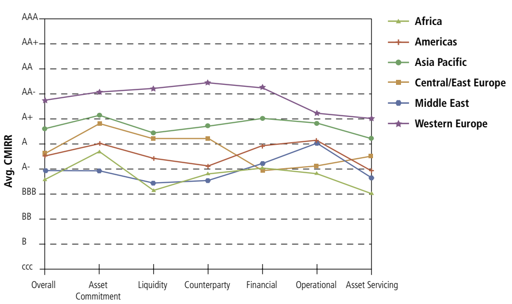
Thomas Murray Capital Market Infrastructure Risk Ratings

In the first of a regular series of contributions to FSR, custody risk ratings and advisory specialist Thomas Murray introduces readers to their Capital Market Infrastructure Risk Ratings (CMIRR) methodology and comments on key market infrastructure developments during Q4 05

Thomas Murray is delighted to contribute a risk analysis of the post-trade environment for readers of Financial Services Research. For this first contribution, we have outlined the criteria used in our ratings of over 85 post-trade capital market infrastructures globally, including an explanation of the rating scale applied. Future quarterly analysis to appear in FSR will focus on a particular geographical region, with risk analysis broken down by country.
This issue describes the overall average CMIRRs at December 2005 by risk type, broken down by region as below:

CMIRR Regional Comparison



Source: Thomas Murray

The average comparative strengths of each region follow a general ranking (strongest to weakest) of Western Europe, Asia Pacific, Central and Eastern Europe, Americas, Middle East and Africa. The exception to this trend is the financial and operational risks of the Eastern European markets, which are well below the average global trend. Eastern European countries have only commenced capital market operations comparatively recently, and were initially set up as retail capital markets (high volume, low value models) to support coupon privatisation programmes. As such, many core clearing and settlement institutions were undercapitalised from the beginning and have not had enough profitable years to build up large reserves. From an operational risk perspective, some of these capital market entities have not fully embraced an operational risk control culture, or an attitude of transparency in assuaging investors' concerns over the effectiveness of internal controls and procedures.

Most regional infrastructures appear to be better at intermediating clearing and settlement risks (ie asset commitment, liquidity and counterparty), which is hardly surprising considering that this has been one of the key focal points for risk reduction since the original Group of Thirty (G30) Recommendations in 1989. However, since then, many local clearing and settlement utilities, such as CSDs, which have solved the core clearing and settlement issues, have moved up the value chain to the provision of additional custody services, thereby carrying asset servicing risks.

Thomas Murray analysis seems to indicate that although the centralisation of this area within market utilities would appear beneficial in standardising service quality and harmonising market practice, the current 'central' service standard is generally not as high as that provided by local banks. Additionally, the potential value of claims arising from this area can be substantial and it does not appear that entities such as CSDs have the balance sheet strength to absorb such claims in the way that custodian banks could. However, it appears that the march towards 'commoditising' these value-added services will continue, as the potential to disintermediate local custodians is realised in different regions.

In terms of recent and impending market developments on a global basis, Thomas Murray considers the following to be the top 10 events influencing market infrastructure during the fourth quarter of 2005:

Austria	– OeKB's new real-time settlement system, DS Advanced, is due to go live on 23 January 2006 after several delays.
Belgium	– Euroclear SA/NV agrees full acquisition of Euronext-CIK from 1 January 2006. Euronext-CIK is to be renamed Euroclear Belgium.
China	– Non-tradable share reforms liberalise the 'A'-share market for foreign investors.
Costa Rica	– A new clearing house for BNV transactions was implemented on 21 November to introduce multilateral netting.
Germany	– Introduction of record date for bearer shares will eliminate securities blocking periods before company meetings.
Greece/Cyprus	– Common trading and settlement platform is scheduled to start on 1 Jan 2006.
India	– Gradual liberalisation of foreign investor restrictions is set to continue in early 2006.
Ireland	– Eurex Clearing AG begins central counterparty (CCP) operations for exchange transactions.
Japan	– Introduction of DVP settlement for 'straight' (corporate) bonds is due in January 2006.
Turkey	– The introduction of the Central Registration Agency (CRA) will enable securities dematerialisation.

Summary Methodology

Capital Market Infrastructure Risk Ratings (CMIRRs) are a Thomas Murray opinion of the post trade risk exposures to which an asset owner (normally an institutional investor) is exposed, either when transactions are settled or while securities are held in a particular country. These assess the effectiveness of organisations and processes involved in post-trade settlement, safekeeping and asset servicing, in minimising investor risk exposure. CMIRRs and individual risk exposures can be compared across markets, since it is the potential level of investor risk that is measured, not the model of risk intermediation itself. These risk ratings have been developed in response to investors' needs for ratings of these risks, since they are rarely intermediated by global custodians.

The key criteria for assessing the CMIRR are as follows:

1. Clearing and settlement

– Primary risks include: asset commitment risk, counterparty risk and liquidity risk.
– Factors include: securities and cash settlement system; credit facilities; stock lending facilities;settlement cycle and model; participation criteria; guarantee funds and fails management procedures.

2. Safekeeping

– Primary risks include: financial risk and operational risk.
– Factors include: procedures and controls surrounding the settlement and safekeeping processes; nominee arrangements; segregation routines and registration arrangements.

3. Asset servicing

– Primary risks include: asset servicing risk exposure.
– Factors include: corporate action and proxy arrangements; information dissemination and taxation services.

The CMIRRs also include a sovereign rating adjustment to factor in an indication of the condition of the local banking sector, which forms the foundation of the local payment system.

Running assessments of risk exposures are maintained by Thomas Murray across 89 countries. Daily notification of changes to local capital market infrastructure arrangements, rules, procedures and controls, are received from multiple local market sources. Market changes likely to affect risk exposures are identified, validated and the risk impact is assessed by Thomas Murray analysts against the assessment criteria.

The CMIRR is based on an alpha scale from 'AAA', being the highest rating, to 'C', being the lowest rating. The scale indicates that Thomas Murray's opinion is that the level of risk exposure suffered by investors within a capital market infrastructure is:

- o AAA extremely low
- o AA+
- o AA very low
- o AA-
- o A+
- o A low
- o A-
- o BBB acceptable
- o BB less than acceptable
- o B quite high
- o CCC high
- o CC very high
- o C beyond any acceptable level of risk exposure

The overall rating contains an Outlook Indicator, which indicates the direction in which the rating is moving. This is established using over 300 information sources, which are employed to maintain the ratings and to identify future changes/announcements that are likely to impact a rating in the future. The outlook scale is:

- <u>Stable:</u> There are no factors at this time that would affect the CMIRR rating.
- <u>Positive:</u> Factors that may result in an improvement in the CMIRR rating.
- <u>Negative:</u> Factors that may result in a deterioration of the CMIRR rating.
- <u>On Watch:</u> Factors that may result in a change in the CMIRR rating, but the direction of the change is uncertain at this time.

To learn more about Thomas Murray's Capital Market Infrastructure Risk Ratings product, please contact Derek Duggan (+44 207 830 8300 or dduggan@thomasmurray.com), or register at www.thomasmurray.com for a free trial.