



The voice of banking
& financial services



BY EMAIL

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Dear Marc,

T2S user requirements and annexes

I am writing to highlight what the UK National User Group (UKNUG) believe are the critical issues for the UK market in relation to Target2 Securities (T2S). The UKNUG is comprised of expert representatives drawn from the major financial firms, trade associations and infrastructure providers (including registrars), as well as observers from the Bank of England, the City of London Corporation, the Financial Services Authority and HM Treasury. In this submission, we have reflected different participant views where appropriate.

We would like to draw your attention to the ECOFIN conclusions of 27th February 2007 on T2S which noted that "The success of the project will hinge upon its capacity to satisfy market needs of all affected parties".¹ As such, we hope that you will find our comments useful in this regard.

We recognise that our response does not utilise the ECB's User Requirements Document (URD) consultation response template. This is because these comments reflect the UK National Users Group's broader view rather than line by line commentary on the URD. We expect individual UKNUG members will also submit responses to the URD using the template.

Multi-currency environment

At present, T2S will only be able to provide a settlement function in Euro. Whilst any decision to join T2S lies with the relevant national central bank, the UKNUG is pleased to note that the ECB is planning to build in from the outset the possibility of future multi-currency settlement functionality.

Cost and Economic Impact Analysis

The UKNUG remains unclear about the potential costs of the T2S project both in terms of build and operational costs which will ultimately be passed on to the users.

¹ Economic and Financial Affairs, 2787th Council Meeting, Brussels, 27 February 2007, PRESS RELEASE, 6610/07 (Presse 35), http://www.consilium.europa.eu/ueDocs/cms_Data/docs/pressdata/en/ecofin/92984.pdf.

For instance, it has been noted that whilst the Economic Impact Analysis asks firms to calculate the cost of settling in 2007 versus the cost of settling with T2S, these figures do not take into account the amount that firms may be asked to pay for in terms of CSD platform upgrades in the intervening period between 2007 and 2013, both to interface with T2S and to perform routine platform maintenance and upgrades, as required.

Furthermore, users need greater clarity about how the data provided will be used and what cost-benefit analysis will be considered favourable for the project to be given the go ahead. UKNUG members also would like more information about whether auditing, or additional cost-benefit analyses, will be done as the project continues- i.e. is the ECB Governing Council's decision in July 2008 irrevocable or is the first milestone on the journey towards T2S?

Governance

UKNUG members very much support the continued involvement of users in the future governance structure of the T2S project. As a significant proportion of Euro settlement arises from trades originating in London, we expect to continue to be involved. Whilst we appreciate that the build phase will require more technical knowledge and greater interaction between the ECB and the participant CSDs, the end users of the system must remain involved throughout the process at a level equivalent to what now exists in the Advisory Group. Users should also be involved in any technical groups that are convened, as well as on the strategic, securities settlement side.

Legal framework

UKNUG members believe that further information is needed on the legal specifics that would be required in order to implement T2S. The ECB may need to do a feasibility study to indicate where changes in national law would be needed to proceed with T2S. Members would strongly urge this work to be done in coordination with the Commission's work on the dismantling of Giovannini Barrier nine.

Members would also welcome details of the legal arrangements that will be put in place between the ECB and participating CSDs. Whilst we understand that CSDs will only be asked for indications of their willingness to participate in summer 2008, as the project continues, users would like to be kept informed of the legal framework that is put in place.

Legal questions discussed in the UK National User Group include:

- Who will accept responsibility, and financial liability, if there is a processing or security failure? How will the financial liability be financed?
- How will the new arrangements connect to existing legal and business structures?
- How will competition law and policy apply?
- What are the ECB and four Central Banks promising to the CSDs? What are the consequences if that promise is broken?
- How can the CSDs satisfy their supervisors - acting on behalf of investors - that the arrangements that the CSDs have in place are of undoubted safety and soundness?

- How will CSDs give effect to a lawful instruction to 'stop processing' on a given account or on multiple accounts (e.g. as part of an anti-terrorist financing campaign, by Government fiat or by court order)?
- Has a thorough analysis been done of the legal consequences of moving processing to Frankfurt (and other remote locations)?
- What rights will the German and other domestic authorities have in relation to data held and processed on the system?
- In regards to differing laws of evidence, what arrangements will be made to admit the results of T2S processing as evidence in criminal and civil cases in Civil Law and Common Law jurisdictions? Which rules of litigation discovery will apply?
- Which provisions of international law will apply, enabling courts in London and New York, in particular, to give effect to legal and administrative arrangements in Europe?
- Does the Settlement Finality Directive apply to T2S? Does the Settlement Finality Directive apply to the Eurosystem?
- What about the situation in which a private sector entity in one jurisdiction (such as the UK) transfers assets to ECB, which in turn transfers the assets on to a public or private sector entity in another jurisdiction: which law applies to efforts to recover the securities?

The collection of stamp duty in Ireland (and in the UK if it should join) is also cited as a concern.

The ECB indicated at our bi-lateral meeting on 11th March that the T2S team would be addressing legal issues in its next tranche of work and we would like to discuss our specific concerns with you.

Risk concentration and mitigation

One of the UKNUG's biggest concerns is the increased risk that T2S could bring to participants, which is closely tied to the outstanding legal issues that need to be addressed, as outlined above. UKNUG members would expect that the ECB will share with users the risk analysis that it has done and the action it is taking to mitigate those identified risks. This should be done as a matter of urgency.

Synchronisation of Corporate events

The UKNUG is concerned about the lack of detail on how corporate events would be synchronised with settlement, notably in relation to events and how balances were to be obtained from CSDs. Settlement deadlines need to coincide with corporate action deadlines to offer a cost efficient service, quite apart from the time lag effects. From an infrastructure perspective, it is also important that the service levels are maintained. It is also not clear whether or not there will be a register on the settlement platform.

There is also concern about how the system would cope with more complicated events and voluntary actions not covered in the User Requirements Document (URD). It has also been noted that the T2S work in this area could be usefully coordinated with the Commission's work on dismantling of Giovannini Barrier three to ensure constituency.

Custodian bank perspective:

Members are concerned that the separation of settlement and asset servicing may increase the operational risk involved in the execution of corporate actions by adding an additional step to processing either to the chain of data transmission or to a reconciliation between the CSD and T2S to ensure that all parties are basing their administration of the corporate action upon the same balance. This is especially relevant for voluntary actions where instructions are received by the CSD close to the deadline.

Whilst we appreciate that the T2S team have indicated that corporate actions processing is outside the scope of T2S, it will undoubtedly have an impact and needs to be considered during the building of the platform, particularly in terms of out of date balances and real time data.

Registrar perspective:

Registrars are concerned that there is no detail in the URD about how issuers and their agents would interact with the system. For example, automatic transformations are not mentioned specifically although transformations are implied.

Although the Giovannini process is mentioned within the URD, the groupings given are not in line with European harmonisation processes or ISO standards.

Direct connectivity

Users support direct connectivity but need particulars about how it will work in practice. For example, will CSDs will be the final determinants of who can have direct access? If this is the case, a standardised model for sign off should be created allowing for non-discriminatory utilisation of this service. More information is also needed around deadlines for both CSDs versus directly connected participants. These need to be close together to provide a level playing field.

Members are also keen to understand how direct connectivity would impact on the business case and on end-to-end costs, and the extent to which a CSD would incur additional cost through having to monitor both direct and indirect connectivity.

Harmonisation*Bilateral and unilateral cancellation*

T2S only allows bilateral cancellations, however, it should be pointed out that, at present, this is not the case across all markets and with all instruments. There are different practices in different countries and also between different markets within the same country. Greater consultation with the user community is needed on this point to ensure that functionality is built into the system to ensure that current market practice is changed only with the agreement of market participants.

Matching

Members believe that further clarification is needed on matching. For example, at present it is not clear whether or not matching should occur at CSD level or T2S. Harmonisation is needed for determining at what level matching should occur, in what fields, how this would be specified and by whom. For the sake of consistency, and taking into account the option of direct connectivity, matching in T2S would appear optimal.

Members have also raised concerns that T2S will not send allegations immediately. There is also a lack of information about prioritisation of cash accounts in the current URD.

Night-time settlement: mandatory or not

Members would like confirmation that T2S's night-time settlement would remain mandatory only for the Euro area. Some members noted that it was also a question, through adoption of night time settlement, of ensuring that EU markets remained attractive internationally in terms of both investment and cost. In practical terms, this could impact all along the value chain, including Treasury functions and Registrars, and in liquidity and risk management terms. Members, in particular, would like to be reassured that the existing certainty was not being replaced by something which led to less efficiency and greater risk.

We hope that you will find our comments useful and would welcome the opportunity to discuss them with you. We are more than happy for this letter to be published.

Yours sincerely,

A handwritten signature in black ink that reads "David Pritchard". The signature is written in a cursive, slightly slanted style.

David Pritchard
Chairman
UK National User Group