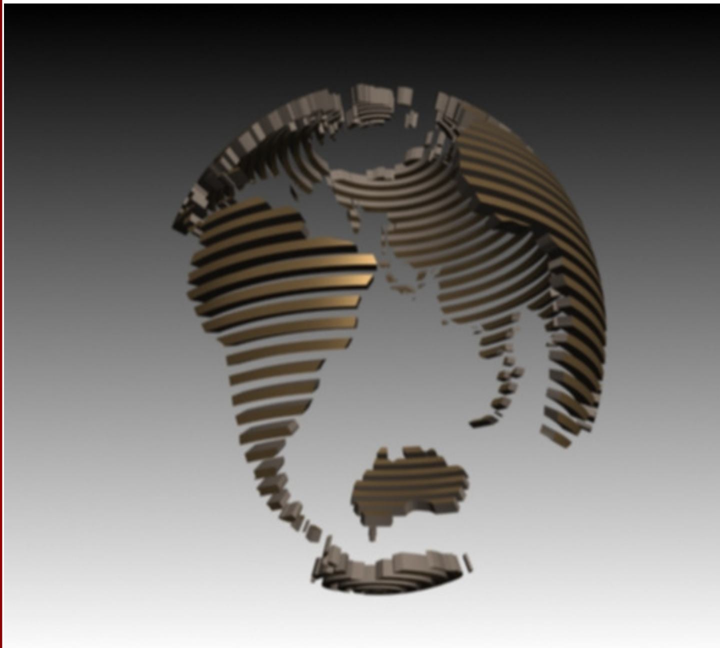
International Securities Services Association



Regulatory Developments and Risk Challenges Impacting Financial Market Infrastructures

ACSDA
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DTCC and Chair ISSA Operating Committee

ISSA

Agenda

1. ISSA Operating Committee
2. Regulatory background
3. Impact of regulatory changes on financial intermediaries
4. Regulatory developments impacting financial market infrastructures (FMIs)
5. Summary of regulatory changes impacting FMIs
6. Conclusion

1. ISSA Operating Committee (OC)

- In order to improve visibility and relevance of ISSA vs other industry groups, the ISSA Board strategic review recommended the creation of a strong, sponsor staffed "**executive body**" to complement Board and Secretariat. Josef Landolt will go into more detail in the following session.
- 3 Working Groups were created with the goal of producing issue lists and best practice suggestions
  - **Working Group 1:** Impact of regulatory changes on the securities services chain (incl. CPSS-IOSCO for FMIs) – Lead: Florence Fontan BNP Paribas
  - **Working Group 2:** Hidden risks for custodians/clearers and ICSDs/CSDs – Lead: Ed Neeck - JPMorgan
  - **Working Group 3:** Communication Standards and Reference Data (especially LEI) – Lead: Irene Mermigidis – Link Up Markets

2. Regulatory Background (1)

Key regulatory trends

- Although regulators' pre-crisis agenda on cost reduction, market efficiency and level playing field continues, all regulatory initiatives since the crisis focus on the reduction of systemic risk, and increasing transparency, ignoring some of the cost implications
- Our securities industry has demonstrated strong resilience whilst living through the crisis
- Regulators are therefore looking at leveraging best practices and expand the model in terms of products (e.g. derivatives) and actors (buy-side)
- Implement a market organization based on:
  - Increased use of market infrastructures
  - A systematic tiered organisation to include more financial actors with custodians / clearers to be risk absorbers for the buy-side

2. Regulatory Background (2)

Key challenges and questions raised by regulation

- Cost of regulation
  - Are the significant short term costs worth the long term benefit of financial stability?
  - Are the regulatory initiatives the right ones to achieve financial stability?
  - How to assume those short term regulatory costs without jeopardizing economic growth?
- Geographical
  - Differences in focus and economic cycles across the globe: EU / US facing low growth with regulatory focus on risk, against Asia's focus on developing their markets with sustained growth
  - Potential regulatory arbitrage in particular around non-G20 agenda items
  - Are regulators and enforcement agencies capable of coping at all with these challenges?

3. Impact of regulations on financial intermediaries

Liability

Increased liability
- AIFM, UCIT V : restitution obligation
- SLD , EMIR : Assets segregation

=> Change in services offers (exit countries ?) and prices to include risk premium

Banking rules

Impact on ROE
- Increased capital requirement
-SIFIS
-Resolution plan

Market regulation

Impact on IT and adaptation costs
-MIFID: custody as investment service
-T+2
-New settlement discipline framework
-LEI

Conflict of interest rules

Impact on services portfolio
-MIFID : ban of inducements
-AIFM contraints on combined depositary and prime brokerage services
-Vickers. volckers;: contraints between custody services and financial services as counterpart

Tax

Impact on It costs
-FATCA, FTT
Impact of profitability of transaction services
-FTT: cost for P/E, FX swaps…

CSD competition

Impact on level playing field
- CSDR : CSDs role and services, willing to move up the value chain
-T2S : removal of local settlement franchise

Financial Intermediaries Custodians

Risk absorber

Access to infrastructures

OTC Derivatives (EMIR, DFA) FATCA, FTT
In creased need to access market infrastructures (CCPs, and TR)

Collateral

EMIR- DFA – Banking rules: requirement for collaterisation of all counterparties risk
Increased need for collateral, collateral optimisation and transformation

outsourcing

MIFID, EMIR
Increased operational complexity to operate transactions . Increased demand for M/O and B/O outsourcing

Buy side

4. Regulatory developments impacting FMIs (1)

OTC Derivatives Regulation

- Dodd Frank and European Market Infrastructure Regulation (EMIR)
  - Move of OTC derivative contracts to exchange and clearing
  - Reporting to Trade Repositories accessible only by regulators and supervisors
  - Legal Entity Identifier (LEI) to identify parties

- Some FMIs not currently clearing OTC derivatives will launch CCPs

- DTCC has established Global Trade Repositories across OTC asset classes
  - National and regional TRs have also been announced
  - Need for global view

4. Regulatory developments impacting FMIs (2)

Global Risk Principles – CPSS-IOSCO

- Consultative Report issued March 2011, requesting comments by end July
- Updated Principles due late March 2012, perhaps with a 90 day comment period
- Key changes from existing standards:
  - One set of principles covers all FMI types
  - Trade Repositories proposed
- Heightened requirements in
  - Governance
  - Credit risk principles
  - Liquidity risk management
  - Mitigation of risks where FMIs are interdependent
- New Principles
  - Segregation and portability
  - General business risk including capital requirements
  - Tiered participation arrangements
  - Disclosure of market data (TRs must provide information to regulators)

4. Regulatory developments impacting FMIs (3)

European regulatory changes for CSDs

A) Proposed CSD Regulation issued March 7th 2012:

-Harmonize market rules relating to settlement cycle T+2

-Common regulatory regime for all CSDs and ICSDs in Europe

-CSDs shall not provide banking services (affiliate can provide)

-Issues can choose any CSD, not just their home market

-CSDs to have “passport”-can offer services in any EU country

-Access rights between CSDs and CCPs/other CSDs granted on non-discriminatory basis

-Third country CSDs can operate if authorized by ESMA (must have equivalent legal and supervisory system)

-Proposed Regulation to be discussed in EU parliament with likely approval in 2013 for implementation in 2015

B) Securities Law Directive (SLD)

- EU considering law changes for book entry securities including methods for acquisition and disposal of securities
- Will cover conflicts of law relating to book entry securities
- SLD is not expected to be adopted by the EU Commission until Q4 2012

4. Regulatory developments impacting FMIs (4)

Target 2 Securities T2S

- ECB initiative to deliver a pan-European Securities versus Central Bank Money settlement solution
- Seeks to resolve inefficiencies in the currently fragmented market infrastructure in Europe
- Settlements will be outsourced by CSDs to T2S
- Access to T2S is restricted to CSDs
  - Commercial banks considering the establishment of CSDs to gain access and function as ICSDs (investor CSDs)
- High investment cost to include requirement to use ISO 20022 access to T2S
- CSDs will seek to expand product and geographic coverage to off-set revenue loss
  - Smaller CSDs will have economic challenges leading to consolidation

4. Regulatory developments impacting FMIs (5)

Foreign Account Tax Compliance Act FATCA

- Enacted in 2010 by US Congress to catch tax cheaters
  - Forecast to increase tax receipts by USD 8 bln over 10 years
  - Requires reporting of data on US nationals
  - Has real teeth to deal with non-compliance
    - Withholding provision under which any payment by a complying financial institution to a non-complying financial institution will be subject to 30% FATCA tax (applies to income as well as sales proceeds)
- Heeding criticism, eased regulations issued in February 2012
  - Expanded grandfathering – withholding and pass thru payments exclude any obligation with a maturity date outstanding as of January 1, 2013
  - Modified due diligence to identify US accounts
    - Preexisting accounts under USD 50k excluded and manual paper review of accounts restricted to those over USD 1 mio
  - Delay for Group compliance until January 1, 2016 under certain conditions – local secrecy law conflicts and delay in withholding on foreign pass thru payments until January 2017
  - Phased in reporting – 2014 for account identification, 2016 for income and 2017 for gross proceeds
  - More categories of "deemed compliant" entities including pension plans

4. Regulatory developments impacting FMIs (6)

Foreign Account Tax Compliance Act FATCA (cont.)

- Inter-government agreement between US and 5 European ountries (UK, France, Germany, Italy and Spain)
  - Foreign financial institutions can report to national authorities which pass information to US Treasury (avoids secrecy law issues)
- Impact on (I)CSDs
  - (I)CSDs are considered foreign financial institutions and must enter into agreements with IRS by June 30, 2013
    - Those resident in jurisdictions with government to government agreements are not required to sign agreements
  - Must perform required due diligence to identify US persons
  - For CSDs operating with beneficial ownership records and having accounts over USD 50k, the account review process will be especially burdensome
  - Those without beneficial ownership record must review entity accounts over USD 50k
  - Due diligence must be certified by (I)CSD's Chief Compliance Officer
  - Must comply with reporting requirements
  - Must withhold 30% FATCA tax on all proceeds for recalcitrant accounts and payments to non participating foreign financial institutions

5. Summary of regulatory changes impacting FMIs

Increased Product Scope

Increased opportunity and investment
-Shift of OTC derivatives to clearing
-Trade Repositories
-LEI

Increased regulatory requirements

Increased compliance and investment
- CPSS-IOSCO Principles for FMIs
-EU regulatory reforms for CSDs
-FSB guidelines for TRs and LEI

Service Portfolio

Centralize and mutualize risk
-Take on risk currently managed bi-laterally
-Mutualize risk to reduce industry costs

Market Rules/ Tax

Update services for market and tax changes
- T+2
-FATCA
-Settlement Discipline

Financial Market Infrastructures

Counterparty risk shifts to FMI exposure

Increased reliance on and exposure to FMIs

Collateral

Higher collateral demands by FMIs as they centrally manage risk
- Need to optimize collateral management

Governance

As FMIs increase their role, participants will focus on governance practices

Participants

6. Conclusion

- Although cost of compliance with new regulations is substantial, they also create opportunities for financial institutions and we are all optimistic:
  - Market infrastructures are being promoted by regulators to mutualize costs and risk (to some extent) to support the financial industry and organize the market
  - Financial intermediaries will be even more risk absorbers for a wider range of financial actors that will be part of the organized market
  - Participants will want FMIs to reduce total industry costs which creates opportunities for new centralized services
  - Within FMIs there may be winners and losers depending on how well they are able to react efficiently to the changes

- This raises two challenges:
  - How to strike the right balance between market infrastructures and financial intermediaries to ensure financial stability at a reasonable cost?
  - Will financial intermediaries be able to price their services to the buy side properly for
    - any increased FMI costs passed through to them, plus
    - their own increased costs and risks

    or will some be forced to review their commitment to business?