

Assessment of NBB SSS against the CPSS-IOSCO Recommendations for SSS

1.1 Introduction - the CPSS-IOSCO Recommendations

In November 2001, the Committee on Payment and Settlement Systems (CPSS) of the G-10 central banks and the Technical Committee of the International Organisation of Securities Commissions (IOSCO) published a set of standards: the Recommendations for Securities Settlement Systems¹. The objective of the 19 CPSS-IOSCO Recommendations is to contribute to the financial stability by strengthening the securities settlement systems (SSS) that are an increasingly important component of the global financial infrastructure. CPSS-IOSCO also developed an Assessment Methodology² which aimed at providing a clear and comprehensive framework for the assessments made on the basis of the Recommendations. For each of them, the methodology provides assessors four possible assessment categories ("Observed", "Broadly observed", "Partly observed" and "Non-observed") defining to what extent the system complies with the Recommendation.

The CPSS - IOSCO Recommendations for SSS

Legal risk

1. Legal framework

Securities settlement systems should have a well founded, clear and transparent legal basis in the relevant jurisdictions.

Pre-settlement risk

2. Trade confirmation

Confirmation of trades between direct market participants should occur as soon as possible after trade execution, but no later than trade date (T + 0). Where confirmation of trades by indirect market participants (such as institutional investors) is required, it should occur as soon as possible after trade execution, preferably on T + 0, but no later than T + 1.

3. Settlement cycles

Rolling settlement should be adopted in all securities markets. Final settlement should occur no later than T + 3. The benefits and costs of a settlement cycle shorter than T + 3 should be evaluated.

4. Central counterparties (CCPs)

The benefits and costs of a CCP should be evaluated. Where such a mechanism is introduced, the CCP should rigorously control the risks it assumes.

5. Securities lending

Securities lending and borrowing (or repurchase agreements and other economically equivalent transactions) should be encouraged as a method for expediting the settlement of securities transactions. Barriers that inhibit the practice of lending securities for this purpose should be removed.

Settlement risk

6. Central securities depositories (CSDs)

Securities should be immobilised or dematerialised and transferred by book entry in CSDs to the greatest extent possible.

7. Delivery versus payment (DVP)

CSDs should eliminate principal risk by linking securities transfers to funds transfers in a way that achieves delivery versus payment.

¹ "Recommendations for Securities Settlement Systems", CPSS-IOSCO, November 2001 (available on the website of the Bank for International Settlement: www.bis.org in the CPSS publication section)

² "Assessment Methodology for the Recommendations for SSSs"; CPSS-IOSCO, November 2002 (available on the website of the Bank for International Settlement: www.bis.org in the CPSS publication section)

8. Timing of settlement finality

Final settlement should occur no later than the end of the settlement day. Intraday or real-time finality should be provided where necessary to reduce risks.

9. CSD risk controls to address participants' failures to settle

CSDs that extend intraday credit to participants, including CSDs that operate net settlement systems, should institute risk controls that, at a minimum, ensure timely settlement in the event that the participant with the largest payment obligation is unable to settle. The most reliable set of controls is a combination of collateral requirements and limits.

10. Cash settlement assets

Assets used to settle the ultimate payment obligations arising from securities transactions should carry little or no credit or liquidity risk. If central bank money is not used, steps must be taken to protect CSD members from potential losses and liquidity pressures arising from the failure of the cash settlement agent whose assets are used for that purpose.

Operational risk**11. Operational reliability**

Sources of operational risk arising in the clearing and settlement process should be identified and minimized through the development of appropriate systems, controls and procedures. Systems should be reliable and secure, and have adequate, scalable capacity. Contingency plans and backup facilities should be established to allow for timely recovery of operations and completion of the settlement process.

Custody risk**12. Protection of customers' securities**

Entities holding securities in custody should employ accounting practices and safekeeping procedures that fully protect customers' securities. It is essential that customers' securities be protected against the claims of a custodian's creditors.

Other issues**13. Governance**

Governance arrangements for CSDs and CCPs should be designed to fulfil public interest requirements and to promote the objectives of owners and users.

14. Access

CSDs and CCPs should have objective and publicly disclosed criteria for participation that permit fair and open access.

15. Efficiency

While maintaining safe and secure operations, securities settlement systems should be cost-effective in meeting the requirements of users.

16. Communication procedures and standards

Securities settlement systems should use or accommodate the relevant international communication procedures and standards in order to facilitate efficient settlement of cross-border transactions.

17. Transparency

CSDs and CCPs should provide market participants with sufficient information for them to identify and evaluate accurately the risks and costs associated with using the CSD or CCP services.

18. Regulation and oversight

Securities settlement systems should be subject to transparent and effective regulation and oversight. Central banks and securities regulators should cooperate with each other and with other relevant authorities.

19. Risks in cross-border links

CSDs that establish links to settle cross-border trades should design and operate such links to reduce effectively the risks associated with cross-border settlements.

1.2 Assessment of NBB SSS

NBB SSS is the Central Securities Depository (CSD) for dematerialised fixed income securities in Belgium; i.e. government securities and corporate debt. The system is operated by the Securities Division of the Financial Markets Department within NBB and provides mainly depository and securities settlement services. The participants of NBB SSS can settle transactions in EUR by book-entry on a delivery-versus-payment basis. The system of NBB SSS has about hundred users, both domestic and international, and holds about 2,000 different issues.

In the course of 2004, the Oversight Unit of the International Co-operation and Financial Stability Department of the NBB conducted an assessment of the system against the CPSS-IOSCO Recommendations. To ensure a level playing field with other payment and settlement systems located in Belgium and to avoid any conflicts of interest, operational entities within NBB like the Securities Division have been strictly separated from the Oversight Unit; i.e. they are located in different departments (the Financial Markets Department and the International Co-operation and Financial Stability Department respectively) with different reporting lines up to Board level.

The results of this assessment are summarised in the table below. This assessment takes into account a series of mitigating actions that were taken by NBB SSS after the preliminary assessment made by the Oversight Unit at the beginning of 2004. As a result, by now, NBB SSS is fully compliant with fifteen Recommendations, whereas two (i.e. Recommendations 13 and 15) are "Broadly observed". Two recommendations are considered not relevant for NBB SSS since they deal with aspects the system cannot be accounted for (i.e. trade confirmation, settlement cycle).

The disclosure of the outcome of the assessment is promoted by the CPSS-IOSCO methodology itself as it should enhance the transparency on the NBB's regulatory role for the participants of the system. Moreover, a level playing field is ensured by making the results of the assessment public for all settlement institutions. Finally, by disclosing this assessment, the NBB intends to promote its accountability as overseer of payment and securities settlement systems

Summary of results of the CPSS-IOSCO assessment of NBB SSS

Recommendations	Assessment category
I Legal Risk	
Recommendation 1 Legal Framework	Observed
II Pre-settlement Risk	
Recommendation 2 Trade confirmation	Not relevant
Recommendation 3 Settlement cycles	Not relevant
Recommendation 4 Central Counterparties (CCPs)	Observed
Recommendation 5 Securities lending	Observed
III Settlement Risk	
Recommendation 6 Central securities depositories (CSDs)	Observed
Recommendation 7 Delivery versus payment (DVP)	Observed
Recommendation 8 Timing of settlement finality	Observed
Recommendation 9 CSD risk controls to address participants' failures to settle	Observed
Recommendation 10 Cash settlement assets	Observed
IV Operational Risk	
Recommendation 11 Operational reliability	Observed
V Custody Risk	
Recommendation 12 Protection of customers' securities	Observed
VI Other Issues	
Recommendation 13 Governance	Broadly observed
Recommendation 14 Access	Observed
Recommendation 15 Efficiency	Broadly observed
Recommendation 16 Communication procedures and standards	Observed
Recommendation 17 Transparency	Observed
Recommendation 18 Regulation and oversight	Observed
Recommendation 19 Risks in cross-border links	Observed

Legal risk

The legal framework applicable to a SSS's operation is highly important for its reliability and predictability. Legal risks may cause one party to a trade to suffer losses because laws or regulations do not support the rules of the securities settlement system or the property rights and other interests held through the settlement system.

The settlement activities of the system of NBB SSS are governed by consistent, clear and solid laws, rules, procedures and contractual provisions that are public and accessible to system participants.

The legal framework supports the enforceability of transactions and the protection of the participants' assets. It also provides an adequate legal basis for the holding of securities (immobilization and dematerialisation), the transfer of securities by book-entry, securities lending and delivery versus payment with finality. The system's rules and contracts are considered enforceable between participants, notwithstanding the insolvency of a participant. Recommendation 1 (Legal framework) is therefore assessed as "Observed".

Pre-settlement risk

Pre-settlement risk refers to the risk that an outstanding transaction for completion at a future date will not settle because one of the counterparties fails to perform on the contract or agreement during the life cycle of the transaction before settlement. The resulting exposure is the cost of replacing the original transaction at current market prices. This risk can be mitigated by trade confirmation mechanisms, shorter settlement cycles, the use of a Central Counterparty or the possibility to lend securities.

The system of NBB SSS settles Euronext stock exchange and over-the-counter trades. Rules and practices regarding trade confirmation, settlement cycles or the use of a Central Counterparty are defined by the market itself. In practice, NBB SSS cannot intervene in these rules and practices, neither as a CSD nor as a securities settlement system. Recommendation 2 (Trade confirmation) and Recommendation 3 (Settlement cycles) are therefore considered not relevant for the assessment of the system of NBB SSS.

Recommendation 4 (Central Counterparties) has been assessed as "Observed". For government bonds traded on Euronext (Brussels), LCH.Clearnet acts as central counterparty for the Belgian segment. Since August 2004, an optional netting service was also introduced on the MTS Belgium platform (via LCH.Clearnet) which settles government debt on the regulated off-exchange market.

NBB SSS operates an automatic securities lending program. This program increases the system's settlement efficiency. Recommendation 5 (Securities lending) is therefore "Observed" by the system of NBB SSS.

Settlement risk

Settlement risk is a general term used to designate the risk that settlement in a SSS will not take place as expected, e.g. because a party will default on one or more settlement obligations to its counterparties or to a settlement agent.

CPSS-IOSCO Recommendations 6 to 8 deal with settlement risk related issues, by requiring securities settlement systems to provide for immobilisation or dematerialisation of securities and transfers by book-entry, to eliminate principal risk by offering effective delivery versus payment (DVP) mechanisms (i.e. in EUR for NBB SSS), to provide intraday or real-time settlement finality that is transparent to the system's users. As the system of NBB SSS complies with this set of Recommendations, it is assessed as "Observed".

As a central bank, NBB is only allowed to grant intraday or overnight credit to the participants of NBB SSS on a collateralised basis. NBB SSS settles securities transactions against payment in EUR in central bank money; i.e. the cash leg of a securities transaction is settled in the accounts of NBB. Overdrafts or debit balances in securities are not permitted in the system. Recommendation 9 (CSD risk controls to address participants' failures to settle) and Recommendation 10 (Cash settlement assets) are therefore assessed as "Observed".

Operational risk

Operational risk is the risk of a human error or a breakdown or deficiencies of some components of the hardware, software or communications systems that are crucial to the settlement process. It covers both operational reliability and business continuity/contingency issues.

The system of NBB SSS is one of the supercritical systems of the NBB. A system is considered supercritical if its failure would have a significant impact on the national financial sector. At the level of NBB SSS, the Business Recovery Plan (BRP) identifies various disaster scenarios and the procedures to address those risks. Escalation procedures for incident management are in place. If deemed necessary, the Crisis Committee of the Bank would intervene.

The current IT infrastructure of NBB is composed of two back-up datacentre facilities and one back-up office infrastructure. Several tests on the contingency plans and infrastructure are organised each year for different scenarios. As a key system of the NBB, the capacity of the system to handle stress volumes of NBB SSS is periodically tested. During the last years, NBB did not face any major failure of critical systems that might have had a significant impact on the functioning of the system of NBB SSS.

Custody risk

Custody risk is the risk of loss of securities held in custody occasioned by the insolvency, negligence or fraudulent action of the custodian or of a subcustodian.

The overall majority of the securities deposited in NBB SSS are held in dematerialised form. For the limited number of physical securities safekept in the vaults of the NBB, risk controls are in place that are subject to internal audit validations. Participants have to segregate between own and clients' securities which protects clients' securities from a participant's insolvency. NBB SSS has never experienced any case of insufficient securities to satisfy any customer claim. Daily reconciliation ensures the correct holding of securities. Recommendation 12 (Custody Risk) is assessed as "Observed".

Other issues

The CPSS-IOSCO Recommendations cover also various other issues that are not directly related to a specific type of risk.

Governance

The system of NBB SSS is owned by the NBB and operated by the Financial Markets Department within NBB. Its governance arrangements are clearly specified and information about them is publicly available. However, due to the absence of formal user committees, there is no formal guarantee that the full range of user interests will always be taken into account. Consequently, Recommendation 13 (Governance) is assessed as "Broadly observed".

Access

Access rules are objective and clearly disclosed to all potential applicants through the system's Rule Book that is available on the website of the NBB. The overall majority of NBB SSS participants are credit institutions or investment firms. NBB SSS takes the necessary measures to comply with anti-money laundering regulations. Recommendation 14 (Access) is "Observed".

Efficiency

NBB SSS is operating on a cost-recovery basis (as requested by law), and has put in place procedures to review pricing and costs regularly. However, NBB SSS does not conduct client

surveys among its users to assess the service levels it is providing. Therefore, Recommendation 15 (Efficiency) is assessed as "Broadly observed".

Communication procedures and standards

NBB SSS uses international communication standards and procedures. The main part of instructions are exchanged via SWIFT messaging that is compliant with the ISO15022 standard. Regarding ISIN codes, NBB SSS complies with ISO6166. Recommendation 16 (Communication procedures and standards) is assessed as "Observed".

Transparency

A securities settlement system should provide its participants with sufficient information in order to accurately evaluate risks and costs associated with the participation to the system. Applicable laws, rules and procedures governing the rights and obligations of the participants, as well as the liabilities of NBB SSS, are described in the system's Rule Book. The Rule Book is publicly available through the website of the NBB. NBB SSS has also completed and disclosed the questionnaire set out in the CPSS-IOSCO Disclosure Framework. Recommendation 17 (Transparency) is assessed as "Observed".

Regulation and oversight

As a securities settlement system, NBB SSS is overseen by the Oversight Unit of NBB. The roles and tasks of the NBB are clearly defined in the relevant laws on the supervision of the financial markets. To ensure a level playing field with other payment and settlement systems located in Belgium and to avoid any conflicts of interest, operational entities within NBB like the Securities Division have been strictly separated from the Oversight Unit; i.e. they are located in different departments (the Financial Markets Department and the International Co-operation and Financial Stability Department respectively) with different reporting lines up to Board level. Recommendation 18 (Regulation and oversight) is considered as "Observed".

Risks in cross-border links

NBB SSS has no link with other depositories or securities settlement institutions for settling cross-border trades. However, NBB maintains a 'technical link' with CIK, the Belgian CSD for equities and corporate bonds. This 'technical link' is being used to convert "*Staatsbons/Bons d'Etat*" from bearer into immobilised form (and vice versa). Physical securities are first booked to NBB's account within CIK upon which securities become immobilised and ready for book-entry transfer within NBB SSS. To keep custody risks for NBB at a strict minimum (i.e. securities are immobilised in the system of NBB SSS but temporarily safekept in the vaults of CIK), physical transfers of securities are organised on a frequent basis between CIK and NBB. As appropriate risk mitigation measures are taken, Recommendation 19 (Risks in cross-border links) is considered as "Observed".