

Assessment of Cassa di Compensazione e Garanzia
SpA
against the CPSS-IOSCO Recommendations for
Central Counterparties

July 2008

Assessment of Cassa di Compensazione e Garanzia S.p.A. (CC&G) against the CPSS-IOSCO Recommendations for Central Counterparties

I. Introduction

Assessor and objective

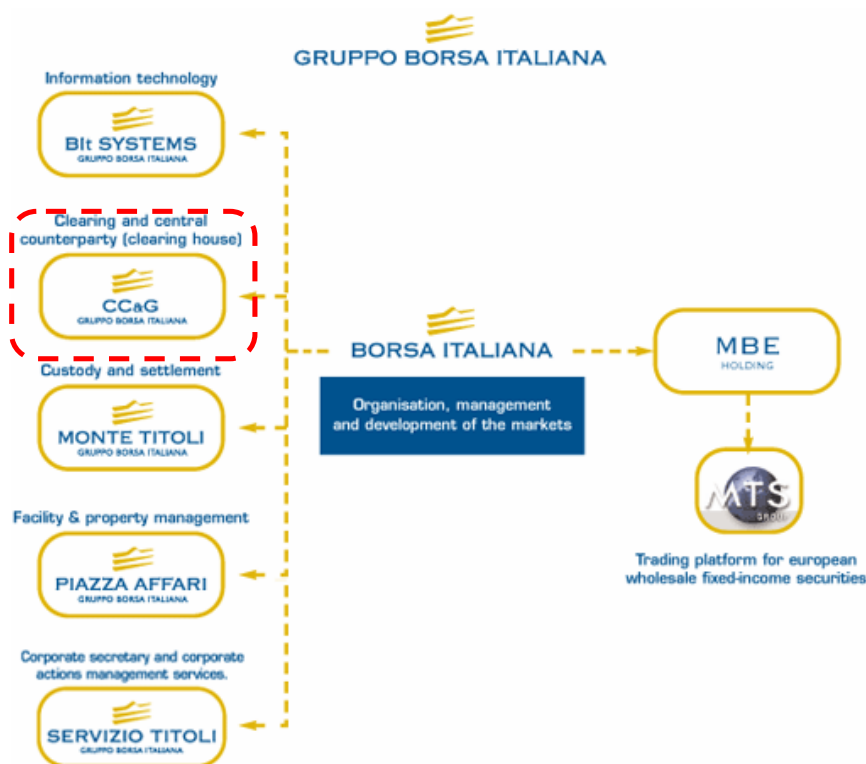
This assessment has been launched and carried out by the Banca d'Italia, with a view to assessing the compliance of the CC&G's rules and procedures with the Recommendations for Central Counterparties developed jointly by CPSS-IOSCO; the conclusions of the assessment embody the opinions of Consob, which participated in the work and the meetings with CC&G.

As regards the link between the French and Italian central counterparties (i.e. LCH.Clearnet SA and CC&G), the assessment has been carried out in cooperation with the French authorities. The assessment refers to the situation as of June 30th, 2008.

Scope of the assessment

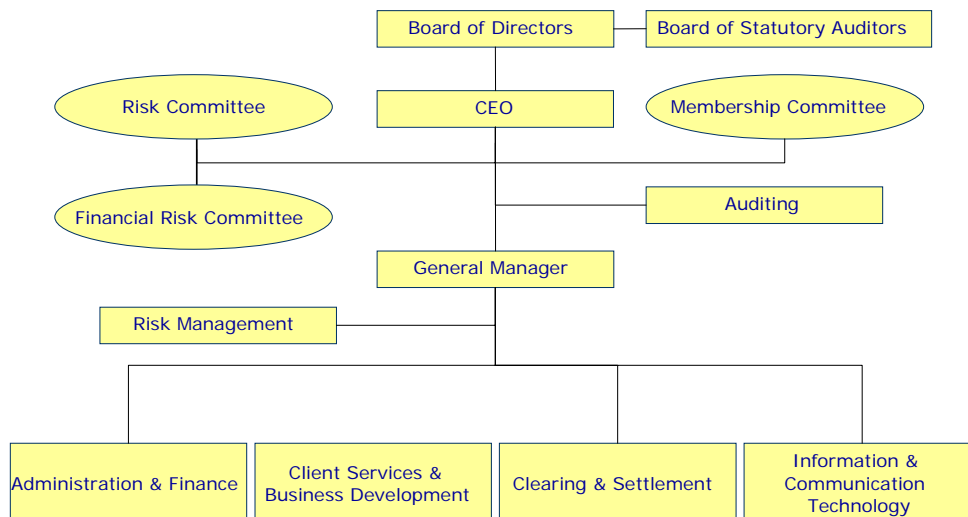
The CCP being assessed is CC&G, which was established in 1992 with a share capital of €33 mln and a net worth of €3.7 mln at March 31st, 2008 (including €30 mln distributed as dividends). The company is part of the Borsa Italiana Group, as shown in the following picture. Since October 1st, 2007 the Borsa Italiana Group is controlled by the LSE Group Ltd.

Chart 1



The Company's staff comprises 44 people as of 31 March 2008, organized as indicated below:

Chart 2



As of now, there are no other CCPs or guarantors in the Italian jurisdiction.

Scope of the CCP's coverage

CC&G acts as a central counterparty for the following financial products:

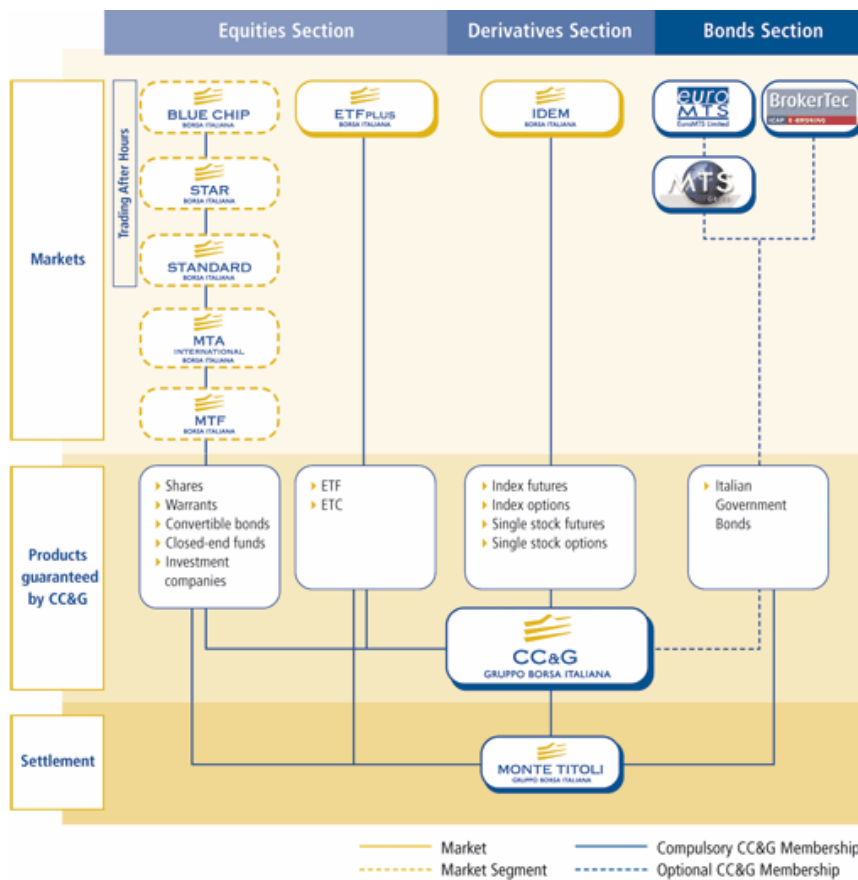
- equities, convertible bonds, warrants, ETFs, ETCs, and closed-end funds listed/traded on the markets organised and managed by Borsa Italiana SpA;
- equity and index futures and options traded on the Italian Derivatives Market (IDEM) managed by Borsa Italiana SpA;
- Italian government bonds (cash and repos) traded on the BrokerTec, EuroMTS and MTS markets.

Institutional and market structure

As mentioned above, CC&G acts as the CCP for the cash and derivatives equity markets managed by Borsa Italiana, and for the Italian government bond markets managed by BrokerTec, EuroMTS and MTS. All the aforesaid markets are screen based. CC&G eliminates counterparty risk and becomes the guarantor of the contracts, interposing itself between clearing members, as buyer towards each seller and as seller towards each buyer. The cash transactions are settled at Monte Titoli. Further details on the markets served can be found on CC&G's website.

In terms of the value cleared, the total as of December 31st, 2007 was €14,095,250 mln. The number of participants as of March 31st, 2008 was 133.

Chart 3



The CCP service for the Bonds Section is optional for market participants and is provided in cooperation with LCH.Clearnet SA.

Regulatory structure

CC&G is incorporated in Italy as a “società per azioni” and as such is subject to provisions contained in the Italian Civil Code. The following laws and regulations govern CC&G’s operations:

- the Consolidated Law on Finance (Legislative Decree 58/1998 as amended by the D.Lgs. September 19th, 2007 n. 164 - MIFID);
- the Settlement Finality Law (Legislative Decree 210/2001), implementing Directive 98/26/EC;
- the provisions issued by the Banca d’Italia in agreement with Consob on December 10th, 2002, in compliance with the Settlement Finality Law, designating CC&G as a “system” for the purposes of the Settlement Finality Law (hereinafter the “Designation”);
- Legislative Decree 170/2004 implementing Directive 2002/47/EC on financial collateral arrangements (hereinafter the “Collateral Law”);
- the provisions issued by the Banca d’Italia and Consob on February 22nd, 2008 in compliance with the Consolidated Law on Finance and the Settlement Finality Law (hereinafter the “Provisions”);
- CC&G Rules and Instructions (hereinafter the “CC&G Rules”).

As set out in the Consolidated Law on Finance, the Banca d’Italia and Consob are responsible for supervising and regulating CC&G and CC&G’s activities. In particular, the Banca d’Italia is entrusted with pursuing the objectives of systemic risk containment and the soundness of securities clearing and settlement systems; Consob is responsible for transparency and protection of investors (see Article 77 of the Consolidated Law on Finance).

The Banca d’Italia issues regulations on matters for which it is competent in agreement with Consob. The Banca d’Italia reports on its activities in its Annual Report and its Report to Parliament and to the Government, Consob in its Annual Report to the Ministry of Economy and Finance.

Information and methodology used for assessment

The assessment follows the methodology developed jointly by the CPSS and IOSCO as set out in their report entitled “Recommendations for Central Counterparties” (November 2004).

The assessment is mainly based on CC&G’s answers to the key questions in the CPSS-IOSCO Recommendations, answers to additional questions, documentation submitted and the authorities’ cumulative knowledge derived from their supervision activity, including on-site inspections.

CC&G provided full cooperation in the carrying out of the assessment.

The authorities deemed it useful to make comments on some recommendations, even though their evaluation was “observed”, and will monitor the follow-up process.

In the part II “Assessment of observance”, the answers to the key questions are summarized.

II. Assessment of observance

Executive summary of the recommendation-by-recommendation assessment

CC&G fully observes 14 of the 15 Recommendations and broadly observes the last one (Recommendation 8), as set out in Table 1.

In determining margin parameters, CC&G relies on end-user computing procedures (Recommendation 8); even though no evidence of operational failure has emerged so far, this approach could result in a potential lack of complete track records and subsequent difficulty in properly following the interventions on the procedure itself.

In order to achieve full observance of this Recommendation (see Table 2), CC&G should assess the risks and identify the actions needed to ensure a complete track record of the interventions, with account also taken of the likely increase in the number of financial instruments dealt with by the clearing system. Moreover, CC&G should carefully assess the quantitative adequacy of the human resources dedicated to its key processes.

Table 1

Collation of assessment results by assessment category

Assessment category	Recommendations
Observed	1, 2, 3, 4, 5, 6, 7, 9, 10, 11, 12, 13, 14, 15
Broadly Observed	8
Partly Observed	
Non-observed	
Not applicable	

Table 2

Actions to achieve observance

Reference recommendation	Actions to achieve observance
Recommendation 8	<p>The technological procedures for determining margin parameters are improved, in order to permit a complete track record of the interventions, with account also taken of the likely increase in the number of financial instruments dealt with by the clearing system.</p> <p>Moreover, CC&G should carefully assess the quantitative adequacy of the human resources dedicated to its key processes.</p>

Recommendation-by-recommendation assessment of observance

Recommendation 1: Legal risk

A CCP should have a well founded, transparent and enforceable legal framework for each aspect of its activities in all relevant jurisdictions.

Answers to key questions

Question 1 - Clarity, coherence and availability of laws and regulations

CC&G is incorporated in Italy as a “società per azioni” and as such is subject to the relevant provisions contained in the Italian Civil Code. CCP activities in Italy are governed and regulated by specific legal provisions and regulations issued by the Banca d'Italia and Consob.

CC&G’s detailed operational procedures are defined in its Rules, approved by the Banca d’Italia in agreement with Consob, and its Instructions, issued by CC&G itself.

In terms of clarity and internal coherence, no difficulty has arisen so far for any part of the overall legal and regulatory framework.

Participants receive comprehensive documentation covering CC&G’s rules, requirements, procedures and instructions. All the documentation is available on request and accessible to participants and the public in Italian and English on the CC&G website.

Laws and authorities’ provisions are published in the official journal “Gazzetta Ufficiale della Repubblica Italiana” and are also available on the Banca d’Italia and Consob websites (www.bancaditalia.it; www.consob.it), in both Italian and English.

Question 2 - Effectiveness of laws and regulations

The Italian legal framework provides a sound legal basis that supports novation, netting, default procedures, collateral and clearing fund arrangements, enforcement of CCP rules vis-à-vis its participants, finality of transfers of funds and financial instruments, insolvency of the CCP, the determination of CCP conflicts of laws. All the above-mentioned aspects are also clearly stated in the CC&G Rules, approved by the supervisory authorities.

Furthermore CC&G has been designated under the Settlement Finality Directive.

Question 3 - Enforceability of rules, procedures and contracts on member default

The Italian legal framework (the Consolidated Law on Finance, the Settlement Finality Law and the Collateral Law) ensures the enforceability of CCP rules, procedures and contracts, should a CCP participant default or become insolvent. Thus the actions taken under such default rules are final and may not be stayed, avoided or reversed, as they prevail over the Bankruptcy Laws.

Question 4 - Conflicts of laws

CC&G's participation contracts (including those for foreign participants) establish that only Italian jurisdiction applies to all the obligations arising from their participation in its Central Counterparty System. Moreover the Settlement Finality Law states that, should an insolvency arise, the insolvent participant's rights and obligations will be governed by the law regulating the system.

In the event of a non-EU entity's admission to the system, CC&G requires the applicant to provide a legal opinion to demonstrate that the CC&G Rules would be enforceable and to highlight any important issues, with particular reference to finality.

Assessment: Observed

Recommendation 2: Participation requirements

A CCP should require participants to have sufficient financial resources and robust operational capacity to meet obligations arising from participation in the CCP. A CCP should have procedures in place to monitor that participation requirements are met on an ongoing basis. A CCP's participation requirements should be objective, publicly disclosed, and permit fair and open access.

Answers to key questions

Question 1 - Financial and operational requirements

CC&G has a tiered membership structure, based on the following categories: General Clearing Member (GCM), Individual Clearing Member (ICM) and Non-Clearing Member (NCM). Only GCMs and ICMs participate in the system as counterparties of CC&G (Direct Members), while NCMs participate in the system through a GCM.

CC&G has established minimum requirements for its participants' financial resources, which depend on the type of membership, the trading venues to be cleared and, for GCM, the number of NCMs represented. CC&G has also established technological and organizational requirements.

Only banks and investment firms may apply for Direct Clearing Membership; all other market Participants may only apply to be NCMs.

Question 2 - Monitoring of requirements

CC&G monitors membership requirements on an ongoing basis. Participants must in fact communicate their supervisory capital periodically (monthly for investment firms, quarterly for banks); if the supervisory capital requirement is no longer fulfilled, CC&G fixes a term (no longer than 90 calendar days) for its fulfilment and notifies it to the Banca d'Italia, Consob and the pertinent Exchanges and NCMs. In this case CC&G establishes ad-hoc risk containment measures, including increased margins or suspension from the Clearing and Guarantee System.

Furthermore, members must promptly inform CC&G of any significant change in their ownership structure and operational activity (e.g. withdrawal from and/or participation in another CCP).

Question 3 - Objectivity and disclosure of participation requirements

The CC&G participation requirements do not limit access on grounds other than risks, are objective and permit fair and open access to the CCP system; they are set out in the CC&G Rules published on the CC&G website.

Applications are evaluated by the Membership Committee, including the CEO, the General Manager, the Client Services and Business Development Director, the Clearing & Operations Director and the Risk Manager.

In the event of refusal of access, CC&G explains in written form the reasons for the denial of access.

Members' suspension and exclusion and the arrangements for orderly exit are clearly dealt with in specific provisions of the CC&G Rules.

Assessment: Observed

Recommendation 3: Measurement and management of credit exposures

A CCP should measure its credit exposures to its participants at least once a day. Through margin requirements, other risk control mechanisms or a combination of both, a CCP should limit its exposures to potential losses from defaults by its participants in normal market conditions so that the operations of the CCP would not be disrupted and non-defaulting participants would not be exposed to losses that they cannot anticipate or control.

Answers to key questions

Question 1 - Measurement of exposures

CC&G monitors its exposure towards its Participants on an ongoing basis, considering separately their house and client accounts; reports on Open Positions are available in real-time upon request.

Margins are determined every evening on members' end-of-day open positions (marked at daily settlement prices) and are collected early the following morning.

Moreover, CC&G routinely calculates intraday margins at least once during the trading day, based on real-time positions and prices and using the same margining methodologies (TIMS for equity cash and derivatives; MVP for bonds) and parameters as for the overnight calculations; if the uncovered exposures vis-à-vis CC&G (stemming from large variations of prices and/or net positions) overshoot pre-set thresholds, intraday margins are collected.

Question 2 - Limitation of exposures

The CCP limits its exposures to potential losses from defaults by its participants through margin requirements, collected at least daily. CC&G observes Recommendation 4, therefore this Key question is not applicable.

Assessment: Observed

Recommendation 4: Margin requirements

If a CCP relies on margin requirements to limit its credit exposures to participants, those requirements should be sufficient to cover potential exposures in normal market conditions. The models and parameters used in setting margin requirements should be risk-based and reviewed regularly.

Answers to key questions

Question 1 - Sufficiency of margin cover

Margin requirements are applied for every type of financial instrument guaranteed by CC&G and are generally aimed at covering the potential losses stemming from the closure of an insolvent member's open positions in all but extreme market conditions.

Different levels of margin requirements are used, depending on the nature and level of liquidity of the financial instruments; further details are provided below.

Cash equities (equities, ETFs, ETCs, closed-end funds, warrants and convertible bonds traded on MTA): the coverage level is set at 99% of the actual daily price variations on a time horizon of two years price series; for longer time brackets (up to 15 years) the coverage level is reduced by 0.25% steps until 97.50%, in order to limit the impact on margin levels of price variations that occurred in the distant past.

Equity derivatives, the minimum coverage level is 99.80% of the actual daily price variation of each underlying asset, registered in the longest price series available (up to 15 years).

Government bonds (cash & repo), the minimum coverage level is 99.80% of the two-day yield variation of the vertex of the zero-coupon curve nearest to the duration of the bond registered since the introduction of the euro (January 2nd, 1999).

The margin parameters are recalculated at least monthly and reviewed at any time, whenever deemed appropriate on the basis of market circumstances. In general, margin parameters are recalculated by CC&G's Risk Dept., compared against the intended coverage, and reviewed by the Risk Committee. In addition to the review of the margin parameters, the whole approach (validation of the model) is revised whenever deemed necessary.

Question 2 - Ability to make intraday margin calls

As indicated in the answer to Recommendation 3/Key Question 1 CC&G routinely calculates intraday margins, based on real-time positions and prices at least once during the trading day. In case of relevant uncovered exposures (stemming from large variations of prices and/or members' net positions), the rules governing CCP activities provide for intraday margins to be collected in central bank money. It is CC&G's policy to calculate and collect intraday margins routinely. In order to identify unambiguously the "significant uncovered exposures", specific thresholds have been established by CC&G's Risk Committee.

Question 3 - Collateral acceptability and haircuts

CC&G accepts the following as margin: cash (euro, in central bank money); Italian, French and German government bonds listed on the MTS bond market; and equities. The latter are accepted only when they are the underlying of short call options or futures positions on the same security.

Italian Treasury bills (BOTs) are valued at their face value; other bonds are valued at their market price, (average market price determined by MTS) updated twice a month.

A conservative haircut is applied to all bonds covering extreme declines in asset value over a multi-day period.

Assessment: Observed

Comments

CC&G has been invited to improve the formalization of the process and results of the model validation, in order to have a detailed track record of the evaluation.

Recommendation 5: Financial resources.

A CCP should maintain sufficient financial resources to withstand, at a minimum, a default by the participant to which it has the largest exposure in extreme but plausible market conditions.

Answers to key questions

Question 1 - Stress testing scenarios and default procedures

In addition to margin requirements, CC&G has established two segregated Default Funds, one for the equity (cash and derivatives) markets, and one for the government bond markets. The size of each Default Fund is set to cover the default, under stressed conditions, at least of the participant with the highest exposure. For the equity (cash and derivatives) Default Fund, the simultaneous default of a number of low-capitalized members – in addition to the most exposed member – is also considered.

CC&G runs frequent stress tests for both equity (cash and derivatives) and bond markets. The results are reviewed by the Risk Committee; the models, parameters and scenario adopted are frequently re-discussed and critically re-examined by CC&G's Risk Committee.

In the event that stress testing results indicate that the amount of a Default Fund no longer fulfils the aforesaid requirements, the amount of the Default Fund is raised by CC&G's Risk Committee. This has occurred on a number of occasions.

The aim of the Default Funds and the methodology of calculating the participant Contribution Quota are published on the CC&G website. The Participant Contribution Quotas are linked to the riskiness of participants' activity as measured by the margins they have posted.

Question 2 - Financial resources in the event of a default

In order to manage defaults in the unlikely event of losses exceeding margins, the Default Funds (as of June 30th, 2008, €750 mln for equity markets and €150 mln for bond markets), whose sizes are gauged on the basis of stress test results, are aimed at guaranteeing the proper functioning of the system under extreme circumstances, including the occurrence of multiple defaults.

In the event of a Participant's default the losses incurred are attributed to the following items:

1. to the insolvent's margins;
2. to the insolvent's Default Fund Contribution Quota;
3. to CC&G's own assets up to €Mln 5;
4. to the pertinent Default Fund in proportion to the Contribution Quota of each Participant ;
5. to the remaining CC&G assets.

So, the CCP's rules ensure that the resources posted by a defaulter are used before other financial resources in covering losses.

Concerning the use of deposited guarantees, the Italian Consolidated Law on Finance clearly establishes that guarantees posted with a CCP may not be used by any entity for any other purpose, including in the case of the default of a CCP Participant and even in the case of the default of the CCP itself .

Furthermore, CC&G rules establish that under no circumstance may the Default Fund be used to cover losses arising from a market segment it does not guarantee.

Question 3 - Any financial resources not immediately available

All guarantees accepted by CC&G are immediately available. In addition, committed credit lines of adequate amounts are available for bridging possible liquidity gaps linked to the liquidation of the collateral accepted as margin coverage.

Assessment: Observed

Recommendation 6: Default procedures

A CCP's default procedures should be clearly stated, and they should ensure that the CCP can take timely action to contain losses and liquidity pressures and to continue meeting its obligations. Key aspects of the default procedures should be publicly available.

Answers to key questions

Question 1 - Default procedures

The CC&G Rules state clearly the circumstances in which it has the authority to close out the positions of a member in default, using its collateral and – if necessary – the pertinent Default Fund(s) to cover losses. In order to provide a degree of protection to clients' interests, in the event of default CC&G will use its best efforts to transfer the clients' positions to a non-defaulting Participant; after this attempt, untransferred clients' positions will be liquidated.

Question 2 - Enforceability of default procedures

Under the Consolidated Law on Finance, the collateral posted with a CCP may not be subject to enforcement proceedings or preventive measures initiated by the creditors of individual participants or by the body that administers the CCP itself, even in the event of bankruptcy proceedings; therefore a stay or a reversal is hardly conceivable. The Italian legal framework permits the identification and separate treatment of client and proprietary resources; as a further guarantee for customers, client account assets may not be used to cover house account losses, whereas house account assets may be used to cover client account losses.

Question 3 - Internal plans for default management

CC&G has a formalised internal procedure for managing defaults. The procedure explicitly focuses on limiting market impact in liquidating the defaulter's positions and foresees a sufficient level of flexibility and coordination with other entities involved. In the event of the default of a clearing member participating in a market served both by CC&G and LCH.Clearnet SA (the interoperability model), the CCP of the defaulting member informs the other CCP. The procedure is reviewed at least once a year and whenever changes occur in laws, regulations or the internal operational system that might affect the default procedure. The authorities are immediately informed of a default and of any relevant information pertinent to its management.

Question 4 - Default procedures publicly available

All the key aspects of the default procedure are described in detail in the CC&G Rules, which are available on the CC&G website.

Assessment: Observed

Recommendation 7: Custody and investment risks.

A CCP should hold assets in a manner whereby risk of loss or of delay in its access to them is minimised. Assets invested by a CCP should be held in instruments with minimal credit, market and liquidity risks.

Answers to key questions

Question 1 - Custody risk

The collateral collected by CC&G is deposited with Monte Titoli, which is the Italian CSD and SSS; SSS Recommendation 12 is observed by Monte Titoli, as stated in the detailed assessment conducted by the IMF as part of the FSAP.

The collateral is deposited on client accounts owned by CC&G, which therefore has prompt access to the deposited securities in the event of a participant's default.

Question 2 - Investment security

Most of CC&G's capital and cash margins are held on cash accounts with leading banks; cash deposits are therefore not subject to market or liquidity risks.

The contracts signed by CC&G with the depository banks explicitly mention that the sums deposited are margins under the Consolidated Law on Finance, with the resulting protection.

Question 3 - Overall exposure to obligors

CC&G holds cash accounts with several leading banks. The main criteria of the treasury policy are: diversification (no more than a certain amount of the cash margin may be deposited at a single bank, even though the actual deposits at individual banks have been

constantly and significantly below the pre-defined thresholds), creditworthiness (banks or bank groups with a rating equal to at least BBB+) and remuneration.

Assessment: Observed

Comments

It is recommended that CC&G strengthen its diversification policy, by setting lower thresholds for the deposit at individual banks.

Recommendation 8: Operational risk

A CCP should identify sources of operational risk and minimise them through the development of appropriate systems, controls and procedures. Systems should be reliable and secure, and have adequate, scalable capacity. Business continuity plans should allow for timely recovery of operations and fulfilment of a CCP's obligations.

Answers to key questions

Question 1 - Procedures to identify operational risk

CC&G has a clear risk map that identifies the risks related to its core activities as well as its accountability for monitoring and managing the risks. The risk map is validated by the top management and by the internal auditors.

For the ICT Dept. the assessment of operational risks is performed by the ICT Manager and validated by the top management, taking into account the recommendations of the auditors (internal auditors, external auditors and statutory auditors).

The business continuity plan contains a methodology for identifying and analysing operational risk.

Internal and external auditors validate the compliance of the Business Continuity Plan (from now onwards BCP) with the above mentioned scenarios in the yearly EDP audit, carried out in accordance with the international COBIT methodology (Control Objectives for Information and related Technology).

With regard to the risks stemming from outsourced processes, CC&G complies with the Provisions issued by the Banca d'Italia and Consob. Essentially it retains full governance of its own processes, since it directly carries out the development, maintenance and production support of its primary and critical applications, including clearing and risk management.

With regard to the determination of the margin parameters, recourse is made to end-user computing procedures; this could result in a potential lack of complete track records.

Question 2 - Business continuity plans

CC&G has developed continuity and contingency plans to cover the failure (temporary or prolonged) of its key systems. These plans cover both the handling of contingencies, emergencies and a major hardware failure (Disaster Recovery Plan). The BCP states the policies and procedures for maintaining business continuity both from a prevention and

from a remedial point of view. It establishes the timing and the manner of addressing contingency situations if and when they emerge.

In 2007 external auditors certified the compliance of the CC&G Business Continuity Plan with the aforesaid Provisions and international auditing best practices.

Question 3 - Adequate controls and staff

In general, the operational reliability and adequacy of controls are monitored by senior and middle management. In particular, any operational error causing problems for CC&G or Participants is reported to senior management and the internal auditors for the adoption of appropriate remedies.

CC&G personnel has always proved to be well qualified and to have a good knowledge of the operational, technical and organizational environment.

CC&G monitors and permanently registers all contingencies and intervention requests.

Question 4 - Availability of key systems

CC&G has not experienced a key system failure in recent years.

The most common cause of temporary unavailability of services is human error.

CC&G's staff is available for production support on a 24/7 basis.

Processing is resumed in less than 2 hours. All incidents are fully documented in dedicated reports. No transactions or data have ever been lost. The planning and control of information systems is managed by a capacity planning process. The ICT Dept. submits the detailed project development and equipment investment plans to top management for approval.

With reference to capacity management, CC&G considers the following as requirements related to security standards: the restart time in abnormal situations, the availability of all needed test environments; and the performance requirements.

CC&G performs stress tests internally by simulating very large volumes of contracts from trading systems in order to verify the adequacy of hardware, operating systems, middleware and applications.

Assessment: Broadly Observed

Comments

The technological procedures for the determination of margin parameters should be improved, in order to permit a complete track record of the interventions, with account also taken of the likely increase in the number of financial instruments dealt with by the clearing system.

Moreover, CC&G should carefully assess the quantitative adequacy of the human resources dedicated to its key processes.

Recommendation 9: Money settlements

A CCP should employ money settlement arrangements that eliminate or strictly limit its settlement bank risks, that is, its credit and liquidity risks from the use of banks to effect money settlements with its participants. Funds transfers to a CCP should be final when effected.

Answers to key questions

Not Applicable. As stated above, fund transfers are made through the central bank.

Assessment: Observed

Recommendation 10: Physical deliveries

A CCP should clearly state its obligations with respect to physical deliveries. The risks from these obligations should be identified and managed.

Answers to key questions

Question 1 - Clarity of CC&G's obligations with respect to physical deliveries

The CC&G Rules clearly state the corresponding delivery obligations.

In accordance with the CC&G Rules, the contractual positions on financial instruments are sent to the Settlement Services at the end of the trading day preceding the relevant settlement date.

Failed contractual positions are recycled within the settlement service for an established period of time, set by the CC&G Rules.

After this period CC&G initiates a buy-in procedure for contractual positions that are still unsettled.

Question 2 - Principal risk management

CC&G executes deliveries of physical instruments using the DVP mechanism of the Monte Titoli settlement system (Express II).

In the management of the buy-in procedure, the physical settlement may also be executed through free-of-payment transfers. In this case Participants must first pay the counter value and only after that will CC&G release the securities.

Question 3 - Liquidity, storage and delivery risk management

CC&G does not perform CCP services for cash commodities or commodities derivatives, therefore is not exposed to storage and delivery risk.

CC&G has identified the liquidity risk to which it is exposed in clearing financial instruments and has managed to rely on committed credit lines and access to central bank intraday credit.

Moreover, in order to reduce the liquidity needs stemming from CC&G's participation in the gross settlement system, Monte Titoli developed shaping (i.e. a single operation is turned into several smaller operations) and mini-netting procedures (i.e. where a CCP – or two CCPs – are interposed in transactions and the securities to be delivered and received are of the same amount, the cash position is netted).

Assessment: Observed

Recommendation 11: Risks in links between CCPs.

CCPs that establish links either cross-border or domestically to clear trades should evaluate the potential sources of risks that can arise, and ensure that the risks are managed prudently on an ongoing basis. There should be a framework for co-operation and co-ordination between the relevant regulators and overseers.

Answers to key questions

Question 1 - Links in operation

CC&G has been involved since December 2002 in a clearing link with LCH.Clearnet SA for the Italian government bonds traded on MTS markets, a link that was subsequently (2Q 2006) extended to include BrokerTec trades. Under this link the two CCPs are reciprocally “special” Participants.

As the link is currently structured: a) for trades between their respective members, i.e. cross-border trades covered by the link, CC&G and LCH.Clearnet SA will interpose themselves between the original counterparties as for any domestic trade; b) the two CCPs have agreed to harmonize their margining procedures and margins are calculated and deposited by each CCP on the aggregated net position of the other CCP (in this way the linked CCPs do not pose any additional risks to each other with respect to any other clearing Participant); c) the two CCPs are reciprocally exempted from contributing to the linked CCP's Default Fund (in this way the default of a Participant of one CCP will not affect the assets of the other CCP deposited with the first in any way, thus avoiding contagion between the two systems). However, the two CCPs exchange an additional initial margin, of equal amount and of the same nature as “regular” margins; this is calculated on the basis of stressed scenarios.

In accepting the non-contribution principle, CC&G has considered that the risk it assumes with respect to LCH.Clearnet SA is of a different nature to the risk it assumes with respect to its ordinary members.

Question 2 - Rules governing link

The link is based on the above mentioned agreement, contemplated by the relevant section of Banca d'Italia and Consob regulations issued on February 22nd, 2008. According to the design of the link, each CCP is a special category of Clearing Member of the other CCP; therefore Italian laws and CC&G contractual rules apply to LCH.Clearnet SA for its membership (“Special Clearing Member”) of CC&G, and French laws and contractual rules apply to CC&G for its membership (“Allied Clearing House”) of LCH.Clearnet SA.

Regarding finality, CC&G's instructions state that transfer orders entered into its system become final as soon as trades are made on the market, i.e. as soon as novation occurs. In accordance with the Settlement Finality Directive, the CC&G Rules state that the CCP's systems are subject to Article 2 of the Settlement Finality Law.

Default procedures applicable by CC&G are defined by its rules (to which LCH.Clearnet SA is subject as a CC&G participant). Collateral is submitted to the jurisdiction of the country where the relevant account is maintained.

As far as the relevant contractual rules are concerned, CC&G recognizes that LCH Clearnet SA governs the relationship with its members by means of its Rules and its Membership Agreement. These rules are considered sufficient to comply with the corresponding requirements of the Clearing Agreement. In turn, CC&G is reciprocally recognized by LCH Clearnet SA.

Question 3 - Operational, credit and liquidity risks

Neither CCP poses additional risks to the other greater than those of any other clearing Participant; operational risks are limited and properly addressed and the credit risk posed by a CCP is extremely small, given that CCPs are highly regulated entities, subject to close supervision; they are also single purpose companies, whose specific objective leads by definition to their maintaining a balanced market position and thus having no exposure to market risk.

Question 4 - Authorities' Regulation and oversight

The Italian and French authorities have signed a Memorandum of Understanding organising the oversight and regulation of the link between CC&G and LCH.Clearnet SA.

The primary objective of the signatory authorities is to establish adequate monitoring of risks related to the link through a co-ordinated approach to supervision/oversight. To this end, the MoU establishes a mutual co-operation framework that includes provisions on information sharing and the division of responsibilities between the authorities. The MoU also recalls that each authority remains primarily responsible for its CCP.

Assessment: Observed

Recommendation 12: Efficiency .

While maintaining safe and secure operations, CCPs should be cost-effective in meeting the requirements of participants

Answers to key questions

Question 1 - Review of costs and pricing

CC&G has procedures in place to control its costs; however it is not possible to benchmark CC&G's costs against those of other CCPs as these are not publicly available.

CC&G's cost-control includes accounting procedures that produce periodic economic status reports, which are compared with the yearly and periodic budgets (budget variances, monitoring of the main performance indicators) and management accounting procedures that allow the authorizations pertinent to every single expenditure to be controlled at every stage of the work-flow.

The CC&G has procedures in place to review its pricing levels against its operating costs at least once a year.

Question 2 - Review of service levels and operational reliability

CC&G continuously reviews its service levels with Participants through its dedicated Business Development & Client Service Dept, which is in charge of fine tuning the service level and developing new functions to satisfy clients' needs. This department currently assesses the service level through one-to-one meetings and consultations with participants.

Operational reliability is monitored by senior and middle management.

Assessment: Observed

Recommendation 13: Governance

Governance arrangements for a CCP should be clear, and transparent to fulfil public interest requirements and to support the objectives of owners and participants. In particular, they should promote the effectiveness of a CCP's risk management procedures

Answers to key questions

Question 1 - Clarity and transparency of governance arrangements

Borsa Italiana owns 86 percent of CC&G. The shares of Borsa Italiana S.p.A. are held by LSE Group. Borsa Italiana is a private for-profit company subject to the provisions contained in the Italian Civil Code (implementing the relevant European Directives on company law) on corporate governance (including on the role of managers and shareholders and on the duties of the internal auditors). Moreover, as a management company for regulated markets, it is subject to the provisions contained in the Consolidated Law on Finance and to Consob's supervision.

For CC&G and Borsa Italiana the Articles of Association establish the basic principles regarding the Board and the Board's functioning. The updated Shareholders' Book is sent to the Chamber of Commerce after the Shareholders' Meeting has taken place.

The corporate bodies of CC&G and Borsa Italiana are the Shareholder's Meeting, the Board of Directors and the Board of Statutory Auditors. The Board of Directors is appointed by the shareholders' general meeting every three years. The Board of Directors of CC&G is currently composed of nine members, three of whom are independent directors.

CC&G's structure includes a Chief Executive Officer and a General Manager.

Question 2 - Separation of reporting lines for risk management

CC&G has a Risk Management Dept. that reports directly to the General Manager and is independent from the operational units.

There is an internal Risk Committee that meets at least once a month. It is chaired by the CEO and comprises the General Manager, the Risk Manager and a Clearing & Settlement (C&S) Director who participates in the Risk Committee in order to ensure the necessary coordination between offices with reference to the operational aspects of Risk Management activities having an impact on C&S.

Question 3 - Skills, incentives and accountability of management and Board

The Financial Law establishes that the Board Members must fulfil the integrity and experience requirements set by Decree No 471/1998 issued by the Minister for the Economy and Finance.

The General Manager is appointed by the Board, which evaluates his/her skills.

In order to help CC&G deliver sound and effective services and meet related public interest requirements, one of the most significant objectives given to the CEO and the management is to ensure full compliance with all applicable laws, rules and regulations issued by a national authority and a complete lack of complaints by the authorities.

With reference to the pursue of public interests, it must be noted that – as indicated on its website – CC&G feels committed to promoting and offering its services in an equitable, transparent and non-discriminatory manner and on the basis of criteria and procedures aimed at assuring interoperability, security and equal treatment among market infrastructures.

Moreover, the institutional/systemic role of CC&G benefits from the protection provided by adequate accountability mechanisms towards internal (Board of Statutory Auditors) and external (national authorities) bodies in respect of the values of substantial and procedural fairness and transparency, thus ensuring efficient, objective and assessable management.

Company results are examined and approved by the Board on a regular basis and significant issues – if any – are reported to the Board by the Group internal and external auditors and by the Board of Statutory Auditors.

Question 4 - Disclosure of objectives, responsibilities and delivery

CC&G's objectives are focused on its CCP functionalities and the quality of its clearing services.

With reference to the CCP functionalities, the main objectives are anonymity, elimination of counterparty risk and sound risk management.

With reference to clearing services, the focus is on the netting process, position keeping, collateral management, and STP post-trading functionalities.

These objectives are clearly indicated in the CC&G Rules and Communications and are described on the company's website.

Assessment: Observed

Comments

In order to take account of all relevant interests, the governance structure should be improved by the introduction of standing user committees to be consulted in the event of major changes; their decisions/suggestions should be reported to the Board.

Recommendation 14: Transparency

A CCP should provide market participants with sufficient information for them to identify and evaluate accurately the risks and costs associated with using its services.

Answers to key questions

Question 1 - Disclosure of risks

The rights and obligations of participants and the relevant laws are part of the contractual agreements signed by participants. The rules of the counterparty service, the circumstances in which CC&G assumes counterparty exposure and the default procedure are clearly stated in the system regulations. The aforementioned documents are available on the company website (in Italian and English). The CC&G publicly discloses the following information on its website: the price list; a description of the steps taken to mitigate risks (kind of margins requested, methodology for their calculation, collateral accepted; default fund); disaster recovery procedures, simulation data and related information; and stress testing information.

Question 2 - Accessibility of information

All the information is made available on the website in Italian and English.

Question 3 - Review of information

Not applicable. This assessment has not been carried out by CC&G but by the Banca d'Italia and embodies the opinions of the Consob.

Assessment: Observed

Recommendation 15: Regulation and oversight

A CCP should be subject to transparent and effective regulation and oversight. In both a domestic and international context, central banks and securities regulators should cooperate with each other and with other relevant authorities

Answers to key questions

Question 1 - Ability and resources of regulator and overseer

The Consolidated Law on Finance charges the Banca d'Italia with regulating CCPs for financial instruments in agreement with Consob; the Banca d'Italia and Consob issued the Provisions on February 22nd, 2008.

The Banca d'Italia and Consob supervise the central counterparty systems and the body (CC&G) which manages them. As supervisory authorities, the Banca d'Italia and Consob may require system managers and participants to provide data and information concerning the clearing and settlement of transactions; they may also carry out on-site inspections.

Question 2 - Clarity and transparency of objectives, roles and policies of authorities

The tasks and role of the Banca d'Italia and Consob with respect to securities clearing and settlement activities are clearly defined in the legislative texts and respective rules and regulations, which are published on the authorities' websites both in Italian and in English.

As set out in the Consolidated Law on Finance, the Banca d'Italia is responsible for the containment of systemic risk and the soundness of securities clearing and settlement systems. Consob is responsible for transparency and the protection of investors.

Relevant regulations are issued by the Banca d'Italia in agreement with Consob, since the Banca d'Italia is the lead regulator of CCPs.

Question 3 - CCP reporting requirements

The Banca d'Italia and Consob may ask the system managers and participants of a CCP for any document, data, and information concerning the clearing and settlement of transactions.

As regards outsourced activities, according to the Provisions, CC&G has to provide competent authorities with information that clearly describes all material aspects of the outsourcing arrangement. Outsourcing contracts must ensure that CC&G meets its regulatory obligations and the competent authorities can exercise their regulatory powers.

Question 4 - Cooperation between authorities

Cooperation between the Banca d'Italia and Consob is defined in the Consolidated Law on Finance, which requires them to a) share information, and b) co-ordinate between themselves to facilitate their respective tasks. This holds both for financial intermediaries and for market infrastructures where there is joint competence. To this end they may not invoke official secrecy in their mutual relations.

Assessment: Observed