

**Euro Area: Report on Observance of Standards and Codes  
Assessment of Observance of the IMF Code of Good Practices on Transparency in Monetary  
and Financial Policies—Monetary Policy and Payment System Oversight, and the CPSS Core  
Principles for Systemically Important Payment Systems  
(Target and the EURO1 Payment Systems)**

This Report on Observance of Standards and Codes on the euro area was prepared by a staff team of the International Monetary Fund as background documentation for the consultation with the European Central Bank. It is based on the information available at the time it was completed on **October 3, 2001**. The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of the euro area authorities or the Executive Board of the IMF.

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# **REPORT ON THE OBSERVANCE OF STANDARDS AND CODES**

**ASSESSMENT OF OBSERVANCE OF THE IMF CODE OF GOOD PRACTICES  
ON TRANSPARENCY IN MONETARY AND FINANCIAL  
POLICIES—MONETARY POLICY AND PAYMENT SYSTEM OVERSIGHT, AND  
THE CPSS CORE PRINCIPLES FOR SYSTEMICALLY IMPORTANT PAYMENT  
SYSTEMS (TARGET AND THE EURO1 PAYMENT SYSTEMS)**

## **EURO AREA**

### **OCTOBER 2001**

INTERNATIONAL MONETARY FUND

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## EURO AREA: REPORT ON THE OBSERVANCE OF STANDARDS AND CODES

This report was prepared by a team from the International Monetary Fund (IMF) on a mission that took place in the period of March 21–April 2, 2001, in the context of the 2001 Article IV consultation with the euro area. It is based on information available to the mission through September 2001. The team was led by Tomás J.T. Baliño and included, for monetary policy transparency issues, Matthew T. Jones and Alessandro Zanello (all IMF), and Graydon Paulin (Bank of Canada), and for payment system issues, Kai Barvell (IMF), Jeff Marquardt, Bridget Spaniel, and Jeff Stehm (all Board of Governors of the Federal Reserve System). The report is divided into two parts.

The first part addresses the observance of the monetary policy section of the *Code of Good Practices on Transparency in Monetary and Financial Policies*, including the transparency of payment system oversight in the euro area. The report does not address transparency aspects of e.g., banking supervision and deposit insurance, as these are national responsibilities that do not fall within the mandate of the European System of Central Banks (ESCB).

The second part addresses the observance of the *CPSS Core Principles for Systemically Important Payment Systems* for the *TARGET* system and the *EURO1* system, respectively.

## MFP TRANSPARENCY CODE

### Executive Summary

Overall, the Eurosystem maintains a high level of transparency in all aspects of its operations, demonstrating a strong institutional commitment to openness and a high degree of observance of the Code. Since its inception, the European Central Bank (ECB) has taken a very active approach to communicating with the public. The ECB has provided extensive written documentation of its policies, procedures and practices, most conveniently available on its website. The ECB has also pursued an extensive publications and visitor program, providing ready access to public officials by the media, as well as maintaining frequent contacts with market participants and the public. However, some gaps remain in the transparency framework of the ECB/Eurosystem. There are several functions that remain in the purview of National Central Banks (NCBs), where disclosure practices vary. Greater consistency in the disclosure practices of individual NCBs would help to ensure that the conduct of monetary policy, payment system oversight, and the development of financial markets proceed on a uniform basis.

The Treaty and the Statute clearly define the institutional framework, objectives, and tasks of the ESCB and the ECB, and their respective modes of accountability. They also provide sufficient delineation of the responsibilities of the ECB and NCBs and of relationships with other national and Community bodies. Improvements could be made in the following areas: responsibility for foreign exchange policy, as defined in the Treaty, and the meaning of the phrase "general orientations" are unclear; and NCBs provide insufficient disclosure of the terms of government deposits and participation in government securities markets.

The ECB provides extensive information on the framework and procedures underlying the policymaking process and the implementation of monetary policy. The *Monthly Bulletin* and regular public statements that accompany policy decisions communicate the stance of policy to the public in an open and timely manner. The ECB maintains an extensive program of data dissemination and high quality publications, supported by an active public information service. The ECB provides ready access through its website to press releases, speeches, regulations, documentation, research, and statistical releases. Improvements could be made in the following areas: in order to meet the requirements for SDDS concerning advance release calendars for monetary statistics, the ECB should extend the advance publication of release dates by one month. The ECB has indicated their intention to do this in the immediate future. The NCBs follow a variety of disclosure practices for emergency financial support, with some NCBs never disclosing this information.

Members of the Executive Board make regular appearances before the European Parliament and many NCB Governors are also invited to testify before their respective national parliaments. The ECB publishes detailed annual accounts in accordance with well-documented accounting guidelines and audited by an independent external auditor. The ECB provides extensive documentation of its internal governance procedures, including its own rules of procedure and code of conduct for employees. Improvements could be made in the following areas: a majority of NCBs do not disclose internal governance procedures; and all NCBs have standards of conduct for employees, but a majority of them do not disclose such standards and rules.

The mission suggests that the ECB review its current practice of selective and informal public consultation on payment issues. It is believed that the ECB could benefit from seeking regular feedback from the public regarding proposed technical, regulatory, and policy changes, (e.g., by posting discussion documents on the website for public comment within a specified timeframe).

## I. MFP TRANSPARENCY CODE—MONETARY POLICY

### A. Summary Assessment

#### Preface

This assessment of observance of the IMF's *Code of Good Practices on Transparency in Monetary and Financial Policies* covers the monetary policy practices of the euro area. Monetary policy decisions in the euro area are made by the decision-making bodies of the ECB and implemented in a decentralized manner in the Eurosystem. The Eurosystem refers to the European Central Bank (ECB) and the twelve National Central Banks (NCBs) that have adopted the euro as the single currency in Stage Three of Economic and Monetary Union (EMU).<sup>1</sup> Thus, this assessment encompasses the activities of the ECB and the twelve participating NCBs that are relevant to the conduct of monetary policy in the Eurosystem.<sup>2</sup>

The assessment of the Eurosystem's observance of good transparency practices for monetary policy was conducted as part of a Report on the Observance of Standards and Codes (ROSC). This assessment addresses observance of the monetary policy section of the *Code of Good Practices on Transparency in Monetary and Financial Policies*. A similar report on payment systems includes an assessment of transparency in financial policies for payment systems in the euro area. Other aspects of financial policies, (e.g., banking supervision and deposit insurance), are not assessed for the euro area, since they are national responsibilities that do not fall within the mandate of the European System of Central Banks (ESCB). The assessment was undertaken by a four-person team<sup>3</sup> and was based on (i) a pre-mission questionnaire; (ii) the Treaty establishing the European Community, as amended by the Treaty of Amsterdam (the "Treaty") as well as the Protocol (No. 18) on the Statute of the European System of Central Banks and of the European Central Bank (the "Statute"); (iii) information available on the website of the ECB; (iv) discussions with officials at the ECB; (v) annual reports and central bank legislation of NCBs in the Eurosystem; (vi) discussions

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<sup>1</sup> The term "Eurosystem" was created in distinction to the term ESCB used in the Treaty, which includes all Member States of the European Union. Neither the ESCB nor the Eurosystem have legal personality. As of January 1, 2001, Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain have adopted the euro.

<sup>2</sup> Many of the NCBs in the Eurosystem have operations outside of the framework of the Eurosystem that are not relevant for an assessment of monetary policy transparency. For example, some NCBs conduct financial operations on their own account and perform other functions such as acting as supervisors of the banking system.

<sup>3</sup> The mission took place in March–April 2001; the team included Tomás J. T. Baliño, Matthew T. Jones, and Alessandro Zanello (IMF) and Graydon Paulin (Bank of Canada). Subsequent discussions were held in Frankfurt in June 2001, in addition to written correspondence.

with officials at selected NCBs; and (vii) discussions with market participants, academics, and commentators in Brussels, Frankfurt, London, and Paris.

The Eurosystem cooperated fully with the assessment team and provided all the information and documentation requested by the mission.

### **Information and methodology used for assessment**

The assessment was based on the *Code of Good Practices on Transparency in Monetary and Financial Policies* (MFP Transparency Code). No standard assessment methodology has been developed as yet, but the assessment has taken into account the implementation issues mentioned in the *Supporting Document* to the MFP Transparency Code.

### **Legal framework and institutions—Overview**

The Treaty establishing the European Community provides for the establishment of the ESCB and of the ECB. Article 105 of the Treaty sets out the ESCB's objectives and tasks. The primary objective of the ESCB is to maintain price stability. Without prejudice to this objective, the ESCB shall support the general economic policies in the Community. The ESCB shall act in accordance with the principles of an open market economy. The basic tasks to be carried out by the ESCB are: to define and implement the monetary policy of the euro area; to conduct foreign exchange operations; to hold and manage the official foreign reserves of the Member States; and to promote the smooth operation of payment systems. In addition, the ESCB contributes to the smooth conduct of prudential supervision of credit institutions and the stability of the financial system. The ECB has an advisory role on issues that fall within its field of competence, especially legislative matters. Finally, the ECB is empowered to authorize the issuance of notes and coins, to represent the ESCB in the field of international cooperation, and to collect, with the assistance of NCBs, statistical information from national authorities or directly from economic agents.

The ESCB consists of the ECB and NCBs of all European Union (EU) Member States. As of January 1, 2001, the Eurosystem consists of the ECB and the 12 NCBs of Member States that have adopted the euro as the single currency in Stage Three of EMU. The NCBs of the Member States that do not participate in the euro area<sup>4</sup> are members of the ESCB with a special status. In the Treaty (Article 122.1 and 3), these Member States are referred to as having a derogation, which means that the NCBs of these Member States are excluded from certain rights and obligations within the ESCB. These central banks conduct their own independent national monetary policies, and do not take part in the decision-making with regard to the single monetary policy for the euro area and the implementation of such decisions.

The Eurosystem is afforded a high degree of legal and operational independence. The Treaty prohibits the ECB and the NCBs and members of their decision-making bodies from

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<sup>4</sup> Denmark, Sweden, and the United Kingdom.

taking instructions from any external body. The Treaty also prohibits bodies and institutions of the Community and Member States from attempting to influence the members of the decision-making bodies of the ECB or of the NCBs in the performance of their tasks. The Statute provides for secure tenure for NCB governors, with minimum terms of office of five years, and the possibility of removal from office only in the event of incapacity or serious misconduct. Executive Board members are granted non-renewable terms of office of eight years, again with removal from office only permitted in the event of incapacity or serious misconduct. The Court of Justice of the European Communities is designated as the competent authority for the settlement of any disputes concerning removal from office.

The ECB implements monetary policy decisions of the ECB's decision making bodies in accordance with the Treaty and the Statute through its own actions, in conjunction with the NCBs. The Governing Council of the ECB adopts guidelines and formulates the monetary policy of the euro area, and the Executive Board of the ECB is responsible for the current business of the ECB, has the responsibility for preparing the meetings of the Governing Council and implements monetary policy in accordance with the Governing Council's decisions and guidelines. The Governing Council consists of the Governors of the NCBs of the Member States participating in the euro area, as well as the members of the Executive Board of the ECB.

In 1998 the Governing Council of the ECB announced the ECB's stability-oriented monetary policy strategy to guide its monetary policy decisions in Stage Three of EMU. This strategy consists of the following main elements: first, a quantitative definition of price stability, and, second, the "two-pillar framework" used to achieve this objective. The quantitative definition of price stability is defined as a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2 percent. Price stability is to be maintained over the medium term. The two pillars represent two complementary analytical frameworks used to assess risks to price stability in the euro area as a whole. The first pillar assigns a prominent role to money, as signaled by the announcement of a quantitative reference value for the growth rate of a broad monetary aggregate. The second pillar focuses on a range of other economic and financial indicators in analyzing the interplay of supply and demand factors in order to form a broadly based assessment of the outlook for price developments and risks to price stability. The instruments available to the Eurosystem in implementing its monetary policy strategy include open market operations, standing facilities, and minimum reserve requirements.

### **Main findings**

Overall, the Eurosystem maintains a high level of transparency in all aspects of its operations, demonstrating a strong institutional commitment to openness and a high degree of observance of the Code. Since the beginning of Stage Three of EMU, the ECB and the Eurosystem have been exposed to intense scrutiny because of its complex architecture, the varied monetary and legal heritages of participating NCBs, and uncertainties about the structural characteristics of the euro area. The differing transparency practices followed by the NCBs of the Eurosystem have provided further complications. These complexities have created particular challenges for the communication of monetary policy and for the implementation of a high degree of transparency best suited to the particular circumstances of the euro area. In order to meet these challenges, the ECB and NCBs have maintained a

high degree of transparency and observance of the MFP Transparency Code. Since its inception, the ECB has provided extensive written documentation of its policies, procedures and practices, most conveniently available on its website. The ECB has also pursued an extensive publications and visitor program, providing ready access to public officials by the media, as well as maintaining frequent contacts with the public and market participants. These efforts demonstrate a strong institutional commitment to high standards of transparency.

However, some gaps remain in the transparency framework of the ECB/Eurosystem. Several functions remain in the purview of NCBs, where disclosure practices vary. These differences have the potential to create asymmetries in the information available to market participants in different countries. Thus, over time, greater consistency in the disclosure practices of individual NCBs would help to ensure that the conduct of monetary policy and the development of financial markets proceed on a uniform basis.

#### ***Clarity of roles, responsibilities, and objectives***

In terms of the clarity of the roles, responsibilities, and objectives of the Eurosystem, there is a high degree of observance of the Code. The Treaty and the Statute clearly define the objectives and tasks of the ESCB and the ECB. The Treaty and Statute also provide sufficient delineation of the responsibilities of the ECB and NCBs with respect to national and Community bodies. The only major area where the Treaty lacks clarity is in the assignment of responsibility for foreign exchange policy between the Council of Ministers and the Eurosystem. Operationally, the varied disclosure practices by NCBs on the terms and conditions for government deposits and participation in government securities markets could be improved by the NCBs adopting a common approach to greater disclosure.

#### ***Open process for formulating and reporting of policies***

In terms of the process for formulating and reporting monetary policy decisions, the Eurosystem has a high degree of observance of the Code. The ECB provides extensive information on the framework and procedures underlying the implementation of monetary policy. In addition, the ECB guideline for Eurosystem monetary policy instruments and procedures is published in the Official Journal of the European Communities. The *Monthly Bulletin* and the regular press conferences along with other public statements enable the ECB to communicate the stance of policy and the underlying main considerations to the public in an open and timely manner.

#### ***Public availability of information***

The Eurosystem maintains a high degree of observance of the Code in the area of public availability of information on monetary policy. The ECB and ten of the twelve NCBs adhere to almost all the principles of the IMF's Special Data Dissemination Standard (SDDS) for coverage, periodicity, timeliness, and access by the public for central bank, banking

sector and foreign reserves data.<sup>5</sup> The ECB publishes a weekly consolidated financial statement for the Eurosystem, and detailed annual balance sheets. The results of tender operations are publicly disclosed promptly upon completion. The ECB maintains an extensive program of high quality publications, most of which are available in the 11 official Community languages, supported by an active public information service. Its Press Service provides ready access to speeches and statements by members of the Executive Board and other regulations and documentation of the ECB through its website. Improvements could be made in the area of policies on disclosure of emergency financial assistance, which are an NCB responsibility. In order to meet the requirements for SDDS concerning advance release calendars for monetary statistics, the ECB should extend the advance publication of release dates by one month. The ECB has indicated their intention to do this in the immediate future.

***Accountability and assurances of integrity***

The Eurosystem practices a high degree of accountability and assurances of integrity in the conduct of its operations, and has a high degree of observance of the Code. Members of the Executive Board of the ECB appear regularly before the European Parliament, including the President who makes quarterly appearances before the European Parliament’s Committee on Economic and Monetary Affairs. Some NCB governors also appear before their own national parliaments and committees. The ECB publishes annual accounts within four months of the end of the previous financial year, in accordance with well-documented accounting guidelines and audited by an independent external auditor. The ECB provides extensive documentation of its internal governance procedures, including its own rules of procedure and code of conduct for employees. It also publishes the *Annual Report* of its internal Anti-Fraud Committee. Annual reports on the efficiency of its management are made by the European Court of Auditors and published in the *Official Journal of the European Communities*. Suggested areas of improvement include the disclosure at the NCB level of internal governance procedures and standards for the conduct of employees.

Table 1. Summary of Main Findings of Assessment of Observance of MFP Transparency Code—Monetary Policy

Subject	Main Findings
I. Clarity of roles, responsibilities and objectives of central banks for monetary policy	<p>The Treaty and the Statute clearly define the institutional framework, objectives, and tasks of the ESCB and the ECB, and their respective modes of accountability. They also provide sufficient delineation of the responsibilities of the ECB and NCBs and relationships with other national and Community bodies.</p> <p>Improvements could be made in the following</p>

<sup>5</sup> The exception being the advance release calendar for monetary statistics, where the ECB needs to announce in advance the dates for the present or pending month’s release plus the following three months in order to fully comply with SDDS. At present, the ECB announces the dates for the present/pending release and the following two months.

	<p>areas:</p> <ul style="list-style-type: none"> <li>• Responsibility for foreign exchange policy, as defined in the Treaty, and the meaning of the phrase “general orientations” are unclear.</li> <li>• NCBs provide insufficient disclosure of the terms of government deposits, and participation in government securities markets.</li> </ul>
<p>II. Open process for formulating and reporting monetary policy decisions</p>	<ul style="list-style-type: none"> <li>• The ECB provides extensive information on the framework and procedures underlying the policymaking process and the implementation of monetary policy. The <i>Monthly Bulletin</i> and regular public statements that accompany policy decisions communicate the stance of policy and the underlying main considerations to the public in an open and timely manner.</li> </ul>
<p>III. Public availability of information on monetary policy</p>	<p>The ECB maintains an extensive program of data dissemination and high quality publications, supported by an active public information service. The ECB provides ready access through its website to press releases, speeches, regulations, documentation, research, and statistical releases.</p> <p>Improvements could be made in the following areas:</p> <ul style="list-style-type: none"> <li>• The advance release calendar for monetary statistics could be extended in order to comply fully with SDDS.</li> <li>• NCBs follow a variety of disclosure practices for emergency financial support, with some NCBs never disclosing this information.</li> </ul>
<p>IV. Accountability and assurance of integrity by the central bank</p>	<p>Members of the Executive Board of the ECB appear regularly before the European Parliament and some NCB Governors appear before their own national parliaments. The ECB publishes detailed annual accounts in accordance with well-documented accounting guidelines and audited by an independent external auditor. The ECB provides extensive documentation of its internal governance procedures, including its own rules of procedure and code of conduct for employees.</p> <p>Improvements could be made in the following areas:</p> <ul style="list-style-type: none"> <li>• A majority of NCBs do not disclose internal governance procedures.</li> <li>• All NCBs have standards of conduct for employees, but a majority of them do not disclose such standards and rules.</li> </ul>

## B. Recommended Actions

### Clarity of roles, responsibilities and objectives

The Treaty lacks clarity in the assignment of responsibility for foreign exchange policy. This lack of clarity could be reduced by additional explanation of the meaning of the

phrase “general orientations,” together with further information on the conditions under which such orientations might be issued by the Council of Ministers.

The varied disclosure practices on the nature and extent of participation in primary and secondary markets for government securities and other involvement in the economy could be improved if the ECB and all NCBs provided similar public disclosures. Consistent public disclosure by NCBs of the terms governing government deposits at the central bank would also be helpful to promote uniformity in the transparency practices of the Eurosystem.

### **Open process for formulating and reporting of policies**

A commitment to consult with a wider range of potentially interested parties on technical changes to monetary regulations could also prove helpful in building support and understanding for proposed regulatory changes. This could be achieved, for example, by posting discussion papers on the website and inviting public comments within a specified time period.

### **Public availability of information**

Improvements could be made in the policies on disclosure of emergency financial assistance at the NCB level. Greater public disclosure of the broad operational procedures in place could provide the public with greater understanding and assurances that the mechanisms are in place to deal with liquidity emergencies.

The ECB could extend the advance release calendar for monetary statistics by one month in order to observe fully the requirements of SDDS. The ECB has indicated its intention to do this in the immediate future.

### **Accountability and assurances of integrity**

To provide the public with sufficient assurances that safeguards are in place to protect the integrity of the internal operations of the entire Eurosystem, it is desirable to have a uniform public disclosure of internal governance procedures by all NCBs. Standards for the conduct of personal financial affairs and rules to prevent conflicts of interest should also be publicly disclosed on a similar basis by all NCBs in the Eurosystem.

Table 2. Recommended Actions to Improve Observance of MFP Transparency Code—Monetary Policy

Subject	Recommended Action
I. Clarity of roles, responsibilities and objectives of central banks for monetary policy	<ul style="list-style-type: none"> <li>• Provide greater clarity on the meaning of “general orientations” for exchange rate policy.</li> <li>• To ensure consistency across the Eurosystem, all NCBs should publicly disclose the terms of government deposits and secondary market arrangements in the market for government securities.</li> </ul>
II. Open process for formulating and reporting monetary policy decisions	<ul style="list-style-type: none"> <li>• No recommendations given.</li> </ul>
III. Public availability of information on monetary	<ul style="list-style-type: none"> <li>• Extend the advance release calendar for monetary</li> </ul>

policy	<p>statistics to observe fully the requirements of SDDS.</p> <ul style="list-style-type: none"> <li>• Provide greater clarity and consistency on policies for disclosure of emergency financial support.</li> </ul>
IV. Accountability and assurance of integrity by the central bank	<ul style="list-style-type: none"> <li>• Adopt uniform disclosure practices of NCB internal governance procedures and conflict of interest rules.</li> </ul>

### C. ECB Response to the Assessment and Recommended Actions

The ECB agreed with the positive overall assessment, noting that in the IMF’s findings in the detailed assessment, the Eurosystem observes all 46 principles contained in the Code (two of which were regarded as not applicable), and only eight of these were considered to be only “broadly” or “partly” observed. These cases largely reflect instances where—due to the particular institutional structure of the Eurosystem—national practices vary and responsibility remains at the national level. On a few specific points, however, the ECB did not fully agree with the way the Code has been interpreted and applied by the IMF.

The ECB disagreed that the Treaty is unclear on the assignment of responsibility for foreign exchange policy between the Council of Ministers and the ECB. It argued that The Treaty and Statute provisions ensure that regular exchanges of information and views take place between the Council of Ministers and the ECB on the exchange rate of the euro. This is consistent with the fact that exchange rate developments of the euro are a matter of common interest for both authorities. The ECB noted that it is solely competent for deciding whether and when to use the instrument of foreign exchange intervention, in keeping with its independence, the tasks entrusted to it by the Treaty and Statute, and its primary objective of price stability.

The ECB also disagreed with the notion that the meaning of “general orientations” is unclear, noting that the term “general orientations” refers to a framework for exchange rate policy, the characteristics of which cannot be specified in advance as they would very much depend on the specific circumstances prevailing at the time of their formulation. The ECB referred to the Resolution of the European Council on Treaty Articles 109 and 109b, adopted at its meeting in Luxembourg (12/13 December 1997), which stated that “the Council may, in exceptional circumstances, for example in the case of a clear misalignment, formulate general orientations for exchange rate policy.” The ECB argued that the reference to “exceptional circumstances,” as well as to “for example, in the case of a clear misalignment,” supports the view that it is difficult, if not impossible, to define ex-ante the conditions that could lead to the formulation of general orientations and the specific features of such an exchange rate policy framework.

The ECB noted that its current consultation practices for proposed technical changes to monetary regulations include regular as well as ad hoc contacts with representative market participants at the level of the ECB and the NCBs. The ECB considered that some degree of flexibility in its consultation practices was of particular importance in the early years of Monetary Union as institutional structures and representation of interest groups at the national and European levels are still evolving. It argued that while a move to more formal

procedures might be considered in the future as pan-euro area interest groups become well-established, its current practices were adequate for the purpose of ensuring that financial market participants are consulted on pending modifications to the institutional environment in which they conduct their activities.

The ECB indicated that it will begin publishing an advance release calendar for the pending release and next three releases for monetary statistics, in order to comply fully with the requirements of SDDS.

On the issue of disclosure of emergency financial support, the ECB argued that the Annual Reports of the ECB and the “Report on financial crisis management” (July 2001) by the Economic and Financial Committee provide enough information for the public to understand the respective roles and responsibilities for emergency financial support—both at the euro area and national level—as well as the arrangements to ensure consistency with the single monetary policy. The ECB noted that emergency financial support is not a Eurosystem function, but instead is a responsibility of NCBs, who bear the risks and costs of such actions. In their opinion, disclosure of the policy framework and operational procedures in place at the national level, which is not explicitly recommended by the MFP Transparency Code, falls under the competence of NCBs.

## **II. MFP TRANSPARENCY CODE—PAYMENT SYSTEM OVERSIGHT**

### **A. Introduction**

This assessment was made by a team of payment system experts in the context of an IMF ROSC mission covering the Code of Good Practices and Transparency in Monetary and Financial Policies and the Core Principles for Systemically Important Payment Systems.<sup>6</sup>

The assessment of transparency of the European Central Bank’s (ECB) practices regarding payment systems oversight was based on: (1) a pre-mission questionnaire; (2) a review of relevant laws, regulations, and policies; and (3) discussions with officials from the ECB. The assessment was based on the *IMF Code of Good Practices on Transparency in Monetary and Financial Policies* (the Code). No standard assessment methodology has been developed as yet, but the assessment has taken into account the implementation issues mentioned in the *Supporting Document* to the Code. The team held extensive meetings with officials from the ECB, supplemented by discussions with selected officials at NCBs as well as with six commercial banks.

The ECB cooperated fully with the assessment and provided all the necessary clarifications and documents.

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<sup>6</sup> The payment system team consisted of Kai Barvell (IMF), Jeff Marquardt, Bridget Spaniel, and Jeff Stehm (all from the Board of Governors of the Federal Reserve System).

## **B. Main Findings and Recommended Actions**

### **Clarity of roles, responsibilities and objectives of financial agencies responsible for financial policies**

The roles, responsibilities, and objectives of the ECB as payment system overseer are clearly defined in the Treaty, the ESCB Statute, the Rules of Procedure of the ECB, and a June 2000 policy statement on payment system oversight. The ECB publishes euro-area payment statistics on a monthly, quarterly, and annual basis. In addition, it publishes key payment system policies, including oversight policies, Trans-European Automated Real-Time Gross Settlement Express Transfer System (TARGET) prices, and a TARGET user guide. The TARGET Guideline—published in the Official Journal of the European Communities, OJ L 140, May 24, 2001 and OJ L 167, June 22, 2001—is available on the ECB website as well.

### **Open process for formulating and reporting of financial policies**

The regulatory framework is described in the document *Role of the Eurosystem in the Field of Payment System Oversight*. The policy clearly outlines the roles of the ECB and the NCBs in payment system oversight.

A commitment to consult with a wider range of potentially interested parties on technical changes to regulations could prove helpful in building support and understanding for proposed regulatory changes. This could be achieved, for example, by posting discussion papers on the website and inviting public comments within a specified time period.

### **Public availability of information on financial policies**

The *Monthly Bulletin* is the key publication where the ECB presents its interpretation of ongoing economic and financial developments in the euro area. Additional information is made available through press statements, at press conferences and in frequent speeches. The ECB also publishes an *Annual Report*, in which there is a separate chapter on payment and security clearing and settlement systems.

### **Accountability and assurances of integrity by financial agencies**

The President of the ECB presents an Annual Report on the activities of the ESCB and the Eurosystem to the European Parliament, the EU Council and the Commission, and the European Council (as required under article 15.3 of the Statute). The President typically appears before the European Parliament's Committee on Economic and Monetary Affairs four times per year. The transcript of the hearing, the President's introductory speech, and background notes prepared for the Committee are available on the European Parliament's website. The introductory statement and transcript of the hearing are also available on the ECB's website.

In accordance with the Article 16.4 of the Rules of Procedure of the ECB, audited financial statements of the ECB are to be adopted by the Governing Council within the first quarter of the subsequent year. These statements are then published (initially appearing on

the ECB's website, and subsequently published in the *Annual Report*). Not all Eurosystem NCBs have disclosed internal governance procedures.

Financial statements are audited by a private sector firm appointed by the European Council of Ministers on the recommendation of the ECB's Governing Council. The accounting policies are prescribed by the ECB's Governing Council, and are described in general terms in the *Annual Report*. The ECB coordinates the audit of the ESCB. These accounts do not have to be signed by external auditors. Each NCB is required to have an external auditor, appointed in accordance with national law and procedures.

The ECB has established a Code of Conduct as well as Insider Trading Rules. The Code of Conduct has been published in the *Official Journal of the European Communities*, and subsequently made available on the ECB's website. Similar plans are in place for the Insider Trading Rules. However, not all Eurosystem NCBs have disclosed standards of conduct for their employees.

To provide the public with sufficient assurances that safeguards are in place to protect the integrity of the internal operations of the entire Eurosystem, it is desirable to have a uniform public disclosure of internal governance procedures by all NCBs. Standards for the conduct of personal financial affairs and rules to prevent conflicts of interest should also be publicly disclosed on a similar basis by all NCBs in the Eurosystem.

Table 3. Recommended Plan of Actions to Improve Observance of MFP Transparency Code—Payment Systems Oversight

Reference Principle	Recommended Action
VIII. Accountability and assurance of integrity by payment systems oversight agencies	Adopt uniform disclosure practices of NCB internal governance procedures and conflict of interest rules.

### C. ECB Response to the Assessment and Recommended Actions

The ECB is fully observant in three of the four areas covering transparency of payment system oversight and agreed with the assessment. Concerning the consultation process, the ECB noted that there is a presumption in favor of consultation of the public at large. The ECB finds that the current consultation practices are adequate for the purpose of ensuring effectively that relevant parties are aware of substantive proposed technical, regulatory and policy changes.

## OBSERVANCE OF THE CPSS CORE PRINCIPLES FOR SYSTEMICALLY IMPORTANT PAYMENT SYSTEMS

### Executive Summary

The mission has found that TARGET has proven effective in transferring funds throughout the EU, despite the institutional and time constraints under which it was established in the run up to EMU. TARGET has fulfilled the policy objectives for which it was set up and largely met the needs of the market. It also broadly meets the Core Principles for Systemically Important Payment Systems. Nonetheless, the mission's assessment points to opportunities for further improvements in operational reliability, efficiency, and governance to ensure full adherence to the core principles.

Risk assessment methodologies and internal audit processes for TARGET could preferably be reviewed by external experts who might help in their development or implementation, including at the national level. In addition, TARGET security requirements should be subject to an independent evaluation, especially as regards data confidentiality and integrity, as well as non-repudiation of payments in the national RTGS systems and their networks. The ECB's informal consultation processes with TARGET participants and users at the EU level could be strengthened to address a wider range of operational and business issues, as well as fundamental choices for the eventual overhaul of the system. In the longer term, organizational and structural approaches could be considered that would minimize the potential for and perception of conflicts of interest for persons (both within the Payment and Settlement System Committee, (PSSC) and some NCBs) involved in both the Eurosystem's management of TARGET and its policy, oversight, and regulatory roles for payment systems generally. Since the Core Principles were included in the set of Eurosystem's oversight standards as recently as in February, the ECB should complete the assessments of systemically important payment systems that it oversees and ensure that these systems observe the Core Principles.

The EURO1 system was developed at the initiative of the Euro Banking Association (the EBA), a nonprofit association of banks having their head office, a branch, or a subsidiary in the European Union. EURO1 is a large value payment system operating on a net basis in euro, and was developed for handling payments denominated in euro. The operation and management of EURO1 is entrusted to EBA Clearing, a limited liability company established by the EBA member banks admitted to participate in EURO1. EBA Clearing is incorporated under the laws of France and is held in equal shares by the EBA member banks that are participants or admitted to participate in EURO1. The operation of EURO1 is based upon the use of a messaging infrastructure and processing service provided by SWIFT (Society for Worldwide Interbank Financial Telecommunication). SWIFT also provides the processing services for EURO1 pursuant to a processing service agreement entered into between SWIFT and the System Operator covering, *inter alia*, agreed service levels for the services provided.

The EURO1 system has been well received by the participants, and it has proved to be a reliable system. It observes all ten core principles in full. As EURO1 relies on SWIFT to conduct their daily operations, it would be advisable for management to have a thorough understanding of SWIFT's contingency operations and security framework. It is recommended that EURO1 management consult with SWIFT on ways EURO1 management can be assured of SWIFT's reliability and security for ongoing EURO1 operations. It is recommended that the management of the EBA Clearing Company should conduct an independent review of SWIFT's contingency testing.

## **I. TARGET: THE EUROSISTEM'S PAYMENT SYSTEM**

### **A. The CPSS Core Principles**

#### **General**

The assessment was made by a team of payment system experts in the context of an IMF ROSC mission.<sup>7</sup> This assessment covers the Trans-European Automated Real-Time Gross Settlement Express Transfer System (TARGET), which was created for cross-border payments between the member countries of the European Union (EU). The assessment does not cover the individual national real-time gross settlement (RTGS) components of TARGET.<sup>8</sup>

The European Central Bank (ECB) has not yet conducted a formal self-assessment of the TARGET system's observance of the Core Principles, but did supply detailed answers to an IMF questionnaire. The team also received a number of documents covering payment systems and their oversight. Most of these documents have been published on the ECB website. The team held extensive meetings with officials from the ECB supplemented by discussions with officials from the Nationale Bank van België/Banque Nationale de Belgique, Banque de France, Deutsche Bundesbank, and Bank of England as well as with six commercial banks and one national payments association. The team also studied a number of documents, including the TARGET guidelines covering the rules and regulations of the system.

The team used the Committee on Payment and Settlement Systems' (CPSS) Report on Core Principles for Systemically Important Payment Systems (CP) and an IMF draft guidance note when assessing the TARGET system. Information available to the mission through September 2001 have been taken into account. The team did not face any obstacles in its work. The authorities and others were fully cooperative.

#### **Large value payment and settlement systems in the EU**

The major payment system within the EU is the TARGET system, which is operated by the European System of Central Banks (ESCB). It is a decentralized system consisting of 15 national RTGS systems, the European Central Bank Payment Mechanism (EPM) and the Interlinking system. The Interlinking system, interconnecting the RTGSs and the EPM, consists of an IT system which provides inter-NCB/ECB accounts for recording mutual claims and liabilities stemming from payment transfers, and a telecommunication network for the real-time transmission of data. TARGET payments are settled one by one on a continuous basis in central bank money. The system thus provides for immediate and final

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<sup>7</sup> The team consisted of Kai Barvell (MAE), Jeff Marquardt, Bridget Spaniel, and Jeff Stehm (all from the Board of Governors of the Federal Reserve System).

<sup>8</sup> A description of the TARGET system is found below.

settlement of all payments, if there are sufficient funds or credit facilities available to the sending institution at its account at the NCB through which a payment is initiated.

The ECB and the NCBs have a responsibility for the oversight of payment and settlement systems including the TARGET system, and the ECB has publicly disclosed its oversight objectives and policies.

### **The functioning of the TARGET system**

TARGET, which opens at 7:00 a.m. and closes at 6:00 p.m. Central European Time (CET), processes credit transfers only. All payments directly resulting from or made in connection with (i) monetary policy operations; (ii) the settlement of the euro leg of foreign exchange operations involving the Eurosystem;<sup>9</sup> and (iii) the settlement of cross-border large-value netting systems that are handling euro transfers, must be made through TARGET. Other payments, such as interbank and commercial payments in euro, payments between EU central banks, and the settlement of ancillary payment systems and security settlement systems may also be effected through TARGET.

National RTGS systems and the EPM are connected via the Interlinking system. Given that TARGET incorporates RTGS systems, which have been established under local conditions, the payment services offered to the end-users of different national systems are not fully identical (e.g., queuing mechanisms and liquidity management features are not uniform across national systems). The Interlinking procedures, however, are the same for all countries. Cross-border TARGET payments are processed via the national RTGS systems and exchanged directly on a bilateral basis between national central banks. In normal circumstances, cross-border TARGET payments reach their destination a few minutes after a debit to the account of the sending participant is recorded.

### **Statistical information regarding volumes and values of transactions**

#### TARGET Payments (2000)

	Average Daily Volume	Average Daily Value (In billions of euro)
Total TARGET Payments	188,157	1,033
Total Cross-Border Payments	39,878	432
<i>Of which:</i> Cross-Border Interbank Payments	26,134	416
<i>Of which:</i> Cross-Border Customer Payments	13,744	16

For 2000, intraday payment flow details for cross-border payments indicate that nearly 50 percent of the total TARGET cross-border volume was processed in the first three

<sup>9</sup> The Eurosystem refers to the members of the ESCB that have adopted the euro in Stage Three of Economic and Monetary Union

hours of operations. This was due to the large number of payments batched by credit institutions overnight and released as soon as TARGET opened.

Regarding the intraday value for interbank payments in 2000, only 26 percent of the total cross-border value was processed in the first three hours of operations. The peak value during the day was processed late in the afternoon.

The larger countries, Germany, the United Kingdom, and France accounted for more than 50 percent of the value of cross-border payments originating in TARGET.

### **General preconditions for effective payment systems**

The EU countries have a well-developed public infrastructure, which supports the financial markets. For historical reasons TARGET interconnects several RTGS systems, without a central party involved in the transfer of funds from one TARGET component to another. This arrangement has both advantages and disadvantages. For example, if one of the participating RTGS systems is not functioning, other participants can continue to make payments between each other. On the other hand, a system consisting of many heterogeneous technical platforms will, almost by definition, be more complex to operate and may suffer a greater overall number of system outages than a more standardized technical platform. It is also more likely that a system using fewer, standardized technical platforms will be less costly to operate and easier to upgrade quickly than one that uses many technical platforms.

Several key EU directives, which all member countries have incorporated into their respective laws, cover the payment system. The ECB has clearly defined its oversight role for TARGET and private sector large value payment systems. In general, the ECB is transparent in relation to payment system issues, although there are opportunities for improvement in certain areas, for example, in relation to the pricing of TARGET payments. The TARGET Information System (TIS) as well as channels on a national level provide information to credit institutions on the operational status of TARGET components.

The Payment and Settlement System Committee (PSSC) assists the Governing Council of the ECB in the fulfillment of the Eurosystem's statutory duty to promote the smooth operation of payment systems, in particular by advising on: (i) the operation and maintenance of TARGET and of the Correspondent Central Banking Model (CCBM) for the cross-border use of collateral; (ii) general payments system policy and oversight issues; and (iii) issues of interest for central banks in the field of securities clearing and settlement systems.

The PSSC has established working groups including the Payment System Policy Working Group (PSPWG); the Securities Settlement Working Group (SWG) and the Target Management Working Group (TMWG). The PSSC and its working groups are all headed by ECB staff and include members from all EU central banks or euro-area central banks, depending on whether the issues discussed have an EU-wide scope or are internal to the Eurosystem.

## **Changes and reforms in process**

The Eurosystem has started to look into the possibility of changing the structure of TARGET from a functional and technical perspective. The reason is that the current design of the system, which is based on the minimum harmonization principle with regard to the TARGET components, translates into a number of shortcomings, which will need to be overcome in the longer run. The present design was chosen because of, *inter alia*, the speed with which the TARGET system had to be created in order to be operational for the start of the final stage of Monetary Union. For monetary policy reasons, it was necessary to build a system for cross-border payments in euro within a relatively short period of time, taking into account the existing national payment systems in all 15 EU countries. There was no time to consider building a completely new system for the entire European Union. Ex post, the chosen strategy has proven highly successful.

The ECB and the euro-area NCBs are considering the next generation of the TARGET system. The main objectives that have been defined by the Eurosystem for the second generation of TARGET are:

- to better meet customers' needs, in terms of availability, intraday information, and liquidity management;
- to provide a more harmonized service in order to ensure a level playing field for banks accessing TARGET via different RTGS systems;
- to ensure cost efficiency; and
- to be prepared for rapid adaptation to future developments, including, *inter alia*, technological progress and the likely enlargement of the Eurosystem.

Given the present division of responsibilities between the ECB and the NCBs, a stated prerequisite that any possible model has to meet is the preservation of the responsibility of each NCB for the accounts of credit institutions.

## **Main findings—Summary**

The mission has found that TARGET has proven effective in transferring funds throughout the EU, despite the institutional and time constraints under which it was established in the run up to EMU. TARGET has fulfilled the policy objectives for which it was set up and has largely met the needs of the market. It also broadly meets the Core Principles for Systemically Important Payment Systems. Nonetheless, the mission's assessment points to opportunities for further improvements in operational reliability, efficiency, and governance to ensure full observance of the core principles.

## ***Legal foundation (CP 1)***

The legal basis of TARGET stems from the underlying provisions of the Maastricht Treaty (the Treaty) and the Statute of the ESCB and ECB (the Statute). In particular, Article 105 (2) of the Treaty (reiterated in Article 3.1 of the Statute) defines as a basic task of the Eurosystem the promotion of the smooth operation of payment systems. Article 22 of the

Statute<sup>10</sup> states that the ECB and national central banks may provide facilities, and the ECB may make regulations, to ensure efficient and sound clearing and payment systems within the Community and with other countries. Such ECB regulations would be directly applicable in the Member States that have adopted the euro. The legal framework for TARGET, as amended, is laid down in a Guideline of the ECB on TARGET of April 26, 2001 (ECB/2001/3) (the TARGET Guideline). In addition, the ECB and all the NCBs have entered into an agreement on TARGET (the TARGET Agreement) in order to provide a mechanism whereby non-euro area NCBs can connect to TARGET and adhere to the rules and procedures for the system, with some modifications and specifications. This legal framework, contained in the TARGET Guideline and incorporated into the TARGET Agreement, is implemented in each of the sets of national rules applicable to the respective national RTGS systems that are component parts of TARGET (the national RTGS rules). Also the EPM has its own set of terms and conditions for its customers (the EPM Terms and Conditions). Moreover, there are several EC directives defining the broader legal framework for banking and payments in the EU, including the Settlement Finality Directive, Cross-Border Credit Transfers Directive, Consolidated Banking Directive, Investment Services Directive, Directive on Electronic Signatures, and directives relating to electronic money.

### ***Understanding and management of risks (CPs II-III)***

TARGET links national RTGS systems and the ECB's EPM into an area-wide RTGS system for the European Union. The implementation of this design substantially reduces overall systemic financial risk from the settlement of large-value euro-denominated payments. The TARGET Guideline sets out the rules and procedures for TARGET.

Intraday information about the operational status of the national TARGET components is reported by the national central banks to the ECB. This information is then disseminated to credit institutions via the TARGET Information System (TIS) over the news agencies Bloomberg, Reuters, and Telerate. The public information provided over TIS is largely intended to inform credit institutions and ease major potential strains in operational management as well as overnight and intraday liquidity management. Furthermore, other information channels at the national level complement TIS.

Intraday information on account balances resulting from the sending and receiving of TARGET transfers is available from all national central banks. The timing of the availability and means of communicating this information, however, appears to vary and is not currently standardized across national central banks. Not all NCBs provide this information in real-time in machine-readable format. At least one NCB expects to upgrade its account balance and other operational systems during 2001. The quality, timeliness, and dissemination of system-related information could be improved. In particular, there could be tighter requirements for NCBs (in reporting TARGET outage information to the ECB), and for major clearing banks (in reporting incidents in their own systems to NCBs). All NCBs should also make available in real time account balance information to participants. The provision of

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<sup>10</sup> See <http://www.ecb.int/about/statescb.htm>

real-time information from all NCBs to credit institutions on intraday account positions would be welcome.

### ***Settlement (CPS IV–VI)***

TARGET is a real-time gross settlement system (i.e., Core Principle V is not applicable), which means that settlement takes place throughout the day whenever a payment is accepted by the system. In TARGET a payment will only be accepted if the paying bank has sufficient funds or credit on its account with the national central bank through which it is making its payment (sending NCB/ECB). TARGET settles in central bank money.

As an interbank payment system, the TARGET rules and procedures address only the rights and obligations of the participants in TARGET, i.e., the sending and receiving credit institutions, and do not address directly the originating and receiving end customers.

TARGET payments become final for a sending participant when its RTGS-account is debited or respective funds are blocked and for the receiving participant when its RTGS-account is credited. This means that participants are able to pass on customer payments they receive to the final beneficiary immediately and without credit risk.

In the institutional setting of the Eurosystem, the Correspondent Central Banking Model (CCBM) has helped ensure that impediments to the cross-border use of collateral do not hinder the provision of collateralized credit by the NCBs. Yet, in many cases, the use of this mechanism implies a one-day lag between the deposit of securities and the extension of credit—a less-than-desirable situation. Thus, notwithstanding a relatively short minimum notification requirement for the counterparty/NCB, it would be helpful to review and test actual procedures for emergency use of this facility on a same-day basis. To date, the CCBM has served the Eurosystem well, although established as a transitional arrangement. Taking a longer view, more efficient market solutions to the underlying structural problems related to the custody, clearing, and settlement of securities in the euro area would be welcomed.

### ***Security and operational reliability, and contingency arrangements (CP VII)***

The ECB has produced a number of documents that cover security and operational reliability and contingency arrangements. Maximum interruption times and outage frequency have been defined for various TARGET components. NCB RTGS systems and networks and Interlinking components should not have an outage in excess of one hour per “normal failure” and four hours per “disaster failure.” In addition, NCBs are to have no more than one “normal failure” per month and one “disaster failure” per year. Over the longer term, the intention is to reduce the maximum downtime for normal failures to zero and for disaster failures to two hours per incident.

The NCBs are required to have a second-site recovery capability and eliminate all single points of failure for TARGET system components. Second site procedures must be elaborated in an IT contingency plan and switchovers must be tested regularly. In addition to second site requirements, procedures have also been defined for manually processing critical payments should an NCB’s RTGS systems/network or Interlinking component suffer an outage that cannot be timely resolved.

The ECB requires a “sound baseline security” in all TARGET domains that conforms to good business practice. Baseline security requirements have been established for data integrity, authorization, authentication, non-repudiation, and confidentiality within TARGET components.

The ECB requires the NCBs to report outages or processing slowdowns greater than 30 minutes and encourages the reporting of incidents lasting less than 30 minutes. The reporting of major outages among banks participating in TARGET is required only if the stability of financial markets may be at stake. Major incidents are discussed via a conference call among the TARGET Settlement Managers, including decisions to release outage information on the TARGET Information System (TIS). Procedures for incident reporting are defined at ESCB level. From the incident reports, monthly statistics on availability (uptime) are calculated and disseminated to the NCBs, but not to the public. The ESCB discloses overall uptime statistics for TARGET to the public.

Compliance with the Requirements is reviewed annually through a defined TARGET Risk Analysis procedure. Using these procedures, analyses are conducted by each NCB on its TARGET components and then reviewed by the PSSC and the Governing Council. For major risks, the NCBs are asked to submit specific action plans to the ECB, which monitors the NCB’s progress in taking corrective action. The ECB also maps reported incidents back to the NCB’s risk analysis. NCB internal audit departments also review and take the risk analyses into consideration in their work.

Risk assessment methodologies and internal audit processes for TARGET could profitably be reviewed by external experts who might help in their development or implementation, including at the national level (Core Principle 7). In addition, TARGET security requirements should be subject to an independent evaluation, especially as regards data confidentiality and integrity, as well as non-repudiation of payments in the national RTGS systems and their networks.

### ***Practicality of the system (CP VIII)***

TARGET went live on January 4, 1999 as one part of the critical infrastructure developed to support European Monetary Union. As such, the system was designed in a relatively short period of time, building in many cases on existing national payment systems, to meet the policy and operational requirements of the final stage of monetary union. In this context, TARGET has provided and continues to provide robust and practical large-value euro transfer capabilities for the euro area.

The current design of TARGET, with its interconnection of several RTGS systems, is a legacy of the constraints and strategy at the time when monetary union was under preparation. From a longer-term perspective, this design appears to add substantial costs to operations, increase the complexity of operations, increase the time and testing needed to make changes to the overall system and limit certain types of improvements, including greater standardization for the benefit of users. The design also may limit opportunities for developing more robust contingency arrangements for the system as a whole.

The current structure of TARGET is embedded within a set of national central banks that use different accounting methodologies for cost measurements, which are subject to substantial margins of error. The lower cross-border payment volumes for TARGET than originally expected and the difficulties in measuring costs suggests that TARGET is not recovering its annual costs of production and arguably is not complying with the Eurosystem's fundamental policy of full cost recovery.<sup>11</sup> Further, the methodology used in measuring costs is not particularly rigorous or transparent and limits the information available to decision makers faced with managing the current system and evaluating future alternative designs. It is noted, however, that preparatory work is under way to develop a proper system-wide cost methodology.

The national central banks have procedures for consulting users and participants locally and the ECB has in place informal consultation procedures on a European-wide basis. No systematic consultations, however, have taken place regarding the fundamental design choices for TARGET and their implications for users.

#### ***Criteria for participation (CP IX)***

The criteria for participating in Target are objective and publicly disclosed.

#### ***Governance of the Payment System (CP X)***

The direction, management and control of TARGET fall within the competence of the Governing Council of the ECB, consisting of the Governors of the euro-area NCBs and the Board of the ECB. The Governing Council of the ECB is assisted by the Payment and Settlement Systems Committee that consists of payment representatives of the NCBs and the ECB. For purposes of TARGET issues, the PSSC has set up the TMWG, composed of NCB representatives for the national RTGS systems and the ECB staff from operations and payment systems policy areas.

The daily management of TARGET has been entrusted to the ECB TARGET Coordinator and to the NCB Settlement Managers. Each NCB and the ECB has appointed a Settlement Manager for the daily administration and monitoring of its respective national RTGS system or, in the case of the ECB, the ECB payment mechanism and for handling abnormal situations and errors. The ECB has appointed the ECB TARGET Coordinator as the manager and coordinator of daily TARGET operations.

The TARGET management structure described above is stipulated by the TARGET Guideline and the ESCB's Rules of Procedure, which are public documents. The rules of procedure and the Guideline are available on the ECB's website. The TARGET Guideline, the TARGET agreement and NCB RTGS Rules provide the detailed framework for TARGET governance.

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<sup>11</sup> See "Minimum Common Features of Domestic Payment Systems," November 1993, and the TARGET Guideline.

The structure of the Eurosystem's management of TARGET, oversight and regulatory roles for euro-area payment systems creates a potential for conflicts of interest between overseers and operators because functions related to both payments system oversight and business operations of TARGET coincide in some bodies (both within the Payment and Settlement System Committee and some NCBs). Although this tension is not uncommon in other systems and may not have created serious problems in practice, special measures are taken by some central banks to address this issue and a case can be made for reassessing the situation in the euro area with a view toward minimizing the potential for such conflicts in the longer term.

***Responsibilities of the Central Bank in applying the CPs***

The ECB will fully comply with the *Responsibilities of the Central Bank in applying the Core Principles* when it has ensured that the systemically important payment systems, overseen by the ECB, observe the Core Principles.

Table 1. Recommended Plan of Actions to Improve Observance of the CPSS Core Principles and Central Bank's Responsibilities in applying the CPs

Reference Principle	Recommended Action
Security, operational reliability and contingency arrangements (CP VII)	Review TARGET security requirements generally and those related to encryption and non-repudiation within each NCB TARGET domain specifically, preferably using external experts. Continue to strengthen the TARGET contingency testing process and the reporting process for incidents and outages at both the NCB level and at the level of the major credit institutions using TARGET.
Practical for the markets and efficient for the economy (CP VIII)	Continue to improve consultation process with the public on technical, design, and policies changes related to TARGET specifically and payment systems generally. Continue to review long term options for changes in the design of TARGET, aiming, inter alia, at remedying the shortcomings of current cost recovery arrangements.
Governance of the system should be effective, transparent and accountable (CP X)	In the longer term, consider organizational and structural approaches that would minimize the potential for and perception of conflicts of interest for persons involved in both the Eurosystem's management of TARGET and its policy, oversight, and regulatory roles for payment systems generally.
Responsibilities of the Central Bank in applying the Core Principles	Complete the assessments of systemically important payment systems that the ECB oversees and ensure that these systems observe the Core Principles.

**Authorities response**

The ECB has noted that it can be concluded from the assessment that TARGET observes six out of ten Core Principles, Core Principle V is not applicable, Core Principles VII and X are broadly observed and Core Principle VIII is partly observed. The ECB was broadly in agreement with the thrust of the overall assessment, but disagreed with some portions of the analysis.

The ECB emphasized that, despite the areas of improvement addressed above, TARGET has fulfilled its policy objectives and has largely met the needs of the market, as noted above. The Eurosystem has also started to reflect on the long-term development of TARGET, including the issues mentioned under section "Changes and Reforms in Process" as well as ensuring an adequate level of standardization.

*Response to recommended action*

The ECB agreed that, in principle, the risk assessment methodologies and internal audit procedures could profitably be reviewed by external experts, and TARGET security requirements could be subject to a tighter regime of oversight and/or other independent evaluation. However, they pointed out that the core principles do not necessarily call for external control, and a tighter internal regime could be sufficient.

The ECB mentioned that in November 2001 certain changes in the incident reporting procedures will be implemented (e.g., slowdowns or outage greater than five minutes will have to be reported, instead of the current 30 minute time-frame) and some consideration could be given to tightening the reporting requirements. However, it should be noticed that the issue of distributing information on the status of private banks has to be first discussed with the banking sector.

The ECB noted that the ESCB has already extensive consultation procedures in place in order to: i) receive feedback on the functioning of the system; ii) enable the market participants to provide their views and proposals on potential enhancements on their own initiative; and iii) collect the views of the market on the Eurosystem's proposals for enhancements. These procedures exist both at the national (meetings with national TARGET User Groups) and ESCB/Eurosystem-level (meetings with market participants and banking associations). However, it may be acknowledged that further enhancements in this field may be possible.

Regarding cost recovery, the future design of TARGET aims, inter alia, to ensure an appropriate level of cost recovery.

The ECB doubts that there exists a potential conflict of interest for the PSSC, as it only has an advisory role (decision making is left to the Executive Board and the Governing Council). Furthermore, while advising on both oversight and operational issues the PSSC pursues the same public policy objectives (i.e., the promotion of smooth operation of payment systems and eventually the maintenance of public confidence in money). Moreover, the division of tasks contributing to the avoidance of conflict of interests is ensured at working group level.

The IMF observed that the Eurosystem has not yet completed its assessments on the payment systems it oversees. This is due to the very recent adoption of the Core Principles. They have been included by the Governing Council of the ECB into the set of Eurosystem's oversight standards on February 1, 2001, i.e., less than two months prior to the IMF ROSC mission.

### ***Response to other observations***

The ECB argued that while recognizing that the provision of information on the account balances in real-time could facilitate liquidity management, the ECB would not consider the lack of provision of this information by some NCBs as problematic from a risk management perspective. This is because the RTGS participants are always in a position to request such information and are thus aware of their account balances in case of need. Furthermore, as the introduction of the real-time account balance feature would entail additional costs for the market participants, there would be a need to discuss with the market participants whether the added value of this feature justifies the investments needed.

Regarding the CCBM, the ECB pointed out that it has been implemented to enable the cross-border use of collateral throughout the euro area for Eurosystem credit operations but the focus was not on the *speed* of mobilizing such collateral. As a result, the procedure is often relying on pre-deposit of securities to secure intraday credit granting; nevertheless intraday deliveries are possible in some cases. It should also be noted that other solutions for cross-border use of collateral are available (e.g., links between securities settlement systems).

## **II. EURO1: THE EURO BANKING ASSOCIATION'S PAYMENT SYSTEM**

### **A. The CPSS Core Principles**

#### **General**

The assessment was made by a team of payment system experts in the context of an IMF Report on the Observance of Standards and Codes (ROSC) mission.<sup>12</sup> This assessment covers the Euro Banking Association's (EBA) EURO1 system.<sup>13</sup>

The EBA did not provide a self-assessment of the EURO1 system's observance of the Core Principles, but supplied detailed answers to an IMF questionnaire. The ECB, which has the oversight role of the EURO1 system, did also attend the team's meeting with the EBA. The discussions were supplemented by discussions with officials from selected NCBs as well as with six commercial banks.

The team used the Committee on Payment and Settlement Systems' (CPSS) Report on Core Principles for Systemically Important Payment Systems (CP) and an IMF draft guidance note when assessing the EURO1 system.

The ECB and EBA were fully cooperative with the mission.

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<sup>12</sup> The payment system team consisted of Kai Barvell (MAE), Jeff Marquardt, Bridget Spaniel and Jeff Stehm (all Board of Governors of the Federal Reserve System).

<sup>13</sup> A description of the EURO1 system is found below.

## **The EURO1 payment system**

The EURO1 system was developed at the initiative of the Euro Banking Association (the EBA), a nonprofit association of banks having their head office, a branch, or a subsidiary in the European Union. EURO1 is a large value payment system operating on a net basis in euro, and was developed for handling payments denominated in euro. It is truly cross-border in nature in that it handles payments among participants that are incorporated or located in 23 different jurisdictions, each participating in the system from their head office or a branch located in a Member State of the European Union. The operation and management of EURO1 is entrusted to EBA Clearing (“System Operator”), a limited liability company established by the EBA member banks admitted to participate in EURO1. EBA Clearing is incorporated under the laws of France in the form of a *société par actions simplifiée* and is held in equal shares by the EBA member banks that are participants or admitted to participate in EURO1.

The operation of EURO1 is based upon the use of a messaging infrastructure and processing service provided by SWIFT (Society for Worldwide Interbank Financial Telecommunication). SWIFT also provides the processing services for EURO1 pursuant to a processing service agreement entered into between SWIFT and the System Operator covering, *inter alia*, agreed service levels for the services provided.

The technical features of the system are such that payment messages are only processed by the central computer after it has been checked that these meet the criteria for being processed. These criteria include, in particular, that a payment message can only be processed if this does not lead to breaching binding intraday limits.

Binding intraday limits ensure that risks on any one participant in the system as well as potential systemic risk are contained. The method for setting these binding intraday limits and the limit structure of the system equally ensure that the participants are able to control and manage the risk resulting from participation in the system.

Payment messages that cannot be processed at the time they are sent are queued, and these queues are revisited on a regular basis to allow processing of the so queued payment messages. A payment message can be revoked or cancelled by the sending participant as long as it is not processed. Once processed, payment messages cannot be revoked.

The balance of each of the sending and receiving participant is calculated in real time. At any time during the operating day, the balance of each participant resulting from the processing of payment messages sent to or by it constitutes a single payment obligation or claim of such participant towards the community of all other participants. Pursuant to the legal structure of the EURO1 system, known as the “Single Obligation Structure,” the rights and obligations of the participants resulting from the sending and receiving of payment messages are agreed, from the outset, to be on a net basis. At each and any time during the operating day, each participant will only have a single payment claim or obligation vis-à-vis all other participants, and no bilateral payment claims or obligations are created by the processing of payment messages in the system.

The Single Obligation Structure does not allow for an unwinding of a transaction. Interbank payments made through the system are discharged between the sending and receiving participant upon processing of the relevant payment message.

The EURO1 system settles same day in central bank funds at the European Central Bank (the ECB). The ECB acts as settlement service provider in respect of EURO1 and a special settlement account has been opened at the ECB for the purpose of conducting the settlement operations. After the cut-off time for processing, the participants having a single obligation will pay the amount thereof into the hands of the ECB by means of a transfer from their account held with a national central bank through TARGET onto the settlement account held at the ECB. After all amounts so due have been received, and upon instruction from the System Operator, the ECB will pay the participants having a single claim by means of a transfer from the settlement account to the account held by the relevant participants with a NCB. Completion of settlement is notified to all participants upon receipt of confirmation that the NCB account of each of the long participants has been credited.

Liquidity and loss sharing arrangements have been put in place to cope with liquidity and credit risk that may arise due to failure by one or more participants to timely meet its or their obligations. A cash liquidity pool is held with the ECB, which can be used immediately—to ensure timely completion of settlement. Additional liquidity resources—in the form of same day liquidity provided by the surviving participants—have been put in place to cover shortfalls stemming from multiple failures for an amount exceeding the amount available in the cash liquidity pool. The system's architecture allows for same day settlement even in the event of multiple failures occurring on the same day (including in the case of a so called market crisis scenario).

### **Statistical information regarding volumes and values of transactions**

#### **EURO1 Payments**

	<b>Average Daily Volume</b>	<b>Average Daily Value (In billions of euro)</b>
1999	67,883	171
2000	97,271	195

### **General preconditions for effective payment systems**

The EU countries have a well-developed public infrastructure, which supports the financial market. Several EU directives, which member countries have adopted in their respective laws, cover the payment system.

### **Main findings—Summary**

The EURO1 system has been well received by the participants, and it has proved to be a reliable system. It observes all ten core principles in full. It is recommended that the management of the EBA Clearing Company should conduct an independent review of SWIFT's contingency testing.

Table 2. Summary of Main Findings of Assessment of Observance of CPSS Core Principles for Systematically Important Payment Systems

Reference Principle	Recommended Action
Security and operational reliability; and contingency arrangements (CP VII)	As EURO1 is reliant upon SWIFT to conduct their daily operations it would be advisable for management to have a thorough understanding of SWIFT's contingency operations and security framework. It is recommended that EURO1 management consult with SWIFT on ways EURO1 management can be assured of SWIFT's reliability and security for ongoing EURO1 operations.

**Authorities response**

The Eurosystem was in agreement with the assessment.