

### **Risk mitigating measures at market infrastructures**

*Question from the floor:* I worked for Lehman Brothers in the operations area when the collapse came. Everything in the end seemed to come down to settlement. It was very interesting to hear the events re-told from the perspective of the Hong Kong market infrastructure. But my question: Beyond simply collecting more collateral, could the Hong Kong market infrastructure consider risk management measures that would be less deterring to foreign investors?

*D. Fung:* At this point we are benchmarking our risk management regime against other major markets. Collecting additional collateral is only one way to cover our risk exposure. An alternative would be to require certain risk-taking participants to be better capitalized. Another possibility is for the exchange operator to increase its own risk capital, and that would have to grow as the operator grows its business further. We are doing this right now. We are looking to source more funding for our clearing business. CPSS IOSCO have strict stress testing requirements for clearing houses that include provisions for maintaining their capital. We are looking into this. We are also looking for other ways that would benefit both our participants and our shareholders.

### **The price tag for increased custodian liability**

*Question from the floor:* It was mentioned several times that custodians need to change the way they are remunerated for the additional risks they are asked to take, and for the associated cost. But just how are you going to do that, and is it not true that everyone is waiting for a competitor to start charging first, because otherwise everyone is afraid of being the first to lose clients?

*Question from the floor:* There is clearly the need for custodians to have more capital. We all agree that capital and collateral costs will go up. But do we have any clear idea of the dimensions?

*M. Laurent:* There are two aspects to look at. The first is to make sure that we understand what exactly is expected in terms of restitution of assets and liability. There is now a general tendency to fine tune everything, and to attempt to fix what is not broken. Not all of this may be necessary in the end, but the cost keeps running up, and be it only for doing the analysis.

The second is the extent of asset protection. BNP2S has no problem with its network, much of which is internal. For external agents, good due diligence and a robust legal framework in the country where the assets are located, is essential. We do not always take the risk and we have indeed refused business we felt we could not service. And we have clients who understand that. A hedge fund may operate in an exotic jurisdiction, may be run by a company consisting of two men and a dog, and it may produce a stellar investment performance. Still we may find the risk intolerable and we would not assume it. This must not become our problem; it is the problem of the investor or its fund manager. If it goes wrong, I am happy to see someone else's name on the newspaper front page, not BNP's. Reputation is valuable. There is a certain level of risk you can take, if you can manage it. Then of course you have the question of how to price the risk. You cannot put a price on a risk that you cannot manage.

*Question from D. Hobson:* Any views on the issue of providing subcustodian guarantees?

*M. Laurent:* That depends to a great extent on the subcustodian's local legislation. If the underlying law gives you great comfort that you will get your assets back quickly in the event of subcustodian default, then why not. But if the underlying law is complex, vague, or plainly does not provide that certainty, you got a big problem. Careful analysis is then required.

*Question from the floor:* Investment portfolios can be very dynamic, changing all the time. As a custodian, I am interested to hear an asset manager's view if I said that I was actually refusing to settle a trade?

*D. Sullivan:* If I take my fiduciary responsibility as an asset manager seriously, I would actually have to expect and be grateful for my custodian to do this! I know this would be a painful conversation with my front office. But if my custodian feels that taking on a certain trade is not safe, not appropriate or not feasible, I would expect to be told.

## **Globalized markets**

*Question from the floor:* With regard to the shift of wealth from West to East, how are the European custodians actually positioned to support this flow?

*M. Laurent:* Custodians must be able to support globalization in all directions. They need a global operating model that can allow a global asset manager to do business all over the world, and they must be able to support all the shifts in strategy and assets. However, it is a big challenge to maintain a home market standard all across the globe. We have practical experience with this and we are working hard on it.

We have a good dialogue with Asian infrastructures and regulators. We feel we can help them benefit from the European experience with handling fragmented markets. There is the aspect of facilitating inbound investments into Asia, but also helping Asian investors to invest cross-border. Achieving balance on a global level is very important in certain aspects, and also the avoidance of regulatory arbitrage.

*Question from D. Hobson:* How do the asset managers cope with differences in market practice and regulation between markets? Do they care at all, or do they expect the custodians to sort everything out?

*D. Sullivan:* We are a global investor, so we naturally have to deal with multiple jurisdictions and cross-border issues. It just comes along with trading that we need to understand the local market, its regulation, restrictions and practices.

## **Globally consistent regulation**

*Question from the floor:* It was mentioned that there was a divergence in the way regulation was going in the US versus Europe and that was unfortunate. Could that be elaborated on a bit more?

*M. Laurent:* The difference is in the focus and emphasis. In the US, the current emphasis is on the prevention of systemic risk. In Europe, the top priority right now is investor protection. Clearly, both are important. But the focus is very different now and the result is that we are moving in different directions with some potential for distraction,

scattering of scarce resources and also potential for conflict in certain areas. It puts a double pressure on the custodians.

### **Industry leadership**

*Question from the floor:* Where should the new leadership come from, that we were repeatedly concluded we need? We all seem to be sitting in the same boat, and we all are busy trying to pass on responsibility to someone else. Should the leadership come from individuals, institutions, industry associations, countries, politicians, regulators? I do not see leadership emerging anywhere, at least not the type we are envisaging here.

*D. Hobson:* I have been surprised by the custodian industry's lack of stance in dealing with unprecedented press and regulatory hostility. To some extent, and under normal circumstances, you could be content with leaving that to the industry associations. What you forget when relying on the industry associations is that you are not really their client. Their "client" is the public official, the regulator. So the industry associations are naturally compromised. Now you are getting yourselves into a situation where you are negotiating with intrinsically hostile partners. They want to unload on the custodians just about every single type of risk. That is of course because the governments have to answer to their retail investors who lost a lot of money. They assume that the custodians have got the money to make the retail investors whole again.

You need to think beyond industry associations. Go to politicians and regulators directly. Go to opinion formers/leaders, think tanks, journalists. Make your own case, explain what you actually do. You did your job well and you came out of the crisis pretty much unharmed. The custodian industry has a lot less to answer for than the asset managers and the investment bankers do. But somehow, there seems to be a cultural cringe in the custody world where people tend to feel they are less important. So, my recommendation to you is: Be more assertive, self-confident and proud of what you are doing. Get out there and fight a good fight!