

67



Rivista trimestrale - 1/2007

Estratto



G. Giappichelli Editore – Torino

The ECB and Target 2 – Securities: questions on the legal basis *


di Marco Lamandini

Executive summary:

The current European system of securities' clearing and settlement is still rather fragmented along national boundaries, thereby making cross border operations costly and less efficient. As a response to this, the European Central Bank («ECB») is launching the project of a centralized public securities' settlement platform, called «Target 2 Securities» («T2S»), which would entitle each participant to settle, through a single Target2 account, any securities' transaction performed through a Central Securities Depository that provides for settlement in central bank money in Euro. The legal basis of T2S is to be found in Article 105 (2) of the EC Treaty and, more specifically, in Articles 17, 18, 22 and 23 of the ECB Statute. This paper is structured as follows. The first part briefly describes the background of T2S. Part two addresses the policy reasons supporting the ECB initiative. Part three discusses the legal basis for T2S. Part four discusses the trade-off between market-driven integration and public consolidation of securities' clearing and settlement in the Eurosystem, also in the light of the «open market» and «free competition» principles set out in Article 105 of the Treaty. Part five briefly examines similar initiatives elsewhere, also looking at those promoted and managed by other Central Banks. Part six concludes with a few initial remarks on the extension of the legal framework of Target to T2S.

1. Introduction

By now Central Securities Depositories (hereinafter, «CSDs») operating in Europe settle the central bank money leg of any securities' transaction denominated in Euro through the local real-time gross settlement component of the Target system. To this purpose, all (direct or indirect) participants in a CSD must also participate (directly or indirectly) in the national real-time gross settlement system of the country where the CSD is located. This makes the settlement procedure particularly costly and less effective when cross border transactions are processed (it has been calculated, indeed, that cross-border securities' settlement in the EU is up to six times more expensive than domestic settlement). The fragmentation of clearing and settlement along national boundaries, moreover, frustrates



* Opinion delivered on December 4, 2006 to the Economic and Monetary Affairs Committee of the European Parliament – Brussels.

the possibility to profit from the economies of scale made available in principle by a single currency and by current market integration. With the introduction of Target2 (hereinafter «T2») (which will open on November 2007) it will be possible, according to the European Central Bank (hereinafter, «ECB»), for each participant in T2 to settle, through a single T2 account, any securities' transaction performed through a CSD that provides for settlement in central bank money in Euro. Cash and securities might be settled, therefore, on the same IT platform along the lines of an integrated model at the Eurosystem level (such a platform is referred to as Target2 Securities, hereinafter «T2S»), with estimated efficiency gains and costs' savings which, even if the system were not compulsorily mandated (a point which seems still open to discussion), should compel *de facto* existing national CSDs to outsource their user accounts to the T2S platform. As recently pointed out by Mr. Godeffroy, Director General of the Payment Systems and Market Infrastructure at the ECB¹

«users consider that the most efficient model [for securities settlement] is the integrated model, where cash and securities are settled in the same platform. Consequently [to achieve this model] there were two options: outsourcing the management of central bank accounts to the CSDs, as in the system which Euroclear will open soon, or outsourcing the CSD accounts to a central bank platform. The conundrum is simple. Outsourcing cash accounts to the CSDs means fragmentation of liquidity. Outsourcing securities accounts to the Eurosystem means integration and economies of scale. Eurosystem has a clear preference for keeping full control of its cash accounts. A central bank is *central* because it holds the accounts of the banks in its country».

2. Policy reasons for T2S

From a European regulatory perspective, the project of a «Euro-common venue» for cash and securities settlement is clearly conceived on the assumption that, in addition to improving market efficiency through a prompter achievement of economies of scale and reducing liquidity risks in the Euro-area – thereby safeguarding and, if possible, enhancing financial stability – it will also lift existing barriers in the cross border trading of securities denominated in Euro, thus creating a level playing field for securities settlement in Euro to all Eurosystem counterparties. In doing so, the ECB intends to respond to a perceived market failure in the regional integration, as it is deemed to be the current persistent fragmentation, along national boundaries, of the existing securities settlement providers. In fact, over the last decade, also in the wake of the CPSS and IOSCO recommendations for securities settlement systems², there have been several attempts to tackle fragmentation and inefficiencies in the European securities settlement market³ and an elaborated action plan was put forward by the Giovannini Group⁴ and by the European Commission⁵. Indeed, it is widely recognized that



¹ Godeffroy, "Ten frequently asked questions about Target2-Securities", Speech at the British Bankers Association, London, 20 September 2006 (available on www.ecb.int/paym/market/secmar/integr/html).

² Committee on Payment and Settlement Systems (CPSS) and Technical Committee of the IOSCO (International Organization of Securities Commissions), *Recommendations for Securities Settlement Systems* Consultative Report, CPSS Publications No. 42, Bank for International Settlements (Basel 2001). Available at <http://www.bis.org/publ/cpss42.pdf>.

³ Lober, "The Developing EU Framework for Clearing and Settlement of Financial Instruments", *ECB Legal Working Paper Series* (No. 1/February 2006) (also available on <http://www.ecb.int/pub/pdf/scplps/ecblwp1.pdf>); Moloney, *EC Securities Regulation* (Oxford, 2002), 714. See also the standards for the use of EU Securities Settlement Systems in the ESCB credit operations, elaborated by the joint group of the ESCB and CESR at <http://www.ecb.int/paym/coll/standards/html/index.en.html>. The idea of integrated clearing and settlement was already promoted by the Segré Report in 1966, 31.

⁴ The Giovannini Group, appointed by the EU Commission, has concluded two important reports [*Cross-Border Clearing and Settlement Arrangements in the European Union* (Brussels, 2001)] and *Second Report on EU Clearing and Settlement Arrangements* (Brussels, 2003), both available on http://ec.europa.eu/economy_finance/giovannini/clearing_settlement_en.htm.

⁵ COM (2004) 312 final, issued on 28 April 2004.

Europ
and s
are di
and e
gree
tion -
ferent
gle cl
what
in par
and fl
tion.
'
that n
integr
integr
mark
denor
ECB'
if son
the cc

3. Q

Th
Treaty
more
specif
system
has, in
a)
of the

tra
agr
not
bas

⁶ C.
site to I
Paper 2
ties Mar
=7520
⁷ Va
availabl
⁸ Fo
4), 24.

European public authorities have some scope for intervention in this field⁶. When trading, clearing and settlement are too costly or complex as a result of insufficient integration, financial transactions are discouraged, and this has a negative effect on the allocation of capital, risk sharing across agents and economic growth within the integrated area⁷. It is therefore common wisdom that a greater degree of integration in the Eurosystem – promoted or realized, as the case may be, by public intervention – is needed, in order to fully exploit the advantages of having a single currency. However, different models of integration are available (from vertical integration to horizontal integration to a single clearing and settlement system)⁸ and the basic question in the current regulatory agenda rests on what instrument is best suited to the purpose of market integration and consolidation. The question, in particular, is whether such integration of clearing and settlement systems should be market-driven and therefore left in the hands of market participants or should be the result of direct public intervention. The ECB project is a clear regulatory response in this latter sense, motivated by the very fact that more than 7 years after the launch of the Euro, despite the efforts made at Community level to integrate European financial markets and to promote market-driven processes of securities settlement integration and despite the economies of scale made available in this respect by the new currency, the market is still far from providing a private, common or truly integrated platform for all Euro-denominated securities. The question remains, however, (and should be clarified in the wake of the ECB's feasibility study under way) whether T2S would be able to achieve a situation in which, even if some market participants will lose once it is implemented, the overall expected benefits outweigh the costs under a Kaldor-Hicks efficiency criterion.

3. Questions on the legal basis

The legal basis for the ECB proposal for T2S rests, in general terms, on Article 105 (2) of the Treaty (according to which the ESCB must promote the smooth operation of payment systems) and, more specifically, on the ESCB Statute (hereinafter, the «Statute»). Although the Statute includes no specific reference to T2S, it contains nevertheless several provisions, which, upon a functional and systematic interpretation, appear relevant in this respect. They confirm, in my opinion, that the ECB has, in principle, the legal authority to carry out the functions it proposes. And namely:

a) A provision often referred to as setting out a proper legal basis to the ECB project is Article 18 of the Statute, which reads as follows:

In order to achieve the objectives of the ESCB and to carry out its tasks, the ECB and the national central banks may:

- operate in the financial markets by buying and selling outright (spot and forward) or under repurchase agreement and by lending or borrowing claims and marketable instruments, whether in Community or in non-Community currencies, as well as precious metals;
- conduct credit operations with credit institutions and other market participants, with lending being based on adequate collateral.

⁶ C. Hirata de Carvalho, "Cross-Border Securities Clearing and Settlement Infrastructure in the European Union as a Prerequisite to Financial Markets Integration: Challenges and Perspectives", *Hamburgisches Welt-Wirtschafts-Archiv (HWWA) Discussion Paper 287*, Hamburg Institute of International Economics; (Hamburg, 2004), 46; Schmiedel-Schonenberger, "Integration of Securities Market Infrastructures in the Euro Area" (July, 2005), *ECB Occasional Paper No. 33*. Available at SSRN: <http://ssrn.com/abstract=752093> (25, 31).

⁷ Van Cayseele-Wuyts, *Cost Efficiency in the European Securities Settlement and Safekeeping Industry* (Bruxelles, 2005), 31, available at SSRN: <http://ssrn.com/abstract=808824>; Schmiedel-Schonenberger (*supra*, n. 6), 24.

⁸ For a brief discussion of existing European experiences of consolidation, see The Giovannini Group, *Second report* (*supra*, n. 4), 24.

The ECB shall establish general principles for open market and credit operations carried out by itself or the national central banks, including for the announcement of conditions under which they stand ready to enter into such transactions.

As it results from the plain reading of the provision, Article 18 includes buying and selling «marketable instruments» and conducting credit operations. Albeit the wording of this Article does not explicitly mention securities settlement operations (the T2S proposal was not foreseen at the time the Statute was drafted, and thus Article 18 contains no explicit mandate to carry out settlement operations of securities), it seems, nonetheless, to cover (also) the basic functions displayed by a securities settlement system, especially when a central counter party is put in place.

b) In addition to Article 18, further (and, in my view, clearer and, perhaps, more convincing) legal basis for the T2S initiative can be found in Articles 22 and 23 of the Statute. Article 22, titled «Clearing and Payment Systems», sets forth that the ECB and national central banks *may provide facilities*, and that the *ECB may make regulations*, to ensure efficient and sound clearing and payment systems within the Community and with other countries. This provision specifies and implements, through the establishment of a specific legal competence of the ECB, the content of the ESCB general task of «promoting the smooth operation of payment systems» laid down in Article 105 of the Treaty and in Article 3.1 of the Statute. It is not surprising, therefore, that, albeit also the wording of Article 22 does not mention specifically the settlement of securities, the ECB Director of the Payment Systems and Market Infrastructure – in his above mentioned recent speech in London – correctly referred to Article 22 as the proper legal basis for the T2S proposal⁹. The payment infrastructure also for securities settlement is indeed one of the first places where financial stress induced by credit and liquidity problems might become real. Liquidity problems can easily lead to contagion and domino effect. It seems, therefore, falling in the full competence of the ECB to address such issues. If Article 22 is applicable, it must also be reminded that Article 34.1 of the Statute entitles the ECB to «make regulations to the extent necessary to implement the tasks defined (among others) by such Article 22».

c) In turn, Article 23, dealing with external operations, does refer to securities when it grants the ECB a triple mandate with regard to operations involving banking transactions and foreign exchange assets. The latter term includes securities as well as all other assets in whatever currency or form. As Professor Smits noted, once the ESCB has been granted such a wide scope of operation in the external field, these competences cannot be denied to the ECB domestically¹⁰. Thus, whilst Article 22 grants a mandate to provide clearing and payment facilities, Article 23 (also in relationship with Article 18) seems to provide for a mandate to carry out virtually any operation involving securities. When read together, these provisions seem to confirm that the ECB has a proper legal basis to introduce the T2S platform.

d) Additional legal basis, for the cash leg of the system, can be finally found in Article 17 of the Statute, which entitles the ECB to «open accounts for credit institutions, public entities and other market participants and accepts assets, including book entry securities as collateral» to the extent necessary to perform its operations.

⁹ «There has never been a problem for central banks to provide infrastructures. Central banks are not profit-maximising institutions. Their role is to foster the smooth settlement of payment and securities transactions, sometimes by providing facilities and sometimes by passing regulations, as it is foreseen in article 22» (available on: <http://www.ecb.int/paym/market/secmar/integr/html/10faq.en.html>).

¹⁰ Smits, *The European Central Bank – Institutional Aspects* (The Hague, 1997), 312.

4. Market-driven integration or public direct intervention?

It might be questioned, however, whether the creation of T2S as a common and public venue for securities' clearing and settlement promoted and managed by the ECB does or does not harm competition. Article 2 of the Statute sets out, indeed, that:

In accordance with Article 105(1) of the Treaty, the primary objective of the ESCB shall be to maintain price stability. Without prejudice to the objective of price stability, it shall support the general economic policies in the Community with a view to contributing to the achievement of the objectives of the Community as laid down in Article 2 of the Treaty. *The ESCB shall act in accordance with the principles of an open market economy with free competition, favouring an efficient allocation of resources, and in compliance with the principles set out in Article 4 of this Treaty.*

In devising the new system, specific consideration must be paid, therefore, to the reasons of an open market economy and of free competition. It should be considered, in this respect, that in discussing the EU clearing and settlement system, the Lamfalussy report¹¹ was clear in concluding that any integration process should be largely in the hands of the private sector, although it *warned that any failure of the private sector to make sufficient progress in integration would justify public-sector intervention*. A similar approach was taken also by the Giovannini Group, which, in its Second Report¹² sponsored a market-driven integration and consolidation, although it added that «the financial industry is the quintessential regulated industry and therefore it is difficult to conceive of reforms that affect the very architecture of financial services which do not involve public authorities. Thus it would be naïve to assume that the integration of the EU clearing and settlement environment could be left to private market participants alone. On the contrary, the public sector can be expected to play a major role – both in co-ordinating private sector actions and re-regulating clearing and settlement on a pan-EU basis». It should be duly assessed, therefore, if, as it seems, despite recent market moves apparently responding to the ECB T2S project as the European Code of Conduct for Clearing and Settlement¹³, the disappointing results achieved so far by market-driven integration after seven years from the launch of the Euro do show the occurrence of that market failure which, also in the opinion of the Lamfalussy Committee, would justify public-sector direct intervention. If this were the case and if it could be shown that the designed public model would enhance efficiency by achieving, within a more reasonable time period, the necessary economies of scale still not attained by the market alone, there should be, in a legal perspective, sufficient ground for the ECB to take over the relevant activity in order to foster efficiency and better integration of the financial market at European level *in full compliance with the subsidiarity and proportionality principles*. In that respect moreover, the following should be considered.

a) Firstly, as it has been correctly noted by the Giovannini Group in its Second Report¹⁴, on one hand, «without integrated clearing and settlement, a single European securities market will never exist and without an integrated European securities market the outcome of the entire process of financial market integration is certain to disappoint». On the other hand, the drive towards integration works at the same time as a strong pressure towards consolidation. This means that the likely outcome of any process of market-driven consolidation would be, in due course, either a private monop-

¹¹ *Final Report of the Committee of Wise Men on the Regulation of European Securities Markets*, Brussels, February 2001, 16 (available on http://ec.europa.eu/internal_market/securities/docs/lamfalussy/wisemen/final-report-wise-men_en.pdf at p. 16.

¹² The Giovannini Group, *Second report* (*supra*, n. 4), 40.

¹³ Issued on November 7, 2006 by FESE – the Federation of European Securities Exchanges, EACH – the European Association of Central Counterparty Clearing Houses and ECSDA – the European Central Securities Depositories Association available on http://www.fese.be/_mdb/news/EuropeanCodeofConductforClearingandSettlement-website.pdf.

¹⁴ The Giovannini Group, *Second Report* (*supra*, n. 4), 39.

oly (as it would be in the model 2 and model 3 envisaged by the Giovannini Second Report) or a private oligopoly (as in the model 1 envisaged by the Giovannini Second Report). This would in any event require very costly and significant (*but not always very effective*) public sector governing measures and monitoring to: i) ensure fair and low cost access without discriminating across users; ii) foster adequate investments in technological innovation; iii) control that prices are close to costs and costs are minimized; iv) provide adequate risk management and safeguards in respect of any financial market crisis or strain. Moreover, despite these measures, the existence of a private monopoly or oligopoly would however be likely to pose a challenge to the open market economy and the public interest greater than the simple consolidation of clearing and settlement through the building of a public platform managed by the ECB (which, moreover, at least from what has been anticipated by the ECB, would be likely to take over only clearing and settlement, leaving to market participants all other functions related therewith)¹⁵. The public ownership and management of a consolidated public platform would indeed entail, *per se*, a response to the governance and open access worries normally associated to a private monopoly or oligopoly and, whilst it is expected to reap the fruits of both greater economies of scale and better control of systemic risk, it would leave open to further scrutiny only the issue of the degree of investments which the public sector could make available in technical innovation. This issue, however, could be similarly doubtful in its outcome also in the case of private monopoly or oligopoly where entry barriers to the market were high.

b) Secondly, as it has been correctly noted by the ECB Director General of the Payment Systems and Market Infrastructure in his above mentioned recent speech, «in reality even if there are many CSDs in Europe today, competition between them is very limited. The multiplicity of actors is a necessary condition for competition. But it is not a sufficient condition. CSDs in the Euro area are, to a large extent, small local monopolies. By merging their settlement function into a single system, the market will benefit from economies of scale, without any meaningful reduction of competition». Cross border competition in the securities settlement system is, in fact, still limited to a few providers (in particular Euroclear and Clearstream International). To this argument, it must be also added that «in fact, competition in the settlement business does exist, not between CSDs but between settlement in central bank money and settlement in commercial bank money». Indeed, there is a major role played in this respect by internalizers: a feature which, as it is well known, is a cornerstone of the MiFID directive (EC/2004/39 of 21 April 2004) and remains well out of the scope of the T2S consolidation, which refers only to settlement and clearing of securities transactions made on the market. It seems therefore correct to conclude that, since T2S shall be limited to settlement in central bank money, it is likely that «it will not kill competition but it will maintain it where it already exists today».

5. A brief comparative overview

Also elsewhere it is, and has been, not uncommon for central banks to provide for securities clearing and settlement services. Outside the Euro area, the most cited examples are those of the Federal Reserve in the US and of the Bank of Japan. The latter provides, in fact, centralised securities settlement services for Japanese government bonds and bills. In the US the SEC published a seminal study on clearing and settlement already in 1975, advocating the establishment of a single clearing house in lieu of the then existing multiple integrated silos and anticipating that this would have made possible a decrease of the post trading costs of about 65% (a percentage of savings which seems to be confirmed by subsequent practice). At that time, the US system was still experiencing a serious «paperwork crisis», with the country's major Stock Exchanges closing one day a week to process the pa-

¹⁵ According to Euroclear Response to the ECB Questionnaire, September 8, 2006, available at http://www.ecb.int/paym/market/secmar/integr/pdf/Euroclear_Group.pdf, if custody were separated by settlement, there would be a loss in terms of economies of scale and scope.

perw
event
«DT
diti
Depo
by ne
ers (r
ket, i
The l
uities
count
more
It is r
Fe
wire
time.
agen
many
ganz
open
as op

6. Th

O
show
with
expar
shall
the ti
down
The (C
mana
would
separ
Indee
ceed
curiti
antici
and ti
functi

16 c
17 c
18 /
19 /
20 F
work cl
open is
account

perwork accumulated. The National Securities Clearing Corporation (hereinafter «NSCC») was eventually founded in 1976 and at about the same time the Depository Trust Company (hereinafter «DTC») started centralising settlement and depository services: operations which, in the US, are traditionally devised as utility services. NSCC and DTC eventually merged in 1999, establishing the Depository Trust & Clearing Corporation (hereinafter «DTCC») – a holding company that controls by now the two entities. The DTCC is, however, a private and mutualized company, owned by its users (major banks, broker/dealers, mutual funds, and other companies operating in the financial market, including the National Association of Securities Dealers and the New York Stock Exchange). The DTCC, through its subsidiaries, provides clearance, settlement and information services for equities, corporate and municipal bonds, government and mortgage-backed securities and over-the-counter credit derivatives. DTCC's depository unit also provides custody and asset servicing for more than two million securities issues from the United States and 100 other countries and territories. It is reported to be the most cost-effective settlement system operating so far¹⁶.

Fedwire, run by the Federal Reserve, provides similar services for Government bonds. The Fedwire Securities Service processes securities' transfers either on an individual or gross basis in real time. The Fedwire Securities Service provides U.S. depository institutions and U.S. branches and agencies of foreign banks the ability to maintain and transfer securities issued by the U.S. Treasury, many federal government agencies, government sponsored enterprises and some international organizations. The Fedwire Securities Service is also used to settle secondary market trades (including open market transactions) and to support activity associated with collateralized lending¹⁷. Fedwire, as opposed to T2S, is a proper CDS and not just a clearing and settlement platform.

6. The extension of the legal framework of Target to T2S

Once conceded that the ECB would have proper legal basis for finalizing its T2S project upon showing the case of efficiency gains and the uncertainty and higher costs, delays and risks associated with a market-driven consolidation, it remains to be clarified to what extent it should be possible to expand the existing Target legal framework also to T2S. This question is, however, premature and shall be properly addressed only after completion of the feasibility study launched by the ECB. For the time being, it might be worth simply recalling that the existing legal framework for Target is laid down in the ECB Guideline of 30 December 2005 (ECB/2005/16)¹⁸ as amended on 3 August 2006¹⁹. The Guideline covers both technical and substantive issues relating to the operation, governance and management of the Target platform. Despite the very fact that the existing Target and T2S platforms would share some common features, key differences between them are very likely to require either a separate legal framework for T2S or a suitable complement to the existing Guideline devoted to T2S. Indeed, should the ECB, after completion of the feasibility study currently under way, decide to proceed further with the project, the T2S guidelines shall specifically address all features concerning securities' settlement. In this respect, there are a number of specific issues on which the ECB did not anticipate its final position, some of which are currently under consultation²⁰. As such, there is room and time for further consideration, in due course, of the legal rules, which will govern in detail the functioning of such a new venue and service.

¹⁶ See <http://www.dtcc.com/AboutUs/origins.htm>.

¹⁷ See <http://www.federalreserve.gov/paymentsystems/fedwire/default.htm>.

¹⁸ Available on: http://www.ecb.int/ecb/legal/pdf/l_01820060123en00010017.pdf.

¹⁹ Available on: http://www.ecb.int/ecb/legal/pdf/l_22120060812en00170018.pdf.

²⁰ For instance, it is not yet clear the scope of the securities covered by T2S nor the area of services provided by T2S. The legal framework clearly depends on whether T2S will eventually offer services such as matching, securities' lending or collateral management. Other open issues involve, i.a., the settlement frequency, the account structure, the communication protocol between CSDs and T2S. For an account of these outstanding issues see http://www.ecb.int/pub/pdf/other/target2_securitiesen.pdf.