

Twenty-five years ago, I took a then innovative course at the Wharton Business School on "De-regulation and re-regulation". We looked back over a hundred year cycle of regulation. We observed that, in any regulated industry, the density of regulation ratchets up after something goes wrong, until it is perceived to be too much of an obstacle to further business development and economic welfare. It is then scaled back. Examples included the financial industry, the airlines, or telecommunications. This reactive deregulation is exactly what was happening around 1985.

One key thesis of the course was that de-regulation feeds re-regulation: in the process of seeking deregulation and unfettered competition, fresh concerns come up; for instance about the need for minimum safety standards in the airline industry, or equal access rights to local distribution in the telecom industry to foster competition. In the banking industry, one concern was about the incentives to take extreme risks if a bank enjoyed implicit public sector insurance. When that is exploited, the regulation cycle begins all over again. The length of such cycles varies greatly, it can be anything from five years to the time span of a generation or more.

There is no single right or wrong answer to the appropriate degree of regulation, it is always a trade-off. There is a cost of providing safety; the cost is that intermediation is taxed. That has an impact on the real economy. The banking industry is right now pointing out that consequence to the regulators in an attempt to mitigate the extent of new regulation that is on the horizon.

I think there are six major themes of relevance for us that will dominate the next phase of the debate:

1. More regulation

As in previous cycles, after the crisis, we will undoubtedly see a substantial raising of the regulatory bar for the financial industry in different dimensions. It will have an impact on the real economy. Yet it will not provide complete safety. We will not have a world where risk is fully removed from the banking system. And there is likely to be a very substantial cost attached to providing the safety net that the regulators are now designing. The industry is resisting too much regulation, but will need to accept a substantial increase.

2. More use of infrastructures

The capital market infrastructures generally performed well during the crisis. Payment and securities settlement infrastructures managed to withstand the turbulent times without suffering damage or creating harm to third parties. That was not by accident. Over the previous decades, a lot of thought had gone into the regulatory framework for our core infrastructures, and into their operational design. They could handle the volumes well. They were the "dog that did not bark" as Don Donahue, quoting Sherlock Holmes, said earlier today.

The focus of the debate is now on central counterparties, and particularly on bringing OTC derivatives into a CCP environment. This is a worthy objective, but CCPs are not the silver bullet that solves all problems. CCPs are essentially about transferring risk to a place where it can most sensibly be managed. They bring important netting benefits. But it is most important that the CCP itself is protected, when all risk is centralized within it.

Infrastructures are seen as a safe haven by many market participants. When liquidity was tight, Euroclear's problem was that massive amounts of liquidity were thrown at the Bank. We were sitting on very large long balances of cash and we had to find safe ways

to redeposit them. This safe haven status was a general experience throughout the financial infrastructure.

3. Attempts to reduce connectedness

The "Too Big To Fail" debate has now shifted somewhat away from size. Now the critical point is whether an organization is too *interconnected* to fail. This is a more appropriate view. Big institutions are often more interconnected than small ones and tend to be higher up the list of those to worry about, but size is not the key criterion for systemic safety. About 20 years ago in the UK a few small banks had a high exposure in certain market segments which was thought to cause a risk of major market disruption. They were covertly supported by the Bank of England to avoid systemic risk, which was not disclosed until much later. The concern was that the failure of several small banking institutions could trigger a run on other institutions and the Bank of England stepped in to avoid that eventuality.

We will see much more discussion about proposals to reduce the extent of connectedness. Concepts that have been proposed so far include living wills for banks which plan how they should be unwound in an orderly way, if the worst came to the worst. Another approach is bank resolution regimes that would make it possible for the authorities to close a bank quickly in an emergency. We will see more transactions done on a secured basis, particularly in Europe where there has been a tradition of doing a greater proportion of unsecured money market transactions. There will probably be more repo activity in Europe, following the pattern in the US market. Pat Parkinson already mentioned the increasing convergence of models between the US and Europe to have real-time roll-overs, longer term repos and substitution of collateral, which is provided in Europe by the two ICSDs.

4. More planning for crisis management

Pressure for the simplification of institutions is likely to intensify. Ten years ago, the Glass-Steagall Act was repealed in the US, which was part of the regular cycle of a bonfire of regulations apparently impeding innovation. These restrictions had lasted since 1933. The public discussion has now begun as to whether single purpose, "old-style" institutions are safer than the integrated, continental European type of universal banks. I certainly do see a role for single purpose institutions. Central infrastructures, such as Euroclear and similar organisations, are strong exactly because they are single purpose institutions. But we will probably see less simplification of banking structures in that sense, but rather more commoditisation and standardisation in the products, to make them easier to identify and to manage. Nevertheless, substantial complexity will remain.

5. Regulatory focus on liquidity risk – it will remain a difficult subject

The debate on the regulation of liquidity risk is intense and difficult. What is liquidity, how can it best be measured, what meaningful rules should be set? The debates are likely to be long and difficult because there is no right answer. Liquidity risk is much more difficult to measure than most other risk types that are relevant to the financial sector. Liquidity risk is essentially an "all or nothing" issue: a firm either has full access to liquidity, or virtually none. There is almost no middle ground.

We will see more demand for easy access to liquidity. That requires the ability to use collateral efficiently, which is particularly difficult on a cross-border basis. At Euroclear, we have put a lot of thought into making the use of collateral across borders as efficient as possible for our clients, by creating as nearly as possible a single pot of collateral that can be moved from one use to another, as seamlessly as possible. Providing that greater flexibility will be a strong trend within the industry.

6. More netting in a legally robust environment

Over the last twenty or thirty years, there have been great advances in the mechanics of trading, clearing and settlement. In the early part of that period, the preferred solutions tended to be real-time gross settlement solutions. Regulators favoured those, because they provided a sufficiently high degree of clarity around the moment of finality. They were very keen then to avoid the interdependence in markets that could arise if the settlement of transactions were dependent on each other. In those days, netting systems were typically "net end of day" systems. If at the end of the day a counterparty had failed, it might be necessary to unwind all the transactions that had happened that day. That was a horrific prospect and it was difficult to make such a settlement institution safe from failure without disrupting markets. Settlement institutions were made more robust by moving to real-time gross systems. RTGS systems, however, have very high liquidity needs. In times of growing transaction volumes and increasing demand for liquidity, that becomes a problem. The ideal solution is to achieve the operational and liquidity benefits of netting schemes, without losing the finality benefits and benefits of separating transactions that gross systems have.

There are now examples of progress in this area, for instance in foreign exchange settlement. Continuous Linked Settlement (CLS) has mastered the trick of managing to get the operational benefits of netting while having the functional benefits of finality in its processes. Even if a counterparty fails in the middle of the process, it is still known exactly what will happen, and the systemic risk that would arise without that certainty is contained.

CCPs are trying to achieve the same benefits: to get the operational benefits of netting while creating a high degree of certainty about the completion of the trade in a legally robust environment. In the repo market, too, much of the work on the ICMA Global Master Repurchase Agreement (GMRA) has been to provide legally robust netting. The European Repo Council has written to the Basel Committee trying to obtain support in the forthcoming Basel III regulations to recognise that, when imposing leverage ratios or other measures to limit gross balance sheet size, true netting that is legally effective should be recognised and market participants should not have to put the gross amounts in their balance sheet. There may be an argument with the accountants, but the repo experts hope to solve that issue.

Conclusion

We have been through a prolonged period of deregulation in financial services since the course I referred to was being run at the Wharton Business School, and we have experienced deregulation's weaknesses as well as its benefits.

We will now see a period, probably lengthy and intense, of re-regulation. That too will have problems as well as mitigating some of today's ills. And so deregulation will surely come again.