COMMUNICATION ON TARGET2

INTRODUCTION

The purpose of this communication is to update market participants on the Eurosystem's recent decisions on TARGET2 participation and pricing.

As requested by the banking community, the Eurosystem has clarified the different ways of participating (see Chapter 1).

Following the publication of the second progress report on TARGET2 on 21 October 2005, the Eurosystem consulted the banking community on the pricing proposals published in that report. Although the proposals were generally well received, some banks considered prices too high, especially for liquidity pooling services. Some expressed a preference for "group pricing". The Eurosystem also re-examined the transaction volume estimates which had been used as a basis for the pricing calculations (Chapter 2).

Taking into account all these elements, the Governing Council has decided to: (i) amend the core pricing scheme slightly and (ii) complete it for the services related to ancillary systems (ASs) (see Chapter 3). In Chapter 4, further clarification is given on the liquidity pooling services, for which a new pricing scheme is also presented.

1 PARTICIPATION IN TARGET2

As described in the General Functional Specifications, there will be a number of ways to access the TARGET2 system. These include direct and indirect participation, "addressable BICs" and "multi-addressee access", also known as "technical BIC access".

The Eurosystem has now developed the general legal structure and principles for participation in TARGET2, which should allow participants to decide on the form of their participation in the system. More detailed access criteria, including precise definitions and detailed requirements to be met by participants, will be developed in the TARGET2 system rules.

1.1 DIRECT PARTICIPATION

The criteria for direct participation in the current TARGET system have proven to be adequate for the Eurosystem and market participants. The framework for direct participation will therefore not be changed. The following institutions will be eligible to be direct participants in TARGET2: (i) supervised credit institutions established in the European Economic Area (EEA), including branches, (ii) investment firms established in the EEA and authorised and supervised by a recognised competent authority, (iii) EU Member States' treasury departments of central or regional governments active in the money markets (iv) EU Member States' public sector bodies authorised to hold accounts for customers; (v) organisations providing clearing or settlement services subject to oversight by a competent authority and (vi) the central banks of the EU Member States. In addition, entities of the types listed above and established in a country with which the Community has entered into a monetary agreement (i.e. the Principality of Monaco, San Marino and the Vatican City) may also be admitted as direct participants under conditions specified in the TARGET2 rules. No exception will be granted (by contrast with the current TARGET system) to institutions that do not belong to one of the above categories (i.e. they will no longer be "grandfathered").

Direct participants will hold an account in the Payments Module (PM) of the Single Shared Platform (SSP) and will therefore be able to: i) submit/receive payments directly to/from the system and ii) settle directly with their central bank. Direct participants will be responsible for all payments sent or received on their account by any entity registered through them in TARGET2 (indirect participants, multi-addressee access entities and addressable BICs as described below).

Credit institutions will be able to have "special purpose" accounts for non-payment activity (e.g. for the maintenance of reserve requirements) in the PM. This may be particularly useful for banks operating in more than one country. Upon the request of the direct participant, the Bank Identifier Code (BIC) of a special account will not be published in the TARGET2 directory.

1.2 MULTI-ADDRESSEE ACCESS

In the TARGET2 system, direct participants will be able to authorise their branches and credit institutions belonging to their group, located in EEA countries, to channel payments through the direct participant's main account without its involvement by submitting/receiving payments directly to/from the system. This offers affiliate banks or a group of banks efficient features for liquidity management and payments business.

The payments will be settled on the main account of the direct participant. Multi-addressee access will be subject to system rules which will be described at a later date. The system rules will also give details of the composition of a group.

1.3 INDIRECT PARTICIPATION

Only supervised credit institutions established in the EEA and EU central banks directly participating in the system[1] will be allowed to intermediate for credit institutions established in the EEA[2] which, for whatever reason, want to have their payments settled in TARGET2 without connecting directly to it. By contrast with multi-addressee access, indirect participation implies that payment orders are always sent to/received from the system via the direct participant. Payments are settled in the direct participant's account in the PM of the SSP.[3]

Indirect participants will be recognised by the TARGET2 system rules. The TARGET2 system rules will define the details of the framework for indirect participation, possibly including a service level to be provided to the indirect participants by the direct participants (covering confidentiality issues, for example).

1.4 ADDRESSABLE BICS

Another category of access already known from the current TARGET system is the TARGET2 addressable BICs. These are not subject to any system rules. Any direct participant's correspondent or branch that holds a BIC is eligible to be listed in the TARGET2 directory, irrespective of its place of establishment. Moreover, no financial or administrative criteria have been established by the Eurosystem for such addressable BICs, meaning that it will be up to the direct participant to define a marketing strategy for offering such status. It will be the responsibility of the direct participant to forward the relevant information to the respective central bank for inclusion in the TARGET2 directory.[3] Addressable BICs will always send and receive payment orders to/from the system via a direct participant. Their payments will be settled in the account of the direct participant in the PM of the SSP.

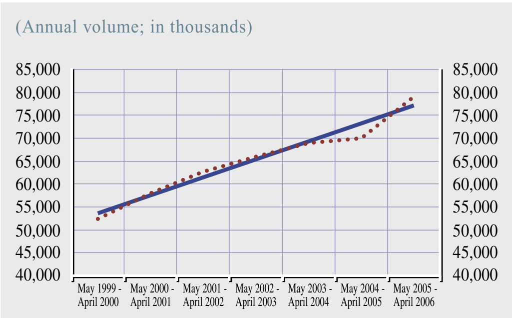
Although technically there is no difference between an indirect participant and an addressable BIC[4] in legal terms, only indirect participants will be recognised by the TARGET2 system and as such benefit from the protection of the Settlement Finality Directive (SFD) (in the countries where such protection has been granted). Addressable BICs would not be entitled to claim under the TARGET2 compensation scheme and they would not have to fulfil any additional requirements which the Eurosystem might consider with respect to indirect participants.

1 The EU central banks will cease providing indirect participation services after the four-year transition period.
2 In line with the provisions of Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems.
3 For technical reasons an indirect participant/addressable BIC can be linked to only one direct participant
4 The TARGET2 directory will distinguish between indirect participants and addressable institutions.

2 TARGET2 VOLUME ESTIMATE

Until now, the Eurosystem had assumed a volume of 81.3 million transactions for the first year of TARGET2 operations, starting 1 January 2007. This was based on an estimated increase in TARGET volume of 3% per year, as during the period 2002-2004. However, the Eurosystem now recognises that during this low-growth period, substantial flows of funds shifted to the Continuous Linked Settlement (CLS) system. In 2005, the growth rate was 8.27%, and in the first few months of 2006 it was above 10%. Therefore it now appears more accurate to use the trend since 1999 as the basis for the traffic estimates.

The following chart shows the volumes processed in TARGET for the seven years from May 1999 to April 2006, including 60% of the German Euro Access Frankfurt (EAF) and the Spanish Servicio de Pagos Interbancarios (SPI) until their closure[5] (in November 2001 and December 2004 respectively) to neutralise the one-off effects on the trend of these systems moving to TARGET. The chart shows average yearly growth of 7.14%.



The Governing Council nevertheless decided to adopt a prudent approach and base its future volume estimates on a growth rate of 6% only. Other one-off events that will influence the volume estimate were also taken into account, in particular (i) the anticipated move of the Dutch securities settlement system from the interfaced to the integrated model, (ii) the closure of the UK CHAPS Euro system and (iii) the closure of the French Paris Net Settlement (PNS) in February 2008.

On the basis of the new assumption, the revised volume estimate for the period from May 2008 to April 2009 is 93.1 million transactions and the total number of transactions during the six years of the amortisation period – based on an average volume of 108 million – is 650 million transactions.

3 TARGET2 PRICING

3.1 TARGET2 CORE PRICING SCHEME

The Governing Council agreed in October 2005 on the envisaged pricing scheme for the TARGET2 core service, on which the banking community was consulted. In general, the Eurosystem received a positive response to its proposals. Nevertheless, larger banks expressed the view that prices were too high, and there was a general feeling that this applied in particular to liquidity pooling services. Some banks operating in more than one country requested the option of group pricing (i.e. the volumes of the head office would be merged with the volume of the branches and subsidiaries to lower the average price per transaction).

Considering these comments and the expected higher cost coverage implied by the volume estimates given in Chapter 2, the Governing Council decided to add another value band to the degressive pricing scheme of €0.125 for all transactions settled by a participant above a volume of 100,000 transactions per month. The amendment lowers the average price for very large participants, which contribute most to the volume of TARGET2. It will therefore create an additional incentive for them to channel traffic through TARGET2.

5 The Deutsche Bundesbank studied the impact of the closure of EAF and estimated that only 60% of EAF traffic had moved to TARGET. It is assumed in this note that the impact of the closure of SPI in Spain and PNS in France had (or will have) the same effect. Similarly, it is assumed that, when CHAPS Euro closes, only 60% of the related traffic will stay in TARGET.

The flat fee option for smaller banks is kept unchanged. However, should TARGET2 revenues be higher than expected, smaller banks would be offered a slightly lower fee in the following years.

The amended pricing scheme for the TARGET2 core service is as follows.

Option A			
Monthly fee			**€100**
Flat transaction fee			€0.80
Option B			
Monthly fee			**€1,250**
	Volume		
Band	From	To	Price
1	1	10,000	€0.60
2	10,001	25,000	€0.50
3	25,001	50,000	€0.40
4	50,001	100,000	€0.20
5	Above	100,000	€0.125

It should be noted that central banks will charge their indirect participants at least the price that they would be charged if they were direct participants, in order to avoid the development of local real-time gross settlement (RTGS) systems at national level. In line with the policy on home accounts (see the second progress report on TARGET2), payments settled on home accounts will be charged above the TARGET2 fee (i.e. above €100 + €0.80 per transaction).

3.2 PRICING OF ANCILLARY SYSTEM SERVICES

In October 2005 the Governing Council decided that ancillary systems (AS) interacting with TARGET2 should be subject to a pricing scheme comprising a transaction fee plus a separate fixed fee charged to each system irrespective of where settlement takes place (e.g. in the PM or in proprietary home accounting (PHA) applications) and the interface used (the ancillary systems interface (ASI) or the payment interface). The fixed fee will cater for the costs of the ASI and for the specific additional services provided by the relevant central bank, and will be charged to each AS on the basis of common parameters reflecting the costs incurred by the Eurosystem (e.g. for monitoring, contingency procedures or support).

The objective of the pricing policy is to ensure cost recovery, taking into account a public good factor, the right balance between price and service and a level playing-field. The scheme should discourage ASs settling on a gross basis and having a high number of transactions in TARGET2 from moving to net settlement.

The Governing Council has now decided that the fixed fee should have two components: i) a fee which is identical for every AS and ii) a fee based on the underlying gross value settled through the AS. The first component reflects the fact that a certain part of the cost is equal for all systems, irrespective of their size (e.g. general costs for connection and administration). The second component makes a distinction between larger and smaller systems, the former being likely to require more resources as regards the management of TARGET (e.g. business continuity requirements, more frequent monitoring). It is considered that underlying gross value is an appropriate criterion on which to base the distinction.

The Governing Council has decided that the first component will be a fee of €12,000 per year, charged to each AS that settles in central bank money, irrespective of whether it settles in an account held at the SSP or in an account held in a central bank's home accounting application. The second component, depending on the size of the system, will be in the range of €5,000 to €50,000 per year.

All transactions that are settled for ASs, irrespective of whether the ASI is used, will be charged according to a degressive transaction fee scale. It has not yet been decided whether core service will be applied to AS transactions. In addition, it is still to be specified whether the transaction fees will be charged to the AS or directly to the participants.

It should be noted that, in addition to the fixed fees for ASs, an AS will pay the respective fixed fees as defined for the TARGET2 core service pricing scheme when holding an account in the PM.

3.3 NEW PRICING ELEMENTS

Given the various possible ways of participating in TARGET2, it was necessary to define a comprehensive and coherent pricing scheme that would cover all types of access. The prices for direct participation are already defined by the core pricing scheme. However, the pricing of other types of access, such as multi-addressee access and direct participation without publication of the account(s) in the TARGET2 directory, have not yet been communicated to the market. These features each have their own benefit for participants and each have their own cost to the system.

The Eurosystem has agreed to apply the following pricing to the various ways of participating in TARGET2, on top of the TARGET2 transaction fees.

Type of participation	Monthly fee per account/BIC
Direct participation	€100 or €1,250 (depending on the scheme chosen; see Section 3.1)
Multi-addressee access	€80 per BIC address in addition to the BIC of the account of the direct participant
Unpublished account in the PM of the SSP	Direct participants who do not wish their BIC to be published will pay €30 per account (BIC) per month in addition to the monthly fee above

In addition, the Eurosystem will charge direct participants a one-off fee of €20 for each registration of an indirect participant and €5 for each registration of an addressable BIC (including BICs of branches of direct and indirect participants) in the TARGET2 directory.

4 LIQUIDITY POOLING

4.1 DESCRIPTION OF THE LIQUIDITY POOLING SERVICE

The concept of liquidity pooling was developed upon the request of TARGET users that were keen to avoid the fragmentation of their liquidity within the TARGET2 system. It was also intended to allow participants to centralise their liquidity management even with decentralised holding of accounts.

TARGET2 will offer two variants for liquidity pooling: i) the virtual account (VA) and ii) consolidated account information (CAI). Liquidity pooling will be achieved by grouping a number of accounts. In the VA option, a payment order submitted by a participant belonging to a group of accounts will be settled if the payment amount is smaller or equal to the sum of the liquidity available on all accounts (including credit lines, if any) in the group. Otherwise the payment order will be queued.

The CAI option is an information tool: it will give comprehensive information to the subscriber about the liquidity position of all the entities of the group at any moment. However, payment amounts will be checked only against the liquidity available on the individual RTGS account of the sending participant. The liquidity available on other accounts in the group will not be used to settle the payment. In the event of insufficient liquidity being available on the sending bank's account, money will need to be transferred to that account.

Only credit institutions established in EEA countries and directly participating in the PM will be able to use the CAI option. Furthermore, owing to business and legal constraints, the VA option will only be available for PM accounts of euro area banks held with euro area central banks.

It will only be possible to establish a group of accounts for the CAI or VA option among credit institutions that belong to the same group. The

Eurosystem is currently investigating whether the most appropriate definition of a group is the "closed link" definition specified in Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions. It acknowledges that other cases of affiliation (for instance the networks of saving and cooperative banks) could also be relevant and could also be submitted to the Governing Council for approval. Remote participants in TARGET2 (institutions established in an EEA country participating in the national RTGS system of an (another) EU Member State) will not be eligible for liquidity pooling (in the VA option), as no intraday credit is granted by central banks to remote participants.

In addition, for technical reasons, accounts held in local central banks' home accounting applications cannot be included in a group of accounts. Other elements of a more legal or technical nature (the format of agreements between the Eurosystem and holders of accounts, the collateralisation technique chosen, the scope of and requirements for the mandate given by the group members to the manager of the group of accounts, etc.) will be clarified by the end of 2006.

4.2 PRICING OF LIQUIDITY POOLING

The liquidity pooling service (VA option and CAI option) is an optional and separately priced core service. In order to ensure that the cost of the service was fully covered by its users, the price for the CAI option was set, as mentioned in the second progress report on TARGET2, at €2,900 per account per year, and that for the VA option was set at €6,800 per account per year (which includes the CAI option). Although the banking community requested the liquidity pooling services when the General Functional Specifications for TARGET2 were established, it now appears from contacts with banks that they will not sufficiently use the service on the basis of these conditions.

Notwithstanding this limited interest, the Eurosystem decided to keep the services for liquidity pooling on the grounds that they could help banks to maintain a decentralised set of accounts across countries instead of concentrating all their euro payment flows in one spot. Liquidity pooling could thus foster a truly decentralised payment system, in line with the decentralised nature of the Eurosystem itself. In addition, it was decided to make the services more attractive to banks. The Governing Council has therefore decided to lower the price to €1,200 per year per account for the CAI option and to €2,400 per year per account for the VA option (which includes the CAI option). Furthermore, within a group of accounts (with either the CAI or the VA option) group pricing will apply, which means the degressive transaction fee will be applied to all payments of the group as if they were sent from one account.

Address: Kaiserstrasse 29, 60311 Frankfurt am Main, Germany
Postal address: Postfach 16 03 19, 60066 Frankfurt am Main, Germany
Telephone: +49 69 1344 0
Website: http://www.ecb.int
Fax: +49 69 1344 6000
Telex: 411 144 ecb d

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