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Third Party Clearing in Asia

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Good morning ladies and gentlemen. What I'd like to do in the next half-hour is to outline the role that third party clearing can play – and already is playing in many markets - in supporting the integrity and stability of the market infrastructure and in providing new efficiencies for market participants. The important message is that, by concentrating clearing and settlement risk into the hands of the soundest, best capitalised financial institutions, third party clearing materially reduces that risk and allows regulators to welcome a broader constituency of market participants to operate as exchange members – with consequent benefits for market liquidity. It is, I would suggest, a win/win situation for regulators and market participants alike.

The slide features the Citigroup logo in the top right corner. The title 'Third Party Clearing in Asia' is written in orange text. Below the title, the question 'What is Third Party Clearing?' is posed in blue. A bulleted list follows, detailing clearing roles in four regions: USA (Correspondent Clearing), Europe (General Clearing Member (GCM)), Hong Kong (General Clearing Participant (GCP)), and Japan (Agency Clearing Participant (ACP)). A small number '2' is visible in the bottom right corner of the slide frame.

Third Party Clearing in Asia

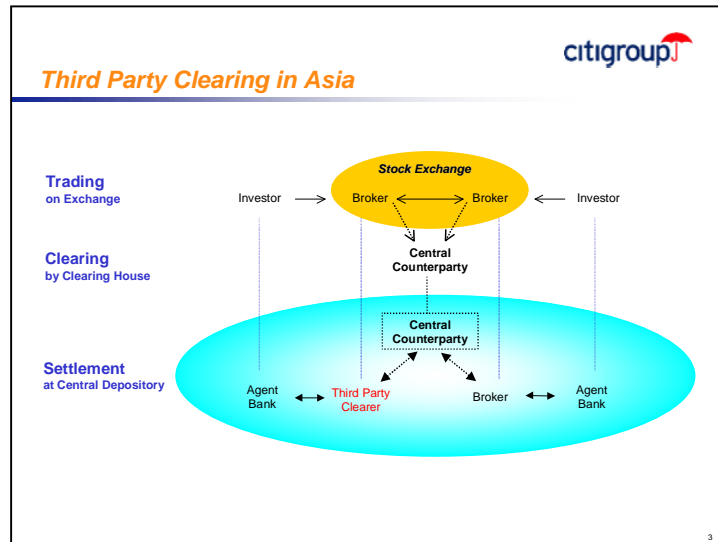
What is Third Party Clearing?

- » USA: Correspondent Clearing
- » Europe: General Clearing Member (GCM)
- » Hong Kong: General Clearing Participant (GCP)
- » Japan: Agency Clearing Participant (ACP)

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Let us first define what we're talking about. What is third party clearing?

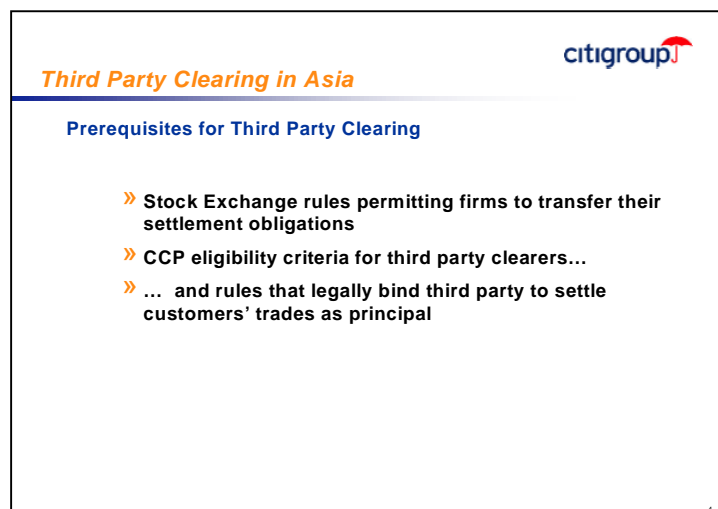
Well, just to confuse, it is the same thing that Americans call correspondent clearing and Europeans call general clearing member, or GCM, services. I apologise in advance for the fact that talking about this business inevitably plunges you into an alphabet soup of three-letter acronyms – GCM in Europe, GCP in Hong Kong, ACP in Japan – all of which basically mean the same thing, a third-party clearer.



Anyway, in this part of the world we most definitely call it third party clearing. And we mean by that an arrangement whereby an exchange member firm – a broker/dealer – transfers the obligation to clear and settle its trades to a third party, usually a custodian bank. And in the classic third party clearing arrangement, ‘obligation’ means just that: the full legal obligation to complete the settlement process even if the broker/dealer in question goes bust in the period between trade execution and final settlement.

Third party clearing is now a common feature of those markets that boast a central counterparty, or CCP. CCPs and third party clearing originated in the exchange-traded futures markets, primarily because there could be a long period between trade date and settlement date and the exchanges needed a mechanism to help members manage the resultant counterparty risk. CCPs and third party clearing were then progressively adopted by the world’s equity markets.

There are certain prerequisites for third party clearing.



First, there needs to be in place a legal and regulatory framework to accommodate it. Stock exchange rules must be in place that allow member firms to transfer their settlement obligations to a third party. Where there is a CCP, the clearing house will put in place eligibility criteria that ensure only the soundest institutions can qualify as

providers of third party clearing services. It will also adopt rules that impose a legally binding obligation on third party clearers to settle their customers' trades as principal with the CCP.

The relationship and service fees agreed between the third party clearer and the broker/dealer are individually negotiated to permit the third party clearer to manage the credit exposure it is taking on. The level of compensation will reflect the risk undertaken. The relationship, however, extends beyond credit provision. It also involves the third party clearer undertaking all systems and operational work for the client, such as data transmission to both the exchange and the clearing house, posting of margin, reconciliation, maintaining the system, providing reports, etc, etc.

What are the benefits of third party clearing? Let us first answer that from the point of view of a stock exchange.

Third Party Clearing in Asia


Benefits of Third Party Clearing

- » **For the Exchange**
 - › Underpins stability and financial integrity of market
 - › Permits broadening of the membership
 - › Makes for more liquid market

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As we have seen, third party clearing involves the transfer of obligations from exchange member firms to, in most instances, a large custodian bank. By its very nature, that process underpins the stability and financial integrity of the market because many of the member firms involved will be relatively small players. Third party clearing allows them to partner with larger firms that have greater financial strength, more robust technology and operations capabilities, more specialised staff, and state-of-the-art back-up sites.

The implications for an exchange are that it can admit firms with a smaller capital base - provided they partner with a third party clearer. You can invite more people to the table. The result is a broader, deeper and more liquid market, but one that has sacrificed nothing in the way of integrity and security.



Third Party Clearing in Asia


Benefits of Third Party Clearing

- » **For a Clearing House/CCP**
 - › Can set higher capital requirements/lower exposure

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From the point of view of a clearing house, the benefits are more direct still. With third party clearing in place, a CCP is able to increase the minimum capital requirements set for membership and thereby lower its exposure. Exchange members that do not meet the CCP's financial criteria can still participate in the market by using a third party clearer. And that third party clearer will, normally, be a big, well capitalised bank for whom the business of extending credit and managing credit risk is a core activity.

For broker/dealers and other exchange members, the transfer of operational work to a third party clearer achieves a number of objectives:



Third Party Clearing in Asia

Benefits of Third Party Clearing

- » **For broker/dealers**
 - › Boost to operational efficiency/access to scale economies
 - › Swaps fixed costs for variable costs
 - › Better credit facilities
 - › One-stop access to multiple markets
 - › Ability to focus on money-making activities

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First, it provides a big boost to operational efficiency. That comes in a number of ways. Instead of having to maintain staffing at a level to cope with volume peaks, the firm shifts the entire burden to its third party clearer. And because it gets access to the scale economies of a large processing platform it enjoys attractive pricing. It swaps high fixed costs for variable costs.

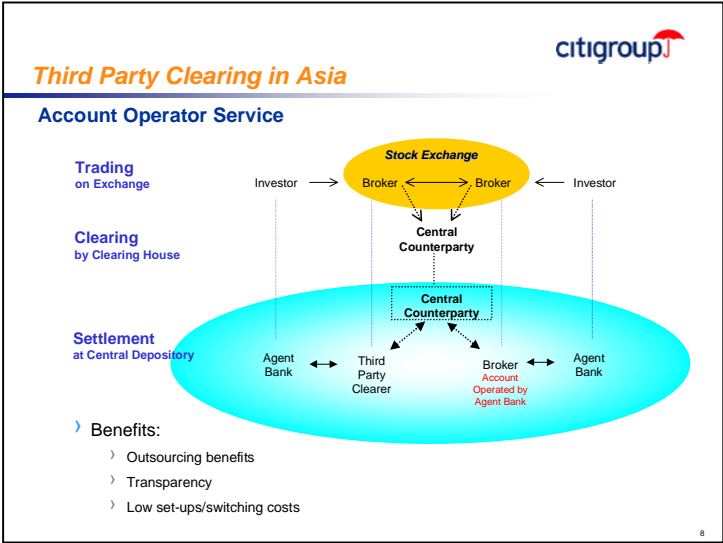
In addition, if it uses the same bank to act both as its third party clearer and settlement agent, it will generally receive better credit facilities and beneficial funding rates to cover overnight liquidity requirements. It will also be able to shed cumbersome back office

functions such as corporate actions, dividend claims, tax reclaims and so on. A broker/dealer that is active in multiple markets will also be able to streamline its operations by using a single, multi-market agent bank that will be a member of all the different CCPs and which will shield it from the different practices that apply in different markets – and from the need to keep up with the connectivity and systems upgrade requirements of many different infrastructures.

But there is one other big spin-off. Outsourcing allows firm to focus on its key competences, such as research, trading and investor servicing. Management time can be directed at money-making activities rather than being tied up in issues of after-trade processing. This is a particularly important issue for smaller firms.

In some countries, third party clearers are able to offer their clients a choice of services. Larger, more financially robust broker/dealers may not need, or want, a third party clearer to take over the legal obligation for clearing their trades. Why should they pay for something they don't need? However, they may still want to access the scale economies that come from outsourcing operations to a leading agent bank.

In this situation, the agent bank provides an 'account operator' service in which it contracts to settle for the client firm as an agent and not as a principal.



While the client firm remains a clearing member of the clearing house in its own right – and continues to own the accounts in question and all the legal obligations that go with them – the agent bank operates the accounts on its behalf.

The primary benefit to the broker/dealer derives from the use of the agent's systems, specialised staff and superior purchasing power at lower rates. The arrangement is completely transparent as far as the market and the firm's clients are concerned. Set-up costs are low – as are the cost of switching to another service providers or reverting to self-clearing. It is important to note that the account operator arrangement does not need to be limited to markets with third party clearing. We believe that firms should have the opportunity to choose the level of service they require from a third party clearer – and not be shoe-horned into a one-size-fits-all solution.

Let us now look at what is happening on the ground – particularly in local markets.




Third Party Clearing in Asia

Third Party Clearing in Asia

- » **Full Third Party Clearing/Account Operator Services:**
 - › Australia, Japan, Singapore
- » **Account Operator Services only:**
 - › Indonesia, The Philippines, Thailand
- » **Third Party Clearing only:**
 - › Hong Kong

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Third party clearing is becoming increasingly accepted in Asia. It is now possible in one form or the other in six countries – Australia, Japan, Singapore, Indonesia, the Philippines and Thailand. In the first three, broker/dealers have the choice of taking either the account operator service or moving to full third party clearing. A seventh country, Hong Kong, is about to join the list – but, in contrast to most other markets in Asia, it is starting by permitting full third party clearing but not account operator services.



Third Party Clearing in Asia

Third Party Clearing in Hong Kong

- » **Two types of Clearing Participants:**
 - › GCP – General Clearing Participants (Third Party Clearer)
 - › DCP – Direct Clearing Participant (Self Clearer)
- » **In addition:**
 - › NCP – Non-Clearing Participant (customer of Third Party Clearer)

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The operating model that is now being finalised in Hong Kong will create two types of clearing participants at CCASS - the Central Clearing and Settlement System:

A general clearing participant, or GCP: The GCP will be a clearing house member authorised to take on the post-execution settlement of exchange member firms – in other words, a third party clearer;


The second category will be direct clearing participants, or DCPs. They will continue to clear and settle their own trades but retain the same rights and obligations as current CCASS broker participants.

Firms that choose to outsource their clearing to a GCP will be categorised as NCPs – or non-clearing participants.

The model imposes a number of requirements on GCPs, which will take on their clients' clearing and settlement obligations from the moment a trade has been matched on the exchange. They are required to maintain a minimum paid-up capital of 100 million Hong Kong dollars - which is in line with the capital requirement for existing clearing participants.

By contrast, non-clearing participants will face no funding requirements. According to the exchange's calculations, they will be able free up as much as 30 million Hong Kong dollars of capital by using a third party clearer.

The introduction of third party clearing will reduce the number of clearing participants.

Third Party Clearing in Asia 

Third Party Clearing in Japan

- » **Two CCPs:**
 - › Japan Securities Clearing Corporation (JSCC)
 - › JASDEC DVP Clearing Corporation (JDCC) – May 2004
- » **Agency Clearing Participants (ACPs) - Third Party Clearers**

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As such, it should improve netting efficiency, lower settlement risk and produce cost savings for both GCPs and non-clearing participants.

Major changes are afoot elsewhere in Asia, too. Japan has already introduced a CCP for on-exchange transactions – the Japan Securities Clearing Corporation, or JSCC. A second one, for off-exchange transactions such as offshore and cross-border trades, will open in May next year. This is the JASDEC DVP Clearing Corporation, or JDCC.

Currently, most major participants in the Japanese market continue to self-clear. This is partly because physical settlement of certificates will co-exist with book-entry settlement at the central depository until 2009 and partly because investors merely accept fails. There remains a strong incentive for broker/dealers to keep settlements in-house so they can prioritise settlement for their platinum customers.

However, the clearing environment is changing dramatically. The JSCC started operations in January this year and acts as the single clearing house for the six local stock exchanges. There is now a distinction between trading membership at each exchange and clearing membership at the JSCC.

The Securities and Exchange Law has also been amended to allow banks (in addition to broker/dealers) to become participants of JSCC or JDCC in the form of agency clearing participants, or 'ACPs', and provide third party clearing services.

While ACPs in the JDCC will be able to monitor and control instructions, those in the JSCC are required to enter into an agency clearing agreement with the client firm that exposes them to a variety of credit and operational risks. As in other markets, some providers may prefer to offer only an account operator service to manage their customers' account at JASDEC. Citigroup, by contrast, is committed to this business and is a member of the major clearing houses around the world, offering as much choice to its customers as local rules will permit.

The Tokyo Stock Exchange is currently examining ways of introducing remote membership for foreign broker/dealers when the Securities and Exchange Law is next amended in April 2004. Foreign firms will be required to appoint a third party clearer. No further details are yet available.



Third Party Clearing in Asia

Third Party Clearing in Singapore:

New membership structure at SGX-ST/new thin capitalisation framework

- » **Three new membership categories:**
 - › Full Service Member – self-clear
 - › Trading Member – must outsource clearing to Third Party Clearer
 - › Clearing Member of CDP – Third Party Clearer
- » **New capital requirements includes variable element:**
 - › Type of membership/activity
 - › Type of instruments traded
 - › Degree of risk undertaken

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There have been big changes this year in Singapore, too. In January, the Singapore Exchange revamped the membership structure of its securities trading market (the SGX-ST) and introduced a new capitalisation framework for securities industry participants.

Historically, all brokers had to be full service members, that is, members both of the trading market, the SGX-ST, and the clearing house, the Central Depository (known as the CDP). As self-clearers, they were obliged to maintain costly back-office operations and meet demanding capital requirements.

The new membership structure establishes three different categories:

Full service member – Full service members can both trade and clear for themselves.

Trading member - Trading members can trade but must outsource clearing to a third party.

Clearing member - A clearing member is a member of the CDP that takes on the clearing and settlement functions of trading member clients in the capacity of a principal.

The new risk-based capital adequacy framework introduced for brokers comprises a base capital requirement for all, and then a variable capital requirement based, broadly, on three criteria: the type of membership or activity – for instance whether the broker is

a member of the securities or derivatives market or both, and whether it is a trading member or a clearing member – the type of instruments traded and the degree of operational, counterparty, price or other risk undertaken.

For third party clearers, the capital requirements also take into account the level of client trades.

Potential market entrants may now apply for clearing privileges as a clearing member of the CDP or trading-only privileges as a trading member of the SGX-ST. Potential trading members must first appoint a third party clearer. Existing local brokers will continue to be members of both the SGX-ST and of the CDP although they may choose to renounce either membership type.

Third Party Clearing in Asia

Third Party Clearing around the World:

- › US – NSCC created 1976
- › Europe – Proliferation of CCPs / Third Party Clearing
 - › UK, France, Netherlands, Germany, Italy, Switzerland
- › Latin America – Brazil & Mexico

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I'd like to finish by putting these local developments in a world context.

Third party clearing is now a common feature of those markets that boast a CCP, although, as I said earlier, a CCP is not a prerequisite.

The US equity market has had a CCP and third party clearing since 1976, when it created the National Securities Clearing Corporation. The NSCC was among the first clearing corporations to process and reduce large volumes of securities transactions and net both the cash and securities positions on a multi-lateral basis. Currently the NSCC is a part of The Depository Trust & Clearing Corporation. On average, it reduces the number of trades settled each day by 95 per cent and the associated dollar value by 97 per cent.

In Europe, the introduction of CCPs was accelerated by electronic trading, which removed the ability of exchange members to select the counterparty they wanted to deal with. Third party clearing was necessitated by the Investment Services Directive and the 'single passport' which gave securities firms the ability to trade in a market where they had no physical presence - provided they were represented by a qualified agent. Currently, there are six markets in Europe – the UK, France, the Netherlands, Germany, Italy and Switzerland - that have operating CCPs and allow third party

clearing. Greece is planning to join that list. In Latin America, the introduction of CCPs and third party clearing is being planned in two markets: Brazil and Mexico.

The driving force behind the introduction of third party clearing in many markets is the desirability of including more smaller firms in the market. But it also offers larger firms the opportunity to improve operational efficiency and make their collateral work harder. And those gains are very real. It is no coincidence that most of Citigroup's third party clearing clients are large institutions that use the service as a means of cutting costs and improving their competitiveness.



Third Party Clearing in Asia

Conclusion

- » **Third Party Clearing**
 - › Broadens market access/deepens liquidity
 - › Reduces systemic risk
 - › Service choice paramount

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In conclusion:

Third party clearing hits two targets that should be of interest to exchanges and clearing houses alike. It is a useful tool in broadening market access to include more brokers as market participants, and it simultaneously reduces systemic risk by allowing a number of robust financial institutions to shoulder the management of clearing risk.

Further, third party clearing should be of particular interest to securities firms at a time when most are more cost-conscious than ever. But firms will also welcome more choice in how they are able to outsource. They should not be denied the choice of engaging a third party either to provide a full general clearing member service (or GCP, ACP service, call it what you will) or, alternatively, to operate the firm's own account under a power of attorney – as an account operator, in other words. Either approach should serve the exchange, the clearing house, the CSD and, more importantly, the national market and its clients.

Thank you.