Building Resilience to Rebuild Trust

Opening Remarks of Michael Bodson
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Introduction

Good morning and thank you all for joining us today.

Earlier, you heard about the evolution of risk management and, in particular, the expansion of the remit of the risk management function beyond the more traditional forms of risk. Nowadays, risk management includes operational, systemic, technology, vendor, and physical risk as well as business continuity management. However, I would like to add one more risk to that growing list – that is, the risk of losing the confidence of investors and the public.

I want to talk about the importance of restoring trust in financial markets because trust is essential for the industry's long-term growth – and I believe risk management has a crucial role to play in this effort.

In looking at this topic, there are three key issues I want to discuss:

- First, the importance of bringing greater transparency to an increasingly complex and interconnected market system;
- Second, the need to strengthen the resiliency of financial markets and institutions as a way to help repair the loss of public confidence. We'll look at the global reaction to the Ebola epidemic last year for parallels and lessons learned on resiliency, and
- Third, actions we can take collectively to regain the public trust.

Bringing Greater Transparency to the Marketplace

Let me begin with my first point on the importance of bringing greater transparency to an increasingly complex and interconnected market system. The 2008 financial crisis exposed not just the industry's limited understanding of the complexities of the financial system, but also of the interconnections both within the financial industry as well as to the broader economy.

In response, policymakers took action to gain a deeper understanding of the financial system as well as to strengthen it to protect against another global financial crisis. These added controls on the marketplace, which included higher capital requirements, leverage ratios and easing firms out of high-risk business lines, have strengthened individual institutions, but they have also increased complexity within the system.

So a logical question to ask is, "Is the financial system stronger today?"

As a whole, I believe the answer is a great unknown because most of the new rules solve the problems of the past, but it is unclear how much they prepare us for the crisis of the future. Many experts in the field, including David Wright, Secretary General of IOSCO, and CFTC Commissioner Chris Giancarlo have voiced this same concern.

While this is an issue the industry will continue to debate, I believe a key to managing this increased complexity and interconnectedness is by enhancing transparency.

If you look at the issues that brought on the financial crisis – the products, the interconnections – they were too opaque for firms, regulators and the public to understand. This lack of transparency nearly brought down the global financial system.

Just a few weeks ago, SEC Chair Mary Jo White – while announcing enhanced disclosure rules – again said that transparency empowers investors to protect their own interests while also being a critical tool for the SEC to exercise its oversight of the markets. Fed Governor Jerome Powell brought the conversation of transparency down to a more tactical level for the markets, specifically for repo, at a conference on "Central Clearing in an Interdependent World" also just a few weeks ago.

"Central clearing could improve transparency and bring a reduction in operational risks. CCPs are in position to aggregate trade information from all clearing members, and thus to monitor and manage counterparty and market-risk exposure better than individual members," Powell said.

These types of calls for transparency to give regulators and the public greater insights into market activities and market risks have been central to regulatory reform efforts going back to the G20 meeting in 2009, but ultimately I believe they are key to restoring investor confidence, which is the cornerstone of robust markets and a strong, thriving economy.

Strengthening the Resilience of Financial Markets & Institutions

Now let me turn to my second point on the need to strengthen the resiliency of financial markets and institutions as a way to repair the loss of public confidence in the system.

Whether the next crisis is global like 2008 or more localized, it is inevitable that there will be breakdowns in the system, so firms need to be prepared to not just manage risk but also to build resilience so they can absorb and recover quickly from systemic shocks.

As I mentioned at the opening, I want to use the Ebola outbreak of 2014 to draw parallels to the financial system and important lessons we can learn and apply from this global health scare.

The Lancet recently published a *Viewpoint* article on the topic in which it defined health system resilience as the capacity of doctors, nurses, institutions and populations to prepare for and effectively respond to crises; the ability to maintain core functions when a crisis hits, and; the need to learn from the lessons of the crisis and reorganize, if necessary, to prepare for the next crisis.

The article explained that health systems are considered resilient if they protect human life and produce good health outcomes for everyone during a crisis and in its aftermath. If you replace "human life" with "financial stability" and "good health outcomes" with "safeguard the public," you could easily be speaking about the financial system.

The 2014 Ebola epidemic in west Africa was the largest in history covering several countries, with nearly 29,000 cases and more than 11,000 deaths, this included 4 cases and 1 death in the US.

The loss of life, the massive social disruption and the collapse of even basic health-care services reflected the lack of resilience of the health system. Within a matter of weeks, the Lancet notes, it was clear that there was limited recognition of the global nature of the crises and clarity about the roles of actors across the global system; limited understanding of the interconnectedness of the system and; limited recognition of how to control the systemic impact of the crisis – in other words, how shocks to the health system of one country reverberated across regions and the world.

Because the system was not resilient, the public quickly lost confidence in its ability to protect them and their families and it led to what, in hindsight, appear to be reactionary responses, such as calls to close the borders and quarantine those who had traveled to west Africa. Fear and misinformation spread like wildfire.

Despite all the years of remarkable work by medical professionals, hospitals and many other parts of the health system, the credibility that the system had accrued was very quickly damaged by this crisis. Unfortunately, it will likely take the system many years to rebuild that trust with the public and fully regain their confidence.

This is very instructive for financial services because we faced a similar situation in 2008 – a global crisis brought on by a lack of resilience and a seemingly haphazard response that appeared ill-equipped to protect the public. To this day, our industry continues to struggle with low public confidence and a lack of trust in our ability to protect the average investor.

As I mentioned earlier, a key to building resilience is learning from the lessons of a crisis and taking action to prepare for the next one. In the case of the Ebola crisis in Liberia, it is now obvious that you need more than 100 doctors to treat 3.5 million people. However, you also need a credible plan to fix the more systemic problem as well as a global commitment to put all the pieces in place should another outbreak occur, including an international fund for well-trained health workers.

In financial services, policymakers have focused on lessons learned by re-regulating the financial markets to prevent a similar crisis from occurring in the future, but unfortunately, execution has been spotty in some cases. I want to share with you our experience at DTCC.

Back in 2009, the G20 put forward a goal of enhancing market transparency by requiring the reporting of all derivatives transactions to trade repositories. This policy enjoyed near unanimous support globally because industry participants recognized trade repositories are an important tool in helping regulators understand market exposures and mitigate risk.

Despite this, trade repositories have not achieved their full potential because data is fragmented across multiple repositories that have been built regionally or by jurisdiction – instead of a single trade repository holding all data globally. As a result, there are now practical and legal barriers that limit data sharing, which hinders the cross-border identification of systemic risk and makes markets less transparent and less resilient than they should be.

In this instance, the industry reviewed the lessons of the crisis, identified a problem and determined a solution. Unfortunately, the solution has not been executed as needed, creating a missed opportunity to strengthen the integrity of the financial system, which, over time, would help rebuild public confidence in the industry.

Regaining Public Trust

Now let me turn to my third topic and discuss why the lack of trust in our industry has the potential to be more damaging than any regulation or economic trend. As I noted earlier, much of the public no longer fully understands what our industry does because financial products have become so complex and, in some cases, appear to serve the best interest of Wall Street only.

Since the financial crisis, we've had the Libor scandal, FX rate fixing, money laundering, tax evasion, misleading product descriptions.

Despite important steps that have been taken since 2008 to regain public confidence – banks have become stronger, balance sheets have gotten smaller, trading practices have improved and capital positions have been strengthened – trust in financial services ranks near the bottom as among the least trusted sectors in the global economy. Believe it or not, only the media ranks lower in trust.

This is particularly troubling because the currency that underpins financial services is trust – trust that when you invest in a mutual fund you will get your money back, trust that when you apply for a mortgage your broker is honest and not setting you up for financial ruin, and trust that the money you squirrel away in a 401k plan or pension fund will be there for you during your golden years.

The issue of public trust must be on all of our radars because many of the top regulators globally are focusing on it. For example, Bill Dudley at the NY Fed spoke last month at a workshop on Reforming Culture and Behavior in the Financial Services Industry, noting the ethical obligations that go beyond regulation:

"Untrustworthy behavior on the scale that we have witnessed in financial services does not arise in a vacuum…the 'implicit

codes of conduct' that govern banker behavior exist apart from 'explicit regulations,'" Dudley said. "These implicit codes must align with the public good – an obligation that banks owe in exchange for the benefits uniquely available to that particular class of institutions."

Mark Carney of the Bank of England also recently spoke about the markets as a public good that depend on the quality of their infrastructure. Carney split that idea between hard infrastructure – the plumbing of markets that determines the mechanics of markets – and soft infrastructure, such as standards and codes that define how market participants should behave. He warned against taking the infrastructure that supports the markets for granted or they won't be able to keep pace, as he said happened with soft infrastructure leading up to the financial crisis.

The concern being expressed by the regulators and public represents a significant challenge that could impact our long-term profitably. As I've mentioned this morning, trust is an essential ingredient in financial services, and as it has slipped since the financial crisis, we have seen the rise of competition to traditional financial institutions.

For example, fintech startups and older technology companies are challenging banks' vulnerable relationships with their customers. Banks in North America are contending with new payment systems from Google and Apple, card and checking account products from Walmart, a Starbucks-branded pre-paid card system and the Lending Tree online lending exchange. Airtel, India's largest mobile network operator, now allows customers to use their phones to pay bills, shop and transfer money. In Africa, the mobile money transfer service M-Pesa is adding savings and loan products, and the UK's Zopa, for example, is mainstreaming peer-to-peer lending.

Rebuilding trust with the public is a business imperative in my view because, just like regulations or changes in market structure, the advent of new technologies and the expansion of the sharing economy could impact the role of financial services in society and, ultimately, the long-term profitability of financial firms.

I believe that financial market infrastructures – the hard infrastructures as Carney put it – have a particularly important role to play in rebuilding trust. FMIs are on the front lines safeguarding market stability – it is our core responsibility and at the heart of our mission.

While FMIs come in many shapes and sizes and have varying incentives based on different operating models, competing priorities and business objectives, we all share a common goal – to monitor, manage and mitigate risk in all its forms in order to protect the stability of the marketplace and the integrity of the financial system.

At the most basic level, I believe responsible risk management with appropriate regulatory oversight working to ensure a transparent and resilient marketplace is essential to winning back the public's faith and trust in the financial industry.

However, we all have a responsibility to help restore the reputation of the industry. This should be a top priority for firms because trust is the currency of our business – and it is critical to ensuring the long-term viability of the industry and creating long-term growth for firms.

So let me share with you some suggestions for how we can all play a role in restoring trust from the Edelman Survey Trust survey:

- First, we need to enhance client engagement and demonstrate integrity. In simple terms, this means that we need to listen to our clients, we need to act in a manner that is honest and authentic, we need to be transparent and ethical in our actions and we need to take responsibility to address an issue or crisis;
- Second, we need to deliver high-quality products and services and drive innovation;
- Third, we must have a larger and more meaningful purpose beyond our business goals and objectives, such as corporate social responsibility initiatives; and
- Fourth, we have to develop outstanding operations, including having the ability to deliver consistent financial returns to investors and have highly regarded and admired leadership.

In short, if we are going to repair the trust deficit, we need to focus on developing a deeper understanding of our clients and their goals, dedicate the time to learning their values and priorities and we need to put them at the center of our focus…

Conclusion

As I conclude, let me reiterate that it is important that we restore trust in financial markets because trust is essential for the industry's long-term growth.

To accomplish this, the industry needs to bring greater transparency to the increasingly complex and interconnected market system to enhance market surveillance and mitigate risk. We also need to strengthen the resiliency of financial markets and institutions to minimize the impact of future systemic shocks, and we need to take action collectively to regain the public trust.

I believe risk management has an especially important role to play in this effort because you are on the front lines of leveraging transparency and building resiliency. By making this a top priority and working together collaboratively, I am confident we can and will regain the public's confidence and create a stronger, more resilient and more stable financial system.

Thank you.