

Message from the ISSA CEO Office

Governance Update

- Change of Board Members
- Change of Operating Committee Members

New ISSA Members

- 6 new Members have joined ISSA in the 3rd quarter 2015.

Are we Risk Managers or Custodians?

Thoughts by John Gubert, a well-known industry veteran

Challenges and Achievements in the Indian Financial Market

Information by G.V. Nageswara Rao from NSDL Mumbai

Account Segregation Practices at European CSDs

Reference to recent ECSDA Study

Sibos 2015 – Take aways

ISSA Thought Leadership Conference

This year's event will be jointly held with afme and will take place on the premises of BNY Mellon, London, in the afternoon of November 17, 2015.

For more details please refer to the relevant section **ISSA Events** on our homepage.

www.issanet.org



Message from the ISSA CEO Office

Dear ISSA Members and interested parties

ISSA's activities in the last months focused on the publication of the **Financial Crime Compliance Principles**. At this year's Sibos in Singapore, ISSA was given the opportunity to discuss these best practices in various sessions with senior representatives of the industry. In all sessions the Principles found a broad acceptance and they were seen as the right way to increase the transparency along the securities value chain. This Newsletter contains a summary of the outcome of these sessions.

The Sibos sessions also offered an excellent opportunity to hear the diverse views about **accounting structures in place**. In this context, this Newsletter provides two contributions: **NSDL India**, who recently joined ISSA as a new Member, informs about India's account structure, resulting in full segregation of client assets and offering various service opportunities. In addition, a link to the recently published **ECSDA** report on Account Segregation Practices at European CSDs is added.

This Newsletter is furthermore enriched with **John Gubert's** thoughts about the increasing risks for custodians and their responsibilities as well as related cost impacts. John Gubert, Chairman GTL Associates, London was a long-time Member of the ISSA Board and is a recognized expert in this field.

Sibos offers always an excellent opportunity to discuss face to face with industry experts their views about industry challenges and developments. We received confirmation that ISSA concentrates on the right topics. In many discussions we were told that ISSA is much more present now and that our Members appreciate their increased involvement. This is also proven by the development of ISSA's membership, which has increased by 20 new institutions since the beginning of the year.

Next month the ISSA Board will convene for a full day meeting in London. New working topics proposed by the Operating Committee will be discussed and the agenda of the forthcoming **ISSA Symposium** will be fixed. The Symposium takes place in Switzerland from May 24 to May 27, 2016. The official invitation to all ISSA Members will be sent in due course.

We hope you enjoy reading this Newsletter and we welcome any feedback as well as recommendations about topics you may wish to be addressed.

With best personal regards,
CEO Office

Governance Update

We are pleased to inform about the following changes in the ISSA Board and ISSA Operating Committee:

Change of Board Members

- As of the end of July, Teresa Heitsenrether replaced Nicholas D. Rudenstine as representative of J.P. Morgan.
- On September 1st, Charles Cock succeeded José Placido as representative of BNP Paribas Securities Services.
- On the same date, Javier Pérez-Tasso succeeded Chris Church as representative of SWIFT.
- As of November 18, Luc Vantomme will replace Pierre Yves Goemans as representative of Euroclear Bank.

Change of Operating Committee Members

- At the beginning of July, Jyi-chen Chueh succeeded Stephen K. Pemberton as Standard Chartered Bank's representative.
- Towards the end of August, Credit Suisse nominated Heiko Zimmermann into this Committee.
- With immediate effect, Edwin De Pauw replaces Jo Van de Velde as the representative of Euroclear Bank.

New Members

Since July 2015 the following 6 new members have joined our Association:

- Indian Clearing Corporation Ltd (ICCL), India
- Fidelity ActionsXchange, United States
- Deposito Centralizado de Valores de Colombia DECEVAL S.A., Colombia
- Central Depository Services (India) Limited, India
- Franklin Templeton Investments, United States
- Centralni depozitar cennych papiru, a.s. (CDS Prague, Czech Republic)

We welcome these organizations and are looking forward to a mutually fruitful relationship.

Board of ISSA

Are We Risk Managers or Custodians?



*John Gubert
Chairman
GTL Associates
London
and former Member of
the ISSA Board*

The simple answer is that we have to be both. Unfortunately, we are not being paid for both, and especially not for the added risk assumed in Europe for safety of client assets.

The initial reaction to the AIFMD was rebellious, vocal and short lived as the industry surrendered to the inevitable. The AIFMD assigned depositaries liability for any loss of assets, unless the cause was «beyond their control». Financial Services history gives interesting precedents on the regulatory perception of the reach of market intermediaries! AIFMD also clearly states that using securities settlement systems is not a «delegated» function and this has been interpreted, somewhat cavalierly, to mean that losses at a CSD are not the liability of the depositary.

The current UCITS V regulations are even more onerous. Quite simply, use of a CSD is a delegated function and this means risk of loss of assets is attributable to the depositary. The optimists believe that this risk can be assuaged by the allowance in the regulations of the «beyond their control» escape hatch.

But both are clear that full liability for the sub custodian is with the depositary and it appears difficult to envisage, under either AIFMD or UCITS V, any real wriggle room for the depositary, especially as the transfer of liability option within AIFMD has not attracted any major takers. In all CSDs, under both regulations, there is a danger that liability could arise if there was pre-knowledge of the failing causing the loss

(such as the CSD refusing liability for its employees in cases of fraud or repeated failure of its IT security if losses arise through cyber-crime) or an event that regulators deem could have been predetermined (such as their treatment of losses resulting from re-hypothecation in the Lehman case).

These risks assumed are un-bankable. Banks should not assume risks they cannot control. They have no ability to influence the value of shares in custody, barring the impracticable capping of those values to clients. Banks should also not accept regulatory ambiguity or ambivalence when the headline extreme value at risk, based on global assets under custody, amounts to some US\$100-150 trillion plus of capital value.

In theory capital is not allocated directly to assets held under custody. That implies a zero risk, bar operational error. But the new EU regulations create liability for legal ownership risk, probably cyber-crime, most likely fraud and potentially losses created by a new and unforeseen «event». The values at risk are too great to be ignored. Regulators, by failing to allocate capital to this risk imply it is minimal, whilst the sell side appear to concur given the absence of sensible risk premiums for the added liability assumed since the enactment of these regulations.

To put it in perspective, Assets under Custody at the three large US banks, whose revenues are dominated by custody related functions, amount to US\$63 trillion against their total capital of US\$36 billion, or just 5.7 basis points. Given that tier one capital and buffer capital at the large US banks is targeted at 1000 basis points plus, this seems extremely modest for any risk function. With fund managers earning globally profits of US\$102 billion on their estimated US\$74 trillion of assets under management and each basis point on that AUM figure equating to US\$7.4 billion annually, we have a problem that cannot be sorted out by pricing alone.

There needs to be clarity, and sensible ceilings, on the exact liability being assumed.

Challenges and Achievements in the Indian Financial Market - Full Segregation of Client Assets



*G.V. Nageswara Rao
Managing Director and
Chief Executive Officer
NSDL Mumbai*

In India, NSDL in a pioneering move introduced the depository system in 1996. NSDL aims at ensuring the safety and soundness of the Indian securities custody and settlement system as well as offering innovative services through its technology platform. The NSDL depository system started with a fully segregated account structure and dematerialization with no legacy.

The full segregation model provides complete client asset protection as the securities are held directly in the CSD in client name. The full segregation of beneficial owner accounts to be maintained at CSD level also provides economy of scale for custody as well as high volume transactions processing, thereby lowering overall cost of the system as a whole since each participant does not have to build a separate infrastructure for the same functionalities. Investors have opened more than 14 million accounts with NSDL and these accounts hold assets under custody of more than US\$1.7 trillion. Every year, 240 million settlement instructions and 300 million electronic trade confirmations are processed by NSDL. NSDL has carried out various technology-cum-investor driven initiatives in the last few years, such as Mobile Application, e-Services for submission of instructions and viewing transactions & balances, E-Voting, platform for registration and generation of Foreign Portfolio Investor (FPI) Certificate, electronic Consolidated

Account Statement (CAS) for investors, SMS alerts to investors for transactions, etc. Let us take the example of NSDL.CAS. Considering that every account of an investor is with NSDL, it has started sending Consolidated Account Statements (CAS) directly to investors consisting of all their investments in the securities market. Thus, investors are able to view in one statement all their investments in their depository accounts as well as in Mutual Fund portfolios registered with transfer agents. NSDL.CAS provides investors an enriched experience of managing their portfolios effectively and benefits them in many other ways viz. better decision making, simplified monitoring, rich analysis of portfolio, etc.

Traditionally, CSDs hold only transferable securities. Considering this strength of CSDs, a new vision of allowing the investors to hold all their financial investments at a single place was envisioned in India. The Government of India has envisioned a Single Demat Account for all financial investments. A Single Demat Account will hold the title records of all financial investments of the investor and support transactions to operate the account. A Single Demat Account is an immensely investor-friendly measure. The benefits of such an account to the investor are numerous and well-recognized. Some of the benefits are single view of all investments, no need for safe-keeping of paper, simplified process for notification of changes, simplified monitoring of investments, simplified transmission and succession, substantial cost savings and shared infrastructure to issuer, to name the important ones.

Account Segregation Practices at European CSDs

ECSDA, the European Central Securities Depositories Association, has carried out a fact-finding exercise among CSDs to better understand existing account segregation practices and how these will be impacted by article 38 of the European CSD Regulation. One of the key conclusions is that the right level of segregation cannot be reduced to a trade-off between safety and efficiency and that, in fact, national law appears to be a more determining factor than CSD account

segregation practices in terms of investor protection and issuer transparency.

ECSDA published its report on October 13, 2015 and expects that the issue will remain high on the agenda of the EU institutions in the coming years. The report can be downloaded from the following link: http://ecsd.eu/wp-content/uploads/2015_10_13_ECSDA_Segregation_Report.pdf.

Sibos 2015 – Take aways

This year, Singapore hosted the biggest Sibos having ever taken place in Asia. More than 8'200 delegates and representatives attended this event. Compliance and regulatory challenges were key topics. As announced in our last Newsletter, ISSA was given a few platforms to present its recently published Financial Crime Compliance Principles for Securities Custody and Settlement. There was hardly any session where «Blockchain», as a prominent example of «disruptive» or «transformative» technology, was not mentioned. Specific topics related to the securities services industry were global trends in regulated securities markets or first experiences with Target2 Securities in Europe. Below there is a choice of topics that warrant coverage in this Newsletter.

Global Trends in Securities Markets

A panel of industry experts debated the question of how regulated securities markets could return to growth in view of the prevailing headwinds. One panelist described the past 15 years of the securities industry as facing a «perfect storm of challenges», such as for example interest rate and margin compression or the emergence of new technologies. While dealing with these challenges, banks had to invest in their business and continue to grow. The big challenge is to grow and de-risk at the same time. Governments' funding needs for country and pension scheme deficits will offer more global investment products in more markets. Accuracy and timeliness of data as well as data security are key features in managing risk better and making better founded decisions. And regulators want better disclosure, hence the industry needs to look at data in a more interactive

manner. The panel concluded that growth is achievable given the rather strong fundamentals in the securities markets.

Distributed Ledger Technology

Blockchain Technology, as the distributed ledger technology is being dubbed more commonly, has the potential to change the very structure of the financial services industry. On many occasions, this prime example for «disruptive» or as one keynote speaker prominently put it «transformative» technology formed the centerpiece of discussions. Major international banks have started to invest in responding to the challenges and opportunities presented by the «digital revolution». Increasingly, banks and other institutions in the financial services industry need to work together with FinTech companies rather than considering them as potential competitors. A close cooperation with regulators is of utmost importance as well. When asked by Sibos Issues about the main priorities when it comes to blockchain, a senior representative of a large bank said: «The first is to establish a common market infrastructure standard for different asset classes, and the second is to identify which asset classes and products are most suited, from a workflow perspective, to being managed and distributed over distributed ledger platforms.» The representative went on to say: «One important question will be how much of our existing processes that take place between different counterparties can be replicated, simplified and streamlined in a distributed ledger environment. This is an area that could impact our business significantly.»

ISSA's Financial Crime Compliance Principles for Securities Custody and Settlement (FCCP)

In three different panels, various exponents of ISSA member institutions had the opportunity to inform about ISSA's recently published Principles, as they were announced in our last Newsletter.

In a specific **Community Session**, five representatives of ISSA Board institutions presented and discussed the 17 ISSA Principles. Some 100 participants attended this session. A significant part of the event was devoted to an unusually active dialogue between the audience and the panel representatives. Despite some critical

comments, the ISSA Principles met with broad acceptance.

A panel named «**Cross Border Challenges of Intermediated Securities: Legal Transparency versus Operational Efficiency**» provided three ISSA Board Members with the opportunity to refer to the ISSA Principles as a way to enable transparency and still maintaining operational efficiency by continuing with omnibus accounts. Some attendees in the audience voiced their preference for segregated accounting models as the more apt set-up to *guarantee* transparency and investor protection. The panelists, all representing Global Custodians, confirmed that they were willing to offer segregated accounts upon customer request, whereas cost and process efficiency issues needed to be given consideration. In this respect, we would like to refer to the **recently completed research paper commissioned by ISSA** via the Swift Institute. The author of the study on the benefits and costs of securities account systems was given the opportunity to hold a Swift Institute Lecture at Sibos.

In a further panel named «**Securities Transparency: Is this the Next Frontier?**» two members of ISSA's Working Group on FCCP were able to speak about ISSA's Principles, specifically in view of the increased regulatory focus on screening securities messages for financial crime and sanctions compliance. When asked whether their financial institutions currently had a means in place to automatically screen securities transactions against relevant sanction lists, 52.4% of the audience said yes, whereas 22.2% had plans for implementation within a year and a surprising 25.4% did not screen securities transactions and had no plans for implementation in the short term. The panel also took the opportunity to ask the audience whether they were aware of the ISSA FCCP and what the Principles sought to achieve. 21% responded to fully understand the Principles and having plans to implement them. 22% were aware of the Principles but had no plans (yet) to implement them. 57% of the respondents were not familiar with the ISSA Principles.

ISSA will continue to engage with the industry and provide a series of implementation support tools.