

*Ray Parodi:* Before we invite questions, let me try to summarize the key points from our three panelists and also from what we heard earlier today – in particular in Don Donahue's key note address – and put that together. As I heard it, essentially, the following suggestions are on the table:

- We should make increased use of infrastructures, particularly central clearing through CCPs.
- Those central counterparties should integrate themselves more, or utilize overlay data repositories of one kind or another, to bring together globally all relevant information. That would create more transparency, from which a systemic view of all market activity could be derived.
- Perhaps the CCPs should extend their services to the buy-side, to institutional investors and to other non-regulated entities. There is some merit to that, but at the same time it raises issues that need to be carefully addressed.
- We should re-think some of our processes globally, for instance adopting a T+1 or T+2 settlement standard, and the consequences of moving into one or the other direction. Even if we have robust procedures in place, they may cause different effects in different areas as the world becomes more global and two sides of a transaction become unbalanced.
- Stress testing: The crisis can be seen as an inadvertent stress test for all market segments. Going forward, more institutionalized, standardized, regionalized stress testing should be done on a regular basis to prevent a repetition of the crisis we are still emerging from.
- What exactly is the role of the custodians and the depositories in the post-crisis world? Let me just pick up one point Chris Coe made about the need for documentation to be clear and watertight: For a long time, particularly on the sell-side of our industry, sales staff preferred as little documentation as possible and the wordings to be as imprecise as possible, for as long as it got the customer on the buy-side to sign the contract. Contrast that with the view of operations staff who want everything explained and agreed in full detail.
- Finally, two main points with regard to technology and data: First, high frequency trading requires standard language, more standardization, more data and more data processing capability. And second, the data itself needs to be more structured, so that everyone involved from issuance to trading to custody and corporate actions can better understand what exactly they are faced with, and manage the associated risks accordingly as the product is moving through each particular step along the processing line.

Now let's get the discussion going!

### **Do we need more regulation?**

*Do we really need more regulation now? We all know what the answer would have been a few years ago. Is it different today? If we do need increased regulation, where?*

*Custodian:* If you had asked this question in any previous symposium we would have said no. But those days are gone. I found it striking that, when we discussed corporate actions earlier today and came to the questions of "How do we get to standardized data, and how do we enforce it that the issuers communicate with us in XBRL?" almost everyone in this room saw the regulators as the solution. It seems that we finally found

an area where we actually call for the regulators to step in and make our lives less risky, at least in one particular part of our industry.

As far as the financial crisis is concerned, there is a general recognition that we are simply not allowed anymore to say no to new regulation. But we do need a dialogue with the regulators along a more constructive line than what we have had up to now, for instance with respect to the AIFM Directive and custodian liability. There is so much unrealistic expectation in that particular area right now. The regulators do need to listen to us. They just cannot insist that they are now in charge of running our part of the world.

*Central Depository:* Market infrastructures should be much more proactive, particularly at this time. We have proven in the past that we have taken a lot of risk out of the markets. Now we must ask again what else we can do to assist the markets further under the current conditions. Also, the banks, instead of feeling threatened about the infrastructures moving into their turf, should be working with us rather than against us. The banks could ask the infrastructures to take some risk away from them. Some of the risk the banks incur causes them only cost, but they do not make any money out of it. Instead, the infrastructures take it off their backs, centralize it, thereby achieving economies of scale, and manage it efficiently. Everyone should do what they can do best. We all must not wait for the regulators telling us what we shall do. We should now work together, take some risk out of the market and surprise the regulators. We should be proactive and tell them: "Look, we noticed a problem and this is what we have done about it!"

*Custodian:* It is crucial to have that constructive dialogue. Regulation, when pushed through in a hurry, can have unintended consequences and be more expensive than necessary. Take for instance the funds regulation in Europe. The way it is currently being drafted, it is likely to mean much higher back office cost for the European funds industry, and it might mean additional systemic risk.

*Central Depository:* The unintended consequences are currently one of the major issues we are facing. They arise because the regulators are not listening. And they are not listening because they are upset. They say: "You had your chance, you did not do what you were supposed to do; we will do it now for you." In addition, there is political pressure on the regulators to take action because public pressure is so strong now to demonstrate serious action being taken quickly. Particularly in Europe, cleaning up the unintended consequences is indeed the biggest risks we face right now.

*R. Parodi:* It is indeed a big problem that the regulators – or the public – do not understand what the operations specialists are doing. The fund managers and the investors are taking so many things for granted which in reality are not, because they simply are not so close to operations and not so familiar with the issues. That begs the question, could and should the custodians and infrastructures provide the same kind of education they give to internal staff, also to the regulators and other outside stakeholders? Regulatory solutions might be better, if the decision makers understood more comprehensively the issues and the potential consequences of their decisions.

*P. Parkinson:* A bit of unsolicited advice from a regulator: Do not use the term "unintended consequences"! It will not strike a positive resonance with the regulators who will read it as language aimed at opposing reform. This is not to say though that you do not have a point.... Also, banks in Europe, the U.S. and elsewhere point out a lot what the added cost of new regulation will be to them. Be aware, the regulators just do not care about this! The better argument would be to point out that any additional cost would

be passed on to the end-consumer wherever possible. It will not be the profits of the banks that will suffer, if the banks are burdened with new regulation. Custodians will try to pass the cost on. New liability rules imposed on global custodians will cause them to see their greatest risk in the markets with the weakest local infrastructures. Therefore, new regulation is going to be most costly in those parts of the world where infrastructures are not yet fully developed, i.e. the ones to get hit hardest are the sub-custodians in emerging markets. That will push up the cost of investing in those markets to the end-investor. In the real world, the cost of new regulation will always be passed on to someone else. That "someone else" is going to be the victim of the unintended consequences.

*Central Depository:* Do we need more regulation? We all would like to collectively move to a world where the bar is set higher to avoid any given risk. We have now lived through a period where things have gone wrong. Our risk tolerance has dropped as volatilities have gone up. It should be easy now to get everyone's agreement that we should set the bar higher so that we all can live safer. The problem of course is: How can we really measure risk?

Basel I was an amazing achievement. It gave us a globally agreed and simple set of rules to mitigate risk. Everyone recognized the need to deal with these issues on an international level, and we agreed globally on some common rules. But that regulatory framework was relatively crude. It created strong incentives for banks to move activity off their balance sheets, which led to the creation of all those Special Purpose Vehicles. And we still live with the consequences of that. Basel II was then all about going to a risk-weighted way to define minimum capital requirements. We should remind ourselves that Basel II was not fully implemented yet when the markets collapsed. So, nobody should say Basel II failed. It was a very important effort but one that remained incomplete. So, do we now need Basel III or 'Basel I½' to come to a better approach? We will always need to measure the amount of capital used against the amount of risk taken, but it will not be easy. I do not want to see a return to crude ratios, because they do not solve the problem and will create more of those unintended consequences we all want to avoid.

C. Coe: If it turns out to be true that we will not find easy ways to measure and mitigate risk in certain markets we operate in, that will have a serious effect on our clients' investment decisions. For if we are not able to satisfy regulators' and clients' safety expectations, we simply may not be able anymore to make some of those markets available to our clients. That may well be one of the consequences to face as we look at the liability pressures that are being put upon us.

*Central Depository:* I want to add a basic remark on risk management and regulation. There are two major types of risk: individual market players' risk, and systemic risk affecting a market as a whole. Everybody has talked a lot about the crisis, but not enough about its causes. In my opinion, one of the major causes was a lack of monitoring of market movements. Who monitored overall market movements? We need more transparency in that area. Central banks and supervisory bodies need to do more monitoring as a basis for new and better regulation. That is most important and necessary all around the world, in a coordinated way! Before we consider new regulation, the causes of failure need to be examined more thoroughly.

*R. Parodi:* We have been talking for a long time about interoperability among clearing houses and among infrastructures in general. Making it come to pass has happened only in some partial areas yet, and much more slowly than expected. Since the market will probably not achieve a comprehensive level of interoperability and interaction on its own,

*is there a level of involvement by the regulators that we would see as useful? What are the concrete issues that we would welcome the regulators to push and pull that would be helpful for us?*

*Central Depository:* I do not share the assumption that the infrastructures, if left to their own devices, are unable to pursue meaningful strategies to achieve interoperability. Take for instance the LinkUp Markets project where ten CSDs decided to operate together across the globe. It started in Europe, currently we are reaching out to South Africa and Egypt, and expanding into Asia may well be the next step.

As to the CCPs, there has not been much concrete movement towards interoperability yet, but the main focus of the European market infrastructure legislation and regulation is precisely about access and interoperability. So that will come, even if "by hammer".

One of the reasons why the European CSDs are not in the focus of the EMIR legislation is the fact that they already started the process on their own. Now we have to complete it. Ten CSDs have joined. We need more of them. Then we need to do the same on the CCP level. Yes, it is forced by legislation there, but nevertheless we are moving to an interoperable environment.

### **Interaction between the front and the back office**

*Custodian:* In my firm, I am responsible for innovation efforts. Sometimes I wonder what that means exactly. Sometimes I get the feeling that, in our industry, it means "Because you *can* do something, you *shall* do it".

We as custodians are at the lowest end of the product development food chain, always at the receiving end. The real innovation takes place in the front office. But there should be some type of basic operations requirements that we should define ourselves and that must be met by the time new products come onto the shelf. It struck me during Don Donahue's speech this morning that it took us about seven years to come to a settlement-like structure to handle credit default swaps, and we applauded ourselves about our achievement. Seven years of struggle seems like a long time to me! So, a checklist to be worked off for every new product prior to its release into the market would be a better way. We need to find some minimum consensus between the front office and operations.

Also, there are products or trading techniques, like for instance the ultra high speed trading, where one could rightfully ask what their greater good for society is, but it is not upon us to make those judgment calls. However, the fact is that they, too, may create unforeseen consequences, and we will have to deal with them at some time. Anyway, a more rational approach to innovation would serve us well!

*Infrastructure:* At what point do we say we have a new product and we now need to do something about it? Often product evolution is a slowly growing process. We need to identify the trigger points where we can say: "Now it has created so much momentum, the infrastructures need to offer a solution". Not every new product takes off, and if we attempt to create standards and infrastructures for everything when we first see it, we may waste a lot of effort and investment.

*R. Parodi:* What I hear now is that industry and investors would both benefit if we had a standard way to identify and understand the key risks before a product is issued. If that were communicated in a standard way and in plain language at the outset, the processing agents would know what they will have to handle, and the investors would know what they are about to buy.

For financial instruments, the issuing prospectus usually contains that information somewhere. Maybe it would be an improvement to standardize the labeling of that section, so that everyone could easily find it, understand it and compare it. You could use a variation of this for corporate actions data as well. We already managed to develop ISO messages to standardize the processing part of corporation actions. We should be able to extend that into the front end of the transaction, with a transmission device that carries the information all the way through to the investor.

### **The role of infrastructures vs the role of custodian banks**

*R. Parodi: Let's pick up a point raised a few minutes ago, about what infrastructures should do versus what banks should do. Infrastructures minimize risk. That is their mission. They should not take on any avoidable risk. Conversely, taking on risk is the reason for being for banks. Banks need to fully understand what that risk is, how much of it they can handle, and how they can control it. A thesis: The banks should take on risk, and the infrastructures should do processing that is as risk-free as possible. Any views?*

*Central Depository: Our capital market infrastructures are evolving. With a few major exceptions – for instance the U.S. and Canada – the infrastructures are now commercial enterprises. They have entered some of the turf that traditionally has been occupied by the banks, because margins in their core business are eroding, and there is an economic reward for taking on and managing some of that risk. That has created an inherent conflict of interest between the custodians and the "pure" infrastructures.*

*Infrastructure: The CCPs are vital infrastructure components and – irrespective of whether they are commercially oriented enterprises or not – are by definition taking risks! So Ray, would you classify a CCP as an infrastructure?*

*R. Parodi: Yes, CCPs are an infrastructure element. They take risk and manage it in a way so as to minimize it. I meant more the taking of "unnecessary" risk, taken purely for profit making motives. That should be left to the banks. Only a risk that can be minimized by the infrastructures – exactly by virtue of them being infrastructures and in a way that cannot be minimized by the banks – should be taken by the infrastructures.*

*Infrastructure: Isn't the problem precisely that those once clear-cut roles are becoming completely blurred? Broker-dealers are now becoming exchanges, even some asset managers and hedge funds are moving in that direction. The world of clear-cut roles has ended, and that increases risk.*

*Custodian: I learned in many years working in credit lending, that when a firm moves outside of its core competencies, they introduce new risk. I feel that this is going on in our industry right now. Organizations move outside their core competencies into fields that are new to them, and that creates risk. That worries me. Such firms tend to drag their cash flows out of their core competencies into the new fields where they struggle. That again weakens their core competencies.*

*Central Depository: We should separate two things here: There is clearly a blurring of roles, but you can manage the risks if you can ring-fence the different functional aspects of what you do. As long as you are able to define clearly what the infrastructure function is, and what your commercial business function is, you can ring-fence the two, and there should not be a significant problem. Your shareholders and investors of course need to understand that there are very different business models in each function. But both sides can work alongside without the commercial side contaminating the infrastructure side with commercial risk. The cleanest way to do that is to put the two parts into separate*

legal entities, each with a distinct remit, and each capitalized separately. This is one model; there may be other models to achieve the goal.

*Central Depository:* The degree to which products are standardized plays a role here. Euroclear, as a key piece of the European market infrastructure, has a mission statement that says, in essence, that it wants to be the leading provider of post trade, commoditized services in Europe and beyond. The key word is "commoditized". That is our operating license we get from our users, as it were. Now of course, we are in the debate of when something is commoditized. Non-commoditized products are high value added products which the market regards as subject to competition. Commoditized products or services are things that the market basically sees as a cost that needs to be minimized, and where the market sees a collective advantage in having those products or services provided centrally by infrastructures. Of course, the border is blurred and moving through time. Products that once were new and varied and were offered by different providers become standardized and commoditized over time. And there are always market players for whom those products are profit centers. They have a keen interest in slowing the process of that product becoming infrastructure provided. Others see the same product as a pure cost that simply needs to be taken out of the market. That debate is always present in infrastructures. It happens in our board, and it is usually solved through market consultation mechanisms. This is always going to be a tense debate because, if you take out inefficiency of a market, there is always going to be a loser. You are taking out cost for the majority of the market, but you are erasing someone's profit base. That will always remain a delicate issue.

### **Risk management by central counterparties**

*Custodian:* Coming back to the CCPs: We have seen a proliferation of them and we have seen them becoming increasingly important. One of the questions that come to mind is: Do they all operate in similar ways? We have different kinds of risk models in different parts of the world. There are different ways and processes to treat margins and other issues, too. Is that a risk? Should there be someone looking into this and make it more transparent?

*P. Parkinson:* In that area, several years ago, central banks and securities regulators spent a lot of time setting standards for risk management by CCPs [see the CPSS/IOSCO Recommendations for Central Counterparties, November 2004]. Those standards do not require all CCPs to address risk management in exactly the same way, but they do require all of them to look at the issues affecting them and manage them effectively. Those standards are under review right now by CPSS and IOSCO because they were developed in a time when the only central counterparty for OTC derivatives was SwapClear. Many unique processing and risk aspects now found in new products were not taken into consideration at that time, so the standards need an update. But in principle, there is a process in place to which all the major countries subscribe for insuring that – even if they take different paths to particular risk management issues – they all get to the same destination.

*Central Depository:* Just an observation: After the financial crisis, in Germany the CSD and CCP were declared systemically important institutions. Regulatory oversight was intensified by the BaFin and the Bundesbank to the point where they are now present in all the board meetings in Frankfurt.

*Closing remark by R. Parodi:* Obviously, an overarching framework is important. But if we want to avoid a repetition of what we have just gone through, there has to be a way to evaluate the interconnectedness and the resulting potential liabilities from a holistic perspective. It is good that ten CSDs are now working closely together, but there are

many more, and we need those to come on board, too. It is good to have a framework, but that is only a beginning, and we have to get to the end. That is part of what we have been discussing today. Thank you all for your participation.