DTCC

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Conference on Managing Counterparty and Systemic Risk Under Dodd-Frank
Welcome Remarks, NYU Stern School of Business, Henry Kaufman Management Center
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Thank you, Dean Henry, and good morning, everyone. It's a pleasure to be here to help launch such an important discussion on such a timely topic, and to be doing so in collaboration with the Volatility Institute of the Stern School of Business at NYU. My hope is we'll have more of these gatherings in the future.

I want to commend the Volatility Institute and the Stern School for their commitment to fostering this dialogue here today. They are in the vanguard of the debate over financial reform, and their expertise shines through in works like the recent publications Dean Henry just mentioned, which will help shape the debate in the months and years ahead.

Our shared aim is to host timely forums for exploring issues that meet at the intersection of public policy, regulatory interpretation and market experience. The idea, obviously, is to bring together experts from government, from industry and from academia – individuals on the cutting edge of research as well as industry practice -- to draw attention to critical issues that would benefit from a full public airing of views and different perspectives. The rulemaking process here in the U.S. is moving at warp speed as, in response to the mandate from Dodd-Frank, regulators look to propose, revise and finalize hundreds of new rules that will literally transform market structure in virtually every area of financial services – and to do it all by the July 2011 legislative deadline set by Congress.

I can tell you from my conversations with our regulators that they understand the magnitude of this challenge – and they recognize the transformative impact their actions will have on global markets and the global economy. They want to get it right, as, of course, do we all. That's why they're looking to us to work with them to help identify the issues that most need to be addressed, and to collaborate on the final product. Our collective challenge, therefore, is to help in the formulation of new rules that effectively meet our common goals of greater risk mitigation and transparency while still maintaining the competitiveness, efficiency, liquidity and robustness that have long characterized the financial marketplace.

We've narrow-cast today's agenda to focus on counterparty and systemic risk questions and issues that are likely to arise from interpreting and carrying out the mandate from Congress to change market structures and practices, especially for over-the counter derivatives. It's the topic du jour, if you will, and we've assembled a group of speakers who bring years of knowledge, experience and critical insight.

Those of you who followed the making of the Dodd-Frank bill know that, as much time as Congress spent on debating the details, in many instances it ultimately offered only broad guidelines for reform, leaving regulators with significant challenges in writing a broad array of new rules. As a result, some critically important issues may not have received the level of public debate that may have been warranted. So the idea behind today's forum is that, by offering the business perspective, academic research and market experience that as a group we bring, we can revisit and re-explore some of these questions in greater depth before regulators put pen to paper.

We anticipate this will be a valuable exercise because some of the very concerns that arose during the reform debate are surfacing again. Just last week, for example, the Bank for International Settlements (BIS) issued a warning about systemic risk problems it sees arising from the creation of new central counterparties for Europe's OTC markets. This is not the first time a red flag has been raised on this matter.

The irony, of course, is that these new central counterparties are being created precisely in response to worries about systemic risk weaknesses in the current market structure. And, of course, this points out the crucial problem: How do we craft solutions that address the issues without serious unintended consequences that may make matters worse? Will proposed policy changes to transfer risk from one entity to another, in fact, create a riskier system in the name of risk mitigation?

Certainly one reason the BIS has issued its warning is that the clock is ticking on these questions in Europe as well. The European Commission's proposals for regulating Europe's market infrastructure have now been put forward. And there's just as much pressure across Europe as in this country for quick change in a market structure many people believe spiraled out of control and helped fuel the global financial crisis two years ago. As you all understand, in today's world of global finance, there's no such thing as regulatory isolation. Brussels is watching what Washington will do, and Washington is watching what Brussels plans to do.

But even as these centers of policymaking are moving quickly to implement reform, a degree of uncertainty permeates the markets. Will the Volcker rule be implemented as originally intended....or significantly modified in its implementation, as some in Congress now seem to be suggesting? What is the definition of a swap execution facility and how will SEFs be regulated? As we know, markets don't sit idle. They are in a perpetual state of innovation and transformation. During this period of uncertainty, markets may be changing in response to what they think the new regulatory environment will look like...but not necessarily what it will be.

Devil in the Details

For our regulatory agencies, providing the certainty that markets need to operate most efficiently is essential. And we will all need to sweat not just the big stuff but the small stuff as well because the reforms implemented over the next eight months will profoundly impact market structure for decades to come.

For many observers, including the BIS, the concern is that simply taking the model that has worked effectively in cash and listed markets and applying it to global OTC derivative markets may cause more problems than it solves. It may especially raise systemic risk questions.

To paraphrase philosopher Ludwig Wittgenstein, nothing misleads like analogy. On the surface, a clearing house model based on the approach used for other instruments may look like a good solution – after all, it's tried and true. If the model works for equities, or listed derivatives markets, why shouldn't it work—with a little tweaking or adjustment—just as well for OTC derivatives?

However, as some of our guest speakers will discuss today, the new OTC derivatives are totally unlike any other financial instrument. This doesn't mean that clearinghouses can't clear derivatives trades. It's just that we need to be cognizant of specific issues that are unique to these instruments.

So the more we are able to identify—and reach a consensus on—which issues are important and outline the accepted elements of the solutions to those issues, the easier it will be for the rule makers at the agencies to write cogent rules that strengthen our financial system. And that collaborative search for answers reflects the post-crisis reality that we in the private sector have to work with our regulators as partners, rather than adversaries, in addressing these fundamental risk management issues. After all, at the end of the day the relationship between regulator and financial enterprise is somewhat symbiotic. Regulators want the financial services companies they supervise to be healthy and safe, and they know that firms cannot be safe and sound unless

they earn strong risk-adjusted returns. So today's session can serve as a good example of the collaborative issue-solving process that we all need to be part of.

DTCC's Interest

Let me add that my own company, DTCC, has a stake in the outcome of this exercise as well. We're the largest post-trade financial infrastructure organization in the world. Here in the U.S., we support more than 50-plus equity markets. We also handle clearing for government and mortgage-backed securities. Last year, we settled $1.48 quadrillion in securities transactions, which means we essentially turned over the equivalent of U.S. annual GDP every three days or so.

While we do not clear for the OTC derivative markets, we do supply a key infrastructure for some of them. We serve as the central data repository and central life-cycle event processing facility for the global credit derivatives market. We capture, sort, store and update all the data underlying this global market through our Trade Information Warehouse – a massive database, or repository, that holds the underlying position data on virtually all CDS transactions globally. Not only do we distill and publish a good deal of the data we collect in order to provide market transparency, we also provide appropriate access to global regulators who use the data to meet their own regulatory responsibilities.

In addition to the Warehouse, which is based in this country, we also operate a trade repository in the European Union. It's regulated by the Financial Services Authority (FSA) and was established, in part, to ensure that regulatory authorities in Europe also have assured access to key CDS market data. Our European subsidiary also operates the global trade reporting repository for the OTC equity derivatives market.

As the CDS and other OTC derivatives markets have begun operating through clearing houses, as both the U.S. Congress and European legislators want them to do, we are working with the clearing houses to supply them market position data as well, and to store data on the cleared transactions following their processes. Having all the data continuing to be held in the central data repository, we think, is crucial to effective risk oversight, both by the clearing houses and by supervisors, so that the totality of a counterparty's positions can be seen, not just the slice in a particular market silo.

Industry context

Risk issues are something we spend a lot of time thinking about at DTCC, because risk mitigation is central to our mission. If new market structures pose risks, we need to pay attention to them. DTCC, as you probably know, is a cooperative enterprise. We're governed by our members, and we help them control risk by serving as a firewall against a member's default. If some of our members get into financial straits because of problems at other clearing houses they belong to, that contagion can spread into our business, which means all our members may be affected. It's a little like second-hand smoke. You may not be a smoker, but if someone else in the room lights up, you can't avoid breathing it. So at DTCC, we must pay attention to our members' involvement in other clearing houses.

We likewise understand that our responsibility as a major infrastructure organization is to bring even more focus to the job of mitigating risk. Although we're proud of how we acquitted ourselves in the financial crisis two years ago, we have since initiated a top-to-bottom transformation in how DTCC thinks about risk, how we oversee risk, how we manage risk and how we plan to address risk—and I mean all aspects of risk—both within DTCC and within the financial system we are a key part of. It also comes with the recognition that, under certain circumstances, what we as an organization do or fail to do can have an impact on system-wide risk. What that means for us at DTCC is that we need to rethink and re-imagine our processes with an emphasis on the ongoing cycle of risk mitigation and risk-taking. DTCC may have been the first organization in the world to have someone carry the title "chief systemic risk officer," reflecting this shift in focus. Business as usual is a very new kind of "business as usual" for us.

And so, as regulators on both sides of the Atlantic gear up to write the rules under which the OTC derivatives markets will operate, we at DTCC are engaging actively in the dialogue. We think we have a unique perspective to share—along with 37 years of operating experience—that can help bring insights to the process and play a role in strengthening the global financial system. And I'm hopeful that today's forum is another step in that direction.

Our first speaker today, who will help set the stage for the rest of our discussion, is Commissioner Michael Dunn of the CFTC. We had the pleasure of hosting Commissioner Dunn yesterday at our offices for a briefing on DTCC. I hope he found that time valuable. I know we did – and we certainly appreciated the opportunity to talk with him more about our company and gain his insight on financial reform. Commissioner Dunn has extensive knowledge of the futures markets from his long involvement in farm credit and commodity markets as well as his role as commissioner on the CFTC for the past six years, including stepping in as acting chairman of the agency for five months last year until Gary Gensler's appointment as chairman could be confirmed.

Before that, Commissioner Dunn was Director of the Office of Policy and Analysis at the Farm Credit Administration and also Under Secretary of Agriculture for Marketing and Regulatory Programs.

In addition, the commissioner brings to us considerable experience with the global financial product side of the futures markets. He is, for example, Chairman of the Commission's Forex Task Force, which has shed some much-needed light on foreign currency futures and options markets.

And after that, you'll get an east coast and west coast view on these same topics – from distinguished professors, Darrel Duffie of Stanford University and Robert Engle of NYU.

My thanks to all of you who are participating in today's panel discussions. And my thanks to Pete Axilrod of DTCC. His concern about the issues to be discussed today helped lay the basis for today's forum. Now, let me hand the podium over to Commissioner Dunn.