Securities Clearing and Settlement Systems and Long Term Local Currency Bond Markets

Trends and lessons learned

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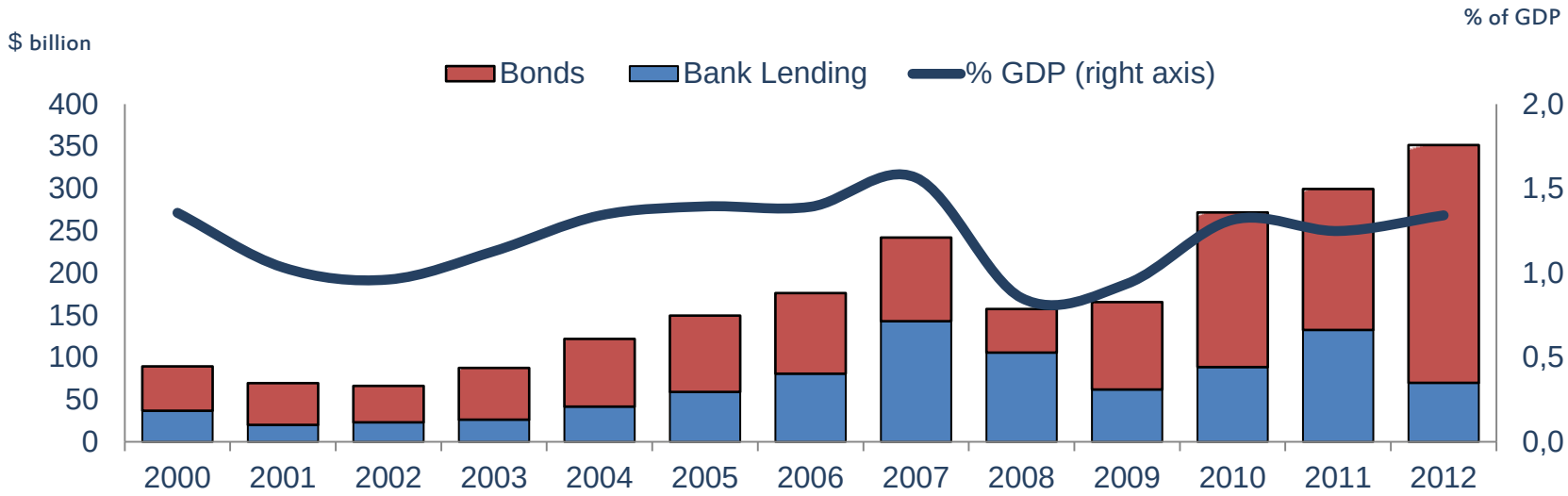
After the crisis: a changing landscape in LT financing

- Direct bank lending, a traditional source of infrastructure financing, has declined across all EMEs versus historic highs in bond market inflows

Figure 1. International Long-Term private debt to Developing Countries

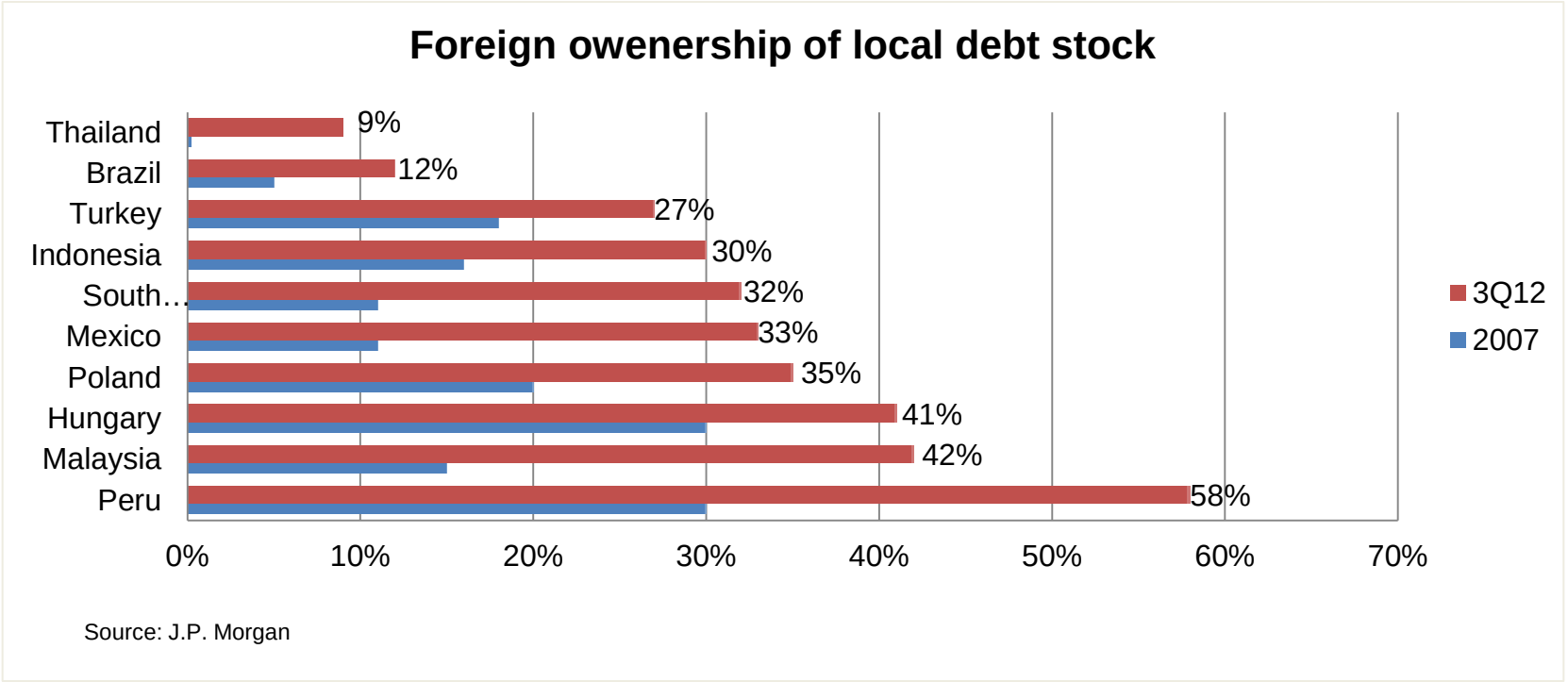


Source: Dealogic and The World Bank

The G20 agenda and the role of LCBMs for long-term financing

- Several sources of LT financing have potential to play a greater role:
  - Local Currency Bond Markets (LCBMs) and domestic capital markets
  - Foreign institutional investors accessing the bond market

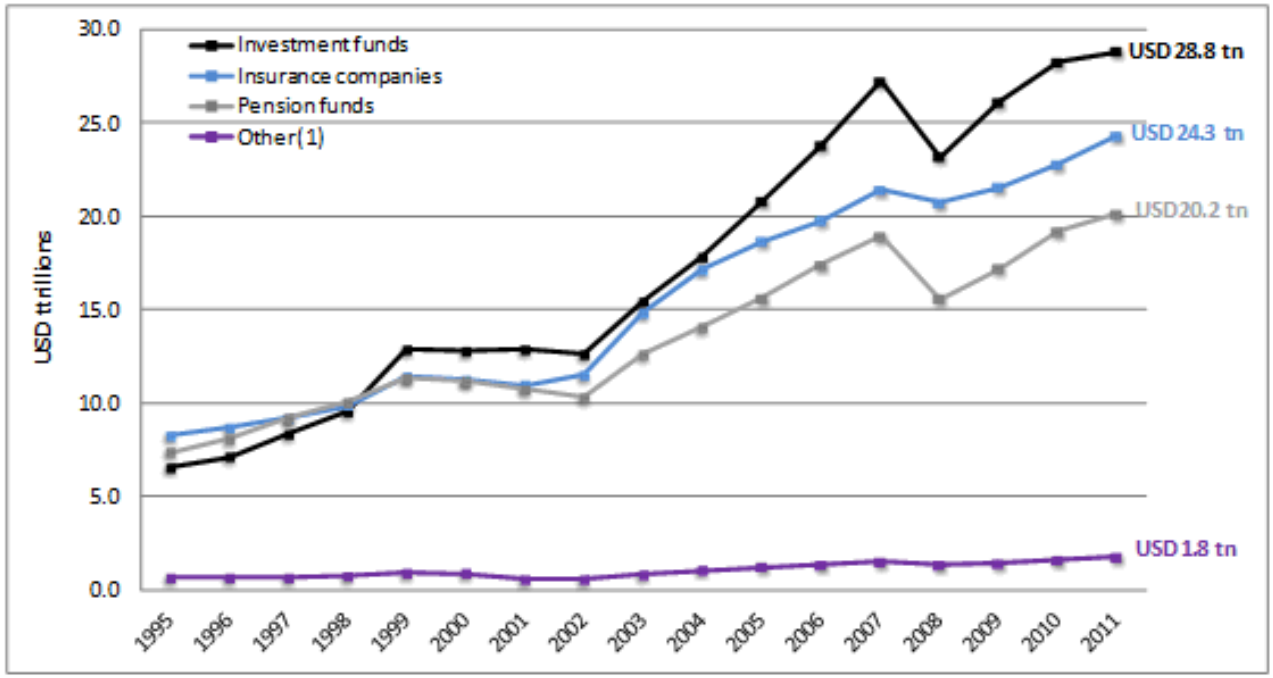
Increased Foreign Interest in LCBMs



Source: J.P. Morgan

Institutional investors potential for LT finance

Figure 6. Growth in OECD institutional investor assets under management (AuM), 2011



Source: OECD Global Pension Statistics, Global Insurance Statistics and Institutional Investors databases, and OECD estimates.

Note: This chart was prepared with data available on 18 December 2012. Book reserves are not included in this chart. Pension funds and insurance companies' assets include assets invested in mutual funds, which may be also counted in investment funds. (1) Other forms of institutional savings include foundations and endowment funds, non-pension fund money managed by banks, private investment partnership and other forms of institutional investors.

Clearing and Settlement Infrastructure and long-term LCBMs

- Lengthening the LCMB yield curve and stabilizing LT foreign investments are still challenges in EMEs

- Efficient C&S systems are essential to lengthen maturities in bond market yield curves as they:
  - Mitigate risk and lower costs in domestic capital markets
  - Facilitate trading and liquidity in long-term maturities
  - Support efficient repo markets as transmission chain between short and long term rates
  - Provide connectivity with global markets and access by international investors

Clearing and settlement infrastructure to support safety and efficiency of financial markets

- Sound CSDs and SSSs are essential for financial system stability & development
  - ✓ If not properly managed, potential source of contagion especially in market stress
  - ✓ Payment and clearing systems depend on SSS for use of securities as collateral
  - ✓ Market liquidity depends on confidence in safety and reliability of SSS
- Safe CSDs and SSSs mitigate risks in financial market
  - ✓ Firewall to prevent contagion of losses from one participant to the other
- Efficient CSDs and SSSs may lead to significant savings
  - ✓ Centralization of settlement and depository reduces cost if governance is adequate
- CSDs and SSSs are important in developing more inclusive financial systems
  - ✓ Use of deposited securities as collateral
  - ✓ Cash settlement preferable in RTGS mode, also for corporate securities
- A CCP interposes itself between counterparties to contracts traded in financial markets
  - ✓ Effective risk controls on participants (e.g., collateral to cover current and potential exposures)
  - ✓ A CCP that has adequate financial resources and sound risk management contributes to reducing systemic risk in the market it serves

Lessons from the crisis

In general, SSS functioned well and supported the liquidity and stability of financial markets

<u>However, the following areas for improvement were identified:</u>

- ‼ Discrepancies in interpretation of cross-border legislation caused information asymmetry, confusion and waste of time
- ‼ Default management procedures proved to be sometimes cumbersome to implement
- ‼ Accounts of investors not necessarily segregated, making it difficult to transfer client positions
- ‼ Access criteria for participants to be enhanced and monitored regularly
- ‼ Lack of cooperation between authorities, domestically and internationally
- ‼ Liquidity management to be enhanced
- ‼ Need for stronger FMI governance
- ‼ OTC markets can create systemic risk. Need for mandatory clearing and reporting of OTC derivatives

Post-crisis actions and World Bank role

September 2009 G20 Pittsburgh Summit Declaration
All standardized OTC derivative contracts should be traded on exchanges/electronic trading platforms, where appropriate, and cleared through CCPs **by end-2012 at the latest.** OTC derivative contracts should be reported to TRs. Between 2009 and 2012, use CCPs and TRs for interest rate derivatives and credit derivatives has "notably increased…particularly by the G15 dealers". However, no jurisdiction had fully implemented the G20 requirements by end 2012

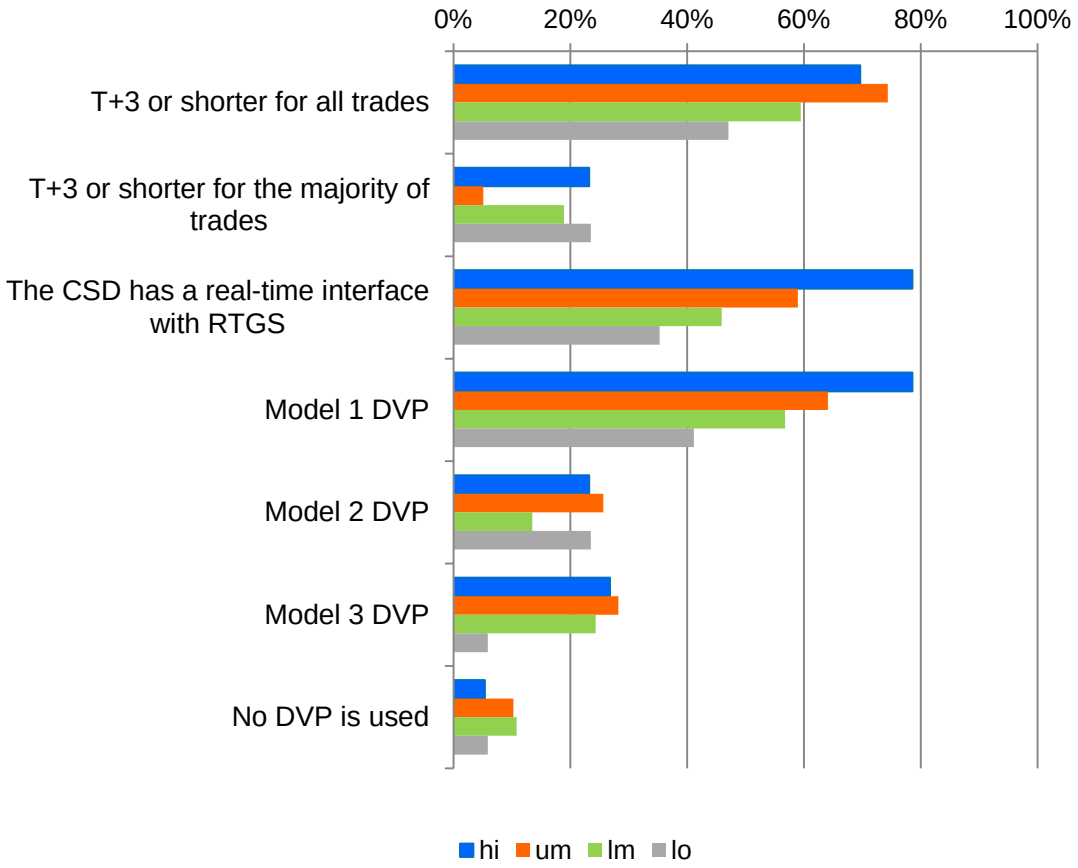
2012 CPSS-IOSCO Principles for Financial Market Infrastructures
These replace the 2001 and 2004 set of standards, while "raising the bar" in terms of risk management, governance, and transparency to take into account the lessons from the crisis. **Strong World Bank involvement** and leadership in production of assessment methodology and monitoring observance at the country level through FSAP and other TA projects. Jurisdictions around the world currently in the process of implementing the PFMIs

Securities clearing and settlement systems worldwide: main features*

- Securities market are at a nascent stage in at least 35 countries worldwide, mainly located in SSA and ECA regions, mostly low-income and lower-middle income countries
- Dematerialization of securities significantly reduces the total costs associated with securities settlements and custody and contributes to eliminating the risk of destruction or theft of certificates. Securities dematerialization (or immobilization) at CSDs largely accomplished (70% of countries surveyed or more, increasing), with SSA showing the lowest levels while LAC and EAP making big strides
- Different CSD models coexist, with no conclusive best practice, rather regional preferences. Many developing countries have one CSD for *government securities* (usually central bank-operated) and one CSD for *corporate securities* (usually private sector-owned). 66% of CSDs surveyed settle not only stock exchange transactions, but also OTC (although this is especially true in higher income countries)
- Only a minority of countries (34%, mostly high and upper-middle income countries) has a CCP due to high cost associated with establishing adequate risk-management framework
- In 47% of the countries the security regulator shares oversight responsibilities with the central bank. At the worldwide level, self-regulatory powers for stock exchanges, CSDs and CCPs are still not very common (23%, 12%, and 8%). EAP and LAC most frequently provide FMIs with self-regulatory powers, SSA does not use this model at all

*Based on 2010 WB Global Payment Systems Survey

Risk management in securities clearing and settlement systems: from principles to practice (1) – SSS risk management challenges*



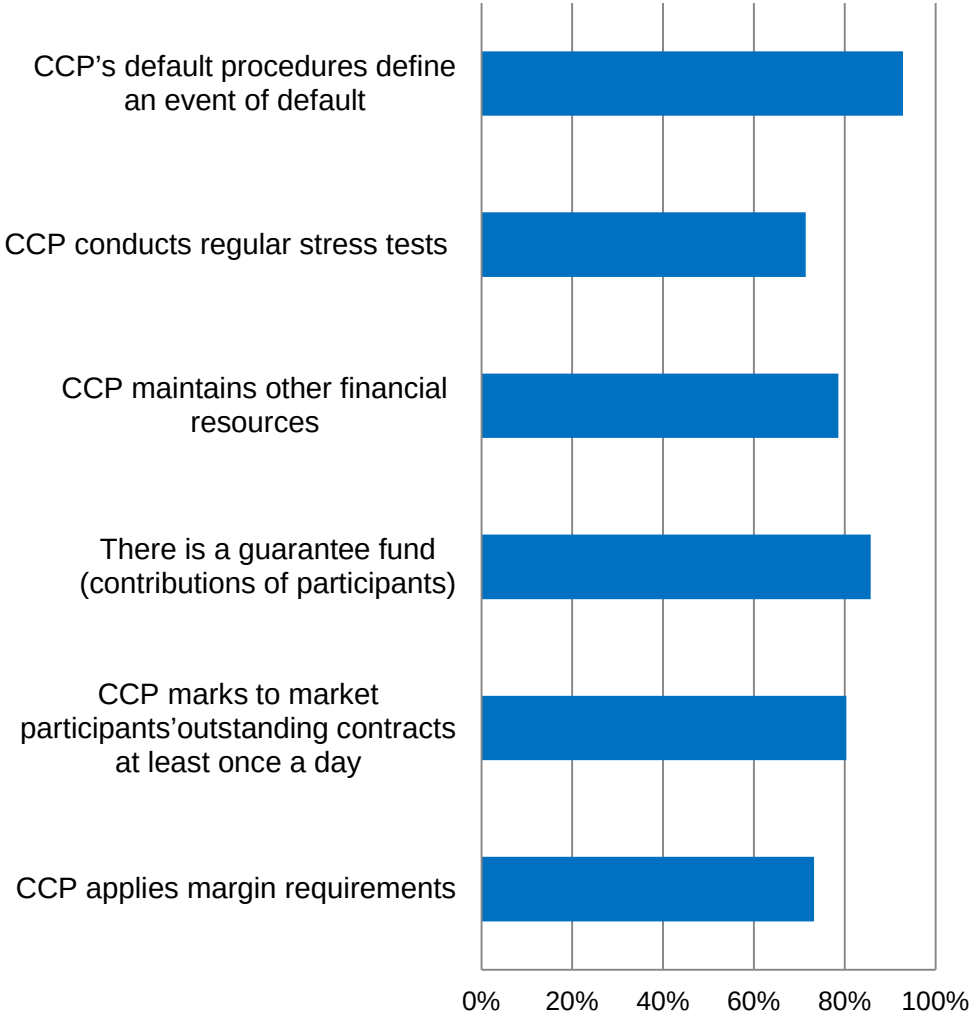
- **Further work needed on elimination of principal risk.** While most systems have implemented a delivery versus payment (DvP) model to settle securities and cash obligations of participants, in many cases there is no “true” DvP (e.g. lack of effective guarantees when model 2 or model 3 DvP are used)
- **Make better use of central bank money /services for money settlements,** especially in SA and EAP. Where this is not possible, minimize and strictly control the credit and liquidity risk arising from use of commercial bank money

Also…

‼ Legal risk still not properly addressed in all regions and increasingly complex due to global markets, cross-border links

*Based on 2010 WB Global Payment Systems Survey

Risk management in securities clearing and settlement systems: from principles to practice (2) – CCP risk management challenges*



- **Risk management measures are clearly less thorough in emerging countries**. Weakest frameworks were reported in lower income countries, and in ECA and SA. **New standards have raised the bar:**
  - CCP to maintain financial resources to cover a wide range of stress scenarios, including default of participant with largest credit exposure (cover 1)
  - CCP WITH MORE-COMPLEX RISK PROFILE OR SYSTEMICALLY IMPORTANT IN MORE THAN ONE JURISDICTION to maintain financial resources to cover a wide range of stress scenarios, including default of TWO participants with largest credit exposures (cover 2)
- **More rigorous stress testing needed to comply with principles**, including: daily stress testing of total available resources, monthly analysis of scenarios, models, parameters and assumptions, annual full model validation

*Based on 2010 WB Global Payment Systems Survey

Thank you

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