

## Plankton put under microscope

Richard Greensted - 26 Mar 2001

### ■ Thomas Murray and Standard & Poor's have teamed up to evaluate CSDs

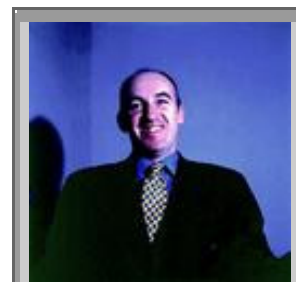
■ In the securities industry food chain, central securities depositories (CSDs) are plankton. They are the lowest of the low, market utilities that hold securities in safekeeping - either in dematerialised or immobilised form - to enable trades to be processed by means of book entry. It really is as exciting as it sounds.

Some depositories, like the UK's Crest, or the DTC in the US, are run exceptionally well and, rather curiously, have some very bright people working for them. Others are not such paragons. Whichever camp they fall into, however, until recently nobody cared too much because there was no alternative. If you want to invest in a market and there is only one depository, the use of which is often mandatory, what choice do you have?

Most sensible people believe that the use of a central securities depository is an investment risk. It is one of the factors that an investor has to assess when looking at the wisdom of putting money into a particular market. But the US's Securities and Exchange Commission disagrees and, a couple of years ago, decided that the time had come to draw up yet another rule suggesting that 'nanny knows best' and that poor, naive American investors needed to be protected from those nasty foreign depositories that wanted to steal all their money.

It didn't take the SEC long to find a suitable way of sorting this out: it would make the custodians responsible for assessing foreign depositories. If that didn't work, then investors should be encouraged to go and buy some insurance that covered them against the risk of using foreign depositories. In the all-time list of dim proposals from regulators, this would comfortably make it into the top 10.

The draft rule - 17f-7 - achieved the rare distinction of uniting US fund managers and global custodians, both of which used their considerable lobbying skills to ensure that the final version of the rule differed quite markedly from the initial dog's dinner.



Some custodians have signed up with Thomas Murray, where Derek Duggan is a director



The point of the rule was not entirely lost, however. Investors started to think more deeply about the risks of using CSDs and custodians began to wonder whether they should also take them more seriously. Typically, many custodians had claimed that they were already conducting comprehensive analysis of CSDs before 17f-7, but this normally meant no more than checking that the address was correct and taking the chief executive out for lunch once a year.

The obvious question was this: why should each custodian individually assess each of the world's functioning depositories (thought to number around 135)? Surely there was an easier way to do what was necessary and still provide better information to clients?

The answer, for some at least, has been to sign up with Thomas Murray, the securities industry consultant, for their depository review and risk evaluation service, run in partnership with Standard & Poor's.

So far, eight banks - ABN Amro, The Bank of New York, BNP Paribas, Citibank, HSBC, Mellon, SE Banken and State Street - have become 'support banks', collating and validating data used by Thomas Murray/S&P to produce the assessments.

Last month, the first report was issued. Understandably, it covered the very boring Canadian Depository for Securities, rather than some meatier and considerably more controversial CSD, but that will come in time. Each review will assess six distinct depository risks:

- Asset commitment risk - the risk associated with the period of time from which use of securities or cash is given up before receipt of the countervalue;
- Counterparty risk - the risk that a counterparty will fail to settle its obligations for full value at any time, and the risk that such a failure will trigger a chain reaction;
- CSD on CSD credit risk - when a CSD links with a peer group CSD, the credit risks that host and inward CSDs are taking;
- Financial risk - the ability of the CSD to operate as an ongoing concern;
- Liquidity risk - the risk that insufficient securities and/or funds are available to meet commitments on their due date;
- Operational risk - the risk that deficiencies in information systems or internal controls, human error or management failure will result in unexpected losses.



Thomas Murray/S&P are keen to stress there will be no rankings, only assessments. They claim, with some justification, that the reviews are written from a local perspective and are not comparable across markets, so they will not be handing out Depository of the Year awards or other suitably asinine gongs (although it must have been tempting to cash in on the fashion for dishing out meaningless titles so that everyone can claim to have won something).

There is another Thomas Murray/S&P project, however, that will result in comparative analysis - Custody Ratings. These assess the operational performance of global and local custodians, looking at their business credentials and service capabilities, as well as the quality and effectiveness of their operational infrastructure, and their willingness and ability to protect their clients from operational losses.

Custodians that submit to these reviews - for which they will have to pay in the same way as an issuer paying for a credit rating - will be given service quality evaluations and will be ranked according to peer group comparisons.

While the big global custodians are unlikely to want or need such validation, there are many smaller players that will be interested in getting an independent rating.

Equally, we all know that there are plenty of truly dreadful custodians for whom such an assessment would prove the kiss of death. Perhaps Thomas Murray/S&P could be persuaded to do some pro bono work to put these perennial laggards, and their unfortunate clients, out of their misery.

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