Global Investor

The role of central depositories in global investment

Global investors need to understand local market infrastructure and its related risks say Simon Murray, Simon Thomas and Derek Duggan of Thomas Murray

Central Securities Depositories (CSDs) play an increasingly important role in domestic and cross-border investment. The advantages of using central depositories in local markets are becoming more visible to global investors and custodians. Progress continues to be made towards the G30 recommendations on the establishment of central securities depositories, and at least 43 major securities markets now have set up operational depositories for equities and/or bonds.

Despite this undoubted progress, global investors should be aware that there is no such entity as a typical or model central securities depository. There are wide differences in the functionality of, or services offered by, depositories; in their ownership and membership profiles; in the guarantees provided to users; and in the conflict between compulsory and optional usage. These differing characteristics create some very real issues and concerns, which global investors should consider as part of their analysis of the risk of global investment, and the pros and cons of alternative custody arrangements.

A recent study by Thomas Murray Ltd* found that 43 out of the top 71 securities markets around the world now have operational depositories. Many more markets are at the planning and implementation stage.

One of the main advantages of investing in markets with fully operational central depositories is that they reduce safekeeping risks. This is achieved by immobilising or dematerializing securities, thereby minimizing the inefficiencies and risks of physical settlement, typically through book entry transfers. Most central depositories operate net clearing systems among their participants and have either direct or indirect means to move cash in parallel to the securities. Finally, the development of central depositories can facilitate the implementation of true delivery versus payment (DVP) in local markets, by reducing the timing differences, (and intra-day credit exposure) between local payment systems and settlement systems.

A lot of attention has been given to problems created in a few major markets by the absence of operational depositories or the weaknesses of existing central securities depositories. For instance, investors are becoming increasingly aware of issues caused by the absence of a central depository for equities in the UK and by the limited services of existing depositories, particularly apparent with Jasdec, Japan's central equity depository.

However, much less attention has been given by investors to problems arising out of the complexity and diversity of central depositories around the world, and their growing role as custodians of institutional assets. Most notably, there is a danger that investors could become more exposed to the risks inherent in asset safety and administration, if their assets sit outside the banking system. Investors may no longer be able to expect, or rely on, their domestic/global custodial banks to assume and underwrite these local market risks.

Functionality

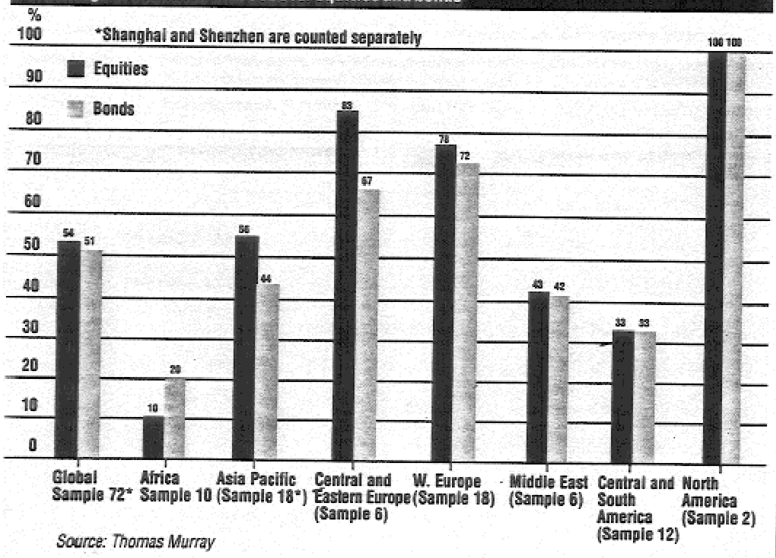
The first issue facing investors and their custodians in using central depositories relates to the functionality of/services offered by depositories, and how this varies on a market by market basis. Some central depositories, for example, cover only a narrow range of securities. Not all central securities depositories cover both equities and bonds, while others have specific depositories for a number of different instrument types. Despite the advantages of DVP, not all central depositories provide matching and clearing services. Some central depositories cover securities lending, but the majority do not *(see chart on page 40)*.

Alongside the need to understand the functions of each depository, investors should consider a number of characteristics which can directly affect the suitability of an individual depository, including ownership, membership, guarantees, and compulsory versus optional usage.

Ownership

It is important to ask whether conflicts of interest exist between the owners of the central depository and other local market participants. There are several examples where commercial banks and brokers have jointly created a central depository to serve their collective needs only to find that commercial conflicts have interfered with the development of the depository. What is the significance of failure? Can the owners allow the depository to fail or would there be too many repercussions? Is the central depository linked to the national payments system? Is there proper matching of responsibility and accountability?

Percentage of countries with CSDs for equities and bonds



Source: Thomas Murray

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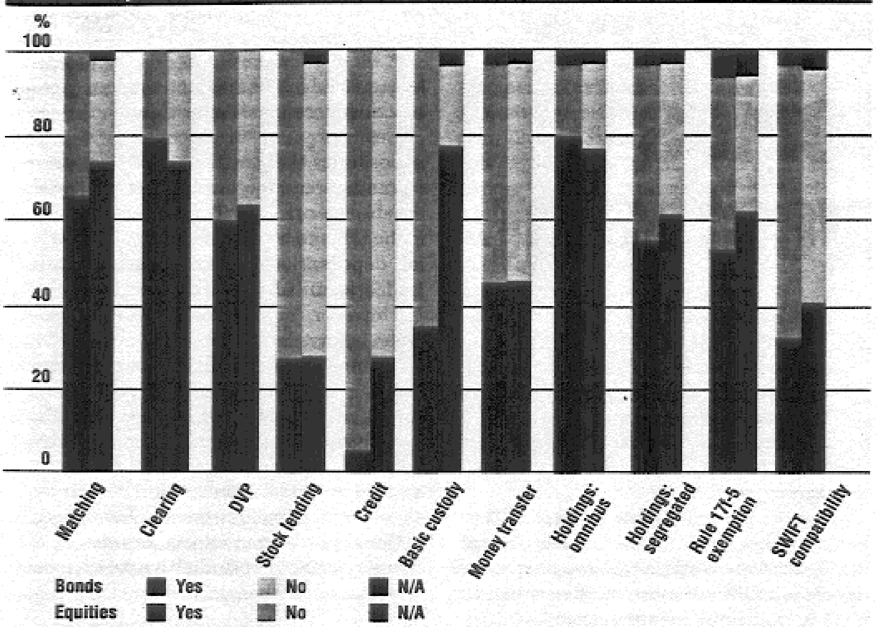
ROLE OF CENTRAL DEPOSITORIES IN GLOBAL INVESTMENT

Functionality/services offered by central depositories for bonds and equities



Source: Thomas Murray

Membership

Direct access to central depositories is possible in some markets where membership rules permit. But even if local membership rules permit direct participation it may well not be cost effective, so it could be beneficial to access the depository via a local agent who is already a member.

The following questions need to be answered: Who can be a member of the central securities depository? Is membership restricted to local market participants or not? Is membership limited to brokers or can banks also be members? Are asset managers and corporates allowed to be members? Are the members sound counterparties? Do they provide the required degree of comfort that they will hold up their side of each trade – cash and securities? Do the rules governing membership cover the sharing of losses across all members? If loss sharing is permitted, is the basis equitable and practical? Are the other members good for the losses? Can you operate outside the central depository?

CSD guarantees

The requirement for guarantees and indemnities has become a critical feature in global and domestic custody mandates. Investors may also want to look below their immediate custodians suppliers to ask whether the central depository itself is guaranteed and, if so, who is the ultimate guarantor? This in turn raises a number of related issues. What sort of guarantees exist to support the members and their settlement through the CSD? Is the guarantee meaningful? If called upon, would the guarantee be sufficient to cover normal intra-day/overnight settlement exposures? What is the guarantee in place to support: settlement default, liquidity shortages, intra-day chaining? If guaranteed by a central bank is the sovereign risk of the country a safe bet?

Compulsory versus optional use

Not all central securities depositories are compulsory. Of the 43 operational central depositories covered in the Thomas Murray research, 29 (67%) were compulsory, and 14 (33%) were optional.

If the use of a central depository is optional then very careful consideration must be given to the benefits/shortfalls of use. If the answers to the above questions on structure and functionality are unsatisfactory, it may well suit the investor to avoid use of the depository where this is permitted. Settlement can take place outside the CSD, where DVP may well be closer to reality.

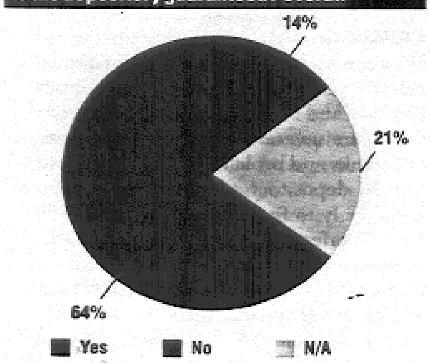
The decision to use a local CSD will invariably be determined by local market regulations. If the use of a central depository is compulsory it remains to be determined how best to do so. Access can be direct, or via a local agent which is a member of the depository. This will largely be determined by the functionality contained within each local CSD.

Implications

Understanding the services offered by each central depository is critical for investors and custodian banks in determining how best to structure their local securities services support. The need for a better understanding of the position of central depositories is driven by the fact that global custodians will not normally stand in front of central securities depositories, leaving investor assets (securities and, perhaps, cash) exposed. The investment community is on notice that it needs to understand local market infrastructure conditions and the related risks. ■

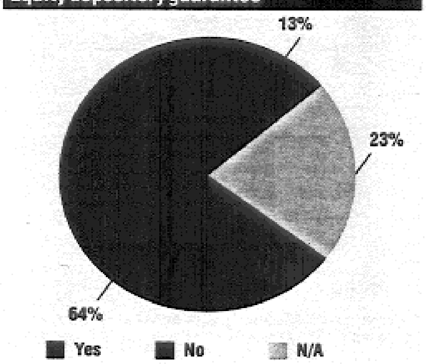
* *Worldwide Securities Market Report (1996) by Thomas Murray Ltd.*

Is the depository guaranteed? Overall



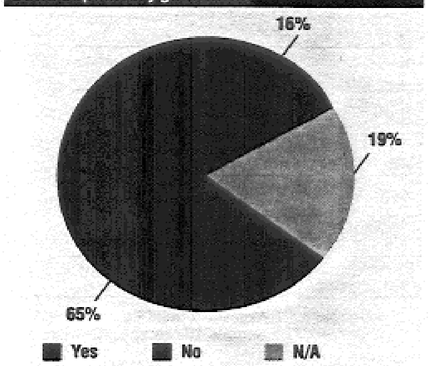
Source: Thomas Murray

Equity depository guarantee



Source: Thomas Murray

Bond depository guarantee



Source: Thomas Murray