will accelerate the consolidation of securities services activities. The number of banks that will be able to provide efficient and international securities services to domestic and pan-European clients will reduce. Only those with extremely high client franchise and international presence will survive. Prices of plain vanilla products will reduce to the T2S target price much before T2S will be in place putting stress on revenues and banks' capacity to continue to invest.

On the CSDs side, consolidation in the field of securities services might also happen. Only those CSDs that will be able to evolve to the more banking and traditional functions will evolve, others will reduce to the minimal central depository functions linked to issuers.

If one thinks of the major projects having impacted the European financial markets, it is easy to imagine that T2S will have a positive impact on all of them: just consider the MiFID, the pan European stock exchanges of the future and the growing need to use cross-border collateral.

Thinking of the financial risk coverage products, as they are needed by European industries and banks, it appears crystal clear that "multi local" CSDs system as it is today need at least to share common operational infrastructures. Intesa San Paolo considers T2S fundamental, owing to its role in the European integration of the financial infrastructures.

It is not measuring the settlement volumes that one may estimate the benefit of T2S. One must rather imagine the financial world as it will be in ten or fifteen years, imagining also the complexity of the future financial products.

Future generations will see T2S as a little thing, but essential, in the foundation of the future European financial market.



Jacques-Philippe Marson
CEO BNP Paribas Securities Services

HITTING THE TARGET

Target2-Securities is a unique opportunity for the euro area, and addresses Europe's need for further integration in the securities environment

The aim of the Lisbon agenda is to increase the competitiveness and attractiveness of European capital markets in order to increase European gross domestic product (GDP). The Council of Europe is more specific, stating that the clearing and settlement of securities transactions is “a key area of financial integration...where substantial progress needs to be achieved to enhance both the efficiency and soundness of post-trading services”. It further “welcomes that the euro system shares this aim and...has undertaken work on the Target2-Securities (T2S) project”.

The introduction of the euro eight years ago was a major achievement on the road towards financial integration, and the euro has undoubtedly contributed to the development of Europe's financial market. But to be fully competitive, there is still work to be done to make market infrastructures more efficient. This is particularly the case in the securities field, where cross-border trade in the euro zone has expanded enormously.

The implementation of Target1, and shortly Target2, together with the implementation of the Single European Payments Area (SEPA), will provide the necessary infrastructure on the cash side for the euro zone. But on the securities side, we still have a very fragmented environment and are far from this objective. In the euro area, there are currently as many as 19 securities settlement systems, and 30 overall in Europe. This compares with only two in the United States: one for equities and corporate issues, and the other for government bonds.

You could explain this lack of consolidation by the presence of the 15 Giovanni barriers. Surely they do not help; it is true that the environment for securities is much more complex than for cash given the significant differences in the legal and fiscal framework in the various Member States. However they do not, on the other hand, forbid consolidation either. Some industry

initiatives have already taken place successfully: the Nordic Central Securities Depository (CSD) covers two securities settlement systems (SSS) and the Euroclear project another four. The capitalistic structure and “for-profit orientation” are probably the main factors limiting consolidation. Neither can European consolidation of stock exchanges be expected to trigger post-trade consolidation across the euro zone.

Let's face it: industry initiatives remain limited in geographical scope, involving a limited number of large markets and, for economic reasons, tend to ignore smaller markets. Experience has shown that the consolidation of four markets will have taken as long as 10 years.

The Target2-Securities initiative has the potential to deliver the missing link in European financial market integration, and we expect it will benefit all financial players and final investors.

T2S will facilitate effective competition at both the trading and clearing levels

The Markets in Financial Instruments Directive (MiFID) has the objective of delivering true competition in Europe at the trading level, and will lead to more fragmentation both at trading and clearing levels, as follows:

New trading venues are developing, with either American platforms seeking European expansion or new European projects trying to challenge incumbent exchanges

Incumbent European central counter parties (CCPs) are also facing new entrants: with NSCC (euro CCP) offering clearing services to the Turquoise platform, for example

This fragmentation reinforces the need for an integrated, harmonised, safe and efficient settlement environment. In the United States, competition at trading level has been effective, as settlement efficiency has been achieved thanks to a single infrastructure. We do not have the same competitive and innovative environment in Europe. Instead, we have a series of silo structures that do not compete with each other very effectively.

We believe T2S is the only credible response to the need for a single settlement solution for the user in the euro zone – and for the European market in general.

T2S will change the competitive landscape for custodians

Despite the risk of disintermediation represented by T2S, local custodians, thanks to their specialist expertise in their local market, may broaden their opportunities in a simplified multi-market environment.

In addition, the extra efficiencies that T2S will bring to euro securities settlement will broaden the range of post-trade options open to financial institutions. Many institutions have typically used a financial intermediary to link to multiple CSD settlement systems across Europe. However, some may now consider accessing directly the T2S settlement link to 13 euro zone markets. The cost of building support services will be substantially reduced, with T2S serving as a single settlement back-office for Europe.

Moreover, the European Central Bank (ECB) may facilitate CSDs to climb the value chain and to offer asset servicing functions, in direct competition with the custodian community. This might broaden the revenue streams available to the CSD community but will require investment on their part.

Custodians will have to overcome these challenges to remain competitive. Nevertheless, we are used to competition and to changes in our environment - one of our key qualities being to constantly adapt to market trends and clients' needs.

Fair competition and safety are key user concerns

At the same time fair competition has to be ensured. CSDs may want to compete with custodians on custody activities but custodians will not be able to compete with CSDs on their core activities. The network effect related to those infrastructure activities from which they benefit should not be optimised so that they compete unfairly. We expect the design of T2S to provide custodians with a chance to compete on an equitable basis, and some safeguards must therefore be implemented.

Furthermore, CSDs may want to develop banking activities. This raises a risk issue both for banks, who will connect to those CSDs and, given the potential systemic risk, for regulators. T2S should remain in central bank money only and clear segregation between central bank money activities and commercial bank money activities should be compulsory.

Thus, there is a need for neutral governance of the system. In this respect, the independence of the ECB is a positive factor.

Remaining issues

Some issues, such as the direct connectivity for banks or the need for central matching, are still being debated. We are confident that these issues will be resolved. Indeed, existing infrastructure projects have raised similar questions, and solutions have always been found.

For instance, the debate on direct connectivity is not a new one: the question was also raised in the T2 project. That project is going live next month and users have a direct technical connection with the system - while maintaining their legal and operational relationship with their respective central banks. For monetary policy operations, we shall maintain our connection with our central banks. Nevertheless, direct connection to T2 will reduce costs and enhance efficiency for users, in particular by facilitating treasury management. A similar arrangement for T2S would be feasible.

T2S will - and should - be a driver for harmonisation. It will remove some of the Giovannini barriers. Central matching and a centralised database are part of that harmonisation process, and are required for CSDs to reduce costs and mutualise investment. The same principles have been employed by market infrastructures to create multi-market, single settlement systems.

So, we have a unique opportunity today to foster European integration, which is why the European Commission and the Council of Europe supports the project. In fact, Europe's financial market cannot afford to miss this chance.

T2S is an essential building block for Europe's financial market integration. In a longer term, when legal and fiscal harmonisation across the EU will have been implemented, it could facilitate the emergence of a true single European CSD.

Target2-Securities has now entered a critical phase: the definition of user requirements. It is our joint responsibility to get these right for T2S to deliver the maximum benefits to the market. BNP Paribas Securities Services is playing an important role in the Advisory Group, the Technical Groups and the European Banking Federation task force. We are actively contributing by making available our local expertise in the key euro markets, where we have direct membership of the CSDs.

OPTIMAL INFORMATION FLOW BETWEEN CSDs AND T2S PLATFORMS BY TARGET2-SECURITIES PROJECT TEAM

Optimal information flow between CSDs and T2S platforms

With the introduction of TARGET2 Securities in 2013 the settlement of securities in central bank money will be offered on a centralised technical platform. For CSDs joining T2S it will mean that while keeping services related to assets servicing (such as custody or notary) will have to continue to perform with a settlement service located on T2S platform. The various stakeholders and in particular the CSDs are debating on the level of service that should be provided by T2S to CSDs to allow a proper functioning of the market infrastructures. ECSDA in a letter sent to the ECB (see on website) explains a multitude of different cases where information can be needed in real-time on the CSD side.

The reality is that currently CSDs in Europe are providing different sets of services and therefore have a different need for information. Some of CSDs will require some information in real-time to be able to continue to perform services such as automated lending/borrowing programme. Some other CSDs will require only end of settlement cycle or day information to be able to process corporate events related activities. Obviously, the more information is needed in real-time, the more powerful

should the technical connection between the CSD and T2S be.

Two techniques are typically used to provide such kind of information: real-time feeding automated for pre-identified event or process result (“push mode”) and the query function whenever needed (“pull mode”). In fact, both techniques are complementary to one another, as CSDs might need to use them for different purposes at different moments during the operation day.

To answer this need, T2S will propose a subscription functionality allowing CSDs to optimise their need for information, and to make use out of T2S in a very efficient manner. They will be able to define which type of information they need, and which type they do not need; or which event should trigger automatically a message as opposed to the one for which it is not necessary. The details of the subscription service (e.g. a matrix showing the different possibilities and combinations to pre-define the flow of information) are being elaborated and will be finally worked out in one of the next phases of the project when the detailed functional specifications will be prepared. This flexibility will allow each CSD to choose the solution that is more economic depending on its needs and its setup.

T2S FORTHCOMING EVENTS CALENDAR

T2S is an important project for the integration of market infrastructures which raises a lot of interest world-wide. For this reason, the ECB organizes regular meetings with stakeholders to inform on the latest developments of the project and participates in external events with the same purpose

The calendar below shows an overview of the events to take place between the publication of this T2S newsletter issue and the next one. You can also find the T2S calendar on the ECB's website (<http://www.ecb.europa.eu/paym/t2s/html/index.en.html>).

DATE	DAY	MEETING WITH	OBJECTIVE	MEETING LOCATION
06.11.2007	Tue	T2S Info Session	Information session	Frankfurt
07.11.2007	Wed	TG2 - Lifecycle management and matching	Working session on T2S user requirements	Paris
		TG4 - Static Data	Working session on T2S user requirements	Frankfurt
12.11.2007	Mon	TG5 - Interfaces	Working session on T2S user requirements	Frankfurt
		TG6 - Non functional requirements	Working session on T2S user requirements	Rome
28.11.2007	Wed	Advisory Group		Madrid
29.11.2007	Thu	Advisory Group		Madrid

T2S website information: www.ecb.europa.eu/paym/t2s
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