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European Central Bank
Secretariat Division
Kaiserstrasse 29

D- 60311 Frankfurt am Main

Milan, 6th of May

Response of Monte Titoli to the TARGET2 consultation of ECB

Dear Sirs,

Please find enclosed the response of Monte Titoli regarding the Consultation of the ECB on TARGET2; an electronic copy of the attached document has been sent to the email address mentioned in the consultation.

On this occasion, I would like to thank ECB for the opportunity to provide our comments and to confirm our availability to further discuss the attached document, if required.

Warmest regards

Giovanni Sabatini
CEO Monte Titoli

Response of Monte Titoli to the ECB TARGET2 consultation (dated 16.12.02) Mai 2003

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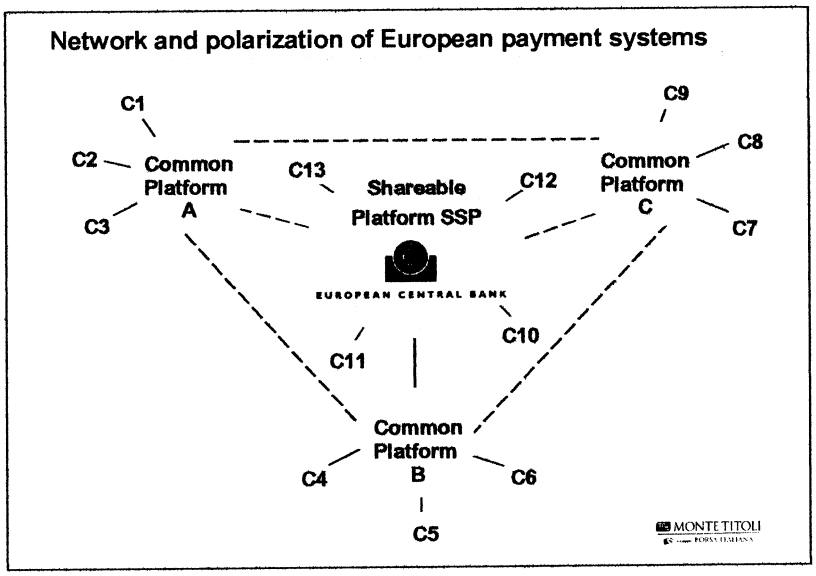
1. GENERAL COMMENTS

Monte Titoli is in favor of the objective of the European Central Bank to harmonize the payment systems across Europe as this will further contribute to the integration of the European financial infrastructure and to the creation of a single EU financial market. We welcome the idea of the ECB to provide one shareable platform and to give the single national banks the choice of

- utilizing the shareable platform, giving up their own system
- sharing their own platform with other countries (e.g. regional polarization)
- continuing to use their own domestic platform.

Providing a shareable platform is considered especially important with regard to accession countries which should be encouraged to use such a solution in order to avoid duplication of investments.



Graphic 1: A network approach in the European Payment System

A network approach as shown in the graphic above and the polarization of the payment system infrastructures, for example on a regional basis and on the shareable platform of ECB, could be an important step towards greater European harmonization and integration. It should be mentioned that such a network approach can be considered a mere technical integration and standardization and that no legal consolidation of national banks will be required. This means that despite using a shared platform, accounts and relationships may be operated by the single national banks during a sufficiently long transition phase (this is considered important for changing the infrastructure and educating users). A network solution will be cost effective and not preemptive of a different long term solution, e.g. of further polarization or of the creation of one single payment platform (if previous cost benefit and risk analyses emphasize the adoption of a single platform).

From a project management point of view, the timeframe set by ECB to implement TARGET2 within the second half of the decade is considered reasonable with respect to the lifecycle of the latest investments made and the respective amortization periods. Special attention should be paid to the analysis of legal aspects before deciding the location of the shared platform(s), to the detailed definition of user requirements for TARGET2 and to the interaction/interfaces to ancillary systems (like securities settlement systems - SSS, described in point 2). This is also important from a risk management point of view, as payment, foreign exchange and securities settlement services are increasingly connected and as the risk of a failure of one system may easily spill over to other systems.

Concerning the question of building the shareable platform from scratch or building on existing platforms, we would prefer the latter option, as investment costs and project risks would be lower and as the current, highly developed technologies have already proved to be efficient, safe and reliable . Also the impacts on users and intermediaries will be lower when using existing state-of-the-art technologies. The shared platform should, of course, be based on the principles of interoperability and straight-through-processing, support the latest technologies and provide different communication channels, like SWIFT Net. As the management of liquidity on a European and global basis becomes increasingly important for users, the shared platform should also provide sophisticated liquidity management features like the reservation of intra-day liquidity, the execution of time critical payments and the safe remote access for users, in order to allow for a real-time and online monitoring of liquidity.

2. INTERACTION WITH ANCILLARY SYSTEMS (SSS)

As mentioned above, the interaction of TARGET2 with ancillary services has to be analyzed in detail. We would, therefore, like to draw your attention to some of the most important requirements of TARGET2 regarding securities settlement systems. Please note that these requirements are only a subset and that a more detailed discussion and analysis has to be done together with ECB.

With the updated Investment Services Directive (ISD) market participants and regulated markets would have the absolute right to choose the location of trading and settlement (single European passport). In order to ensure this right, the necessary infrastructure has to be provided by the public and private bodies.

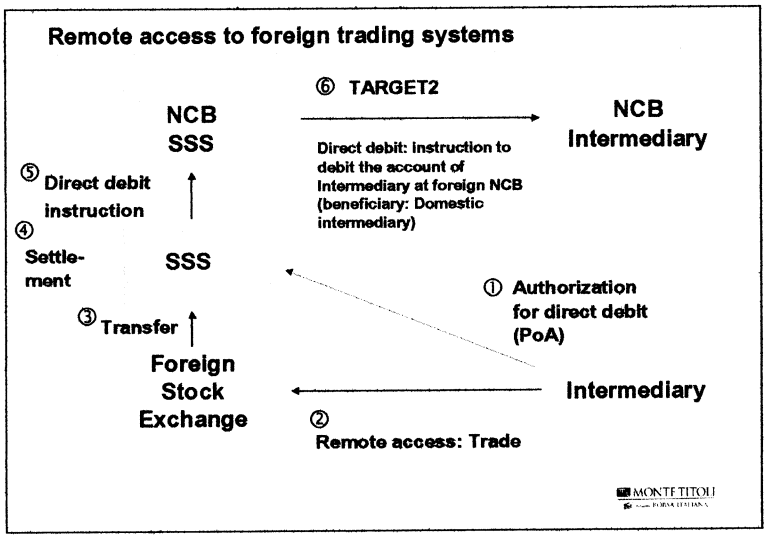
2.1 Direct debit messages

One of the most important requirements to ensure this right is to allow a pan European debit scheme in order to foster the use of **direct debit messages** for cross border payments. Under existing procedures, cross-border direct debiting would be expensive, time-consuming and not transparent due to different domestic schemes and national legal environments (common features of the various national schemes are, for example, the pre-authorization and the debtor's right of revocation). It should, therefore, be ensured that there will be a European-wide standard for direct debits (including consistent rules of finality) and that direct debits will be supported by the technical infrastructures of TARGET2. For SSSs, the direct debit offers the advantage

that the money transfer could be controlled more easily by the CSD (and in close connection with the securities settlement), the time required for the transfer of the cross border cash leg could be shortened and payment messages be reduced.

We can distinguish the three different cases "Remote Access to trading systems", "OTC transactions (with two CSDs having remote access) and the "ECSDA buyer model", analyzing the respective advantages of the introduction of direct debits.

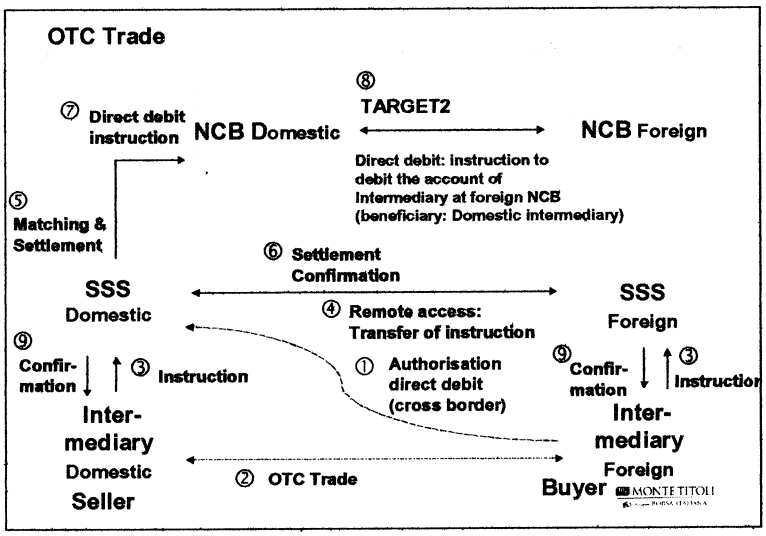
In the first case, the intermediary has remote access to a trading platform in another country and has previously authorized the respective CSD to effect direct debit messages from its account held at its national central bank (graphic 2). The settlement of the securities takes place in the CSD; custody could take place in the same or in another CSD (e.g. via a FOP link). Regarding the cash leg of the transaction, the intermediary would have the possibility to regulate the cash in its own country without using the cash services of a local/ global custodian in the foreign country or without opening an account at a foreign NCB. The transfer of the cash would be initiated by the SSS by sending a direct debit message via its own national central bank and TARGET2 to the central national bank of the intermediary, where the account debit is done in the account of the intermediary. The SSS, therefore, has full control of settlement and payments.



Graphic 2: Direct debit with remote access to foreign trading systems

In the second case, an OTC trade, within the new ISD, both counterparties will be completely free to decide the location of settlement. If there are two settlement systems involved, the SSS could have remote access to each other. An intermediary in one country could previously authorize a CSD in another country to debit its account held at its own national central bank. The CSD of the seller would, at the settlement date, send a direct debit message via its national central bank to the foreign national central bank, with the instruction to debit the account of the foreign buyer at the foreign national central bank and to credit the respective NCB account of the seller (graphic 3). The counterparties of an OTC trade may even choose a settlement location in a country where neither party is located. As matching and settlement can be done within one system, the settlement will be similar to a domestic settlement even if both

intermediaries are located abroad. Once again, the SSS could use a direct debit message for the payment.



Graphic 3: Direct debit with SSS having remote access to each other

Finally, the possibility of direct debits will also facilitate the DVP buyer model developed by ECSDA (see also point 3). The buyer SSS can debit the buyer in its national central bank, make a transfer via TARGET to the seller's account in the NCB of the seller and survey the whole process.

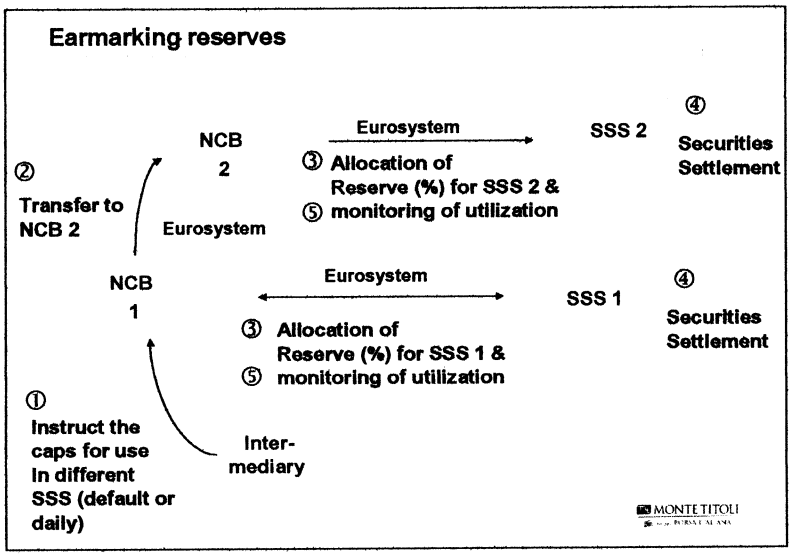
All three models could, of course, be further simplified, if there were a shared payment platform where the transfer of cash could take place as a simple account transfer within the single payment system, without the TARGET cross border transfer.

2.2 Earmarking and transfer of reserves

Another alternative to be considered would be to allow intermediaries to **earmark reserves** of cash for ensuring the smooth securities settlement, not only in the domestic securities settlement system, but also within another SSS. In this case, on the one hand a domestic intermediary might instruct (for example daily in the evening or on a default basis) its domestic national central bank to attribute part of its total cap for securities settlement (e.g. 70%) to its domestic SSS and part (e.g. 30%) for settlement in another SSS (Graphic 4). The domestic NCB would then pass on the information and the percentages to the foreign NCB where the reserve would be constituted. Vice versa, also the foreign investor could transfer intra-day reserves to the domestic NCB.

However, in order to carefully monitor the earmarked reserves and to observe any updates of the allocations and utilizations, a close cooperation within the Eurosystem will be needed.

Once again, the process could be simplified by the polarization of payment systems (as a limit split will not be needed at all).



Graphic 4: Transfer of liquidity reserves

2.3 The different settlement models

Finally, the approach mentioned in the ECB's consultation document to give the single domestic platforms the choice to keep their settlement models, e.g. the **interfaced or integrated model**, is welcomed. For some countries, changing the settlement model may not be easy considering the specific domestic laws and the impact on the systems' users. Before deciding which settlement model will be supported, a business case would be required; the business case should include an analysis of the acceptance of both models by Western Europe and accession countries, the advantages and disadvantages of each settlement model and the costs for changing the single domestic infrastructures compared with the costs of supporting both models by the shared platform. We believe that both models have their pros and cons. The integrated model (e.g. the French RGV), where cash accounts are operated by the SSS and where the settlement of cash takes place in the SSS itself, is likely to allow a faster continuous real-time settlement in central bank money, offering the possibility of an automatic transformation of the asset component of the purchasing power into central bank money by intra-day repurchase agreements. Furthermore, the integrated model may have advantages regarding the global (non-EU) environment, as it is less dependent on the different time zones and operating hours of the various systems, allowing a CSD to operate independently of those (e.g. during the night).

On the other hand, the interfaced model facilitates the autonomous liquidity management of the intermediaries, as their liquidity is not split between two different accounts but can be monitored on just one account.

3. BENEFITS OF POLARIZATION OF PAYMENT SYSTEMS WITH REGARD TO THE SETTLEMENT OF CROSS BORDER SECURITIES TRANSACTIONS

In this last section, we would like to summarize the important benefits that a regional polarization of payment systems might have on SSSs and on the settlement of securities transactions, especially in a cross border context. For our considerations, we assumed that both intermediaries are participants in the same payment platform (which may be possible either with only one account in the payment system or by maintaining two separate accounts within the shared technical platform).

The European CSDs should replace existing cross border FOP links with **DVP links**, following the recommendations issued by regulatory authorities and international associations[1]. Principally, they have two options for doing so:

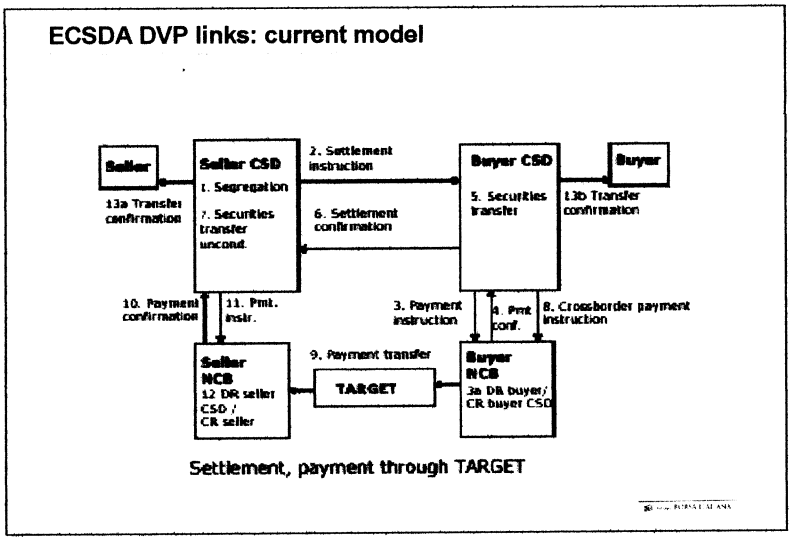
- **bilateral remote access** to the SSS: one SSS becomes remote participant in the other SSS (and vice versa), with the option to act as local agent for each other (offering fiscal services and solutions for regulating the cash leg of the transaction)
- **direct or relayed DVP links** (ECSDA model)

Both models will be facilitated by the polarization of payment systems. As the cash will remain in the payment system where both intermediaries have their accounts (like a local payment), there will no longer be the need to transfer cash via TARGET cross border to the other domestic payment system. The transfer of cash could be done by a simple book entry on the cash accounts of the intermediaries held with the payment system, without the exchange of multiple payment messages. Also the chain of the parties involved in a cross border securities transaction will decrease, since there will no longer be the need to use cash clearers, which are currently providing access to foreign payment systems. Cross border DVP settlement will take place faster, the total costs of a transaction will decrease and risk will be significantly lower because the time gap between effecting and receiving the payment will be minimal and because less systems will be involved.

An example for the first model, **remote access for CSDs**, is shown in graphic 3; there will be two options: either the seller CSD (in some cases the issuer CSD) will initiate a direct debit to debit the accounts of the buyer or the payment may be initiated by the buyer CSD via a credit instruction. In both cases, the cash transfer could be done by a simple book entry in the single system.

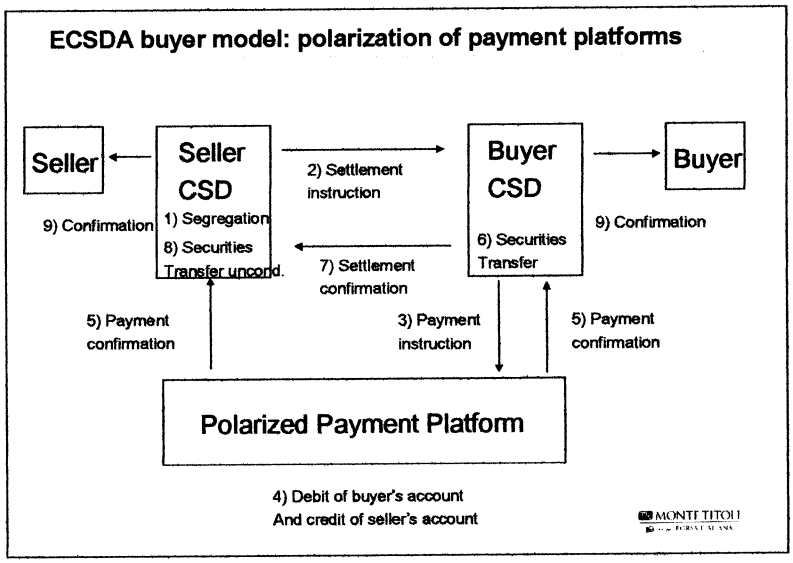
[1] E.g. EMI Standard 7, CPSS IOSCO Recommendation 7 and G30 Recommendation 11

The second model for DVP links, **the direct and relayed link model (ECSDA style)** could be simplified as well, if all involved CSDs would use the same payment system. At the moment, a TARGET transfer (see No. 9- 11 in the graphic 5) is required for each DVP transaction; this transfer will no longer be necessary (for transferring the money, once again there is the choice between direct debit messages or credit instructions).



Graphic 5: ECSDA DVP links payment via TARGET (current situation)

In the future polarization model, CSDs and market participants need to open only one account (within their NCB): the transfer of cash could, therefore, be controlled more easily, even in a longer chain of CSDs, like in the ECSDA relayed link model.



Graphic 6: ECSDA DVP links payment after polarization

Finally, the current CCBM (Correspondent Central Banking Model) for cross border use of collateral in monetary policy operations was designed as an interim solution until adequate alternatives are available. Currently, for these transactions national central banks have to open securities accounts with one another, acting as custodians for transferring collateral for each other. Having a reliable cross border settlement model would probably encourage CSDs to set up and use assessed links. These links could then also be promoted and used for the transfer of collateral instead of the CCBM model.

To conclude, a polarization of payment systems would have overall positive effects on the utilization of liquidity, as liquidity would remain within one system and netting effects would be broadened. The safe remote access to the shared payment platforms will allow market participants the online and real time monitoring of their intra-day liquidity, including all different types of payment flows, such as securities, foreign exchange and money market transactions, for all the different countries participating in the shared platforms.