



EUROPEAN CENTRAL BANK

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TARGET2: PRINCIPLES AND STRUCTURE

INTRODUCTION

On 24 October 2002 the Governing Council of the ECB decided on the long-term strategy for TARGET. It was acknowledged that, although TARGET had successfully met its main objectives, its heterogeneous technical design, reflecting the reality of the mid-1990s, would translate over time into a number of problems for its users, who increasingly expect a more harmonised service. Cost efficiency was also considered problematic. Furthermore, the ability of the present TARGET system to cope with future challenges, in particular EU enlargement, was questioned. TARGET2 will have to overcome these shortcomings.

The present document describes the principles behind, and the structure of, TARGET2. Section 1 outlines the general features and structure of TARGET2; section 2 of the note addresses issues related to the perimeter, the business, the services and the interfaces of TARGET2; section 3 elaborates on governance, financing and pricing issues; and section 4 describes the further steps in the establishment of TARGET2.

I. GENERAL FEATURES AND STRUCTURE OF TARGET2

TARGET2 will be a multiple-platform system based on the principles of: (i) a broadly defined and harmonised core service offered by all platforms; (ii) a single price structure applicable to that core service as from the start of operation of TARGET2; and (iii) cost effectiveness, which implies that the single price is based on the most efficient RTGS system (i.e. the system with the lowest cost per item) and that, by the end of a four-year period after the start of TARGET2 operations, subsidies going beyond an acceptable public good factor¹ have to be phased out obligatorily².

The multiple-platform TARGET2 system will consist of individual (tailor-made or cloned) platforms and, in the first three years of its operation, *one* shareable platform available to those central banks which –

¹ The public good factor will take due account of the positive externalities generated by TARGET, inter alia, in terms of reduction of systemic risk and will be determined by the Governing Council of the ECB.

² Platforms which do not comply with this requirement will have to be given up.

from the start or in the course of that period – decide to give up their individual platform. After that initial period, any central bank will be free either to maintain its individual platform³, or to join the already existing shareable platform, or to create another shareable platform with any other central bank that is willing to do so.

The single shareable platform available from the start of TARGET2 will be an integral part of the structure of TARGET2. It will not be implemented until the central banks which are in principle interested in joining it have finally decided to do so. It could be developed from scratch or could be based on one of the existing platforms. Subject to a technical analysis at a later stage, it might be built on a so-called active/active model in which the key tasks and staff are split between locations in different countries.

The design of the shareable platform should allow each NCB which joins it to preserve the business relationships with “its” banks, including monetary policy and lender of last resort relationships. As at present, the ECB will not open accounts for credit institutions, regardless of the platform it chooses to use.

All platforms that are part of TARGET2 shall be subject to the same guiding principles, for example, for pricing, cost recovery, access, core services etc.

2. PERIMETER, BUSINESS, SERVICES AND INTERFACES OF TARGET2

2.1 Perimeter

The perimeter of TARGET refers to the distinction between TARGET and other payment systems. In this respect the distinctive feature of “RTGS” is “the transfer of central bank money from one holder to another with intraday finality on a continuous basis”. Indeed, due to the increased similarities between traditional RTGS and hybrid systems, the key concept for defining the direct competence of the Eurosystem in what used to be called “RTGS” systems is no longer necessarily the “gross” settlement modus, but the “intraday finality of payments on a continuous basis”, as opposed to end-of-day finality of netting systems. Therefore, the Eurosystem has the same key interest and competence in all systems that settle individual (cross-border or domestic) payments (i) in central bank money, and (ii) with intraday finality on a continuous basis, whether or not they are technically integrated in TARGET (respective examples are RTGS^{plus} in Germany and PNS in France). Of course, the integration of such systems into TARGET should always be possible (and even encouraged).

The TARGET Guideline will be amended as soon as possible so as to take this new perimeter into account. Those systems which are technically integrated into TARGET will have to fully comply with the amended Guideline; those which are not presumably only with a subset.

³ Subject to the fulfilment of the cost recovery obligation as defined above.

2.2 Business

As is the case for the present TARGET, TARGET2, while used for a variety of payments, owes its origin to the need to settle predominantly systemically relevant, large-value euro payments in central bank money. TARGET2 will of course continue to be compatible with the existence of other systems processing payments in euro. Nevertheless, TARGET2 will be open “downwards”, which means that there should be no *de jure* or *de facto* limits, set by the Eurosystem or the NCBs, to any payment which users wish to process in real time in central bank money (so-called large approach). There will be three classes of payments: i) payments that must be obligatorily channelled via TARGET, as is the case according to the current TARGET Guideline (i.e. monetary policy payments and the settlement of ancillary large-value systems); ii) payments that the Eurosystem considers desirable to be processed via TARGET; and iii) other payments that users choose to channel via TARGET.

2.3 Services

When TARGET started operations, the *cross-border* TARGET functionality was considered as the basic common element of all RTGS systems participating in or connected to TARGET. At that time, the different RTGS systems provided a more diverse level of services to their participants than at present. In TARGET2 the scope of the commonly provided core service will be even wider. TARGET2 will have a far more harmonised service level than the present system and include a broadly defined core service, which will be offered by all TARGET components, even if this is done in technically different ways. Nevertheless, based on the input of the user communities, central banks – be they managing an individual platform or the shareable platform available from the start of TARGET2 (or any shareable platform that may be available in the future) – will have the possibility of providing some additional services in addition to the core service.

In TARGET2 there will be clear procedures concerning the provision of additional services. Additional services will be implemented only on the basis of a consultation of the users and there will be transparency within the ESCB about the services provided by the different components of TARGET2. The latter would ensure that services which are implemented first by only one platform could become part of the core service of TARGET2 if the users of other platforms also considered the services to be useful for them.

The services and functions of TARGET2 should be seen from the users’ perspective, meaning that it is the service offered that counts, and not the production process. The service level of TARGET2 will be defined in close co-operation with the TARGET user community.

The Governing Council of the ECB has the competence to define and periodically revise the list of core services from time to time. It will exercise this competence in a way that fosters innovation. In particular, it may decide to include in the list of core services innovative additional services which have proven to be efficient in some platform(s) and may be of interest to the whole TARGET user community.

2.4 Interface with users and ancillary systems

As requested by the users, TARGET2 will follow, if not anticipate, the move towards harmonisation of services also regarding (i) the interface between the RTGS system and its users and (ii) the settlement of ancillary systems.

Concerning the *interface*, TARGET started operations in January 1999 as a system where central banks maintained different interfaces to their RTGS participants, either SWIFT or a national telecommunications provider. In the meantime, almost all central banks have chosen SWIFT as their interface to their RTGS participants or will use SWIFT in the near future. This is in response to the strong demands of market participants. The SWIFT standards for payment messages have become a commodity in the payment business and allow at the same time some flexibility in their use. Since throughout the entire debate on the long-term evolution of TARGET it has been a commonly shared view within the Eurosystem that a single interface to TARGET would be beneficial, it is very likely that TARGET2, including the user interface, will be based on harmonised use of SWIFT message standards.

With regard to the *ancillary systems*, it should be considered that at the time when the respective solutions were implemented, the settlement of ancillary systems was a purely local issue for central banks. At the different local levels, different solutions have been implemented, each of which, in its domestic context, has usually been recognised as being efficient. However, this does not mean that the settlement of ancillary systems could not have been done differently if there had been co-ordination of settlement standards at a European level. From today's perspective, the methods for the settlement of ancillary systems are thus *legacy* solutions of "how it was done" in the past within a national context rather than a fulfilment of the needs of credit institutions in the euro area environment of today.

In TARGET2, individual platforms may keep their current settlement modes for the ancillary systems, but as regards the shareable platform the question arises whether these legacy settlement solutions will all have to be supported. The different settlement solutions have common elements and they can be divided into two general models:

- The "interfaced model", in which the settlement in central bank money of the positions of the participants in the ancillary system takes place in the RTGS system.⁴
- The "integrated model" for the settlement of securities transactions in central bank money, whereby the cash settlement takes place in the ancillary system itself.⁵

⁴ The interfaced model is based either on credit transfer or on direct debit procedures. In the first case, the settlement of the ancillary system is effected via a credit transfer procedure in which the participants with a short position in the ancillary system pay into a settlement account of the ancillary system in the shared platform. As soon as all funds are received, the participants with a long position in the ancillary system are paid out. Such a model is currently used, for example, by Euro1. In the second case, the ancillary system would generate direct debits and collect them from the obligors via the shared platform.

⁵ This is the way in which in France securities transactions are settled in central bank money in the securities clearing and settlement system RGV.

The shareable platform available from the start of TARGET2 (as well as any other shareable platform that may be available in the future) could provide these harmonised settlement solutions without reducing their stability and performance.

During a transitional phase it could, however, also be foreseen that the ancillary systems do not settle on the shareable platform but on normal settlement accounts of the participants with their home central bank. The ancillary systems could then maintain their current settlement model for a while and “connect” to the shareable platform when appropriate. However, it is likely that TARGET2 will become a catalyst for further harmonising the different settlement methods. Indeed, the industry is pushing for such harmonisation in order to increase efficiency and save costs.

In this respect, it should always be considered that national specificities in many cases are not really “tailor-made services” in the sense that the service is required specifically in this and in no other way. Often they are simply country-specific solutions from the past which answer the market needs of settling efficiently and safely their transactions, but which could as well be done differently today. Technically, the shareable platform available from the start of TARGET2 (as well as any other shareable platform that may be available in the future) will be able to provide different country-specific services and settlement solutions for ancillary systems at the same time. It is only a question of the adaptation costs and how they are split between the shareable platform and the ancillary systems. In the long run, a greater degree of harmonisation would in any case save costs and is thus favoured by the industry. The trade-off that exists between transition cost and harmonisation suggests that enough time be allowed for the process. In the short term, pragmatic solutions can help to achieve this goal.

3. GOVERNANCE, FINANCING AND PRICING ISSUES

There will be three levels of governance in TARGET2. As at present, the decision-making bodies of the ECB constitute the top of the line of command for TARGET2 and have final competence in domestic and cross-border TARGET-related issues (first level). Within the general framework defined by the ECB, the central banks maintaining their individual platform or sharing one with other central banks will have a subsidiary competence in all TARGET-related issues which are left to their discretion. In particular, the second level of governance of the systems will be carried out by the respective central banks in the case of individual platforms, and by the participating central banks in the case of shareable platform(s). The technical operator of the shareable platform(s) and of each individual platform constitutes the third level of governance.

In the decision-making process at the different levels of governance, the close involvement of the system users (mainly credit institutions and ancillary systems) is a crucial aspect.

The ECB will provide any kind of co-ordination function that will be needed in TARGET2, as it does today.

As far as the financing of the different components of TARGET2 is concerned, individual platforms will be financed by the central banks maintaining them. The shareable platform will be financed by the central banks participating in the platform.

3.1 The first level of governance

The role of the ECB will be, to the largest possible extent, the same for all components of TARGET2 and will include decisions on the issues mentioned above, e.g. core services, common cost methodology and single price. Among other things, the “first level” of governance should aim at an equal treatment of all components of TARGET2. Only where the single shareable platform raises specific issues related to its unique character as the only shareable platform available at the start of TARGET2 should the first level be involved. The ECB will ensure that the single shareable platform can play its intended role as a Eurosystem-wide platform in which any central bank is free to participate at a later stage, having the same rights and obligations as those which join the shareable platform at the outset.

3.2 The second level of governance

The second level of governance rests, for each platform, with the NCB(s) participating in it. Under the general guidelines of TARGET2 as a whole and within the specific framework defined by the ECB for the shareable platform as the only shareable platform at the start of TARGET2, the central banks sharing the platform have the same freedom to govern it as the central banks maintaining an individual platform have for their systems.

The decisions to be taken at this level of governance include *structural issues* such as the initial design and development of the platform, and, for the shareable platform, the question whether it will be built from scratch or be based on an existing platform. Also in this category comes the decision on the location of the shareable platform which, however, will be taken only after consultation with the first level of governance. Factors such as costs, expertise of the operator, and security should determine this decision. Security considerations could result in the primary and the secondary sites of the shareable platform being located in different countries.

In addition to these structural decisions in the implementation phase of TARGET2, there are also *ongoing decisions* to be made at this level of governance once the system is in place. Examples are the choice and development of new additional services requested by the (national or platform-wide) users of the platform, the pricing of these additional services, the staffing of the management bodies of this level of governance and the monitoring of the long-term business development. Responsibility for maintaining business relations with the users (in order to remain well-informed about the financial markets and to be able to act appropriately in emergency situations, to admit participants to the system, to monitor the day-to-day operations and intraday liquidity positions of the central banks’ “own” customers, to ensure the smooth flow of payments and to solve problems in contacts with credit institutions and ancillary systems etc.) remains with the individual central banks, even in case of the shared platform.

With regard to *financing*, a scheme will have to be developed to ensure that central banks joining the shareable platform at a later stage bear an appropriate share of the initial development and implementation costs of the platform.

3.3 The third level of governance

Individual platforms may be operated by the relevant NCB and/or by an external entity. The technical operator(s) of the shareable platform could be an NCB, the ECB or several central banks together on the basis of a rotation system. Alternatively, the operation of the platform could be outsourced to a separate legal entity, either privately owned or jointly owned by the central banks which join the shareable platform. As more than one central bank can be involved in the *operation* of the shareable platform, the platform *development* does not necessarily have to be done by only one entity. The decisions to be taken by the entity(ies) entrusted with the technical provision of each (individual or shareable) platform will concern the daily technical running of the system on the basis of defined service level agreements with the relevant central bank(s).

3.4 The role of the users

In order to ensure that each platform is developed and maintained as an efficient component of TARGET2 which meets the requirements of its users, a consultation procedure involving the user community will be established as an integral part of the decision-making processes. The involvement of the users in the decisions will be ensured in two ways. The users will be consulted on all issues arising at the different levels of governance that have an impact on them, such as the service level. They will also express their views and be entitled to make proposals concerning all issues of relevance to them on their own initiative. Procedures for fair and wide participation of users in the consultation process will have to be defined. On the one hand, due account will be given to the weight of the individual users in terms of payment values and volumes. At the same time, possible specific needs of the smaller credit institutions will have to be appropriately reflected.

The close involvement of the users does not call into question the fact that the ultimate decisions are taken at the respective levels of governance. Indeed, there will be no automatism according to which the result of a user consultation would determine the final decision to be taken. In certain, but presumably rare cases, a greater importance may need to be attached to public policy considerations, such as systemic risk reduction. How the dialogue with the users of the shareable platform will be organised, and in particular the roles of the individual joining central banks, will be decided in more detail at the second level of governance.

3.5 Pricing

For the services which are part of the core TARGET service, there will be a single TARGET-wide price structure to be decided upon by the ECB, which will be inspired by the principle “same service, same price”. This does not necessarily imply one price only. For example, the price structure could graduate prices according to the number of payments a participant sends or according to the timing of the payment. Additional services can continue to be priced separately and independently by each central bank.

The “same price” will be based on a benchmark RTGS system defined as the one with the lowest average cost per transaction (domestic and cross-border). It will have to allow for full cost recovery by the benchmark RTGS system, taking into account, however, a “public good factor”. The public good factor will be uniform for all components of TARGET2.

The single price structure will apply as from the beginning of TARGET2.

The benchmark RTGS will not be asked to increase its price in order to ensure a higher degree of cost recovery by TARGET as a whole.

4. FURTHER STEPS IN THE ESTABLISHMENT OF TARGET2

TARGET2 will start when:

- (i) the Guideline for TARGET2 comes into force;
- (ii) all TARGET components provide the core services as stipulated in the Guideline;
- (iii) those services are offered at a single price; and
- (iv) the shared platform is operational.

The October 2002 decision of the Governing Council focused on the guiding concept for TARGET2, leaving several aspects for further elaboration.

The further preparation of TARGET2 can be divided into three phases: (i) the pre-project phase; (ii) the project phase; and (iii) the testing and trialling phase.

The following steps belong to the *pre-project phase*:

- The views of the entire community of TARGET users on the best way to implement the approach chosen for TARGET2 as well as on its service level will be obtained via this public consultation. On this basis, the requirements of the TARGET users (i.e. mainly credit institutions, ancillary systems settling in TARGET and central banks) will be identified.
- The NCBs wishing to be part of the single shareable platform available at the start of TARGET2 will start discussions which will be open to any NCB interested in becoming involved in such an initiative. The ECB will co-ordinate these discussions. An agreement on the details of the governance and financing of the shareable platform as well as on its location and its technical service provider(s) has to be reached.
- The TARGET Guideline will be amended so as to reflect the decisions which have been taken by the Governing Council of the ECB concerning TARGET2.
- On the basis of the user requirements, a list of core services for TARGET2 will be established, thereby taking as a starting point the higher degree of factual similarities between the present RTGS systems, rather than the “minimum common features” approach prescribed in the current TARGET Guideline.

The *project phase* for TARGET2 will start once the above tasks have been completed. During this phase, detailed user requirements together with business and technical specifications have to be defined and agreed. Subsequently, software has to be developed or upgraded. The central banks maintaining their individual platform will have to adapt it to the specifications of the TARGET2 system and the Interlinking (if changed). Specifically for the shared platform, this phase should ideally be launched with the signing of the contract(s) by the provider(s) of the shareable platform and the joining central banks and implies at least three sub-projects:

- First, the provider(s) of the shareable platform and the joining central banks will have to adapt their system(s) to the specifications of the shareable platform.
- Second, if there are changes to the Interlinking, the shareable platform has to be interconnected with the other TARGET components according to the new specifications.
- Third, ancillary systems and possibly credit institutions will have to adjust to the interface and functionality of the shareable platform.

At the end of this phase the benchmark RTGS has to be identified (taking into account costs related to the processing of domestic payments and cross-border payments in that system) as the basis for a single TARGET-wide price structure which has to be elaborated, also taking into account the existence of a public good factor. An analysis will also be made of how the proposed price structure would affect the policy objectives of the system, such as the processing of the largest possible number of large-value payments and broad direct access.

In a third phase, intensive *tests and pre-production trials* are the essential prerequisites to ensure a smooth start of live operations of TARGET2 as a whole.

Given the large scale of the project, as illustrated by the above-mentioned steps that need to be completed for the preparation of TARGET2, its full implementation cannot be expected before the second half of this decade. This raises a number of *transition issues*:

- In the period until the start of TARGET2, certain steps could be anticipated as long as they do not conflict with the decision taken for TARGET2, e.g. the start of the shareable platform should not necessarily wait for the implementation by all TARGET components of the core services. The TARGET Guideline should be amended so as to take the new perimeter (see section 2.1) into account.
- The start of TARGET2 as well as the availability of the shareable platform will be preceded by EU enlargement. The Governing Council of the ECB has decided that the accession country central banks will be given the same rights and obligations with regard to the TARGET connection as the current non-euro area NCBs. For those accession country central banks that do not wish to establish their own euro-RTGS platform, an interim solution will be offered until the shareable platform becomes available.

- The ESCB will soon identify the improvements to the current TARGET system requested by TARGET users which could be realised within a limited time frame and at reasonable cost, assuming there are any.