Western Hemisphere Initiative

Lessons from IMF/World Bank Financial Sector Assessment Program—FSAP

Payment and Securities Settlement Systems

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Financial Sector Assessment Program - FSAP

- Joint IMF-World Bank Initiative
- Two-times two weeks on-site and with 10-20+ mission members
- Evaluation of the Financial System
- Observance of Codes and Standards
  - BIS - CP for Effective Banking Supervision
  - IOSCO-Capital Markets and supervision
  - IAIS—Insurance Regulation and supervision
  - IMF-Transparency Code in Monetary and Financial Policies
  - CPSS-Core Principles for Systemically Important Payment Systems
  - CPSS-IOSCO Recommendations for Securities Settlement Systems (formally as from mid-2002)
FSAP Mission by end 2002

- 45 countries and 60 payment systems have been assessed.
- Areas of major concerns are
  - Legal foundation
  - Managing risk
  - Governance
  - Central Bank lacks a statutory oversight role

Core Principles I

**Legal foundation**

- Observance 65%; Non Observance 35%
- Zero hours rule exists
- Bankruptcy Law does not accept netting
- Lack of laws dealing with payment systems and/or payment instruments
- Uncertainty about pledging of securities
- Real-Time finality is not assured
- Central bank’s role in payment systems is unclear
Core Principle II
Clear understanding of financial risk

- Observance 80%; Non Observance 20%
- System rules and procedures are not fully described
- Rules and procedures for handling a crisis situation have not been defined
- Roles of various parties are not defined
- Perception that the Central Bank guarantees settlement exists

Core Principle III
Procedures for management of risks

- Observance 75%; Non Observance 25%
- No real-time information system on outstanding positions
- No central bank intraday lending
- No queuing facilities in RTGS systems
- Unwinding, the only way to solve a participant’s default
- Bilateral and or multilateral limits on positions exist, but are not effective
- Check clearing systems handle large value payments
Core Principle IV
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**Final settlement on the day of value**

- **Observance 80%; Non Observance 20%**
- Final positions are known only the following morning
- Zero hour rule exists
- Legal uncertainty about finality of payment
- Legal uncertainty about netting

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Core Principle V
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**Ensuring settlement in a multilateral net settlement system**

- **Observance 35%; Non Observance 65%**
- No “Survivors Pay” or “Defaulters Pay” schemes exist
- Unwinding is the only way to solve a participant’s default
- Difficult/impossible to ensure settlement in a check clearing system
Core Principle VI
Settlement Assets – Central Bank Money

Observance 95%; Non Observance 5%

Core Principle VII
High degree of security and operational reliability

- Observance 75%; Non Observance 25%
- Low level of system security
- No back up system
- No secondary site for the back up computer
- No contingency arrangements
- No comprehensive regular testing of continuity and disaster recovery arrange-ments, also involving the secondary site and the participants.
- No regular independent risk analysis
Core Principle VIII

*Practical and efficient for its users*

- Observance 70%; Non Observance 30%
- No cost benefit analysis
- Operational and/or development costs are not covered by the fees
- Central Bank takes the risk in the settlement process
- Lack of real-time and intraday settlement
- Too many settlement failures

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Core Principle IX

*Objective and publicly disclosed access criteria*

- Observance 90%; Non Observance 10%
- Access criteria have not been disclosed
- Exit criteria do not exist, or have not been disclosed
Core Principle X

**Governance**

- *Observance 70%; Non Observance 30%*
- Lack of written strategic objectives and plans
- No clear lines of responsibility
- No independent audit function
- No risk management function
- Information about the system’s performance, and how it is governed, are not published on a regular basis
- Legal protection is not provided to Central Bank officials performing payment system related duties
- **A number of the other Core Principles are not observed**

Central Bank Responsibility A

**Disclosure of objectives and policies**

- *Observance 55%; Non Observance 45%*
- The Central Bank
  - ▼ has not clearly defined and disclosed its payment system objectives
  - ▼ does not have a formal oversight responsibility
  - ▼ has not separated its responsibilities for oversight and of operations of payment system, respectively
  - ▼ approaches payment system issues only from a supervisory perspective
Central Bank Responsibility B

*Ensuring own systems observe CPSIPS*

Observance 65%; Non Observance 35%

Central Bank Responsibility C

*Oversee Observance of Private Systems*

Observance 60%; Non Observance 40%
Central Bank Responsibility

Cooperation with central banks/authorities

*Observance 70%; Non Observance 30%*

The Central Bank

- has no formal agreement with relevant domestic and foreign oversight/supervisory agencies

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FSAP Missions by end 2002

Securities Settlement Systems

- 10 countries and 21 securities settlement systems have been assessed.
- Areas of major concerns are
  - Legal framework
  - Lack of Delivery versus Payment (DvP)
  - CSD Risk Control (improvement needed)
  - Lack of Transparency (procedures/risks)
  - Regulation and Oversight (co-operation)
Recommendation 1

Legal framework

Observance 60%; Non Observance 40%

- Bankruptcy proceedings may invalidate settlement rules and procedures
- No legal foundation for netting
- No legal foundation for secured interest
- No definition of finality
- Securities not fungible
- Legislation does not cover all securities
- Dematerialization is not allowed

Recommendation 2

Trade confirmation

Observance 80%; Non Observance 20%

- Equity trades are not confirmed on T+0
Recommendation 3
Settlement cycles

Observance 95%; Non Observance 5%

- Need to shorten timing of settlement
- Information between clearing members/brokers and their clients need to be improved

Recommendation 4
Central counterparties

Observance 50%; Non Observance 20%
Non Applicable 30%

- No evaluation of the cost and benefits of a CCP has been undertaken
Recommendation 5
Securities lending

Observance 70%; Non Observance 25%
Not Applicable 5%

- Too many securities are not dematerialized.
- Too many Bearer Instruments
- No legal basis for repurchase transactions

Recommendation 6
Central Securities Depositories (CSDs)

Observance 70%; Non Observance 30%

- No requirement to dematerialize securities
Recommendation 7

**Delivery versus Payment (DvP)**

*Observance 75%; Non Observance 20%*
*Not Applicable 5%*

- No DvP, as principal risk is not eliminated
- Unclear if principal risk could be mitigated due to bankruptcy laws

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Recommendation 8

**Timing of Settlement Finality**

*Observance 80%; Non Observance 20%*

- No intraday settlement
- No specification when settlement is final
- Settlement takes place on S+1
Recommendation 9

CSD Risk Controls

Observance 30%; Non Observance 35%
Not Applicable 35%

- Timely settlement is not ensured
- Overdrafts on securities accounts are allowed
- The risk control mechanism does not guarantee end of day settlement
- Unwinding of transactions is the only solution should a participant default

Recommendation 10

Cash Settlement Assets

Observance 80%; Non Observance 20%

- No settlement in Central Bank Money
- Concentration risks due to a few settlement banks
- Perception that supervised settlement banks would be supported by the authorities in case of a default
- Settlement of the cash side occurs in a net settlement system, even though an RTGS system is in place
Recommendation 11
Operational Reliability

Observance 90%; Non Observance 5%
Not Applicable 5%

- No back-up site exists
- No contingency arrangements
- No regular independent risk analysis

Recommendation 12
Protection of Customers’ Securities

Observance 90%; Non Observance 5%
Not Applicable 5%
Recommendation 13

*Governance*

*Observance 75%; Non Observance 10%*

*Not Applicable 15%*

- The Board of an SSS (owned by banks) is avoiding taking necessary steps to upgrade the system due to concerns that such a move may have on the banks’ custodial activities.

Recommendation 14

*Access*

*Observance 65%; Non Observance 20%*

*Not Applicable 15%*

- The Board of the SSS are free to decide which institutions that should have access to the SSS even though neutral access criteria exist.
Recommendation 15
Efficiency

Observance 70%; Non Observance 30%

- More than one CSD exist, but no CCP and no RTGS system to settle the cash side of securities transactions

Recommendation 16
Communication Procedures

Observance 65%; Non Observance 10%
Not Applicable 25%

- The system has not adopted a message format based on international standards (ISO 15022)
Recommendation 17

Transparency

Observance 60%; Non Observance 25%
Non Applicable 15%

- Fragmentation of the settlement procedures
- Information about the risks in participating in the system has not been made public

Recommendation 18

Regulation and Oversight

Observance 55%; Non Observance 45%

- No framework between domestic regulators and with concerned foreign authorities
- No supervision/oversight schemes exist
- Limited ongoing oversight
- Supervisory agency lacks the necessary knowledge about SSS
- The Central Bank has not publicly disclosed to the public its role as overseer of the SSS
Recommendation 19

*Risks in Cross-border Links*

*Observance 30%; Non Observance 0%*

*Not Applicable 70%*