



## TARGET 2 and Settlement Finality

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**Abstract:** This article examines how TARGET 2 as system implements the idea of settlement finality regulated by Directive 98/26 EC of the European parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems (Settlement Finality Directive) and Directive 2009/44/EC of the European parliament and of the Council of 6 May 2009 amending Directive 98/26/EC on settlement finality in payment and securities settlement systems and Directive 2002/47/EC on financial collateral arrangements as regards linked systems and credit claims (Directive 2009/44/EC). As the title of the article states two points are the cornerstones – TARGET 2 and finality of the settlement in this system.

**Keywords:** TARGET 2; settlement; settlement finality; Directive 98/26 EC; Directive 2009/44 EC

### 1. TARGET 2 as System

What does TARGET 2 mean? According to the Guideline of the European Central Bank of 26 April 2007 on a Trans-European Automated Real-time Gross settlement Express Transfer system<sup>2</sup> (Guideline of the ECB), TARGET 2 is a “Trans-European Automated Real-time Gross settlement Express Transfer system”, which has a decentralized structure linking together national real-time gross settlement (RTGS) systems and the ECB Payment Mechanism (EPM). Payments executed via an RTGS system are settled individually; in all other arrangements clearing balances are calculated and then settled<sup>3</sup>.

The design of the TARGET 2 system was mainly inspired by the Former German RTG-Plus system operated by the Bundesbank and the New BIREL system of Banca d’Italia (Geva, 2008, p. 114).

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<sup>2</sup> <http://www.ecb.int/ecb/legal/pdf/02007o0002-20101122-en.pdf>.

<sup>3</sup> Cf. Clearing and Settlement Arrangements for Retail Payments in selected Countries, BIS (September 2000) 16.

Each Eurosystem CB<sup>1</sup> operates its own TARGET2 component system<sup>2</sup>. The component system is a formal arrangement, which is defined as an arrangement:

- between three or more participants, excluding the system operator of that system, a possible settlement agent, a possible central counterparty, a possible clearing house or a possible indirect participant, with common rules and standardized arrangements for the clearing, whether or not through a central counterparty, or execution of transfer orders between the participants;
- governed by the law of a Member State chosen by the participants; the participants may, however, only choose the law of a Member State in which at least one of them has its head office;
- designated, without prejudice to other more stringent conditions of general application laid down by national law, as a system and notified to the Commission by the Member State whose law is applicable, after that Member State is satisfied as to the adequacy of the rules of the system.<sup>3</sup>

Each component is a system designated as such under the relevant national legislation implementing Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems<sup>4</sup> (Settlement Finality Directive)<sup>5</sup>.

Some authors share the opinion that the wording “real time” can be misleading, because there is always a time lag between Transfer Order system entering and settlement (Vereecken & Nijenhuis, 2003, p. 38). It is not very clear how this statement refers to TARGET 2, because the only information about business day system operations could be found in as set out in Operating schedule, Appendix V of Annex II, Guideline of the ECB. This information states that between 7.00 and 18.00 a daytime processing is operating. There is no indication of lags in specified time during daytime.

Who may participate in TARGET 2 system? Participants in the system may be both – direct and indirect. TARGET 2 direct participants may be credit institutions established in EEA including their branches, EEA branches of credit institution established outside the EEA, NCBs of EU Member States, and the ECB (Geva, 2008, p. 117).

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<sup>1</sup> “Eurosystem CB” means the ECB or a participating NCB.

<sup>2</sup> Art. 3 Guideline of the ECB.

<sup>3</sup> Art. 2 (a) Settlement Finality Directive.

<sup>4</sup> Official Journal L 166, 11/06/1998 P. 0045 – 0050.

<sup>5</sup> Art. 3 (1) Guideline of the ECB.

Direct participant means an entity that holds at least one PM account<sup>1</sup> with a Eurosystem<sup>2</sup> CB (central bank). Indirect participant is defined as a credit institution established in the European Economic Area (EEA), which has entered into an agreement with a direct participant to submit payment orders and receive payments via such direct participant's PM account, and which has been recognised by a TARGET2 component system as an indirect participant<sup>3</sup>. The indirect participants benefit from the protection of the Settlement Finality Directive) in the countries where such protection has been granted (Geva, 2008, p. 118). Some systems do not accept indirect participants. Compared to Clearing Rule Book of The London Clearing House, Clearnet SA system has only direct participants who are its Clearing Members and its Allied Clearing Houses, and it does not have indirect participants<sup>4</sup>.

## 2. TARGET 2 Operations

Two types of orders can be submitted to TARGET 2: credit transfer orders and direct debit instruction carried out under a direct authorization (Geva, 2008, p. 119). Another possibility for participants is so called 'intraday credit'. The intraday credit is credit extended for a period of less than one business day<sup>5</sup>. It is provided only on the business day and be free of interest (Geva, 2008, p. 120). Both creditor and debtor should be TARGET 2 participant<sup>6</sup>. It is also based on eligible collateral<sup>7</sup>. Eligible collateral consists of the same assets and instruments as eligible assets for Eurosystem monetary policy operations, and is subject to the same valuation and risk control rules as those laid down in Annex I to Guideline ECB/2000/7<sup>8</sup>.

The failure to reimburse the intraday credit at the end of the day shall automatically be considered as a request for recourse "to the marginal lending facility" and will further entail penalties (Geva, 2008, p. 120).

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<sup>1</sup> "PM account" means an account held by a TARGET2 participant in the PM with a Eurosystem CB which is necessary for such TARGET2 participant to submit payment orders or receive payments via TARGET2 and settle such payments with such Eurosystem CB.

<sup>2</sup> Art. 2 Guideline of the ECB.

<sup>3</sup> Art. 2 Guideline of the ECB.

<sup>4</sup> Article 2.1.1.1, Clearing Rule Book, LCH.Clearnet SA (December 16, 2010).

<sup>5</sup> Art. 2 Guideline of the ECB.

<sup>6</sup> Art. 7 Guideline of the ECB.

<sup>7</sup> 4 Guideline of the ECB, Annex III, Provision of intraday credit.

<sup>8</sup> *Ibid.*

### **3. Settlement in TARGET 2**

Settlement refers to the fulfilment of the legal obligation (Hasenpusch, 2009, p. 18). Settlement process in TARGET 2 is arranged in Annex II, Guideline of the ECB and the Supplemental and Modified Harmonised Conditions for participation in TARGET 2<sup>1</sup>. TARGET 2 participants may choose among different priority settlement orders (normal, urgent and highly urgent<sup>2</sup>).

### **4. TARGET 2 and Settlement Finality Implementation**

How is TARGET 2 protected under the Settlement Finality Directive? To answer this question a definition of ‘finality’ is needed. Finality of the payment has different meanings:

- a) “finality of payment” connected with irreversibility of the payment process, particularly in insolvency (Geva, 2008b, pp. 633-644);
- b) it can also signify the loss of the right to recover a mistaken payment (Geva, 2008b, p. 634);
- c) it can be used to mark accountability to the payee/beneficiary by a bank instructed to pay to the payee/beneficiary<sup>3</sup>. Finality is not defined directly by Settlement Finality Directive. Under Settlement Finality Directive “finality” meaning is closer to the irreversibility of the payment process, particularly in insolvency.

Legal theory provides some finality principles:

- a. the netting of Transfer Orders cannot be challenged, even if participant insolvency proceedings are opened against a system participant (Vereecken & Nijenhuis, 2003, p. 14);
- b. system participants are not entitled to revoke Transfer Order that has been entering in a system, neither can a third party’s action result in a Transfer Order being revoked;<sup>4</sup>
- c. insolvency proceedings take effect from the moment at which the decision to open them has been taken; they cannot be given retroactive effect to midnight

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<sup>1</sup> Art. 6 (1) Guideline of the ECB.

<sup>2</sup> Art. 15 Harmonised Conditions for participation in TARGET 2, Guideline of the ECB.

<sup>3</sup> *Ibid.*

<sup>4</sup> *Ibid.*

before the decision and neither can application of a Transfer Order entered in a system (Vereecken & Nijenhuis, 2003, pp. 14-15);

- d. conflict of law rules (Vereecken & Nijenhuis, 2003, pp. 14-15) - which are outside of the scope of this paper.

First principle is settled in art. 3 (1) Settlement Finality Directive (Löber, 2006, p. 17).

1. Transfer orders and netting shall be legally enforceable and binding on third parties even in the event of insolvency proceedings against a participant, provided that transfer orders were entered into the system before the moment of opening of such insolvency proceedings as defined in article 6(1).

This principle is detailed described in annex II, Harmonised conditions for participation in TARGET2, Guideline of the ECB. Transfer Orders are protected by entering into TARGET 2 at the moment that relevant participant's PM account is debited<sup>1</sup>. The only exception of payment order revocation is the moment until it is entered into TARGET2<sup>2</sup>.

A new text was added in art. 3 (1) in its first paragraph by Directive 2009/44/EC of the European parliament and of the Council of 6 May 2009 amending Directive 98/26/EC on settlement finality in payment and securities settlement systems and Directive 2002/47/EC on financial collateral arrangements as regards linked systems and credit claims<sup>3</sup> (Directive 2009/44/EC):

*“This shall apply even in the event of insolvency proceedings against a participant (in the system concerned or in an interoperable system) or against the system operator of an interoperable system which is not a participant.”*

This new text covers not only system, but also interoperable system which is not a participant. Interoperable system was also defined by art. 2 (o) Directive 2009/44/EC as:

*“two or more systems whose system operators have entered into an arrangement with one another that involves cross-system execution of transfer orders”*

This text extended the scope of the first principle over interoperable system too. The aim is to reduce the liquidity risk (Dalhuisen, 2007, p. 482).

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<sup>1</sup> Art. 22 (1) Annex II, Harmonised conditions for participation in TARGET2, Guideline of the ECB.

<sup>2</sup> Art. 22 (2) Annex II, Harmonised conditions for participation in TARGET2, Guideline of the ECB.

<sup>3</sup> OJ. L. 146, 10.6.2009, pp. 37–43.

Second principle is connected with so called irrevocability of payment orders. Irrevocability is in close connection with finality. The moment of entry of a Transfer Order into a system is defined by the rules of the system in question<sup>1</sup>. Irrevocability has also another effect connected with rights of pledge. Any amounts paid into the PM account whose balance is pledged shall, by the mere fact of being paid in, be irrevocably pledged, without any limitation whatsoever, as collateral security for the full performance of the secured obligations<sup>2</sup>.

What is the moment of entering in a system? This question should be arranged by the system rules. Many Settlement Finality Directive texts forward the definition of that moment in system rules – Recital 14, Recital 14a and Recital (22a), art. 3 (1) second paragraph, art. 3 (3), art. 3 (4) and art. 5.

In ancillary systems credit instructions shall be deemed to be entered in the relevant TARGET2 component system at the moment and irrevocable from the moment that they are accepted by the ASCB<sup>3</sup> (art. 5 (1), Annex IV, Settlement procedures for ancillary systems). Debit instructions in ancillary systems shall be deemed to be entered in the relevant TARGET2 component system at the moment and irrevocable from the moment that they are accepted by the SCB<sup>4</sup>.

Other system rules accept that principle and designate any transaction received by the system from its members as irrevocable as soon as it is registered in the system<sup>5</sup>.

Third principal is connected with insolvency proceedings effect and their possible retroactive application of a Transfer Order entered in a system (as for example there is the abolition of retroactive effects of the opening of insolvency proceedings (*zero hour rules*)). It is very important to note that underlying transactions are still at risk of invalidation as a consequence of fraud or even under normal insolvency rules (Löber, 2006, p. 17).

The moment of opening insolvency proceedings shall be the moment when the relevant judicial or administrative authority handed down its decision (Löber, 2006, p. 17). Two “moments” are important in case of insolvency – “before before the

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<sup>1</sup> Payment systems in Denmark, Danmarks Nationalbank. June 2005, p. 177.

<sup>2</sup> Art. 36 (3), annex II, Harmonised Conditions for participation in TARGET 2, Guideline of the ECB.

<sup>3</sup> „Ancillary system central bank (ASCB)” means the Eurosystem CB with which the relevant AS has a bilateral arrangement for the settlement of AS payment instructions in the PM.

<sup>4</sup> Art. 5 (1), Annex IV, Settlement procedures for ancillary systems.

<sup>5</sup> Cf. art. 1.3.2.1, Clearing Rule Book, LCH.Clearnet SA. December 16, 2010.

moment of opening of such insolvency proceedings” and “after the moment of opening of insolvency proceedings”<sup>1</sup>. In the second case, Transfer Orders shall be legally enforceable and binding on third parties only if the system operator can prove that, at the time that such transfer orders become irrevocable, it was neither aware, nor should have been aware, of the opening of such proceedings.

## 5. Conclusion

TARGET 2 is a special settlement system, which is designated by Settlement Finality Directive. This system provides Settlement Finality Directive as binding not only to the system participants, but it extends that effect also to third parties. Irrevocability of payment is also a part from that finality. Irrevocability is in dependence of the moment of entry of a Transfer Order, which is defined in Guideline of the ECB. The third finality “element” is also applicable to the TARGET 2 system. It excludes insolvency proceedings effect and their possible retroactive application of a Transfer Order entered in a system. TARGET 2 should be only the beginning of integration and unification in the field of EU settlement.

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<sup>1</sup> Art. 3 (1) second paragraph Settlement Finality Directive.

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