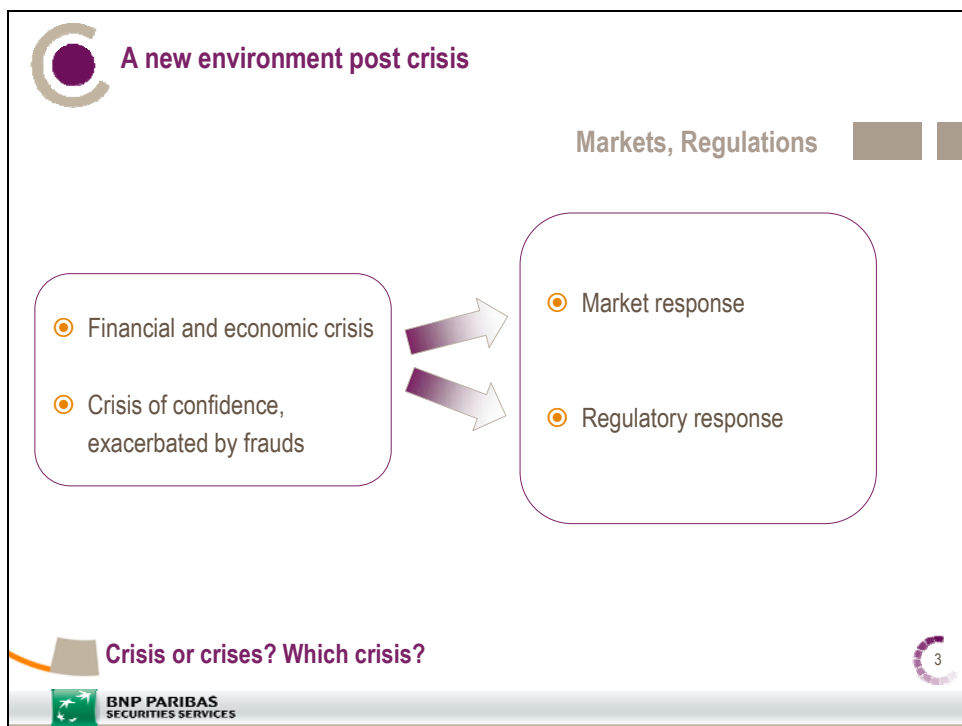




I will focus on just two talking points: What is our new market environment after the crisis? And: What are the implications, particularly for custodians?



My first observation is that we did not have one crisis, we had a combination of several: When we had the internet bubble, we also had the incident around Enron. We had Madoff right after the sub-prime credit crisis. Now we have the sovereign debt crisis. The question is: Which could be the next scandal shattering confidence in the financial system?

It is important to understand that a lot of the activity around defining a strategic approach is driven by a mixture between two components, namely the financial and economic crisis, and the confidence crisis.

So I will look, firstly, at the impact of that mixture on the markets, which echoes very much what Dominic already touched upon in his introduction, and secondly, at the regulatory response which is very important.

The Market Response

From the market side point of view, let me start with the conclusion: Yes, the model is shaken, but it is not broken. What we see is an evolution.

A new environment post crisis

Market response

- **Products**
 - Return to traditional, simpler products
 - More selective on complex products
- **Players**
 - Consolidation of broker-dealers with banks
 - Buy side move to more diversified counterparties
- **Markets**
 - Strong competition among trading venues
 - Diversification of stock exchanges as response (new products and vertical silos)
 - Move towards more structured OTC derivatives market

The model is shaken, not necessarily broken

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There is a change in product design. We heard that we are moving back to more traditional, simpler products. That is a fact.

We see that the players are changing. What is going to happen to the broker-dealers? They are at the heart of the system in terms of generating the activity, the transaction volumes that make up our market. So when we saw Lehman go down, when we see consolidation like Bear Stearns being absorbed by a large universal bank, what does that mean to the intermediation model? There will be fewer actors. Is that going to significantly impact the way securities and other financial instruments are traded?

At this stage, we have seen not only consolidation; the market has also created new players. Orders are taking new routes. We already talked about the new alternative

trading facilities. Overall, they have created rather more arbitrage opportunities than consolidation has destroyed.

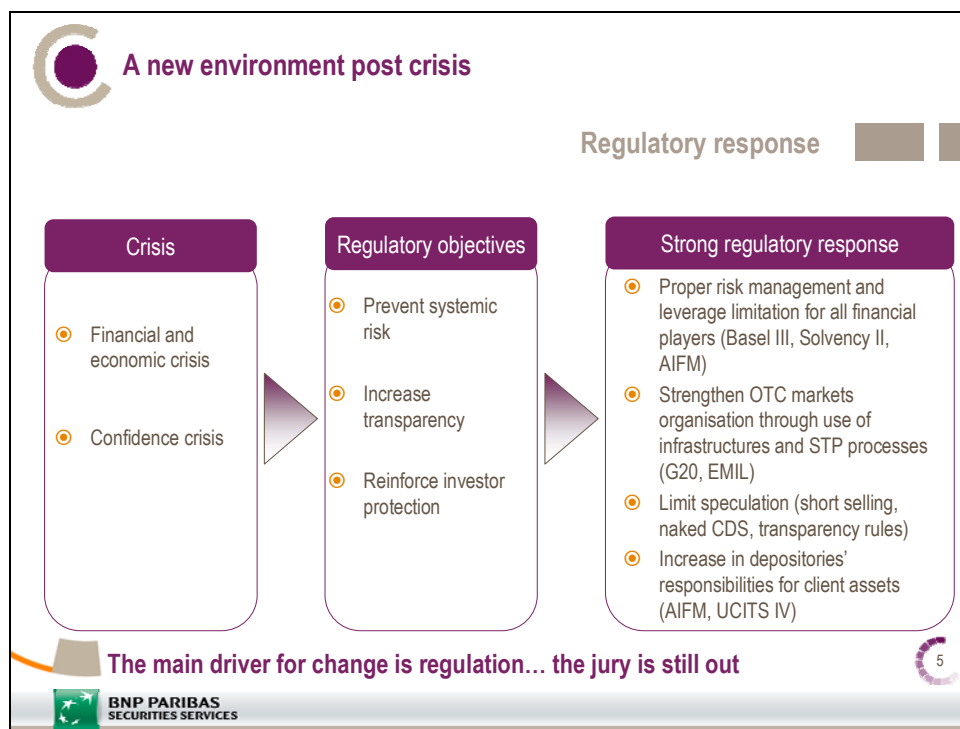
It came across very clearly in yesterday's discussion that volatility is still a driving factor for the business volumes that are being generated. If we look at the latest issue of Financial News, European trading volumes in May have reached the highest peak since the previous highest peak that occurred in the last quarter of 2008. So we continue to see ups and downs, but the essential observation is that the peaks are still growing. That is a good indication that the engine of our market is not broken.

All these changes are impacting the markets. The industry has to adapt to new competition between trading venues, to new responses from the traditional stock exchanges, but most importantly, to new products and services. When OTC derivatives are now going to be cleared through CCPs that is not taking away activity and volumes from the industry, that is creating opportunities to provide new services in that area.

So at the end of the day, there are as many opportunities as threats for the market players.

The Regulatory Response

You asked the right question in one of yesterday's sessions: Do we need more regulation made for us, or can we shape better regulation by ourselves? Actually, in a way it is a rather irrelevant question because we are not asked whether we would like to have new regulation, it will just happen. This is a fact of life. But it is important that we realize that the two major drivers I mentioned – financial/economic and loss of confidence – are triggering different initiatives that have different objectives.



As Xavier Lépine said yesterday, we do not necessarily have a financial crisis in the first place. We had an economic crisis that is behind the financial crisis. What the regulators are doing – we heard that yesterday already – is to try to prevent systemic risk. That is not necessarily addressing the core of the issue. It is just ensuring that, if you have an

issue, it is not spreading to other market participants. That will not necessarily prevent people from investing in sub-prime instruments and other products that may not be suitable for them.

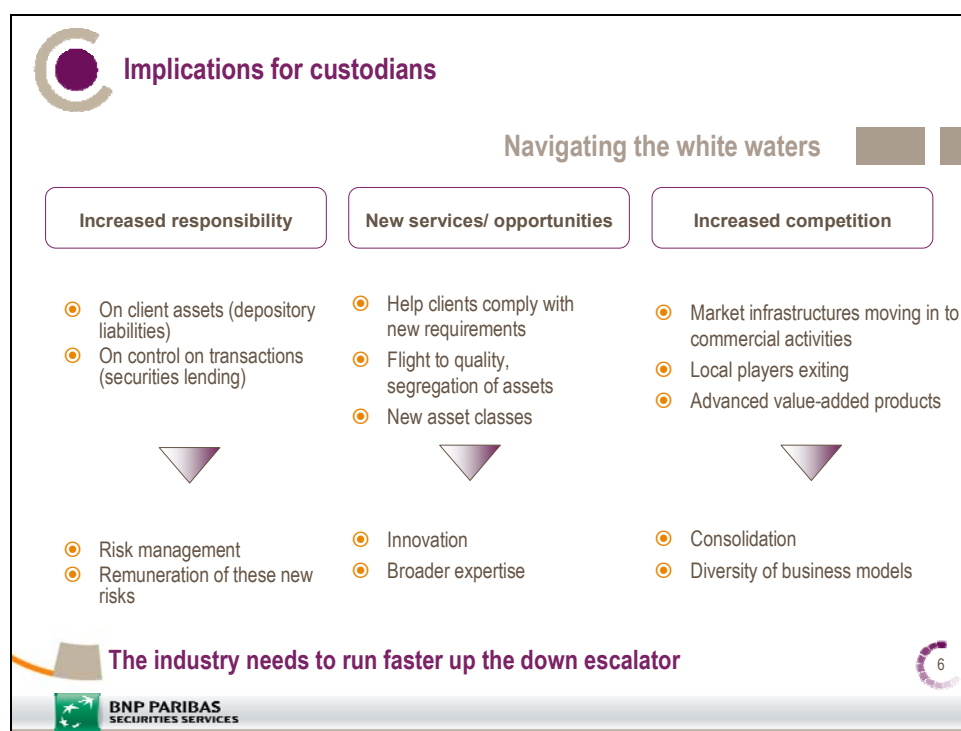
Increase transparency – that goes a bit more to the issue of having a better understanding of the components of the toys we are playing with.

But most of the regulation, that is affecting the industry most profoundly, is in the area of investor protection. This is mostly triggered by the prominent fraud cases that have caused such a confidence crisis. However, those are really exceptional situations.

There are a number of public sector initiatives you are all familiar with. I do not need to explain them in detail but it may be interesting for you to see how we classified them. Once we classify them, we are in a position to sort and align them. And it is striking to see that some of the directions our American friends are taking, have a very different focus from the initiatives that are taken in Europe. This is a bit disturbing.

Some of these regulations have a huge potential impact on the industry. At the top are the liabilities imposed on custodians for the restitution of assets. There is nothing wrong about being responsible for the safe keeping of assets on behalf of customers. The real problem is that we do not always control the underlying regulatory or legal environment in which some of these assets are ultimately located. As long as we have a responsibility, we need to understand how far reaching it can be on the underlying assets, and on the freedom of asset managers and investors to pick and choose investment instruments and asset classes that do not have the same level of "reliability".

That is not only an issue for the custodians to address. There is no way we are going to take on ownership and responsibility for decisions that have entirely been made by investors or their investment managers. What we *can* do is to highlight to them the intrinsic risks of these instruments, but not much more than that.



I would like to build on and highlight something that Marc van den Berg said earlier, from the end-investor point of view: The number one priority is safety of the assets. Rating is one aspect, but more broadly, making sure that you are not losing the assets. It just cannot be otherwise.

Second: capability. That is where you find opportunities for custodians to develop new services. There is a lot of expertise and skill in the custody industry to help investors understand the potential risks they are taking, and to service the investors and their asset managers in that area. Of course, if we just see the custodian as the safekeeper of assets, we are missing out on many opportunities for a custodian to provide added value.

Then: the cost. That is the most popular element of the economic impact. But it is very important that we all agree that cost is only coming in as the third priority. Organizing a market and its component processes well, will of course transpire into lower cost. But the last thing we want to do is to compromise the asset safety and the service delivery by cutting cost at the expense of the investments the industry needs to make to remain safe and innovative.

It is a difficult equation. On one hand, we have indeed increased responsibility. This is under intense discussion at least in the European scene; I am not sure if it is the case with the same intensity in other parts of the world. So we have to think about the potential for regulatory arbitrage. We should address this issue on a more global level.

Control of transactions: We talked already a lot about securities lending. Custodians have a role to play in helping the investors understand and manage their securities lending transactions. When we were talking in Danny Sullivan's part about having a regular reporting on the exposure in securities lending, this is certainly something the custodian can help with – on top of execution. Of course, this is creating additional risk for the custodian. We need to be very cautious and aware of our risks. And we need to explain and be very transparent and cooperative about it in our dialogue with the regulators. We must make clear what the legitimate risks and the liabilities are which the custodian can and should take, while making sure that we are not taking on liabilities that are the result of the sole decision of the asset manager or the end investor.

Systemic risk management is like making sure you are building strong factories, if you want to make dynamite, and making sure that your dynamite production does not blow up the neighborhood. Investor protection is like making sure that the toys that are sold to children do not contain any dynamite. This is where we can help.

New services, new opportunities: We see a complete change in the kind of questions clients are asking us. They now ask about ratings, about segregation of assets, about how we are managing the assets that are held at subcustodians. Contracts that have been in place for thirty years are now being reviewed line by line. That is fine and fair, as safeguarding the assets is paramount.

This being said, our business is no longer just about securities services. Indeed, maybe ISSA should change its name, because the asset classes custodians are now servicing are far more diversified than just securities. And from what we heard yesterday, the end of asset diversification is not in sight yet. When you go to Asia, you are now often asked questions like "How are you servicing private equity, private or commercial real estate, or infrastructure?" We need to be able to stay on the edge of innovation.

Very importantly we need to be able to continue bringing broader expertise into our industry. We need to leverage the expertise from colleagues from other fields in the

banking industry. We need to be able to continue investing so that we can service the new products we are asked to "keep in custody"!

At the end of the day, the main driver of the economics in our market is not the regulator, not the customer, not the market itself; it is the level of competition. Consolidation and competition will continue and intensify.

The European market is about the same size as the US market, but 10-20 times more custodians are competing in it. Consolidation is inevitable. We will see more small actors exit the market and more restructuring of the industry around a more global model.

That said, it is interesting to note that there are probably no two custodians doing exactly the same thing. If you take the car industry, you could argue that Toyota and Volkswagen are doing more or less the same thing. That is not true of the custodians. Each has a different business model. Each services a different client mix. Each offers a different product mix. Some are very specialized on one client segment, some are very broad. Some are stand-alone operations, some are integrated with investment banks and asset managers, and exploiting cross-selling potential is a key aspect of their business model. For that reason, there will not be a single answer to the question "Who will pay the bill?"

Implications for custodians

Taking the long view

- The industry is indeed under pressure
- But let's not forget:
 - Continuing need to support investments (savings, pensions, projects)
 - Shifts in wealth (West – East)
 - Globalisation is not a buzz word
- ISSA could consolidate and promote the industry's views
 - A global approach to regulation
 - Go for realistic measures

Custodians need to adapt to stay fit and lean

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What we discussed so far, was a rather short-term view. Seeking an answer with a long-term view, my observations are the following:

We need to go back to the core values and the basics of our industry. We should remind ourselves that the custodian business is something we can do with a bit more pride. We need to realize that we did not create the problem, but we are a very important part of the solution.

We heard yesterday that the custodian function remains important because the need to service savings, pensions and all categories of investment instruments becomes ever

greater. The industry is changing a lot, but it will continue to grow overall. There is an unprecedented and rapid amount of wealth accumulation in Asia, and the industry there is asking for services and our help to manage this wealth.

If there is one area where regulation can help us, it is to avoid protectionism. Globalization must be able to continue within a reasonable and realistic regulatory framework, without individual country or regional responses that create hurdles.

There could be a role for ISSA: ISSA could represent the end investors, the market players and the infrastructure, and voice their views and needs for a globally consistent and realistic regulatory framework.

Let me close with a quote from a French philosopher: "Life is not a day of victory, nor a day of defeat; it is a day of fighting".