

Consultations on Feasibility of Establishing Central Securities Depository

for the

FINANCIAL SUPERVISORY AUTHORITY (FSA)

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Final Report

By

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SUPPLEMENTAL REPORT FVSC ALBANIA DEPOSITORY PROJECT

This report supplements the Interim Technical Advisor Report, submitted by Dennis Grubb on January 21, 2010, d. b.a. Investasia Ltd. (www.investasia1.com). Mr. Grubb visited financial institutions in Tirana, Albania, December 16-21, 2009.

The volunteer was expected to present the working group an assessment of the feasibility of building up a central securities depository in Albania. The report outlines recommendations on the possible options for its establishment.

I. THE ISSUE:

The question being deliberated in the Albania capital market is whether the current financial intermediaries should consider establishing a central securities depository (*1) that is "home grown" versus a "outsource model". The effort would be led by the Albanian Central Bank and not by the traditional depository leader, the stock exchange.

A cornerstone in building the Albanian Securities industry is ownership of a clearing and depository system serving all appropriate market participants. The development should be a cost sharing arrangement between the private sector and government operations (i.e. central bank.)

In examining the depository history in 48 countries, both developed and emerging markets, only 5 former Eastern bloc country's have depositories controlled by a government body. For example, the Ministry of Finance in Bulgaria, Croatia, Czech Republic, Poland and Slovakia control the depository. The other countries have various forms of ownership structures that include stock exchanges, banks, broker-dealers, investment funds and other market participants *with some ownership by the central bank.*

As stock exchanges are the primary beneficiaries of depositories, Albania has a dilemma as the stock exchange, although organized and an operating company has no listed companies, and no transactions. Therefore, the role of prime mover rests with the central bank which is currently selling and settling T-Bills. In addition, *as the Republic of Albania announces plans for the issuance of a debut Eurobond in the international debt capital markets in the 2nd quarter of 2010, the urgency of addressing the need for a central depository is clearly evident. The effort is being led by the Albanian Central Bank, based on an earlier IMF assessment that the ACB should develop a depository system as the CB aim is to develop a money market for T-Bills and Government Bond*

The Interim Technical Report supported the option for the establishment of a central securities depository and made this recommendation...*The international technical advisor recommends the SPI Secretariat and PMG shadow (adopt as a model and standard) the international experience of the Sri Lanka country example, known as LankaSettle-a real time gross settlement (RTGS) System and LankaSecure, a system operated by the Central Bank of Sri Lanka. (F:\Central Bank of Sri Lanka Financial System Stability)*

Frankly, the "outsource" model is not an option. In a review of the 48 countries with depositories no country is using such a model. However, the recent restructuring (last five years) of European Stock Exchanges and Settlement Systems indicates trading activity, market liquidity, and capital market growth depend on safe and efficient trading and settlement systems. Until recently, each country in Europe had its own stock exchange. In addition, individual countries have their own distinctive legal

and regulatory apparatuses. The institutions and arrangements required to execute stock trades (and debt) were therefore replicated numerous times. This fragmentation along country lines has led to low trading volumes and transactions conducted primarily among local investors As a result, European markets have experienced lower liquidity for individual stocks and higher trade execution fees charged by exchanges.

II. QUESTIONS FOR THE PWG

First, what will be gained by choosing to execute this project or plan? The actors (financial intermediateness) need to understand how the plan will enhance operations already in place, and possibly create new revenue streams and otherwise raise the prestige level of the Albanian capital markets. If there appears to be little or no advantages or benefits to implementing the plan, then the analysis may stop at this point and the project not proceed.

Second, this report does not present a completed financial cost model (*2) with estimates of possible capital expenditures and annual operating costs for a depository, nor the number of participants and the number of transactions it will process in settling dematerialized trades. **However, the APPENDIX A of the attachment Bombay Depository Study can serve as a template, inserting Albanian generated numbers, for the Albanian model (*3.).** A normal convention is cost savings would result primarily from decreased processing costs and opportunity costs currently incurred at settlement, ownership transfer and safe custody. The collection of relevant data and formatting a model will require additional FSVC or an Accounting firm man hour. The Bombay example is the assessment in a operating stock exchange context, *and therefore, we repeat the model most applicable for Albania, as the depository that will be initially settling and clearing CB debt instruments, is the recommended Sri Lanka Central Bank system, LankaSettle.* If the PWG examines either report (Bombay and Sri Lanka) it will be able to assess the organizational impact of different project options by calculating the Net Present Value (NPV), Internal Rate of Return (IRR), Return on Investment (ROI) and Payback Period of the two project options ("Home grown" or "outsource") and generate comparative graphs that show ROI, cumulative ROI over a five-year period, NPV, and IRR for each option under consideration.

Third, a profit analysis, most often referred to as Cost/Volume/Profit (CVP) analysis, is normally used to determine "what if" scenarios. For example, the depository business wants to settle transactions (debt or equity) at an efficient price. In the Albanian case, the initiator of the depository, the Central Bank, would perform a CVP analysis to determine potential profit. The profit analysis is basically comparing cost and volume to determine profit. The Central Bank breakeven point, the point at which zero profit is produced, and the projected profit may require subsidization (both its variable and fixed costs) by the depository owners.

Four, as high costs are a major impetus to the consolidation of European exchanges and settlement systems, (Economic theory suggests that industries with high ratios of fixed costs to marginal costs are prone to long-term consolidation.) the proposal to consider "outsourcing" the CDS function, at first glance appears attractive. However, as stated in a review of the 48 countries with depositories no country is using such a model. In fact larger considerations are in effect, as the major European exchanges, such as Euroclear or another depository, require a MOU. The MOU conditions would stipulate that (1) the Albanian depository have the official designation by the regulator that ACDS (Albania Central Depository System) is the only institution providing clearing and settlement operations, and (2) that a guarantee fund ensures effective deliver (DVP) for foreign transactions.

(Footnote *1) The three principal steps in a securities (equity or debt) transaction through a book-entry system maintained by a *central securities depository (CSD)*.

Execution

The trade execution process brings together the buyer and seller of a security. The trade execution platform may be a formal exchange, an electronic trading system, a brokered market, or a matching system where buyers and sellers trade directly.

Clearing

The post-trade clearing process facilitates proper completion of a transaction. The first step is trade comparison, or trade matching, which confirms that the buyer and seller have agreed on the price, quantity, and other details of the transaction. Next, the buyer and seller identify the accounts to which the security and payment should be delivered.

In some markets, large broker-dealers that frequently trade with each other use *central counter parties (CCPs)* to minimize the risks of failure. A CCP "stands between" inter dealer trades, becoming the buyer to all sellers and the seller to all buyers. The CCP lowers the risks to dealers by offsetting, or "netting," buy and sell trades. In addition, it reduces the number and size of securities and money movements at settlement.

Settlement

Settlement represents the exchange of a security and its payment. In most developed financial markets, few participants actually hold physical certificates for the publicly traded securities they own. Rather, ownership is tracked electronically through a book-entry system maintained by a *central securities depository (CSD)*. At the depository, ownership transfer at settlement occurs on the system's records

On a cross-border trade, settlement becomes more complex. To settle such a trade—say, a French institutional investor purchasing a German stock—the investor has to take possession of securities held in the foreign CSD. Thus, the investor must be linked, either directly or indirectly, to the foreign depository. Because most institutional investors use a *custodian*—a financial entity that offers safekeeping and administrative services for financial assets—the custodian must be linked to the foreign depository. This linkage can be established in several ways. For example, the investor may use a local custodian that is a member of the foreign depository or it may use a *global* custodian, typically a global bank that is a member. (A direct link from the custodian to the foreign depository may not be necessary if the domestic depository provides a link to its foreign counterpart, although this seldom occurs at present.) Alternatively, the foreign security may be deposited in an international CSD that, unlike a purely domestic CSD, may hold international securities, such as eurobonds, as well as securities from several countries.

Regardless of the mechanism used to link an investor and a foreign securities depository, completion of a cross-border trade clearly requires more complicated institutional arrangements. Moreover, settlement problems can arise from differences across countries in settlement cycles (the time between trade execution and settlement), in currencies (which may require a separate settlement process for conversion), in the legal systems, and in the myriad settlement arrangements for different types of securities.

(Footnote* 2) Cost Considerations

The typical failure of a cost benefit analysis is not including all the costs. In the case of the Albania start up depository , capital costs are identifiable(computer hardware and off site communication links--IT is the backbone of a depository system) , current transactions cost (no equity transactions) costs and do not overlooked third party intermediary account costs as they are embedded in account and custody fees of holders of T-Bill securities.

High costs are a major impetus to the consolidation of European exchanges and settlement systems. Economic theory suggests that industries with high ratios of fixed costs to marginal costs are prone to long-term consolidation. **These high fixed costs are prevalent in stock exchanges and securities settlement systems, where long-lived and costly investments are made in information technology, communications systems, and legal and regulatory structures.** Recently, some exchanges and settlement agencies have made large investments in information technology and communications systems, mostly out of a desire to stay competitive. **Moreover, the marginal costs of additional securities or trading volumes, once all necessary systems are in place, are small relative to the fixed costs.** At the same time, there has been some regulatory convergence across European financial markets. These developments have heightened the incentives for exchanges and settlement agencies to consolidate in recent years. Institutional investors have also been pushing for consolidation in the hope that such a move will substantially reduce their all-in trading costs.

To appreciate how consolidation can generate savings, one must first understand the costs—direct and indirect—that arise following the execution of a trade .Understanding transaction costs is very important for all intermediaries involved in buying or selling any financial product, whether it is stocks, bonds, currency or valuable metals. It does not matter whether you are buying or selling assets, transaction costs can be incurred in a number of different situations.

In depository operations, direct settlement costs include safekeeping and transaction fees paid to a central securities depository or a central counterparty, along with forgone interest income. These costs may account for about 30 percent of post-trade expenses.

(Footnote *3 Fee Rates)

Account opening fees

Safekeeping fee per Issuer per month

Internal transfer (Free of Payment) per transfer per counterparty

Internal transfer (DVP) per transfer per counterparty

External transfer (withdrawals involving re-registration) plus all re-registration expenses

External transfer (deposits involving re-registration)

Free Corporate information services

Free for items relating to securities owned by the client

Dividend processing per dividend transfer

Indirect post-trade costs are the other costs incurred by broker-dealers and investors in utilizing clearing and settlement systems. These costs are magnified by the redundancies and inefficiencies inherent in the fragmented nature of these systems. For example, a broker-dealer wishing to settle foreign securities trades may have to engage foreign custodian banks, maintain business relationships and telecommunications links with several settlement organizations, hold collateral at multiple clearing organizations, and suffer settlement delays. According to industry estimates, the indirect component of post-trade costs is at least twice as large as the direct component

Cost Benefit Analysis - Start up Depository
(Need to determine amortization period)

Purchase of Equipment
includes interest and taxes

Installation of Equipment
including screens & removal of existing stampers

Increased Revenue
total net value of transactions

Quality Increase Revenue
calculated at % of existing independent cost

Reduced Labor Costs
3 employee salary base

Daily Operating, Space (Rent), & Utilities
power consumption increase for new machine

Net Savings using CDS over individual systems