Hans Georg Fabritius: The new TARGET2 system and recent developments in European securities settlement

Welcoming address and keynote speech by Dr Hans Georg Fabritius, Member of the Executive Board of the Deutsche Bundesbank, at the TARGET2 conference, Frankfurt am Main, 15 November 2006.

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Good morning ladies and gentlemen, I would like to welcome you very warmly to the Bundesbank's TARGET2 conference organised as part of Euro Finance Week.

Today's conference will focus on two topics: the new TARGET2 system, launching in exactly 369 days from now, and recent developments in European securities settlement. Both are key components of Europe's financial infrastructure and constitute a primary duty for a central bank: namely, to ensure that payment and securities settlement are both efficient and secure.

Central banks can achieve these objectives by assuming various roles including operating their own systems, acting as a catalyst and performing an oversight function. A not insignificant number of experts expect central banks to withdraw from operational activities in the long term and limit themselves to overseeing private payment and securities settlement systems. Proponents of a less active role for central banks have a motto: "Let the market decide". They believe that, as public bodies, central banks should concentrate on ensuring an efficient operational framework. Otherwise, as "authorities" and "monopolists of central bank money", they risk distorting private competition and hence restricting it.

However, the question we need to ask ourselves is this: in a competitive economy with a stable private sector, why should central banks operate their own systems at all?

I

Central banks do have a monopoly over the supply of central bank money. Even though the term monopoly rightly has negative connotations, one thing is clear: in this context, it makes perfect sense. Total control over the provision of central bank money is key to modern monetary policy and is therefore essential if we are to achieve our primary task of safeguarding monetary stability. In addition, central bank money is also a byword for security and liquidity. In other words, no credit risk and maximum availability. This also makes central bank money especially suitable for settling financial obligations, particularly individual payments and securities transactions.

The necessary systems must remain under the control of the central banks. Monetary policy aside, there are a number of other reasons why this is the case.

- First, it allows us to make a significant contribution to financial stability. In times of crisis, it is particularly important to react rapidly and discreetly. This is ensured by operating our own system ensuring full control over our accounts and the provision of liquidity. In addition, we attach high importance to a comprehensive range of contingency provisions; think, for example, of TARGET2's innovative business continuity concept.
- Second, we ensure that market participants have open and competitively neutral access to central bank money. Moreover, this guarantees that our systems are widely and directly accessible. A total of 1,000 institutions across Europe are directly connected to TARGET2 and many thousands more indirectly.
- Third, offering our own system allows us to make a direct contribution to security and efficiency. It was mainly central banks that helped to bring the idea of real-time gross settlement to fruition. That said, in addition to speed and security, the Bundesbank, in particular, has attached great importance to liquidity efficiency as well (think of Euro Access Frankfurt).
- Fourth, it enables us to avoid liquidity fragmentation. I think it would be counterproductive to split up central bank liquidity by allowing other entities to manage our accounts. The principal benefit of TARGET2 is plain for all to see: all central bank liquidity throughout the euro area

will be combined in a **single** technical platform which, in turn, will make it easier for participants to manage their liquidity.

Some countries use shared operator models where the settlement systems are owned jointly by banks and/or central banks. However, I believe that this should be done only in very specific cases where the market structure and the legal framework make it appropriate.

II

Ladies and gentlemen, even if central banks are monopolists of central bank money, they must still face competition.

Market participants are not obliged to use central banks' systems. That's why there is always a choice between settling in central bank money (in TARGET2, for example) or in commercial money (as in the EURO1 system). For obvious reasons, TARGET is, however, compulsory for settling monetary policy operations.

Moreover, our systems are not developed in a distant "ivory tower", nor are they decreed to the market. In order to ensure that they are actually being used, market participants are actively involved in the design of our systems.

One only needs to remember the great success experienced when developing RTGS^{plus}, which incidentally now contributes about 50% of the whole TARGET volume. Without the support of the banking industry we would not have managed to successfully establish this system in the market in such a short time.

The European banking industry is likewise intensively involved in TARGET2. Indeed, if it were not strongly requested by the banking industry, the Single Shared Platform would still be nothing but a distant dream. And it is also clear that we will only be able to realise TARGET2 Securities with the active involvement and constructive cooperation of the banks and the central securities depositories (CSDs).

TARGET2 Securities should not be understood as a hostile or, indeed, friendly takeover of the CSDs' business by the Eurosystem. The main issue here is also our core function, ie settlement in central bank money. The Eurosystem has no intention of using TARGET2 securities to set up a European central securities depository. In this respect TARGET2 Securities differs from the US FEDWIRE Securities System which is a fully-fledged central securities depository though only for government paper.

In Europe, the CSDs will retain full responsibility for the safe custody and administration of securities and for relationships with their customers. However, TARGET2 Securities demands that, in technical terms, the maintaining of securities accounts also be effectively transferred to the Eurosystem platform.

Given the fact that if for reasons of security and efficiency the integration of securities and central bank money accounts is required there are just two options. Either the central banks "outsource" their money accounts to the various CSDs or the CSDs shift their securities accounts to the Eurosystem.

For the reasons I mentioned at the start of this speech, the second approach is the clear favourite. However, I would like to emphasise again that using TARGET2 Securities will make sure that the proven, clear delineation of responsibilities in the market will remain intact, ie central banks provide the settlement in central bank money, CSDs are the owners and custodians of securities accounts.

Naturally, we must also bear in mind economic considerations when providing settlement services. This prevents "public" money from being "wasted" and guarantees that it will be used sensibly. At the same time, it enables us to tackle any potential competitive distortion.

Take, for example, TARGET2: it will not only meet user demands but will also ensure cost-effectiveness. The idea to establish a single technical platform for TARGET2 translates into exploiting economies of scale and achieving cost reductions.

Cost-effectiveness also means making maximum use of the synergies the Eurosystem has to offer with regard to TARGET2 Securities as well. This, in turn, means that the present operators of TARGET2 - the Banque de France, the Banca d'Italia and the Bundesbank – want one **single** technical platform for TARGET2 Securities and TARGET2. To put it simply, in our view the creation of a second settlement platform within the Eurosystem in addition to TARGET2 would serve no economic purpose and would only make liquidity management more difficult.

Naturally, I would also like to mention the principle of cost recovery. Fundamentally, we pursue a policy where the prices paid are sufficient to cover costs so that at the end of the day users themselves finance the services being provided. There are, however, two aspects to be considered.

On the one hand, payment systems and settlement systems are infrastructures with a high share of fixed costs. It follows that in order to successfully recover costs a certain settlement volume is crucial. Reasonable unit costs – also beneficial for the participants – are the consequence of economies of scale by means of corresponding volume effects. Here, we share a common aim with users. The equation is simple: a 20% rise in the volume of TARGET2 would result in a further reduction in average costs by just over a fifth!

On the other hand, infrastructures can also generate external effects with which the individual participant will not have reckoned. These might be a particularly secure gross settlement or a particularly high quality of contingency provisions. Full application of the cost recovery principle could prompt banks to resort more often to less expensive private systems.

As a consequence, external effects have to be considered when setting prices. However, such deviations from the general cost recovery principle would have to be well-founded because of their potential implications regarding competition.

III

Ladies and gentlemen, do you really think that central banks are crowding private competitors out of the market with state intervention? I believe that, with TARGET2 and TARGET2 Securities, this statement can easily be refuted. Central banks are by no means acting in an anti-competitive way. On the contrary, they are, in fact, stimulating competition by providing a neutral basis infrastructure in central bank money for CSDs, banks and other service providers competing in the market.

Take the planned Single Shared Platform in TARGET2 for instance. Here we are breaking new ground by moving away from the networking of national markets to create an integrated single European market. The advantages of this are obvious.

- Firstly, the harmonisation of services and prices will create a level playing field for all banks across Europe.
- Secondly, the standardisation in connection with TARGET2 promotes a more efficient structuring of the business processes. It enables participating banks, especially credit institutions active across Europe, to consolidate their internal system landscape and it creates a leeway to offer customers a better range of services. In future, priority payments will be executed more quickly, securely and more effectively.
- Thirdly, the extensive settlement opportunities for ancillary systems provide for greater efficiency in terms of procedures and liquidity and also for greater security. Furthermore, TARGET2 creates optimal settlement opportunities with cross-border access to other systems.

The issue of competition is more controversial in the case of TARGET2 Securities. Although here too, I firmly believe that – owing to the settlement of securities transactions in central bank money on a single platform – we are ultimately more likely to significantly stimulate competition rather than restrict it. Just like TARGET2, TARGET2 Securities represents an integration of the basic settlement infrastructure in Europe.

The various settlement markets in Europe are still very fragmented. In this respect, I see certain parallels with the discussions regarding the Single Euro Payments Area in retail payments. As a result, there are clear price differences between securities settlement systems. Moreover, cross-border transactions, which require interaction between various systems, are also relatively expensive.

What positive contribution can TARGET2 Securities make in this respect? First and foremost, I believe that it will reduce costs and abolish some Giovannini barriers. In other words, TARGET2 Securities stands for:

- harmonisation of technical interfaces, primarily in the area of settlements

- Europe-wide finality of securities trades
- interoperability between central securities depositories, that is to say the settlement of transactions between different service providers will be simplified and more transparent. In future, it will be possible to settle cross-border transactions just as easily and securely as national transactions. The country in which the securities are held will no longer be an issue for the settlement of securities.

In this respect, I believe that TARGET2 Securities could enhance other initiatives rather than contradict them. These initiatives, eg the Code of Conduct, will also result in a more efficient settlement of securities in Europe.

TARGET2 Securities offers a high degree of efficiency as an integrated settlement model and, owing to the consolidation of the settlement, it will ensure economies of scale and greater cost efficiency. TARGET2 Securities stands for competitive neutrality and, in our view, avoids the outsourcing of central bank account management. It also sets the benchmark for alternative proposals that may be put forward by private companies.

IV

Are central banks faced with a conflict of interests in their function as both system operators and overseers? This question has already been adequately discussed and convincingly answered in the context of TARGET.

Even if conflicts of interest were to arise, we counteract these by applying international oversight standards and by keeping a strict separation of our various roles. The general public is also aware of this separation of functions.

The discussion regarding possible conflicts of interest is, of course, always brought up again whenever central banks, using their own oversight authority for example, would try to enforce the use of their own systems. This would be fundamentally problematic like any approach to prescribe the usage of a specific market infrastructure by means of the oversight function or by other regulatory powers.

I do not think that it would be a wise decision for us to withdraw from our role as service provider and to restrict ourselves to the pure oversight function. In my opinion, this would not be beneficial to our objectives in payments and financial stability. It would also be contrary to experience in other countries, such as in the United States and Japan. The role of a central bank would then ultimately be guided by a different model in which the regulatory aspect could become much more significant.

This means, however, that we should take care of the economic and functional viability of our own systems. Otherwise, the political significance of our systems and our role could be put into question. Therefore, it would be very unfortunate if activity in our own systems were to be eroded by an increased provision of central bank liquidity to other systems. I am, however, confident that with TARGET2 and TARGET2 Securities, we are providing a convincing answer in all respects to the issue of the operational involvement of central banks.

V

Ladies and gentlemen, “we are living in a system where you are either on the wheel or under it”. These are not my words but those of a great German philosopher from the 19th century, and yet they are still as relevant as ever. Applied to central banks, the underlying message is that we must act as the wheel and ensure momentum by means of our own systems. And to ensure that we do not end up under the wheels, we have to take on the competition.