Box 18

ESCB-CESR STANDARDS FOR SECURITIES SETTLEMENT SYSTEMS

In October 2004, the Governing Council of the ECB and CESR approved a report entitled "Standards for Securities Clearing and Settlement in the European Union". The report, prepared by a joint ESCB-CESR working group, contains 19 standards for securities settlement systems, in particular central securities depositories (CSDs), including international CSDs, and custodian banks in the EU. This Box briefly describes some of the most important aspects addressed by the 19 standards. A major aim of the standards is "to limit and manage systemic risk". Five types of risks in the securities settlement process are explicitly addressed.

Credit risk

Credit risk is the risk of loss due to the default of another party. There are different types of credit risk in securities settlement. Principal risk, for example, is the risk that one party in a securities transaction, the buyer or the seller, could lose up to the full value of the assets involved in the transaction. It materialises if, for example, the buyer transfers the payment to the seller and thereafter the seller proves unable to deliver the security to the buyer, typically due to insolvency. The losses may also lead to the insolvency of the buyer with possible further contagion effects. Principal risk can be eliminated by settlement in delivery versus payment (DVP) mode. Payments are then delivered from the buyer to the seller if and only if securities are delivered from the seller to the buyer. ESCB-CESR Standard 7 requires that securities transfers be linked to payment transfers "in a way that achieves delivery versus payment".

Another form of credit risk is the risk that the settlement service provider could itself default. A few CSDs act as banks in the sense that they grant credit to participants. If a major participant defaults on such a credit, then the CSD itself may be in danger. As a consequence, the disruption of securities settlement and thus of the entire financial market is possible. For this reason, Standard 9 requires CSDs to limit their credit activities and to collateralise their credit exposure whenever practicable. Furthermore, it requires securities regulators, banking supervisors and overseers to ensure that the credit activities of custodian banks do not create undue risks for the financial system.

Liquidity risk

Liquidity risk is the risk that one party in a security transaction is unable to fulfil its delivery obligation in time. Settlement may be postponed in this case. However, if the other party urgently needs to deliver the assets it was expecting to a third party, which again may urgently need these assets, a contagion effect could be created. To mitigate liquidity risk, Standard 5 aims at encouraging the setting up of securities lending arrangements. If an efficient securities lending arrangement is in place, then a seller which would otherwise be unable to deliver securities in time can borrow the respective securities and ensure timely settlement. In some cases, the settlement service provider, for example a CSD, may act as the central principal in all securities lending transactions and can thus be exposed to credit risk. With a view to Standard 9 (see previous paragraph), Standard 5 emphasises that in this case, the settlement service provider should apply adequate risk management measures.

Custody risk

Shares in a security may get lost or may be transferred to the wrong party, typically due to human error, negligence, fraud, insolvency and the like. Obviously, this may result in disruptions to the financial markets. Standard 6 encourages the dematerialisation and immobilisation of securities because paper certificates, especially if they are often transported from place to place, can be lost more easily than securities kept in electronic form. Standard 12 requires that the securities that an investor holds on a securities account with a settlement institution are protected against insolvency of the settlement institution: it must be ensured that creditors of the settlement institutions cannot claim these securities, i.e. they must not be included in the estate of the settlement institution, should this institution become insolvent.

Operational risk

Standard 11 aims at limiting the risk of operational problems which, in a major settlement system, can have a severe impact on financial markets. It stipulates, among other factors, that such systems must have business continuity plans and backup facilities in place to enable a fast resumption of business after a technical disruption. Alternative communication means should be available. Finally, IT systems should be capable of processing peak volumes.

Legal risks

Legal risks arise, for example, if applicable laws, rules and regulations are unclear or if there are different conflicting laws, rules and regulations and it is not clear which of them is applicable. This is especially relevant in the case of cross-border settlement. Court decisions may be delayed in these cases, and the continuous use of assets may be blocked. Standard 1 therefore requires settlement systems to have a sound legal basis.

It is important to note that the ESCB-CESR standards are a refinement of the CPSS-IOSCO recommendations for securities settlement systems discussed in Box 20 of the December 2004 FSR. The CPSS-IOSCO recommendation, drafted by a joint task force of the CPSS of the central banks of the G10 countries and the International Organization of Securities Commissions (IOSCO), are designed to be applicable worldwide. The ESCB-CESR standards adapt the CPSS-IOSCO recommendations to the EU environment. The latter are recommendations and, as such, are not always easy to enforce. The ESCB-CESR standards however will be applied by the relevant authorities and compliance with them will be reviewed on a regular basis. As a result, the new standards have significant potential to enhance financial stability in the euro area and in the EU.

It should be noted that the ESCB-CESR working group's report identified a number of issues that require further analysis. These issues will be addressed in close cooperation with market participants while an assessment methodology is being developed. The ESCB-CESR standards will come into force when this methodology has been finalised.