

**OECD/ADB/IBI 7th Round Table on Capital
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SESSION 5:

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Governance of Clearing House and Central Depository

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After trade execution

- Comparison (of terms of the trade):
 - affirmation by the client to the agent
 - confirmation by the counterparties
- Communication of settlement instructions to central depositories / custodians.
- Computation of the obligations of the counterparties resulting from the comparison
 - gross settlement
 - net settlement (bilateral, multilateral)
- Settlement:
 - Final delivery of securities and final payments.

C&S institutions and their integration

- Types of institutions
 - (Trading system)
 - Clearing House
 - Depository
 - Registrar
- Integration across Functions / Instruments
 - ▶ Economies of “Scope”
- Consolidation across Institutions
 - ▶ Economies of “Scale”

Integration across instruments and functions

- Integration across instruments

- Equity
- Corporate debt
- Government securities
- Derivatives

e.g., Hong Kong (equity, corporate debt and derivatives), UK (Crest; all), France (Sicovam; all), Sweden (VPC; all),

- Integration across functions

- Clearing House
- Depository
- Registrar
- Clearing / Depository
- Clearing / Depository / Registrar
- Trading / Clearing
- Trading / Clearing / Depository / Registrar

C&S institutions as infrastructure

- Clearing house and central depository are faced with strong scale economies. They are increasingly becoming a centralized (monopolistic) public infrastructure in a globalizing market while trading markets are increasingly becoming a private business competing for profit.
- Critical to ensure that the monopoly serves well for the interest of users, stakeholders and the public; i.e., Sound governance is needed.
- CPSS-IOSCO Recommendations for SSS.

CPSS-IOSCO

Recommendations for SSS

- Legal framework, regulation and oversight
- Pre-settlement risk
 - Trade confirmation/affirmation; Settlement cycles; Central counterparties (CCP); Securities lending
- Settlement risk
 - CSD; DVP; settlement finality (same day funds); CSD risk control of participants' failures; cash settlement assets.
- Operational reliability & business continuity
- Custody risk mitigation
- **Governance, access** and transparency
- Efficiency vs. safety
- Communication procedures and standards
- Cross-border links

Why access as well as governance?

- Need to ensure that C&S institutions serve to meet business needs of their users. I.e., there should be an effective mechanism to enable the users to voice their business needs and to ensure that C&S institutions accommodate those.
- Users are those who have access to the system, i.e., governance and access are inseparable. Access can be direct and indirect. Customers of direct users are indirect users.
- The governance arrangements should facilitate to reconcile conflicting interests among C&S institutions, direct users and indirect ones.
 - Between C&S institutions and direct users.
 - Between direct users and their clients.

Recommendation No. 13 on Governance

- Focus on CSDs and CCPs which sit at the heart of the settlement process.
- They are often sole providers of services to the market they serve due to scale economies, and therefore, their performance is critical to the safety and efficiency of the entire market.
- Their monopolistic position can impair the forces of competition that might otherwise be relied upon to ensure that they operate safely and efficiently. I.e., sound governance is needed.

Recommendation No. 13 on Governance

- Their governance arrangements should be designed to fulfill the public interest and promote the objectives of owners and users.
 - Should encompass the relationships between the management and owners and other interested parties, including users and authorities representing the public interest.

- The key components of governance include:
 - the ownership structure;
 - the composition of the board;
 - the reporting lines between management and board; and
 - the process that makes the management accountable for its performance, e.g., an audit committee.

Recommendation No. 13 on Governance

- Transparency and disclosure
 - Governance arrangements should be clearly specified, coherent, comprehensive and fully transparent.
 - Objectives, those principally responsible for achieving them and the extent to which they have been met should be disclosed to owners, users and public authorities.
- The management should have the incentives and skills needed to achieve those objectives and should be fully accountable for its performance.
- Reporting lines between management and board should be clear and direct, and the board should contain suitable expertise and take account of all relevant interests, whether it is a mutual or for-profit entity.

Recommendation No. 13

Questions on Governance

- How is the composition of the board determined? What steps are taken to ensure that board members have the necessary skills, and represent or take into account in their deliberation the full range of the interests of shareholders, users and the public?
- What steps are taken to ensure that management has the incentives and skills needed to achieve the system's objectives and is accountable for its performance?
- Are the system's public interest, financial and other objectives clearly articulated and publicly stated? What are they? Do the objectives reflect the needs of users as well as owners? How is the public interest taken into account?
- How are major decisions communicated to owners and users? What information is publicly available regarding the system, its ownership and its board and management structure, and the process by which board members are appointed, major decisions taken and management made accountable?

Recommendation No. 14 on Access

- CSDs and CCPs should have objectives and publicly disclosed criteria for participation that permit fair and open access.
- Broad access to CSDs, CCPs and other provider of C&S services (e.g., trade comparison or messaging services) encourages competition among users and promote efficient and low-cost C&S.
- But participants must have sufficient technical, business and risk management expertise, necessary legal powers and adequate financial resources so that their activities do not generate unacceptable risk for the operator or for other users and their customers.

Recommendation No. 14 on Access

- CSDs and CCPs need to establish criteria that balance fairly the benefit of open access against the need to limit the participation. The precise criteria are likely to vary according to the role the participant plays in the system.
 - CCPs, which incur direct credit exposure to their members, tend to emphasize financial resource requirements.
 - CSDs, particularly those in which members incur little or no liquidity or credit exposure to one another, tend to emphasize technical expertise and legal powers.
 - Some CSDs and CCPs may establish more stringent criteria for members that act as custodian or clearer for other members or for customers.

Recommendation No. 14 on Access

- Unnecessarily restrictive criteria can reduce efficiency and generate risk by concentrating activity and exposure within a small group of users.
- The more restrictive the criteria, the greater the importance of assuring that members can control the risks generated by their customers.
- To avoid discriminating against classes of users and introducing competitive distortions, criteria should be fair and objective, and publicly disclosed so as to promote certainty and transparency.

Recommendation No. 14

on Access

- Criteria that limit access on grounds other than risks to the CSD or CCP should be avoided.
 - Restrictions on access for non-resident users are not acceptable unless system rules are not enforceable against them or remote access would expose the operator or other users to unacceptable risks.
 - Indirect indicators of risk such as whether an institution is supervised may be used as criteria, but these should be related clearly to relevant risks the operator is managing.
- Restrictions on access for competitors providing similar services is acceptable only if clearly justifiable on the same risk grounds.
 - CSDs should grant access to foreign CSDs or foreign CCPs, provided the legal and other risks associated with such links can be controlled effectively.

Recommendation No. 14 on Access

- Some jurisdictions may find it useful for the anti-monopoly authorities to have a role in reviewing access rules or for there to be an appeals procedure that is independent of the CSD or CCP if access is denied.
- CSDs and CCPs should have procedures facilitating the orderly exit of participants that no longer meet membership criteria, and those procedures should be publicly disclosed.

Realities and issues – 1

Stock exchange

- A CSD is often dedicated to a stock exchange and owned by it or its members.
 - Membership in a stock exchange is often limited to or dominated by securities brokers, and its board governed by them.
 - This tends to be the case particularly when bond market is underdeveloped.
- Demutualization can lead to a stock exchange's divestment out of a CSD.
 - How about clearing / CCP function? Is it better to stay with an exchange or go with a CSD or be independent?
- Bond market development tends to necessitate and, therefore, promote strengthening of C&S systems as a public utility.

Realities and issues – 2

Central bank's role

- Central Bank often assumes the role of CSD for government securities (and central bank bills), separately from one for other securities.
 - CB is a competent and trusted institution with resources.
 - GSs are used for monetary operations by Central Bank.
- However,
- It fragments C&S arrangements and reduces efficiency by prohibiting the efficient use of a long position in GSs to meet a margin required for a short position in others.
 - It duplicates system investment.
 - Central Bank needs to provide commercial services not essential for Central Bank's mission (e.g., SLB, collateral management, cross-margining, etc.) while it is not governed by its users.

Realities and issues – 2

Central bank's role

- How should they be linked or consolidated?
 - Delegate or transfer the custody function to a private CSD?
 - Delegate or transfer even the registry function to a private CSD?
 - Outsource the serve to a private CSD?

Realities and issues – 3

Payments system links

- CSD needs to be linked to a payments system to achieve DVP, but the payments systems often restrict the access only to credit or, in some cases, even to deposit-taking institutions.
 - Brokers and institutional investors can have only indirect access through banks. But they often face conflicting interest with banks which are dealers in the bond market.
 - Should qualified brokers and/or institutional investors be accepted into payments system networks?
 - Can they be permitted to have money accounts in Central Bank for the settlement of financial market transactions?

Realities and issues – 4

Different participants

- Different types of intermediaries participate in different segments of the markets, e.g., bond market vs. equity market.
- A CSD serving for multiple segments of the market with different participants requires a different governance arrangement for each segment.
 - Bond market tends to be dominated by banks (and institutional investors in more developed markets) while equity market is run by securities brokers.
 - CCP may or may not be feasible in bond market while it is commonly adopted to equity market.

Realities and issues – 5

CSD as a registry

- A CSD is often capable of serving also as a central registry for securities or companies.
 - However, CSD's primary users are intermediaries while the registry's are issuing companies.
 - Each function with different users requires a different governance arrangement.

Realities and issues – 6

CSD vs. custodians

- CSD vs. custodians
 - CSDs are to provide “core clearing” services while custodians are for more custom-made services for institutional investors (e.g., NPV calculation, etc.)
 - Custodians tend to be important participants of CSD and have seats on the board to ensure that CSD share the role with them.
 - However, CSDs are also increasingly capable of providing custom-made services.
- Are CSDs competing with their own participants? Is outsourcing a solution?

Realities and issues – 6

ICSD vs. global custodians

- Can a global custodian play the role of ICSD in Asia where a true ICSD does not exist even though they are not governed by their users?
 - State street
 - Citibank
- Should they be governed by their users? Or, should there be competition even at the cost of fragmentation?