Dream up the future.

2009

lakyara

Kyara, which means "precious" in ancient Japanese,
is an aromatic resin regarded as the highest quality of all agarwood.
"lakyara [la-kǽla]" aims to deliver the same quality as Kyara together with
NRI's endeavour for continuous excellence and innovation to provide
the most advanced and up-to-date information to our readers worldwide.

vol.57 (10.July.2009)

Post-dematerialization reform of securities clearing systems

Nomura Research Institute, Ltd.

In Japan, listed companies' stock certificates became completely paperless in January 2009, ending one phase of securities clearing system reform dating back to the 1990s. In the wake of the global credit crisis, OTC derivative trading and securities lending have emerged as targets for future reforms. Such reforms should contribute to ensuring the global financial system's stability.

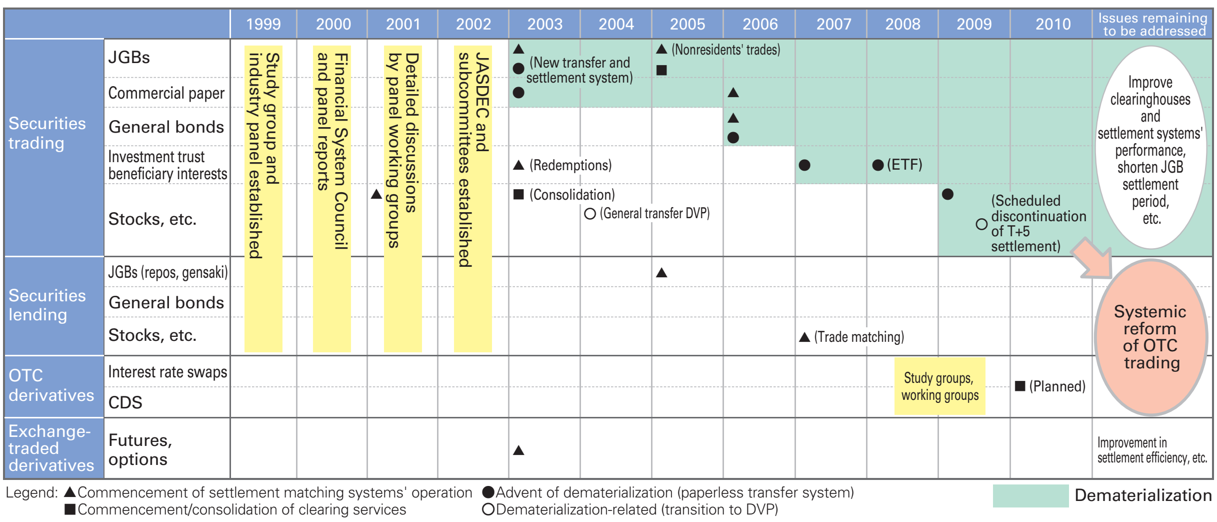
Reforms to date have focused on securities trading

Reform of Japan's securities clearing system began in earnest in 1999. The process was spearheaded by the Ministry of Finance's Financial System Council and industry panels. Specific reforms to reduce securities clearing costs and risks include enactment of unified securities clearing legislation, reform of securities clearinghouses' role, transition to straight-through processing[1)] (STP), and adoption of delivery-versus-payment (DVP) settlement, where securities and cash are exchanged simultaneously.

Dematerialization (transition from physical certificates to electronic book entry) began in 2003. It was initially limited to selected debt securities with a limited number of issuers and investors (e.g., commercial paper, JGBs). Dematerialization contributed substantially to reducing administrative costs, enabling issuance of retail JGBs and other new small-denomination products. Dematerialization was extended to general debt securities (e.g., corporate bonds, municipal bonds) in 2006 and investment trust beneficiary certificates in 2007, contributing further to reducing settlement risk and back-office costs.

Dematerialization of stock certificates required prolonged preparations because of the multitude of issuers and investors in the equity market and also because equities are deeply rooted in Japan's capitalist system. For example, the Companies Act had to be amended for dematerialization to proceed. The final preparations for dematerialization of stock certificates were ultimately carried out from the summer of 2007. Despite coinciding with the global credit crisis, the process was successfully completed without major difficulties by virtue of the diligent preparation of involved parties and the compliance of issuers and investors. Among major developed countries, dematerialization of stock certificates has taken place

Exhibit. Japan's roadmap for reform of securities clearing systems



only in Japan and France[2]. In Japan, dematerialization was preceded by a campaign to get investors to deposit stock certificates into the custody of the Japan Securities Depository Center (JASDEC). Japan also took the bold step of nullifying stock certificates that remained extant after the deadline for delivering them to JASDEC. Unlike France, Japan consequently did not require a protracted period for collection of stock certificates. Dematerialization of stocks certificates has substantially reduced costs and risks associated with trading listed equities. It also marked the end of one phase of reform of Japan's securities clearing system.

However, there is still scope for further systemic reform with respect to OTC derivatives and securities lending. The credit crisis that originated in the US has spawned a global recognition that regulatory oversight was inadequate with respect to OTC derivatives trading in particular. In the US and Europe, the role of securities clearing infrastructure is expanding as the regulatory authorities intensify oversight. What steps does Japan need to take in this regard?

Intensification of regulatory oversight and centralized clearing of OTC derivatives

In March 2009, the US Department of Treasury proposed a package of financial regulatory reforms focused on systemic risk. The proposal outlined a comprehensive framework for OTC derivatives market oversight, protection, and information disclosure. One of the proposal's aims is to centralize information on all OTC derivative trades at clearinghouses or record-keeping institutions to enable the regulatory authorities to monitor OTC derivatives trading in detail. Another aim is to enhance transparency by broadly disseminating statistical information[3]. In a letter sent to Congress in May, the Department of Treasury advocated strengthening the federal government's regulatory authority over OTC derivative trading[4] and expressed intent to lobby foreign governments, presumably including Japan, to do likewise to ensure that new regulations are effective.

In the credit default swap (CDS) market, a number of centralized clearinghouses were set up in the US and Europe in late 2008 or 2009. In Japan too, preparations are underway to set up a similar clearinghouse by a target date of 2010. Given that the volume of CDS traded in the Japanese market to date is small, some are skeptical of the need for a separate Japanese clearinghouse, but if a newly established clearinghouse enhances investor confidence and facilitates back-office processing, it should contribute to the Japanese CDS market's growth and development.

Reduction of securities loan settlement risk

Another interesting provision of the US reform proposal pertains to clarification of regulatory authority over markets for short-term lending of securities and funds. Even in Japan, such markets were hard-hit by the credit crisis.

According to the BOJ[5], many market participants in the JGB repo market, one of Japan's main short-term funding markets, became more risk-averse in terms of counterparty selection or completely suspended trading following Lehman Brothers' collapse. In the immediate aftermath of the collapse, defaults by Lehman Brothers triggered a chain reaction of failures to deliver JGBs[6], exacerbating market participants' concerns about settlement default risk and heightening anxieties about failures to deliver. In the BOJ's view, the keys to reducing JGB settlement risk are to increase the percentage of major repo market participants that clear their trades through the Japan Government Bond Clearing Corporation and to improve clearinghouses' function. The BOJ considers shortening the JGB settlement cycle to be another effective means of limiting settlement risk.

The bankruptcy of Lehman Brothers' Japanese subsidiary had adverse repercussions on settlement of stock lending transactions also. In Japan, stock lending transactions are not yet settled on a DVP basis. In some cases, stock was delivered without receipt of compensatory payment. Since the credit crisis erupted, ensuring the delivery of shares in stock lending transactions has apparently become more of a concern even overseas. In Europe, EuroCCP, a clearinghouse affiliated with the US Depository Trust & Clearing Corporation is in fact preparing to launch clearing services for stock lending transactions by the third quarter of 2009. Even in Japan, DVP settlement of stock lending transactions and establishment of clearing services for such transactions are considered important issues to address.

In sum, the global securities settlement infrastructure is responding to new issues that have arisen in the wake of the recent credit crisis. It is important for Japan to pursue further dialogue with overseas regulatory authorities, clearinghouses, and domestic and overseas market participants to deepen mutual understanding of systemic reform and realize reforms that contribute to the global financial system's stability.

Note

1) JASDEC has an electronic trade and settlement matching system required for STP of institutional investors' trades and uses it to settle trades in various securities.

2) The US, UK, and Germany have depository institutions that centralize custody, settlement, and transfers of securities, but securities can be withdrawn from the depositories by their beneficial owners.

3) Specific measures include (1) regulation of OTC derivatives including CDS, (2) strong regulatory oversight of dealer financial institutions, (3) mandatory use of a central counterparty for standard OTC derivative trades and recommended use of exchange-traded derivatives, (4) mandatory reporting of non-standard OTC derivative trades to a record-keeping entity, and (5) disclosure of statistics on trading volumes and open positions.

4) The letter advocated restriction of OTC trading that poses systemic risk, improvement in OTC market efficiency and transparency, prevention of market manipulation, fraud, and other market abuses, and enhancement of investor protections to ensure that OTC derivatives are not sold to unsophisticated investors.

5) "The Lehman Brothers bankruptcy's lessons for Japan's settlement system," BOJ Payment and Settlement Systems Department (March 2009).

6) The backlog of failed deliveries was reportedly nearly eliminated by September 30, 2008 (ibid.).

Author's Profile

Ken Katayama

Senior Researcher
Department of Financial Markets and Technology studies

E-mail : kyara@nri.co.jp

Inquiries to : Department of Financial Markets and Technology studies
Nomura Research Institute, Ltd.
Marunouchi Kitaguchi Bldg.
1-6-5 Marunouchi, Chiyoda-ku, Tokyo 100-0005, Japan
E-mail : kyara@nri.co.jp

http://www.nri.co.jp/english/opinion/lakyara