EXECUTIVE SUMMARY

A. Background

Well-functioning settlement systems are a prerequisite for efficient securities markets. The lack of a secure and efficient settlement system operating at a reasonable cost with good risk management mechanisms can significantly affect investors' confidence in a market and hence can hinder the development of that market, both in terms of volume and quality. Therefore the Foreign Exchange Transactions and Settlement Issues Working Group of the Association of Southeast Asian Nations plus the People's Republic of China, Japan, and the Republic of Korea (ASEAN+3) requested the Asian Development Bank (ADB) to help identify options and make recommendations for effectively accelerating the linkage of domestic settlement and payment systems to facilitate enhanced cross-border investment.

B. Methodology

The project team initially undertook a review of the existing settlement systems in the ASEAN+3 region; examined existing links between settlement systems in the region and internationally; and identified the different types of cross-border settlements available, the advantages and disadvantages of the various options, the hurdles faced in establishing effective regional settlements, and the risks involved in cross-border settlements. The team also reviewed developments in Europe in terms of links and mergers of national and international securities depositories and developed initial proposals for overcoming the hurdles that were then discussed with market participants through consultations in Hong Kong, Singapore, and Tokyo. The team also identified areas that need improvement in the settlement infrastructures of some member countries. Some market participants emphasized the need for improvement in regional infrastructure. This is in line with the stance of the members of the team.

C. Existing Settlement Systems and Links

Bond markets in the region are at very different stages of development, and although no formal data are available on the volume or value of cross-border trading in bonds, anecdotal data indicate that it is very small. Settlement systems are national, i.e., each country has its own settlement arrangements for different types of instruments, and participation in these systems is generally limited to locally regulated participants. Although there are exceptions, as a general rule, government (and quasi-government) bills, bonds, and notes are traded over the counter between banks (inter-bank market) and settled through settlement systems operated by the central bank. These systems do not provide a guarantee, i.e., they are not linked with a clearing company or a central counterparty, but they do have a link for payment into real-time gross settlement systems (RTGS) where these exist. Corporate bonds are generally listed and traded on the national stock exchange and settled through the central clearing and depository systems associated with that exchange. Many of the central securities depositories (CSDs) are linked with the international CSDs (ICSDs). This is more to enable international market participants to trade and settle local government bonds than it is to facilitate local market participants trading and settling international bonds.

Within the region, there are currently only very few links and those that do exist are very seldom used. In Europe, links were originally developed between the two ICSDs and national markets to facilitate the settlement of highly liquid government bonds between European based banks. This type of link was extended to enable Asian and other governments, multinational agencies, and large companies to issue bonds into the international market. Links were also developed to support cross-border trading in equities. These links, however, were not able to reduce the costs of cross-border settlements to make them equivalent to domestic settlement costs. This and the risks involved in the time delays caused by different settlement cycles have driven the development of multinational CSDs through mergers between national CSDs and the (agreed) acquisition of one CSD by another.

D. Advantages and Disadvantages of Existing Settlement Arrangements

The cross-border settlement options that are used by market participants are not mutually exclusive and investors will usually use a range of options. The mechanisms in use are (i) direct access where a participant in one market gains direct access to the settlement systems in another market, (ii) local agent where an investor uses a local custodian, (iii) global agent where an investor appoints a global custodian (GC) to settle business in some or all overseas markets, (iv) ICSD, (v) links between national CSDs, and (vi) multinational CSD where a depository settles for a number of national markets so that cross-border transactions within those markets are settled in the same way and at the same cost as domestic transactions and where the multinational CSD also acts as an ICSD for cross-border links outside the national markets.

The drawbacks to using a local agent or a GC are several. The market participant (i) incurs counterparty risk, (ii) bears the cost of employing the agent, and (iii) may have difficulty employing a reputable agent if the entity wishing to undertake cross-border settlement is small or deals infrequently.

It is very difficult to compare the costs of different settlement methods as the services offered by a GC are very different from the services offered by a national CSD. Analyzing the cost that GCs charge Japanese investors, for example, turned out to be quite difficult. It is also difficult to compare costs across the region. This is consistent with experience in Europe. A European Union 2001 report[1] stated, "It is very difficult, if not impossible, to compare settlement fees, as they vary according to market, instrument, mode of payment" and, "Moving securities from one system to another will necessarily be more expensive than staying within one system." Although the current trend is for a reduction in the fees charged by GCs, there may also be concentration risk as the number of custodians offering services is decreasing. This may ultimately lead to increased costs.

[1] The Securities Settlement Industry in the EU. Structure, Costs and the Way Forward. Karel Lannoo and Mattias Levin. Published by the Centre for European Policy Studies – December 2001.

The hurdles to using an ICSD are very similar. However, for investors in Asia, the time difference between Europe and Asia puts them at a disadvantage in terms of ensuring that securities and cash are in place for settlement.

The drawbacks to using the direct access model or settling through linked CSDs (or a multinational CSD if one were to be available in Asia) are the following.

(i) legal and regulatory including (a) regulations that may prevent overseas investors or overseas CSDs from direct participation, (b) lack of certainty regarding finality of payment which may prevent CSDs from implementing delivery versus payment (DvP), (c) disclosure relating to beneficial ownership may be difficult for overseas investors, (d) different tax rules and reclaiming procedures, (e) foreign exchange controls and monitoring that either prevent investment or prevent repatriation of profits and/or principal, and (f) different legal agreements (for either direct access or between different CSDs) may result in legal expenses and/or legal uncertainty;

(ii) technical, i.e., each CSD has its own technical standards for communications between itself and its participants that must be complied with, and in addition, each CSD may have a proprietary network which does not extend overseas and the lack of straight through processing (STP) requires re-keying which is expensive and increases the level of risk;

(iii) market practice including settlement dates, types of instructions (formats), cut-off times for instructions, DvP methodology (RTGS or commercial bank money) and access requirements for custodians;

(iv) risk the most important of which is Herstatt risk (or foreign exchange settlement risk).

E. Market Consultation

All of the market participants that we consulted individually expressed considerable optimism for the development of domestic debt markets in Asia. In general, they took the view that an emerging requirement for a long-term secure investment would support such a development. However, none of these market participants believed that the current settlement arrangements were a significant impediment to the development of a regional bond market although there were still many areas where improvements could be made. The key issues for further development of a regional bond market that are not connected with settlement issues but that were identified by the market participants are (i) price transparency; (ii) a credible yield curve; (iii) the development of repo and securities lending markets; (iv) regularity, consistency, and transparency of issuing procedures for government bonds; and (v) more information about all aspects of the market.

In terms of settlement systems, all of the participants believed that compliance with international standards and convergence of market practice across the region is important. They stressed however, that it was important that market practitioners were actively involved in any developments or recommended developments to ensure that priority areas were addressed in an appropriate manner. They therefore, in general, supported the recommendations for a detailed review of individual markets to see how they conformed to international standards particularly in the areas of (i) legal certainty; (ii) DvP; and (iii) support for repos and lending securities (including legal certainty in terms of tax treatment).

When the team discussed with market participants the reasons why existing links were not heavily used they gave two basic reasons. First, a local presence was important for dealing face-to-face with regulators and other market participants in the overseas market and for first-hand knowledge of market practice. Second, the links did not cover all securities that could be settled in the local market, and if a single security or security type could not be settled through the link, they needed a local agent. Once a local agent was appointed, it was cost effective to use that local agent.

The need for a new regional CSD that would hold regional securities and settle them in local currencies was also discussed. Whilst many of the interviewees said that the development of such a body would be helpful, they all saw many difficulties. These included (i) under what regulatory authority would the CSD operate; (ii) how could it be operated at a cost that would be lower than the fees they currently experience; (iii) could it gain commitment from all markets for all securities (including government securities) because if this was not possible, the participants would need to retain local agents and thus would not generally use the centralized system; (iv) would it be able to link to all RTGS payment systems; and (v) would it be able to link efficiently to the existing ICSDs, a key requirement of the international banks that are active in both domestic and international bond markets?

In general the private sector participants did not think that the private sector would be interested in developing a regional facility solely for bonds as there was not enough volume to make it financially viable. They also thought that the time was not right for the public sector to make a significant commitment to such a facility. The market participants did not express any support for the development of a regional secure network.

F. Recommendations

Transparency

One key request from the market participants was for transparency, in terms of pricing and in terms of market infrastructure. In many cases the information on the websites maintained by national institutions concentrates on equities (or does not clearly identify whether corporate and/or government bonds are included in the description). The team therefore recommends that the information we have documented in this report concerning the national settlement systems be uploaded onto the AsianBondsOnline website (http://www.asianbondsonline.adb.org.) if countries agree on a voluntary basis to update the information whenever necessary. It would also be helpful for each government to request the relevant settlement organization to increase the level of detail that is available within their settlement infrastructures.

International Standards

There have been many recommendations published that set out international standards for the settlement of securities. From the public sector, the Committee on Payment and Settlement

Systems and the Technical Committee of the International Organization of Securities Commission made recommendations in November 2001. Private sector groups, such as the International Securities Services Association, the Group of Thirty, and the Giovannini Group also proposed recommendations or actions that should be taken. Operators of clearing and settlement systems should therefore be encouraged to conduct and disclose results of self-assessments to ascertain their level of compliance against international standards.

Private sector recommendations have concentrated on the European markets. It would be helpful for a detailed review to be undertaken for Asia on the extent to which each market in the region complies with international standards. If appropriate, this study could collaborate with or use existing work by other regional fora like the Executives' Meeting of the East Asia Pacific Central Bank or ASEAN. Private sector consultation should be an integral part of the study to ensure that the assessment of each market is based not only on a theoretical international standard but also that the standards can be applied from the viewpoint of market participants. Where a market does not fully meet the standard, the report should identify the steps needed to achieve compliance and who should take those steps. This should be an interactive process between officials and regulators. Once again, the private sector should be consulted to determine the importance of such a step for the development of a regional bond market.

Regional Cooperation

To ensure that market participants and investors have a choice of settlement methodologies, the same study should identify any laws, regulations, or rules that impede either direct remote access or links and mergers between national depositories. Each market will then be able to compare itself with other markets in the region and, if appropriate, take steps to remove impediments. It would be very helpful if ASEAN+3 governments endorsed the findings of the study and cooperated with the private sector to take whatever actions are necessary to improve their respective clearing and settlement systems.

Further Study on Risk Reduction

During meetings and interviews, several market participants supported the idea of a regional settlement intermediary to mitigate various risks and to reduce the operational burden to which they are currently exposed. To assess the viability of such a proposal will require further discussion and analysis beyond the scope of this study on the functions and the roles of such an intermediary. An analysis of the effectiveness of such a regional settlement intermediary would be useful. For example, a regional settlement intermediary that facilitated true multicurrency DvP by links with the RTGS payment systems in the economies could theoretically reduce foreign exchange settlement risks.

A regional intermediary that handles the settlement of bond issues in a common unit will be needed in the future. The study into the development of a regional settlement intermediary should look into the feasibility of including such a function.