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Why the Chicken Won't Cross the Road: Rethinking Risk Management

Thank you, Randy.

Good morning, everyone. It's a pleasure to speak to this group once again. Let me particularly thank SIFMA, which organizes these operations conferences so capably every spring, and recognizes the skill and value that all of us who labor within the infrastructure bring to the industry. For the most part, as you know from experience, we all work behind the scenes. We are not the public face – we're not the American Idols – of the financial services industry.

But we do have one very influential judge.

Just last month, for – as far as we know – the first time ever, the chairman of the U.S. Federal Reserve gave a speech entirely devoted to financial market infrastructure. In remarks at a conference sponsored by the Federal Reserve Bank of Atlanta, Federal Reserve Chairman Ben Bernanke zeroed in especially on clearinghouses. "Financial stability has depended on the resilience under stress of clearinghouses…" he said, "and we must do all that we can to ensure their resilience."

But you didn't need to be in Georgia to understand the Fed chairman's message. While new regulations coming out of Dodd-Frank will affect all of us, including DTCC, they also affect the Fed and its regulatory mandate. What this means is that our work at DTCC to maintain the infrastructure and control risk is now one of the key items on the Fed's "check list". And the likely impact of this laser-like focus by the Fed on infrastructure is something I want to talk about today because it obviously has consequences for how DTCC works with you.

This focus is part of what is driving a radical rethinking of risk management at DTCC. This effort is already spilling over into the way we process payments, calculate margin and work with you – and there's more to come, which I want to touch on today.

Third on my list of issues is the likely effect of the push we're making at DTCC to meet international standards and global best practices as they dramatically change in the coming years. The reason for doing this is the growing recognition across the industry and the regulatory establishment that we truly operate in a global industry, and that the standards governing our operation have to be global standards. Now these standards are being revised to address the lessons from the financial crisis, and to "raise the bar" on the performance of the industry's infrastructures – much as Chairman Bernanke urged last month. But "raising the bar" will involve some big changes, and we need to examine them.

Finally, it's also important to summarize how, in the nearly three years since the apex of the global financial

crisis, DTCC has unleashed a powerful series of initiatives to reduce risk, improve processing and help you manage your post-trade obligations. Six weeks ago, for example, we launched New York Portfolio Clearing, our joint venture with NYSE Euronext to provide common margining for Treasury cash trades and offsetting Treasury futures. Is it innovative? Yes. Is it successful? Yes. Have trading volumes exceeded expectations? Yes. Does it cut risk? Yes. Does it cut margin costs? Yes!

Despite the public perception that not much in the financial services industry has really changed since 2008, in fact, we've made huge strides in how we measure and manage risk, and we've worked especially hard to help you foresee and eliminate post-trade risks as well. It is definitely not business as usual.

Rethinking Risk Management and Preventing Road Kill

Let me begin, however, with that weighty question about why the chicken did – or did not – cross the road.

We all know the old joke that poses the question: "Why did the chicken cross the road?" The answer, of course, depends on who you ask. If you put the question to Captain James Kirk of the Starship Enterprise, the answer is likely to be…"to boldly go where no chicken has gone before."

We've had some experience at DTCC in boldly going where no one in their right mind would want to go. We had to cross over to the far side of the road during the financial melt-down in 2008. We went because we had to sustain reliability and manage risk across all the industry's infrastructure systems during those frightening weeks. In the wake of the Lehman collapse, as you may recall, we closed out more than a half trillion dollars in open positions, and we prevented losses for the industry, and perhaps ultimately for taxpayers, that could have been in the hundreds of millions or billions of dollars.

We're proud of that accomplishment. But it's not the way we like to do business, and it's not the way you like us to do business. We would rather stay on the safe side of the road. We would rather have our risk controls work so well that we never have to step out into the traffic on the road. It's no secret that the Fed and our other regulators are also eager to keep us from having to cross over that road during emergencies. They really don't want the chicken anywhere near the road.

Overhauling Risk Management

So, to protect that chicken, we are in the midst of a complete overhaul of our whole approach to risk management at DTCC. We have given it a new structure, a new discipline, a more focused approach and more dedicated resources.

For example, in addition to an office specifically focused on "Systemic Risk," we now have:

- A revamped governance structure, starting with the split in the functions and responsibilities of the Chairman and the CEO. As I'm sure you know, Bob Druskin joined DTCC as its Executive Chairman last month, with direct responsibility for the firm's risk and control functions. As CEO, I retain responsibility for DTCC's businesses, technology and operations.
- A consolidated risk oversight structure, reporting in to Bob through a new Group Chief Risk Officer position.
- A "three lines of defense" structure, with risk officers embedded in each of our lines of business,
- A new, much more intense process for evaluating the risks of new products and services,
- A substantially beefed-up and aggressive internal audit system, and
- An enhanced operational risk organization.

As part of our more structured approach, we now target our risk management activities toward four key areas. First is our responsibility for monitoring and managing systemic risk. Second is our job to manage risk within DTCC itself, something we're now even more aggressive about than in the past. Third is "raising the bar" on how effectively we help you manage your overall risks too. We've always done that, of course. That's the reason

we're in business. But we're working to be more thorough, focused and methodical about it. Our ultimate aim is to take the risk burden off you wherever it make sense by continuing to automate post-trade activities, and by centralizing within DTCC – as much as possible – risk for various asset classes.

Infrastructure Resilience

These efforts aim to ensure that the infrastructure supporting the markets is as robust and as resilient as it is humanly possible to make it. As Chairman Bernanke said in his remarks last month, doing so will require a strong focus on "requirements for credit and liquidity risk management, robust liquidity buffers, the maintenance of adequate amounts of high-quality collateral, and effective member-default procedures." These are issues that we at DTCC will be intently working on, and they are also matters that our regulators will be carefully assessing and actively looking to drive improvements on.

An important aspect of this renewed focus on infrastructure resilience is the likelihood – realistically the certainty – that the Financial Stability Oversight Council, which was created by Dodd-Frank, will designate DTCC's main subsidiaries as "systemically important". That will involve significant changes in how we operate and in how we interact with you, our members. Similarly, European authorities are moving to implement a "systemic risk" oversight structure over the European markets, to address many of these same issues. The reality that these issues are, in fact, global in their scope and require a global response is also driving convergence of these systemic oversight activities. This has led to the issuance of proposals to revise the standards for the operation of industry infrastructure organizations, which are currently in the comment process.

Let me give you some background here. For the past decade-plus, DTCC and other industry infrastructures have been subject to a consolidated set of global standards for the operation of "securities settlement systems" and "central counterparties." The standards are issued jointly by the Committee on Payment and Settlement Systems of the Bank for International Settlements – the central banks' central bank – and the International Organization of Securities Commissions, the global association of securities regulators. Known as the "CPSS-IOSCO recommendations," these standards set forth globally agreed principles and practices for the safe and sound governance and operation of these systems. DTCC's regulated subsidiaries are subject to these standards, and every other year we post self-assessments of our compliance with them on our website. Last year the International Monetary Fund conducted a Financial Systems Assessment Process over the U.S. financial system that included an independent appraisal of DTCC's operations against those standards, and the results of that appraisal are posted on the Treasury Department's website. Needless to say, our compliance scores are very high.

But the significance of this for our discussion today is that CPSS-IOSCO has developed a new set of global standards for depositories and clearinghouses, "principles for financial market infrastructures" to use their new phrase, that reflect lessons learned from the crisis. These new principles were issued for comment in March, with comments due by the end of July.

While these principles build on the existing standards, they also incorporate some significant changes that will represent a challenging agenda for us in the coming years:

- The draft principles reflect an increasing focus on settlement finality, and ensuring that finality is achieved as early on the settlement date as possible. This represents an immediate problem for the U.S. markets, since – in contrast to most other markets around the world – we do not require a binding pre-settlement match before DTC processes a book-entry delivery in its system. It's not clear how significant a deficiency global regulators would view this to be, or what kinds of changes would be needed to address it. It could be as simple as limiting a receiving participant's right to reclaim a delivery to the actual delivery date itself, rather than the 24-hour period we currently permit.

More broadly, though, the principles suggest that the end-of-day net settlement process that we follow also needs to be reconsidered, and we need to begin thinking about how to move towards intra-day settlement processes – perhaps settlement payment processes at several set times during the day, as an example. The SEC also raised this issue in the draft rules for clearing agency operations it recently released for comment.

- Another issue the draft principles raise is the structure of the clearing fund. DTCC's U.S. clearing agency subsidiaries have always maintained a single clearing fund, which serves both as members' individual margin deposits and also as the collective self-insurance fund against potential member defaults. Many other clearing houses – and DTCC's European clearinghouse – keep two separate funds, one holding members' margin and the other a separate "default fund" that is the specific self-insurance resource against loss due to a member failure. Will we need to adopt this new split structure in future, and, if so, what does that mean to individual members? In a separate development, the Basel Committee on Banking Supervision has proposed capital charges against certain member exposures to the clearing house, and technical aspects of this proposal also suggest that the time to split out our clearing funds may have come.

- The draft principles also reflect concerns arising from the handling of the bankruptcy of Lehman's European subsidiary about how strictly customer transactions and activities are differentiated from a firm's other activities. As you know, since their creation NSCC and FICC generally have not differentiated between transactions for customer accounts and proprietary transactions. Again, the draft principles suggest that this may be something we need to start doing, which clearly would entail major changes for some of our clearing systems.

Those are just some of the headline changes that we see embedded in the new proposals. We are preparing to comment on them, but it is a topic that you also will want to keep informed on.

Legal Entity Identifiers

This push for standards to be global standards underlies another issue the industry faces, which is the need to recognize and identify our counterparties. Juliet, of course, famously asked about Romeo "What's in a name?" In today's financial services industry, regulators are asking the same question. But they want more than a name. They want specific identification numbers too. Late last year, the Treasury Department's office responsible for supporting the Financial Stability Council announced that it wanted to see the introduction of an identification system that can not only be used to identify legal entities involved in securities transactions, but also provide background information on them. The president of the European Central Bank immediately endorsed the idea as a requirement that should be applied globally.

How would this work? Well, as part of its systemic risk monitoring, the Financial Stability Council may ask us at DTCC to submit information on our members' positions and transactions in a particular type of financial asset, information that they want to correlate with related information they're obtaining from other sources. But doing that, of course, requires that they have a consistent way of identifying across all those information sources what legal entity is involved in those transactions. And the only way to ensure consistency in that reporting is to create a legal entity identification system. Think of it as a CUSIP system for companies. Every legal entity would have its own unique number, which, in turn, would be linked to specific reference data about that company or entity.

Creating this kind of system is a huge task, and you don't have to think about it very long before you realize, as we did, that having the system set up and administered by a global utility is probably the only cost-effective way to get the job done. Given our at-cost business model and experience as a utility, we think DTCC should play a principal role in creating and running this new system. We're prepared to do this job, and to create economies of scale by operating the system globally.

We wouldn't expect to take this on alone, however. Recognizing that SWIFT maintains a related system for identifying its global membership, we've had long discussions with SWIFT about working together. Under the proposal that emerged, SWIFT would be the global registration authority to assign the legal identity numbers, and DTCC would be the facilities manager, using the Avox subsidiary we acquired last year to collect, validate and maintain the core data record on each entity and its parent or subsidiary, marrying that with the SWIFT-assigned identification number.

You clearly have a stake in this project. SIFMA has been asked by federal regulators to work with its members to define the ID requirements. In other words, what do you need to know about your counterparties? The deadline for establishing the groundwork for this new, global ID system is not many months away. So I would urge you to come up with recommendations as soon as possible. We don't want to see this proposal suffer the same fate as Romeo and Juliet. And I'm very pleased to see that you have several sessions on this topic scheduled for Wednesday morning.

T+2 Settlement

Now let me circle back to something I spoke about last year, which is the possibility of shortening the settlement cycle to T+2. Over a year ago, market participants on the other side of the Atlantic began floating the idea of harmonizing settlement cycles all across Europe's markets. Now the European Commission is preparing to move past the talking stage and take action within its proposed legislation for securities settlement infrastructures. The goal is to make T+2 standard throughout Europe within the next few years.

So we now have to confront the question of whether we should move consistently with Europe down this road, making T+2 the de facto international standard. Although adopting T+2 would mean a big change in how we do business, there are good arguments for shortening the settlement cycle. The shorter the cycle, for example, the less counterparty risk you run and the less time you have to keep margin posted. If both Japan and Europe switch over to a T+2 cycle, and we do not, there would certainly also be a concern whether that impacted the competitiveness of the U.S. industry.

On the other side of the argument, however, is the reality that, as you well know, switching to T+2 is easier said than done. One challenge in reducing the settlement cycle in the U.S. market is likely to be the need for same-day affirmation. The sooner trade details are locked in, as we all know, the more opportunity we have to identify and resolve any possible errors. But we face a "chicken or egg" dilemma. It may be quite difficult to shorten the settlement cycle without speeding up affirmation. And it may be quite difficult to speed up affirmation without the pressure of a shorter settlement cycle.

Other steps we are taking are also relevant to this discussion. As you also know, we've been working with our regulators over the last year on shifting the equity trade guaranty from midnight on T+1 to the point of trade validation. The goal is to speed up our monitoring process so that, first of all, we can reduce your risk by taking over responsibility for the trade as soon as it has been reported to NSCC, and secondly, we can monitor and calculate our risk frequently enough throughout the day to ensure that we'll have sufficient collateral from you to meet price fluctuations before settlement. While this insulates you against risk, it also, of course, lengthens the period over which we have to margin the market exposures involved. Shortening the settlement cycle would compress that period, resulting in margin savings.

I continue to believe this is an important issue for the industry to think hard about. I'm pleased to see there's a panel on harmonizing European settlement cycles scheduled for tomorrow. In my judgment, the industry needs to come to some conclusions on this issue soon, and I appreciate SIFMA's leadership on that discussion.

Reducing Customer Risk

Finally, let me return to what I emphasized at the outset, which is the long list of initiatives we have designed or already put in motion over the last 18 months specifically to reduce risk and directly assist you in managing

your post-trade obligations or other aspects of your business. Here is a sampling….

- Obligation Warehouse - Earlier this year, we launched the Obligation Warehouse as a way to solve a couple of longstanding risk problems. One is the fact that ex-clearing broker-to-broker trades often run into operational problems because they're confirmed and settled directly between the trading parties rather than through the clearinghouse. Our solution is to automate the matching and confirmation of this type of trade, and to provide a real-time way to track its progress. The other risk in these trades is that if they go awry, there was never a good way to track or store them until the fails could be sorted out. Now there is. We put these fails in our Obligation Warehouse, and we help avoid tedious manual processing by automating comparison of the failed obligations. Tom Sakaris from DTCC will be filling you in on this at the DTCC Core Processing session tomorrow.

- Universal Trade Capture – Another initiative we've had operational for several months now is the new "universal trade capture" system. It replaces our old equity trade processing engines and gives you near-real-time equity trade information. That means you are better equipped to risk-manage today's huge volume of trading. Meanwhile, it allows us at DTCC to manage risk in real time as well. Tom Sakaris will also be giving you more detail on this tomorrow.

- Corporate Actions – Another risk area we continue to chip away at is corporate actions. Just two weeks ago we launched a pilot program to test new corporate actions announcement messages derived from international standards, plus a browser-based system to support them. This is yet another step in our long-term plan to change and improve the way corporate actions are processed. A key component of the new system is the adoption of ISO 20022 formats for our corporate action messages, finally migrating the U.S. to the global messaging standard. Our goal is to build a common platform with the ability to process corporate actions on a straight-through basis. We expect huge dividends in risk reduction from this effort, and Dan Thieke will tell you more about it in tomorrow's DTCC Core Processing update panel.

- CNS for Value – Still another area where we think we can reduce systemic risk while improving post-trade processing involves changing how we settle obligations in CNS. Right now, settlement of these trades in our depository is done on a free-of-payment basis, not on a DVP basis. In NSCC, where the actual money settlements occur, there are no constraints over a member's settlement exposure for the day. If these transactions were handled as DVP transactions in DTC, however, the depository's debit caps would protect us from suffering a liquidity shortfall if one of our large participant firms were to fail. Equally important, a DVP system would allow you to offset your net credits in the clearing system against your debits at the depository, further reducing risk and intra-day liquidity demands in the process. We are moving in this direction, and plan later in the year to publish a white paper with extensive detail on how this would work in order to get feedback from you. We'll be providing more detail on this at tomorrow's session.

Conclusion

Finally, let me remind those of you who handle fixed-income instruments that there's also a panel this afternoon covering FICC and its various initiatives. And, of course, our chief operating officer, Mike Bodson, will participate in the open discussion tomorrow morning on "Operations Challenges".

In any case, you can rest assured that we are very actively working to protect the infrastructure and to protect you as effectively as we can against the complex and troubling risk issues we now, post-crisis, know that we face. So on behalf of all my fellow employees at DTCC, let me thank you for the opportunity to speak to you this morning. And if you take any thought with you today, know that it is our intention to boldly go into the future…without ever having to cross the yellow centerline again.

Thank you.