Assessment of Monte Titoli's observance of the ESCB-CESR Recommendations for Securities Settlement Systems

Premise

Monte Titoli is Italy's central securities depository (CSD). It manages the securities settlement system (SSS) and provides net and gross securities settlement services (Express II) to its participants, as well as typical CSD services including the dematerialization of securities issues and immobilization of securities issued in physical form.

The SSS is jointly supervised by the Bank of Italy and Consob pursuant to Legislative Decree 58/1998 (the Consolidated Law on Finance), with the Bank of Italy responsible for the containment of systemic risk and financial stability and Consob for transparency and investor protection. The Bank of Italy is also responsible for overseeing the system, to ensure that it works efficiently and securely in view of its importance for the smooth functioning of payment systems and orderly conduct of monetary policy. This assessment of Monte Titoli was carried out jointly by the Bank of Italy and Consob in compliance with their respective statutory tasks and uses as reference standards the ESCB-CESR Recommendations for Securities Settlement Systems and the related Assessment Methodology. Monte Titoli also conducted a self-assessment based on a questionnaire which was revised by the authorities that provided the ratings for observance of the individual recommendations. The final assessment was subsequently returned to Monte Titoli, which was invited to comment on it. This document summarizes the outcome of the assessment. The opinions it expresses are those of the supervisory authorities, the Bank of Italy and Consob, only. The reference period for this assessment is October 2013.

As of January 2014, following the adoption of the Principles for Financial Markets Infrastructures (PFMIs) by the Committee on Payment and Settlement Systems (CPSS) and the International Organisation of Securities Commission (IOSCO), and of the relative Assessment Methodology, the Bank of Italy and Consob will use the PFMIs as reference standards for the performance of their respective supervisory and oversight tasks.

Main features of Express II

Express II provides securities settlement services on both a net and gross basis. Net settlement takes place in two distinct cycles, one during the nighttime (from 7:45 p.m. to 7:00 a.m.) and one during the day (from 9:30 a.m. to 1:00 p.m.): transactions which are not settled during the night settlement cycle are forwarded to the day-time cycle. Transactions which are not settled in the net settlement system are forwarded to the gross settlement system. There is also a roll-back procedure that, by identifying and subtracting the minimum amount and/or value of transactions that cannot be settled due to lack of securities and/or cash, optimizes the settlement process in the net settlement cycles. A securities lending facility and access to central bank credit facilities pursue the same objective. The gross settlement service runs during the day from 7:00 a.m. to 6:00 p.m.; the settlement of transactions stemming from the day-time net settlement cycle takes place until 4:00 p.m. Settlement services have recently been made more efficient by the launch of new functionalities aimed at strengthening early matching: the unilateral suspension of transactions until a specific release instruction, in the event of temporary unavailability of securities or funds (the hold and release functionality); the bilateral cancellation of matched but not final transactions; and second-layer matching that reaches trading members.

Monte Titoli is part of the London Stock Exchange Group (LSEG); this is reflected in its risk management policy as well as its governance structure.

The ESCB - CESR Recommendations for SSSs

1. Legal framework

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

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.

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.

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.

11. Operational reliability

Sources of operational risk arising in the clearing and settlement process should be identified and minimised 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.

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.

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.

Outcome of the assessment

General

The Bank of Italy and Consob have concluded that all the ESCB-CESR Recommendations have been observed by Monte Titoli, following initiatives taken to enhance the overall efficiency and security of the services provided by the CSD/SSS in the last two years.

The securities lending facility provided by Monte Titoli is not widely used by its participants. A collateral management system between participants and the central bank was recently launched and will soon be extended for use among system participants; this should improve access to and the use of securities for collateralization purposes. Supervisory authorities recommend that the completion of this platform be prioritized in order to meet users' needs more effectively.

Legal risk and the institutional framework

Recommendations 1 and 18: the CSD/SSS has a well-founded legal basis comprising primary legislation and secondary provisions issued by the Bank of Italy and Consob, as well as the system's Operating Rules approved by the aforementioned authorities. This legal framework is clear and comprehensive; the legal acts are available on the authorities' and Monte Titoli's websites. The Consolidated Law on Finance entrusts supervisory powers on CSDs and SSSs to the Bank of Italy and Consob following a functional approach, with the central bank responsible for containing systemic risk and pursuing financial stability and Consob for transparency and investor protection. As a result, the Bank of Italy is the lead regulator for SSSs while Consob is the lead regulator for CSDs. The two authorities closely cooperate.

Pre-settlement risk

Recommendations 2 to 5: pre-settlement risk is the risk that a counterparty to a transaction for completion at a future date will default before final settlement. Typical mechanisms to limit this risk include confirmation of trades and matching of transactions prior to their entry in the SSS, rolling settlement at fixed time intervals, and the guaranteeing of trades sent to the SSS by a central counterparty. Monte Titoli provides trade confirmation and settlement matching services through its X-TRM platform, which is connected to regulated markets, multilateral trading facilities, and is also available for, and widely used in, over-the-counter transactions. Prior matching is a requirement for settlement in Express II. All market trades processed by Express II are settled on a rolling basis of T+3 or less**,** depending on the type of security/contract.

Central securities depositories

Recommendation 6: CSD services are based on the dematerialization of securities issues (about 99%) and immobilization of securities issued in physical form (about 1%). Reliable securities recording and transfer is ensured by a reconciliation procedure at the end of the accounting day, end-to-end audit trails, and the provision of real-time and batch information to participants. Transfers are always performed by book entry and are immediately final. A reconciliation procedure is mandatory both at system and participants' level, to guarantee that the sum of the balances of intermediaries' own and customer accounts and, where applicable, the CSD own account, matches the balance of each issue. There is no time lag between settlement and registration on securities accounts.

Settlement risk

Recommendations 7 to 10: settlement risk is the risk that settlement in a SSS will not take place as expected, for example because one party defaults on one or more settlement obligations to its counterparties or to a settlement agent. In a SSS settlement risk is mitigated in the first instance through the use of a delivery-versus-payment (DVP) settlement mechanism, whereby delivery of securities takes place if and only if the corresponding payment of funds has been made. Express II settles on a gross DVP basis (DVP Model 1) and on a net basis at various cut-off times during the operational day (through a combination of DVP Model 1 and DVP Model 3): the two settlement services interact in such a way as to optimize settlement and minimize fails by rerouting unsettled transactions to the next available settlement session. Intraday finality of settlement is provided both in real time (thus allowing the immediate re-use of credited securities) and in multi-batch processing. Monte Titoli does not provide credit to its participants, which can instead obtain intraday credit from the central bank, nor does it provide overdrafts on securities accounts. The cash leg of all transactions is settled in central bank money. Incentives to settle take the form of penalties on uncovered securities positions that at the closing of the Real Time Gross Settlement (RTGS) system have still not been settled and when they are above a specific amount. Monte Titoli provides a centralized securities lending service on an agent basis; in order to reduce fails, during both net settlement cycles the service is automatically activated when participants fail to deliver securities.

Operational risk

Recommendation 11: operational risk is controlled and managed on an ongoing basis across all business units, following the recommendations of the internal and external auditors. Updates of risk-control measures are conducted yearly; moreover, when new services are launched, operational risk and related mitigants are identified ex ante. Operational risk is minimized via highly automated processes that reduce administrative activities and formalized procedures for all services. Risks are identified and ranked by the Risk Register, which monitors incidents, investigates the relative triggers with the responsible units, and identifies possible corrective measures. Risk management policies and procedures are set out and defined by the London Stock Exchange Group and formalized in dedicated policies. At company level, risk management procedures are formalized in the company's official documentation. Italy's financial market infrastructure, Monte Titoli, participates in the Committee set up to provide a coordinated response by the Italian financial system in the event of a major crisis (Business Continuity Committee); the Committee is coordinated by the Bank of Italy. Monte Titoli recently adopted additional measures to improve the operational risk management framework and the relationship with outsourcees. The implementation of the aforementioned measures is monitored by the Bank of Italy and Consob and supports the assessment of full observance by Monte Titoli of Recommendation 11.

Efficiency of the securities settlement services

Recommendations 12 and 15 to 17: Monte Titoli is committed to providing efficient services that meet users' needs in terms of safety, cost-effectiveness and service levels. With regard to safety, the system has procedures in place that establish a complete segregation between its proprietary accounts, the intermediaries' own and customer accounts and issuers' accounts. Special control procedures are applied to the physical certificates and there are specific provisions for compensating investors in the event of damages. The safe issue, holding and transfer of securities is ensured even in the event of insolvency of the entity holding them. The account procedures employed by Monte Titoli are robust and include a double book-entry principle that applies to the securities transfers between participants. As to cost-effectiveness, Monte Titoli verifies its operating costs on a monthly basis; these are directly allocated to the expenses incurred for the provision of each service. Pricing policies are reviewed each year and aim at covering costs and ensuring the efficient provision and use of services. No discrimination among different categories of clients is made when applying the pricing structure, which is public and available on the company's website. Service levels are agreed with providers, although Monte Titoli may modify them in specific circumstances. Monte Titoli verifies daily compliance with service levels, while operational reliability is checked with the IT providers on a monthly basis. In offering communication channels, Monte Titoli opts, where available, for international standards.

The terms and conditions that govern the services provided by Monte Titoli are defined in the contractual agreements with participants which are available on its website. These documents describe Monte Titoli's risks and the steps taken to mitigate them. Risk management is performed according to the London Stock Exchange Group policy. The risk management methodology and the main risks at group level are disclosed in the consolidated annual report available on the London Stock Exchange's website, while the main Monte Titoli risks are disclosed in its own Annual Report.

Governance and access

Recommendations 13 and 14: Monte Titoli's governance is based on a number of principles including the central role of the Board of Directors, management's accountability, the efficiency of the audit system, transparency towards participants and supervisory authorities, and commitment to the achievement of the company's objectives which have a public interest connotation. Major decisions are taken by the Board of Directors upon proposal by the chief executive officer (CEO); when these decisions entail significant changes to the system or services provided, a market consultation is conducted and the results and modifications are then notified to the supervisory authorities (which in some cases must also approve them). Ongoing dialogue with participants and stakeholders is facilitated through the Post-Trading Technical User Group, where authorities participate as observers. Every care is taken to avoid conflicts of interest, in compliance with Italian legislation and with the policies of the London Stock Exchange Group. Access to Monte Titoli's services is based on criteria that are objective and non-discriminatory and change according to the type/category of participant; access criteria are established by secondary legislation and Monte Titoli's Operating Rules and are publicly available on the company's website. Specific attention is devoted to access requests made by other financial market infrastructures (i.e. CCPs and SSSs). Monte Titoli has never refused access to a requesting entity, however, should it do so, an explicit motivation would be provided in writing. Conditions for suspension from participation as well as for terminating participation are set out in the Operating Rules and Service Manuals.

Links

Recommendation 19: Monte Titoli has direct links to foreign international and national CSDs based on the "General terms and conditions" of the linked CSD. In general, before the opening of a link or when changes are planned in the contractual framework of existing links, an internal assessment is performed on the basis of Principle 20: "FMI links" of the CPSS-IOSCO Principles for Financial Markets Infrastructures. Most links in place with Eurosystem SSSs have been positively assessed by the Eurosystem for the cross-border provision of collateral in monetary policy and intraday credit operations. Any link project must be submitted to the supervisory authorities before any action is taken. In addition, a risk management structure in Monte Titoli aims to ensure that any risk is controlled and dealt with, in order not to have disruptions in the system or to cause losses for clients. No cross-border settlement occurs before the availability of assets needed to fulfill the settlement obligation has been checked. In particular, the booking of cross-border settlement is always gross, with no possibility of provisional transfer of securities or of transactions unwinding. Finality and irrevocability follow the rules of the system where settlement occurs.