

Global Banking

Risks in payments, clearing, settlement and custody

How risky is the securities sector? The infrastructure, payments system, clearing house, Central Securities Depository and banking/settlement arrangements in many markets place the investor at varying degrees of risk. But only a systematic review of each market can expose the underlying risks for investors and allow them to make an informed decision on how to mitigate the risks. Consultants **Thomas Murray Ltd** outline the issues.

With global securities asset pools currently valued at approximately \$45 trillion and the cross-border component of that estimated to be in the region of \$10 trillion, the need for investors to understand the market environment and infrastructure in which they invest, is now more important than ever.

Although the basic process of acquiring and disposing of an interest in a securities market is essentially the same the world over, the risks of that process are very different, market by market. The infrastructure, payments system, clearing house, Central Securities Depository and banking/settlement arrangements in many markets place the investor at varying degrees of risk and assumptions built up over years of experience in domestic markets, often dulls investors sensitivity to administrative/custody risk.

Only a systematic review of each market can remove those assumptions and expose the underlying risks for the investor to make an informed decision as to how to mitigate the risks.

Typically, the custodian network function has had the responsibility for investigating the global securities markets and legal opinions are sought prior to the global custodian entering into an agreement with a sub-custodian to open an account in the market. The depth of these reviews varies bank by bank but typically, our research has shown that the custodians do not focus much attention on infrastructure and how the sub-custodian interacts with the market infrastructure. In fact one major custodian said to us that they were "no big visitors of CSD's".

Our view is that the clients assets should not be invested in a market until a full custody risk analysis has been carried out including detailed analysis of the payment system, clearing house, CSD and agent bank.

Assessing custody risk

How safe are assets held by custodians? The more optimistic members of the custody community argue that an investor's

exposure to custody risk is now minimal because securities can be ring-fenced from the claims of creditors, and investment managers are well aware of the need to diversify cash balances. At the same time, optimists in the industry assume that any losses arising from custody operations can be covered in contract.

However, it does not pay to be too optimistic when billions of dollars of assets are involved. Not all securities can be totally ringed-fenced in all markets. Not all cash is or can be diversified at all times into highly rated entities/securities. There are risks inherent in all clearing, settlement, safekeeping and asset servicing functions, and these risks escalate (in number if not in value) as more assets are invested overseas. Furthermore, risks cannot always be covered in contract, especially when so many different agents and counterparties are involved.

Assessing the safety of CSDs and clearing houses

It is insufficient that assumptions are made as to the ownership of the CSD, the extent to which the guarantee fund is supported by government or the fact that the local Central Bank as the owner of the payment system, ensures DVP.

To assess the safety of a CSD and clearing house, a thorough analysis of each must be performed in a highly structured way. We would typically include the following areas in such a review:

- Clearing House
- Ownership
- Guarantor
- Regulation
- Participation criteria
- Clearing fund
- Margin on open positions
- Capacity of entity
- Loss sharing provisions
- Adequacy of capital support
- Access to stock loans

...continued on page 108



Global Banking

- Access to safe and efficient stock lending/borrowing service
- Integrated real-time electronic link to payment system with shared technology platform

Payment Systems

- Single payment system, Central Bank owned and operated
- Payment through central bank funds
- Electronic transfer of funds through secure systems
- Real-time processing through RTGS, continuous net settlement cycles or a combination
- Same day value on funds
- Cash movements finality within system
- Integrated real-time electronic link to CSD with shared technology platform

Agent Bank

- Solid financial structure/backing with minimum A credit rating
- Custody, a major revenue contributor; low risk of being "hived off"
- Segregation of bank and client's assets
- High S.W.I.F.T. usage, with ISITC compatibility
- Strong STP capability, with direct electronic access to CSD
- Realistic but equitable attitude to risk liability
- Flexible and efficient reporting capability
- No lien taken on client assets, bar those required to secure custody fees
- Secure, efficient IT systems, with formalised disaster recovery plans
- Bank delivers value for money

Source: Thomas Murray

Once the risks are identified we would always advocate appointing agent banks with strong credit ratings, sound balance sheets and those who are willing and able to take responsibility for losses.

Allocating responsibility for risk

A proper analysis of custody risk must take into account the different activities and participants in the investment process, including investment managers, brokers, cash payment/FX banks, global custodians, sub-custodians, and local clearing and safekeeping entities such as CSDs.

In theory, it should be possible to formally allocate responsibility for risks relating to specific custody activities to at least one of these participants. There are, of course, some risks that none of the main

participants will be willing to assume. Losses created by local market laws and practices, in particular, are likely to be left with the investor. We recommend that market side risks should be treated as investment risks, and factored into the overall investment mandate.

This type of risk analysis may sound simple, but in practice it can be almost impossibly difficult to implement. The initial problem for investors and their advisors, is that they do not have the time, skills or information to conduct such a thorough analysis of custody risk across all instruments and markets. Secondly, even if an investor can determine who is responsible for specific risks, there is still the issue of how to ensure that liability for risk is formally set out in contract with the relevant party.

Finally, assuming that investors do have warranties and indemnities in contract, what guarantee does the investor have that the relevant party can actually cover the losses. What if a local broker acting as a cash clearer or custodian for shares on its own account becomes insolvent? Will it have the capital or external support to pay its debts? Broker collapses have happened before and no doubt they will happen again.

How to minimise risk

Minimising risk in global markets is relatively simple if certain procedures are followed and the risks are properly identified in advance.

Only when the risks are properly identified, can we seek to minimise them. As a first step we must research the infrastructure thoroughly, obtain comprehensive legal opinions and understand precisely how the market works from a settlement/processing perspective. The relationship that the agent has to the market infrastructure is critical.

In at least one market if the bank appoints the CSD, no lien is exercisable over the client securities, but if the client makes the appointment, then they in effect give a lien over their assets. Market tricks such as these, while not common, should urge investors to exercise all caution.

At all times an investor must have confidence that they know where and how their cash and securities are held. Once the risks are identified we would always advocate appointing agent banks with strong credit ratings, sound balance sheets and those who are willing and able to take responsibility for losses.

Part of that process will necessarily involve securing clear and precise legal terms. The overall arrangements should be reviewed on a regular basis to ensure that market best practice has not changed and that the service being offered to the client has not become less than competitive as the market moves on.

Asset protection must be the foundation of the securities industry. Without it, all of the initiatives in the amalgamation of exchanges, proliferation of CSDs and straight through processing are like the biblical house that was constructed upon the sand.

Thomas Murray Ltd is a London-based research and consultancy service specialising in the securities market.

CUSTODY & CORRESPONDENT BANKING / GLOBAL BANKING



THOMAS MURRAY