In November 2001, recommendations were published for the design and operation of securities settlement systems, drafted by a joint task force of the Committee on Payment and Settlement Systems (CPSS) of the central banks of the Group of Ten countries and the International Organisation of Securities Commissions (IOSCO). These 19 CPSS-IOSCO recommendations set out minimum standards that securities settlement systems should meet. They encompass the legal framework for securities settlement, risk management procedures, access, governance, efficiency, transparency and regulation and oversight, and they explicitly aim at “maintaining financial stability by strengthening the financial infrastructure”. This Box discusses some of the recommendations that have a direct relation to financial stability.

Some of the CPSS-IOSCO recommendations address credit risk. Credit risk is the risk of loss due to the default of another party. For example, one party in a securities transaction, say bank A, may not be able to fulfil its delivery obligation, on the settlement date or later, typically due to insolvency. The other party, say bank B, may lose up to the full value of the assets involved in the transaction (principal risk). This is the case if assets are transferred from B to A and included in A’s estate so that A’s creditors can claim them, even though no assets have been transferred from A to B. As a consequence, B and B’s creditors may also become insolvent. To avoid this type of contagion, CPSS-IOSCO recommendation 7, for example, suggests that CSDs should settle in delivery versus payment (DVP) mode. This means that if a transaction involves delivery of securities (from the seller to the buyer) and payment of money (from the buyer to the seller), then securities are delivered if and only if money is actually paid.

Defaulting is not only limited to one party in a transaction: it is also possible for an operator of a securities settlement system or a cash settlement agent (i.e. a bank in which cash is held that is used to settle the cash leg of transactions). The default of a settlement system or of a major cash settlement agent could potentially disrupt a large part of the financial markets. Recommendation 9 therefore suggests that CSDs should provide no credit or only limited, and preferably secured, credit to participants or other parties. Recommendation 10 proposes that measures should be taken to avoid a situation whereby participants in a CSD incur losses from the default of a cash settlement agent. It also expresses a preference for the central bank to act as the cash settlement agent for all transactions settled in a CSD.

Another concern addressed by the CPSS-IOSCO recommendations is liquidity risk. Liquidity risk arises if one party in a securities transaction, say again bank A, is unable to fulfil its delivery obligation in time. Settlement is postponed in this case and carried out later. However, the other party, bank B, can still incur losses if it urgently needs funds (B has sold securities to A) or securities (B has bought securities from A). In the worst case, B has already sold on the funds or securities to a third party and consequently finds itself unable to fulfil the delivery obligation in time. To avoid such contagion effects, recommendation 5 suggests that participants in settlement systems should have access to securities lending and borrowing arrangements so that they can borrow securities if needed. Recommendation 4 promotes another alternative to mitigate liquidity risk that also helps in reducing some forms of credit risk, the establishment of a central counterparty (CCP) clearing house.

Finally, recommendation 11 aims at strengthening the operational reliability of securities (clearing and) settlement processes. It is clear that the technical breakdown of a settlement system or any other important settlement service provider would lead to substantial disruption of the financial markets. Recommendation 11 therefore stresses the need for reliable and secure systems, and furthermore suggests that backup facilities should be put in place to avoid information loss, and that measures should be taken to ensure that activities can be resumed quickly in case of technical problems.

Central banks and regulators have used the CPSS-IOSCO recommendations several times since 2002 to assess settlement systems. In addition, they have been used extensively by the International Monetary Fund and the World Bank in undertaking their Financial Sector Assessment Program (FSAP) assessments. In October 2001, the ESCB and CESR set up a joint working group to adapt the CPSS-IOSCO recommendations to the EU environment. After intense discussions with interested parties, the ESCB-CESR working group drafted a report with a set of 19 standards that was formally approved in October 2004. The standards will come into force when an “assessment methodology” has been developed. These standards aim at strengthening the CPSS-IOSCO recommendations in the European context. Furthermore, it is expected that the ESCB-CESR standards will become part of national legislation, making them also easier to enforce.