
The Debate Over Settlement Infrastructure Reform in Japan¹

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1. The Need For Reform

Over six months have now passed since the report on securities settlement system reform, published by the Bond Issues Committee of the ruling Liberal Democratic party in August 1999, sparked off debate over the issue. During this period the Japan Securities Dealers Association and the Financial System Council, an advisory panel to Japan's finance minister, have held various meetings and set up a working group to examine the issues raised.

Nevertheless, until recently the debate over reform of the settlement infrastructure has taken some elements by surprise, while others have voiced doubts over whether it is necessary at all. On the other hand, some industry participants are of the attitude that "if it has to be done, then do it as cheaply as possible." Such observations are testament to a general lack of recognition of the urgent necessity of system reform.

In the U.S., fundamental reform of the settlement system to accommodate settlement in T+1 has graduated from the debating stage to a concrete tackling of the issues concerned, with the understanding that reform is inevitable. The issue of T+1 settlement is, as was the case with the Y2K problem, not a debate that can be conducted in simple cost-benefit terms. Out of an appreciation of the large risk factors posed by a failure of the settlement system (despite the difficulty of exact theoretical cost forecasting), market participants in the U.S. now understand that, whether they like it or not, action is required. Naturally plans do exist to assess potential costs, but the priority lies with deciding a course of action. In the U.S. the practical process towards realizing T+1 settlement is now firmly underway.

As securities settlement risk, like the Y2K issue, has the potential to cause unpredictable and substantial damage to the overall social and economic system, the U.S. government is playing an important role in the move to T+1. The Securities and Exchange Commission has been urging the industry to take action for several years.

The whole question of securities settlement reform and not only T+1 is in itself fundamentally a public-policy issue, and therefore quite naturally falls within the remit of government action. In the U.S. for example, Congress played a vital role in the 1970s when the so-called "paper crisis" precipitated an urgent need for settlement reform. Meanwhile CREST, the U.K.'s central depository organization, is a result of the Bank of England's

1 This report is a revised and updated version of comments made by the writer to the Financial System Council's working group examining reform of Japan's securities settlement infrastructure.

decision to tackle settlement system reform head-on and create a paperless settlement infrastructure for all securities types.

The current debate over securities settlement reform in Japan includes doubts over the political nature of the initiative, and consequently voices calling for it to be taken out of the hands of politicians and given to the private sector. From an international perspective however, government involvement is by no means unusual. Far stranger is the idea that this is a “sudden” movement in Japan. Japan’s government is finally and belatedly tackling an issue which the SEC was calling attention to several years ago and which the Securities Industry Association has been debating for over a year.

If, as seems to be the case, the private sector is unaware of the urgent need for settlement reform, then Japan must progress by way of public policy. Further, the government will still need to maintain an active role once the private sector is tackling the problem on its own, as happened with Y2K. This is particularly true given that the reduction of settlement risk is not a problem that once dealt with, like Y2K, can be forgotten about, but will continue to be an important area of concern.

2. Significance for Japan’s Financial Industry and Markets

Market participants do need to view action on securities settlement system reform, including (DVP-based) T+1, as essential. At the same time however, they should recognize that proactive movement on this issue will support the development of Japan’s financial markets and industry, and so contribute in a large way to strengthening their own competitiveness, and enhance their chances of survival in a harsher competitive climate.²

Needless to say, the reduction of overall market risk and improved efficiency of the financial markets are vital issues for all market participants. Further, in order to provide a higher quality of service to end users such as pension funds and individuals, these same market participants must rise to the challenge of U.S. or Europe based financial service providers. Amidst a worldwide trend for shortening settlement periods, Japan’s institutions must for their part actively promote real-time processing. Serious problems would arise if Japan-based providers were not able to offer a competitive service to Japanese end users.

Now, in a stage further from the previous concentration on front-office Straight Through Processing, leading U.S. buy-side institutions are now advocating “end-to-end STP,” the entire automation of front to back-office settlement processing. These institutions are aiming at squeezing out even just a few extra basis points in profits by streamlining their back office operations, using the most up-to-the minute information on cash and securities positions to invest and / or lend securities in order to maximize profit potential and minimize waste. The use of public policy to advance the cause of settlement infrastructure reform works to support this strategic buy-side initiative, and also responds to the requirements of “end-users” such as pension funds. However the lateness of Japanese buy-side institutions to tackle real-time processing due to lack of progress in settlement system reform threatens to

2 see Y. Fuchita “The Trend Towards Computerization of Securities Markets And The Outlook for Japan,” (Securities Analyst Journal, November 1999).

cause a widening gap between Japanese and non-Japanese asset management companies over the next several years.

U.S. securities firms are eager to realize T+1 because it means they can reduce the size of their capital commitments. The establishment of internal systems capable of real-time processing is also high up on the agenda. If Japan lags behind in its response, Japan-based securities firms may no longer be able to compete with their U.S. counterparts in terms of IT, and end up offering inferior services to their end-users.

Over and above abstract considerations of relative competitiveness, if the U.S. has T+1 and Japan does not, then more practical problems will undoubtedly arise. For example, take a Japan-based institutional investor wanting to sell Japanese shares and replace these with U.S. shares. With Japan on T+3 the proceeds of the sale would come in two days later than the settlement of payment for the U.S. shares, giving rise to a position that needs to be financed. The obverse scenario also arises for foreign investors investing in Japan.

3. Trade Matching Systems As The First Stage Towards STP

The above has so far put the case for securities settlement reform. Now I would like to present my own personal opinion about the priority of the debate over reform in concrete terms.

To realize T+1 in the U.S., priority is being focused on the development of the stage prior to the “settlement layer,” the “matching layer.” However the role of developing a matching system involves much more than facilitating the speedy matching of trades. Through the implementation of a trade matching system connecting industry participants, an electronic trading environment is set up that standardizes the whole trading infrastructure. This is the first essential step towards achieving STP.

In Japan the focus of industry debate has been on development of the settlement layer, on such questions as whether settlement organizations should be merged and centralized or split up. Instead, I think Japan needs to form an industry consensus to look first at the matching layer and discuss implementation of a trade matching system.

Considering the schedule for realization of T+1 in the U.S., Japan urgently needs to begin building a similar trade matching system. It needs to be up and running soon, and offer global connectivity.

In addition, the following two conditions need to be taken into account:-

- (1) Users are strongly in favour of several systems in competition with each other (the “demand-side condition”), and
- (2) Multiple providers should be available with workable and detailed plans that fully meet user requirements, possessing the international expertise to implement these plans in line with the schedule for system reform (the “supply-side condition”).

If these two conditions can be met, then it is possible to envisage the healthy co-existence of a number of competing systems. If not, then initially it would be more practical to implement a system infrastructure under the auspices of a single user-led framework. This

would not of course preclude the later appearance of rival systems that also meet user requirements.

If Japan has multiple service providers, it will then be important to maintain a commonality of standards and specifications. It would be preferable if a framework could be established that would ensure that “user governance” is a central concern of each system provider, without government interference. If the cause of reducing settlement risk were in danger however due to the difficulty in achieving such a framework, then some sort of government guidance would undoubtedly be necessary.

4. ‘System Architecture’ vs. ‘Institutional Framework’

Once general consensus has been obtained on the need for automation of the trade matching infrastructure, then the debate should quickly move on to an examination of the “settlement layer.” At this stage it will be important however to clearly separate the debate on system and technological architecture, and questions of the institutional framework – the particular regulations that should govern Japan’s settlement organizations.

This need is apparent because so much of the debate up to now in Japan has confused these two areas. For example, the debate as to whether a single unified system would be better, or whether a “distributed” system is the way forward in terms of future technological development and lower cost, or that certain instruments need to be handled by separate systems due to major differences in trading practices, are essentially system architecture problems. Systems specialists and users can resolve these issues together by examining the practicalities involved, free of interference from the Financial System Council.

On the other hand, it is apparent that whatever type of system architecture is opted for, implementation would be a problem under the current legislative framework. This is the question regarding institutional framework that the Financial System Council’s working group should tackle, in its capacity as a public policy discussion forum.

Debate over the past six months has pointed to Japan’s current legislative framework as an obstacle to settlement system reform, considering the way other countries have proceeded to reform their own systems, Japan’s market environment and end-user requirements.

For example, market participants and users pointed out at the working group meetings that while it was desirable that one settlement organization would handle many different types of securities, the present system in Japan is for different security types to be handled by different systems. Equities are settled by the Japan Securities Depository Centre (JASDEC), corporate bonds via JBNNet and corporate bond registration organizations, and government bonds by the Bank of Japan. Clearing is further divided, with even the same equity issue being cleared through different institutions depending on the exchange on which the trade is made. The fact that there is no clearing organization for OTC trades is pointed to as another problem. Also, in order to realize DVP-based T+1 settlement through JASDEC, regulations would have to be reinterpreted and amended in order for it to engage in other forms of business operations, including settlement of funds, collateral, member fund administration and credit limits. The working group should be discussing the revision of such laws and regulations to resolve these problems, and come up with some workable proposals.

From the requirement for one institution to handle many different types of securities it does not necessarily follow that there should be complete centralization in one settlement organization. If:

(1) Users are strongly in favour of several systems in competition with each other (the “demand-side condition”), and

and at the same time,

(2) Multiple providers are available with workable and detailed plans that fully meet user requirements, possessing the international expertise to implement these plans in line with the schedule for system reform (the “supply-side condition”).

then there is no problem in having several organizations that can each handle a number of different security types existing in competition with each other. It should also not be precluded that settlement organizations specializing in providing settlement services for a certain security only would exist if that is the result of matching the requirements of both supply and demand-sides.

However, if the above demand-supply side condition applies, then it would not be in anyone’s interests to have one organization monopolizing the settlement processing of a particular instrument, to the exclusion of all competitors. Needless to say, if trading practices differ for different instruments and consequently require different processing, then settlement organizations would need to develop, based on practical discussions with users, multiple system architectures to accommodate this situation. It does not necessarily follow that Japan’s institutional framework needs to be based on either multiple statutory and regulatory systems governing securities settlement, or multiple securities settlement organizations.

Current legislation does not require JASDEC to be the sole organization carrying out custody and transfer of stock certificates, and does not prevent another organization from competing with JASDEC by promoting services more attuned to users’ requirements. In this sense, there is plenty of scope for improving JASDEC through the pressure of private sector competition. The problem however remains that under the current legal framework it is difficult to realize the unified settlement of various security types or DVP / T+1, as sought by at least some users, whoever the service provider is.

Considering that product innovation is likely to continue, Japan must establish the laws and regulations under which settlement organization(s) capable of dealing with various securities under a flexible and uniform environment can exist. Further, a new legal framework is desirable from the point of view of keeping up with global competition in settlement infrastructure, symbolized by “T+1” and “DVP”. As a statutory and regulatory issue, this should not be entrusted to private sector discussion and competition, but has to be solved by government. Accordingly, I would like to see the working group of the Financial System Council debating this issue.

5. The Need For A Flexible Institutional Framework

The debate over the new legal framework should not proceed based on the assumption of any particular system architecture. Ideally it would position itself to adequately incorporate future developments in IT, and develop a framework that can accommodate many different practical approaches.

For example, there is no need to assume that securities would be settled through a central securities depository and funds through a central bank. That a CSD might be able to fulfil both these roles should not be ruled out at this early stage. No option should be ruled out, but clear criteria should be established for determining any particular framework, with plenty of allowance made to accommodate possible future innovation.

It is difficult however for legislative reform to keep up with the incredibly fast pace of change in technology. Once a particular framework is decided on, then vested interests arise. These may militate against the introduction of new technologies, however desirable on an objective basis, that would then require further amendments to the legislative infrastructure. Japan needs to guard against the risk of such a situation arising and thwarting the cause of reform.

6. A User-Led Debate

Accordingly the Financial System Council debate must proceed without being beholden to any particular system architecture, concentrating on the basic legislative framework. On the other side, the debate among market participants must also proceed as an objective and flexible analysis of the possibilities while not being blinkered by the current legislative framework. Likewise, if it is possible to have a superior infrastructure functioning under current legislation, then this too should be brought out in the public policy debate.

The main players in the system architecture debate must be the users. Up to now debate in Japan seems to have revolved around what reforms the settlement organizations would like to see, rather than a response to user requirements. Consequently the debate has tended to start from the assumption that there will be a number of co-existing settlement organizations.

In order to hold a constructive user-led debate it is also necessary to solicit the objective analysis of IT specialists, and avoid as far as possible having the debate run by “vested interests.”

Europe’s leading financial institutions set up the ESIUG (European Securities Industry Users’ Group) in May 1999. Its main purpose was to function as a user platform to call for the unification of securities settlement in Europe, due to spiraling systems costs incurred by the constant upgrading of systems infrastructure by settlement organizations.

Japan’s user institutions also need to play an active role in the debate regarding system architecture, since what sort of settlement and STP infrastructure eventually emerges will have a significant impact on their ability to compete with their U.S. and European counterparts.

In all likelihood, as happened in Europe, Japan's users will also call for a unified settlement organization. From the users' standpoint, I am still of the opinion that this is the most desirable outcome.³ However my basic premise is that, as I have argued throughout this report, that if both demand and supply side conditions are met, then there is no objection to having a number of competing settlement organizations. However, these two conditions are not so easily met.

Most of Japan's user firms will have to implement electronic trading systems entirely from scratch. They would therefore require that an STP infrastructure is first established for settlement and basic, standardized trade matching services. At the moment there is little call for a number of organizations to be offering competing services.

This also holds true on the supply side. In the U.S. the monopoly of the Depository Trust Company in matching services was broken in 1999 with the entrance of Thomson, who quickly went on to prove that it was able to offer superior ancillary services. Currently in Japan however it is hard to believe that there might be a number of plans for matching services available that adequately meet user requirements. In such a situation it would not be particularly constructive or practical to urge the theoretical benefits of competition.

In terms of user institutions, both securities companies and particularly asset management companies have not yet had enough of a voice on this issue. I have already explained how important the issue of STP is to buy-side institutions. Out of the interests of end-users such as investment trust investors and pension funds, buy-side institutions should also be calling for the establishment of a superior securities market infrastructure.

7. In Conclusion

It would be difficult to say that over the past six months the "who, what and why" of the debate on securities settlement infrastructure reform has been finally sorted out. What is needed now is for both public and private sectors, users and service providers, to clarify their role and commit themselves to the cause of reform.

Japan cannot afford to not jump on the reform bandwagon, as the revolution in securities trading processes is a worldwide phenomenon based on remarkable advances in IT and huge increases in securities trading volumes. The debate on institutional infrastructure must not be limited by the current state of systems architecture, just as the debate on a systems architecture must not be limited by the current institutional framework - Japan urgently needs to set the foundations for the establishment of a securities market infrastructure fit for the 21st century.

3 Y. Fuchita "The Advent of a New Age of Inter-market Competition and the Necessity for a More Advanced Market Infrastructure," (Capital Research Journal, Autumn 1999).