

Reforming the Securities Settlement Systems for Public Debt

1st REGIONAL

Workshop on Developing Government Bond Markets in Latin America

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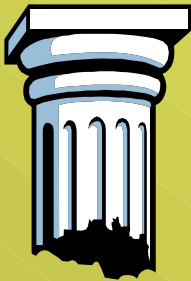
The Western Hemisphere Payments & Securities Clearance and Settlement Initiative



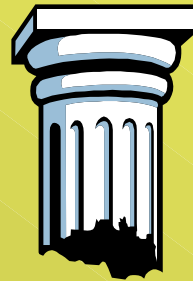


A. PILLARS OF THE STRATEGY

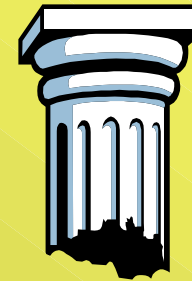
OBJECTIVE: Assessing and recommending improvements to payments and securities settlement systems in the Hemisphere



Integration of securities and payments

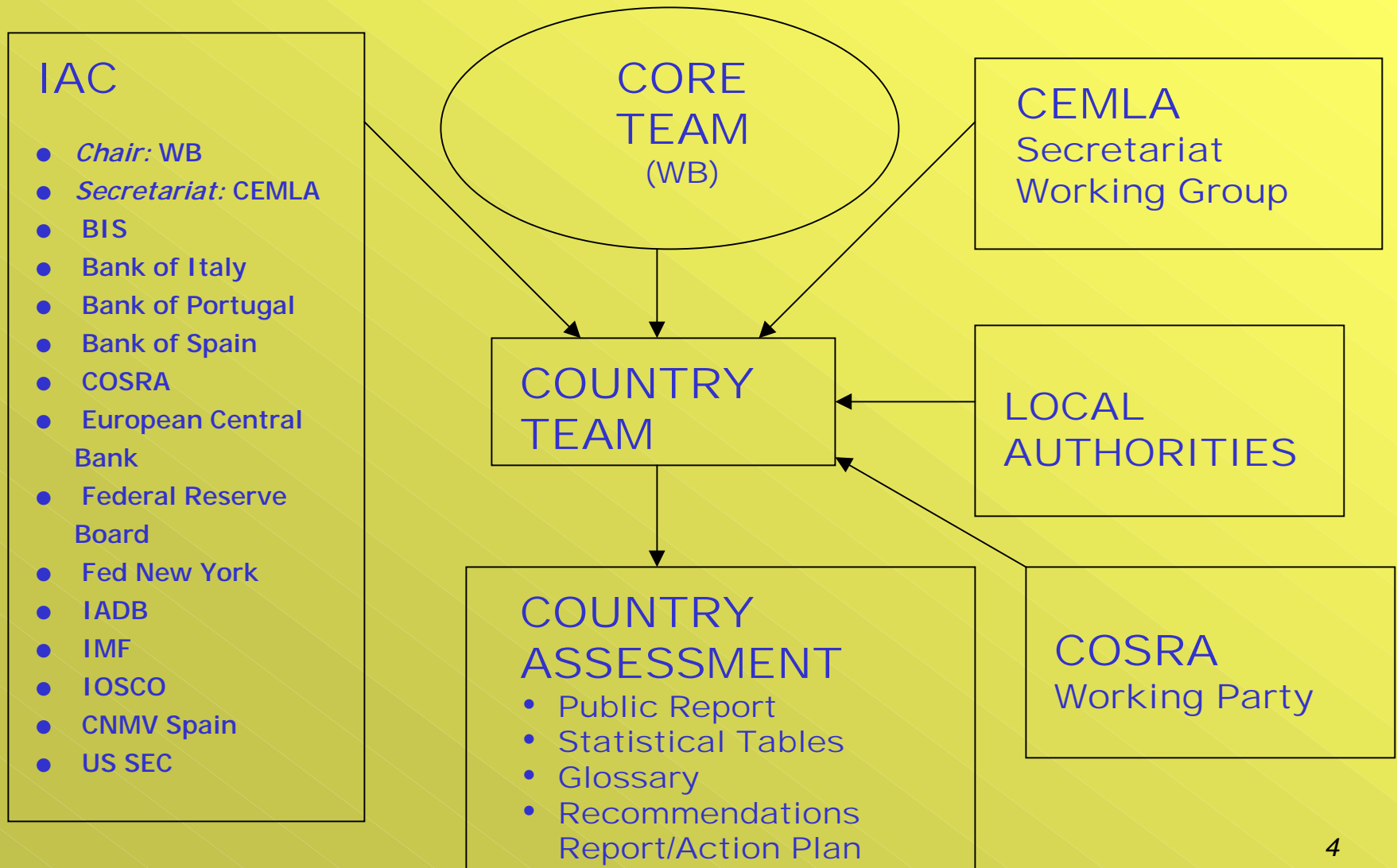


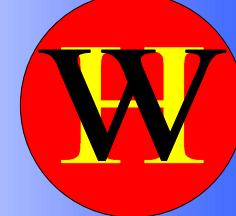
Cooperation with international organizations



Country Ownership

ORGANIZATION OF THE INITIATIVE





C. INITIATIVE ACTIVITIES

Phase 2 (From March 1999 to June 2001)

Meetings

*IAC meeting
November 1999*

*IAC meeting
January 2001*

Groups

*COSRA
Working Party
December 1999*

*CEMLA
Working Group
January 2001*

10 Country Assessments

*Peru
June 1999*

*Argentina
July 1999*

*Chile
December 1999*

*Trinidad & Tobago
February 2000*

*El Salvador
February 2000*

*OECS-ECCB
April 2000*

*Brazil
November 2000*

*Colombia
February 2001*

*Mexico
March 2001*

*Costa Rica
June 2001*

Workshops

*Argentina
July 1999*

*Trinidad & Tobago
February 2000*

*OECS / ECCB
April 2000*

*Brazil
November 2000*

*CEMLA-WB
January 2001*

Tools

*CEMLA
Web Page
www.ipho-whpi.org*

*Core Principles Matrix
Securities Matrix
WG TOR*

Presentation structure

- ▲ Definition of Securities Settlement Systems (SSS)
- ▲ The Importance of Payments and Securities Settlement Systems (PSSS)
- ▲ International Standards for SSS
- ▲ SSS System Reform Objectives, Strategy and Key Design Decisions

Definition of PSS Systems

What is a Payment System?

- 1.** A payment system is the collection of procedures, rules, standards, instruments, institutions and technical means used to exchange financial value between two parties discharging an obligation.
- 2.** Although the purpose is simple, payment systems evolve over a period of years. The different conditions in each country (size, legal systems, business practices, technological infrastructure, stages of development of financial sector institutions) make each set of payment mechanisms unique.
- 3.** Appropriate payment systems will satisfy the “evolving needs and requirements” of both current and future users - all users - of the payments clearance and settlement mechanisms.
- 4.** Securities systems, because of their close linkages with payment systems, are increasingly considered as integral part of the payment system.

Definition of SSS

The SSSs include the full set of institutional arrangements for confirmation, clearance and settlement of securities trades and safekeeping of securities

- ▶ Quite a few institutions may be involved in the process
- ▶ Most markets established Central Securities Depositories (CSDs) that immobilize physical securities and transfer ownership by means of book entries to electronic accounting systems

Definition of SSS

The SSS include the full set of institutional arrangements for confirmation, clearance and settlement of securities trades and safekeeping of securities

- ▶ Other institutions perform critical functions: the confirmation of trade details is often performed by an exchange or trade association or by counterparties bilaterally, rather than the CSD
- ▶ In some markets, a central counterparty interposes itself between the buyer and the seller

Definition of SSS

The SSS include the full set of institutional arrangements for confirmation, clearance and settlement of securities trades and safekeeping of securities

- ▶ Fund can be transferred through internal accounts at the CSD, but in most cases accounts at the central bank or at one or more private commercial banks are used

Definition of SSS

The SSS include the full set of institutional arrangements for confirmation, clearance and settlement of securities trades and safekeeping of securities

- ▶ Not all buyers and sellers of securities held accounts at the CSD, but they can hold and settle trades through a custodian, and the custodian may hold its customers' securities through a sub-custodian
- ▶ International Central Securities Depositories (ICSDs) play a relevant role in the global marketplace

The Importance of PSS Systems

Payment systems and securities settlement systems represent a basic infrastructure for the functioning of market economies

— PSSS are essential components for the smooth transmission mechanism of monetary policy

— The soundness of PSSS is fundamental for the stability of the currency

The Importance of PSS Systems

- The soundness of the PSSS is indispensable for the stability of financial markets -
Financial market crises are likely to show their first signs in settlement systems
- Weaknesses in SSSs can be a source of inefficiency
 - Impede capital formation due to higher costs

The Importance of PSS Systems



Weaknesses in SSSs can be a source of systemic disturbances due to:

- Creation of liquidity pressures
- Potential relevant credit losses
- Potential spillover effects to payment systems
- Uncertainty on who bears risks



The Committee on Payment and Settlement Systems (CPSS, Bank for International Settlements) and IOSCO have traditionally been the forum to discuss and develop international standards and best practices in the payments and securities settlement arena




In May 1998, the CPSS established a Task Force on Payment System Principles and Practices

International Standards for PSSS



The TF comprised representatives not only from G10 CBs and the ECB but also from other 11 CBs of countries in different stages of development, the IMF and the WB



The CPSS published a draft of Part I of the report and in December 1999 and a draft of Part II in July 2000, for public comments. The Report (Part I and II) were released in their final version on January 2001

The TF identified:

- ▲ Two Public Policy objectives (safety and efficiency) in systemically important payment systems (SIPS)
- ▲ Ten core principles for SIPS
- ▲ Four central bank's responsibilities in applying the core principles

Evolution of Standards for SSS

- 1989: G30 Recommendations
- 1990: IOSCO C&S Blueprint
- 1991: OECD Systemic Risks in Sec. Mkts
- 1992: BIS - CPSS DVP Report
- 1992: IOSCO Blueprint for Emerging Mkts
- 1995: BIS Cross Border Sec. Settlements
- 1996: FIBV Best Practices
- 1996: COSRA Principles
- 1997: CPSS/IOSCO Disclosure Framework

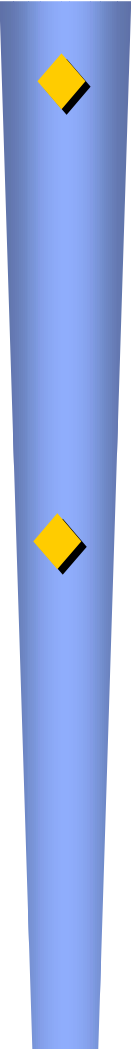
Evolution of Standards for SSS

- 1997: IOSCO Legal Framework for SSS
- 1998: IOSCO Principles of Securities Regulation
- 1999: FIBV Best Practices
- 2000: ISSA Recommendations
- 2000: ACSDA Identification of Risks
- 2001: CPSS/IOSCO Recommendations
- 2001-02: New G-30 Projects

Evolution of Standards for SSS (Other References)

- 1998-99: ESCB requisites for the use of securities as collateral in TARGET
- 2001: World Bank Guide to Best Practices
- 2001: Evolution of Securities Markets and Infrastructure in Europe (Committee of Wise Men, Giovannini Group, etc.)

International Standards for PSSS



- ◆ In December 1999 CPSS and IOSCO established a Joint Task Force to set up recommendations for sound and efficient securities settlement systems.

- ◆ The recommendations were released for public comments in January 2001

◆ Key Public Policy Objectives for SSS

Reduction of Systemic Risks

Protection of Investor Assets

Efficiency

To Guarantee Well Functioning Financial Markets and Efficient Capital Formation

CPSS-IOSCO Recommendations for safe and efficient SSS

- I Securities settlement systems should have a well-founded, clear, and transparent legal basis in the relevant jurisdictions.
- II 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.
- III 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 assessed.

CPSS-IOSCO Recommendations for safe and efficient SSS

- IV The benefits and costs of a Central CounterParty should be assessed. Where such a mechanism is introduced, the Central CounterParty should rigorously control the risks it assumes.
- V 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.
- VI Securities should be immobilized or dematerialized and transferred by book-entry in CSDs to the greatest extent possible.

CPSS-IOSCO Recommendations for safe and efficient SSS

- VII Securities settlement systems should eliminate principal risk by linking securities transfers to funds transfers in a way that achieves delivery-versus-payment (DvP).
- VIII Final settlement on a DvP basis should occur by the end of the settlement day. Intraday or real-time finality should be provided where necessary to reduce risks to users of the system.
- IX Deferred net settlement systems should institute risk controls that, at a minimum, ensure timely settlement in the event the participant with the largest payment obligation is unable to settle. In any system in which a CSD extends credit or arranges securities loans to facilitate settlement, best practice is for the resulting credit exposures to be fully collateralised.

CPSS-IOSCO Recommendations for safe and efficient SSS

- X Assets used to settle the cash leg of securities transactions between CSD members should carry little or no credit or liquidity risk. If central bank money is not used, steps must be taken to protect participants from potential losses and liquidity pressures arising from the failure of a settlement bank.
- XI 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.

CPSS-IOSCO Recommendations for safe and efficient SSS

- XII 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.
- XIII Governance arrangements for CSDs and Central CounterParties should be designed to fulfil public interest requirements and to promote the objectives of owners and users.
- XIV CSDs and central CounterParties should have objective and publicly disclosed criteria for participation that permit fair and open access.
- XV While maintaining operational safety, securities settlement systems should be cost effective in meeting the requirements of users.


CPSS-IOSCO Recommendations for safe and efficient SSS

- XVI Securities settlement systems should use or accommodate the relevant international communication procedures and standards in order to facilitate efficient settlement of cross-border transactions.
- XVII CSDs and Central CounterParties should provide market participants with sufficient information so that they can accurately identify and evaluate the risks and costs associated with using the CSD or Central CounterParties services.

CPSS-IOSCO Recommendations for safe and efficient SSS

XVIII Securities settlement systems should be subject to regulation and oversight. The responsibilities and objectives of the securities regulator and the central bank with respect to SSSs should be clearly defined, and their roles and major policies should be publicly disclosed. They should have the ability and the resources to perform their responsibilities, including assessing and promoting implementation of these recommendations. They should cooperate with each other and with other relevant authorities.

International Standards for PSSS

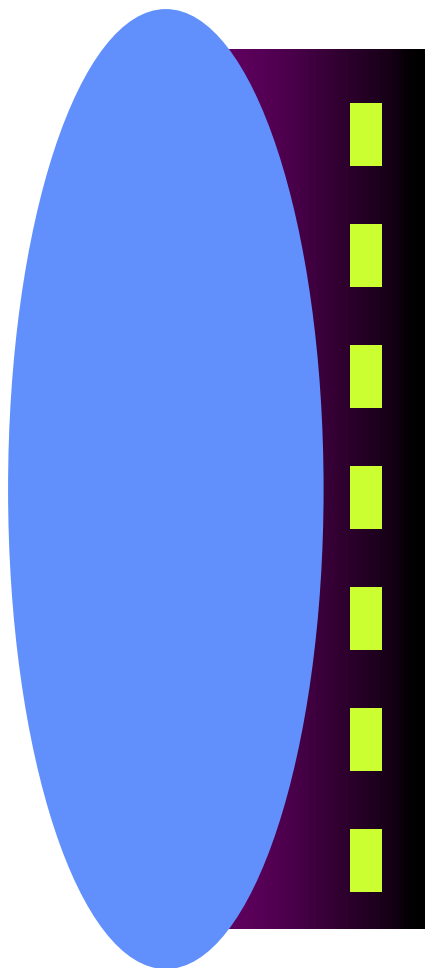


As shown standards for SSS are emerging from a variety of sources that have created an evolving literature. This literature taken together provides guidance to the owner, designer, operator, overseer and regulator of SSS

Local conditions and policy objectives will always need to be taken into account in solving the several trade-offs implicit in the application of these standards

SSS Reform Objectives

Securities Settlement Requirements



Speed

Certainty

Reliability

Safety and soundness

Convenience

Cost

Universality



- Settlement of a Securities Transaction takes a long time in some emerging countries
- Most securities transactions should require no longer than 2 to 4 days for clearing and settlement
- Securities transactions require same-day settlement on the settlement date

Certainty



User confidence must be established that:

The correct amount will be paid and securities will be transferred (DVD)

The correct parties will be paid and receive the securities

Transfers of Securities and Funds will be made on the correct date

Clear understanding when payments and securities finality (non-revocability) occurs


SSS Reform Objectives

Reliability

System must be available 99%+ during the hours of operation

System must work according to the published rules and regulations

Safety and soundness



System must have adequate controls to ensure against:

Fraud

Credit and systemic risk

Unauthorized disclosure of transactions data

Convenience

- System must provide for easy access of Investors to their securities accounts
- System must be consistent with technological capabilities and skills of originator, receiver and intermediate processor
- System must meet user's need and be consistent with the market and economy structure

Costs

- Capital and implementation costs must be realistic
- Operating costs must be consistent with the level of service provided
- Operating costs must be consistent with users ability and willingness to pay

— Universality



Systems must be usable on an equitable basis by all financial depository institutions

International Standards



Systems should meet international standards to put the country in condition to play a role in the global marketplace



CPs (and most likely SSS Recs) are part of the list of standards and codes of the Financial Stability Forum and countries will be assessed with them

Implementation Issues

Decide appropriate scope of application

Identify Private sector entities to involve

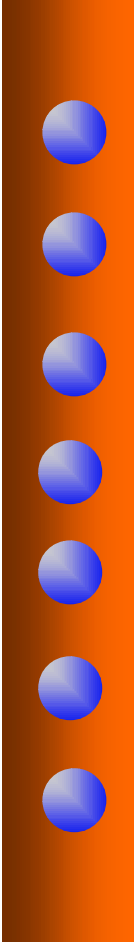
Assess the existing system

Prepare a strategy to take into account all aspects of the Payments Systems

Develop action plan identifying all the steps, responsibilities and schedule

Follow up assessments to monitor progress⁴⁰

Components of a Strategic Reform

- 
- Vision
 - Fundamental Principles
 - Critical Success Factors
 - Strategies
 - Conceptual Business Processes
 - Role players and Responsibilities
 - High Level Implementation Plan

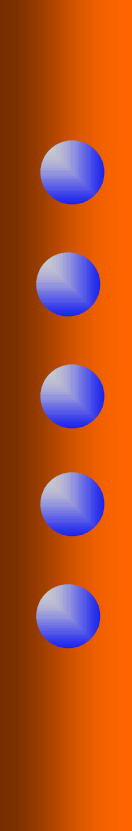
Prerequisites for success

- A Driving Force - Top Level Sponsor
- Process Management Skills
- Project Management Discipline
- Patience with Process
- Continuous Progress - manage sub-projects
- Continuity in Participation by Senior Personnel
- Wide and Active Involvement
- Communication with Stakeholders
- Perseverance

Typical Problems

- Technology driven decisions (e.g. deciding on software before elaborating the vision and strategy)
- Finding Experts
- Intra- and Inter-organizational Politics
- Ineffective Communication within Participating Organizations
- Changes in Representation
- Affinity towards Operational Issues (deviating from the strategic approach)
- Questioning the Role of the Reform Leader

Benefits of the Strategic Approach

- 
- Smooth Implementation
 - Ease of System Design and Development
 - Transparency
 - Developing the Knowledge Base in the field
 - Platform for Cross-organizational cooperation

Important Decisions need to be made when developing the strategy for the reform of SSS for Government Securities

- ▶ Approach (Gradualist versus Leap-Frog)
- ▶ Degree of Sophistication and Automation
- ▶ Dematerialization-how to manage the transition
- ▶ Settlement Procedures (Model I, II, III)
- ▶ Settlement Leg

Important Decisions need to be made when developing the strategy for the reform of SSS for Government Securities

- ▶ Liquidity Implications (especially for brokers)
- ▶ Combination of Risk Management Tools
- ▶ Number of CSDs
- ▶ System Operator (central bank, external provider, private provider)

Important Decisions need to be made when developing the strategy for the reform of SSS for Government Securities

- Ownership of the System (Central bank, private, joint)
- Central Counterparty
- Pricing Policy
- Regulatory Structure
- Stock Exchange Trading

Important Decisions need to be made when developing the strategy

- ▶ Access and layered structure
- ▶ Regional Consolidation
- ▶ Timeframe for the reform: normally 2-3 years, but choices should be consistent (e.g. full time core team)
- ▶ Degree of Cooperation
- ▶ Compliance with International Standards (Immediate/Gradual)