ENHANCING FINANCIAL STABILITY TODAY FOR THE FUTURE

A Q&A with Michael Leibrock, DTCC Managing Director, Credit and Systemic Risk, and Adrien Vanderlinden, DTCC Executive Director, Systemic Risk Office

Recognizing that "fighting the last war" won't adequately prepare the financial industry for the next financial crisis, DTCC recently released a white paper, *The Next Crisis Will Be Different – Opportunities to Continue Enhancing Financial Stability*. In the paper, DTCC reviews how the nature of risk has morphed dramatically since 2008 and discusses the implications of this evolution on the risk management function.

In addition to highlighting some of the key risks facing the industry today, the paper identifies trends that could have systemic ramifications and outlines a series of forward-looking opportunities to help enhance financial stability in anticipation of future market shocks.

Michael Leibrock, DTCC Managing Director, Credit and Systemic Risk, and **Adrien Vanderlinden**, DTCC Executive Director, Systemic Risk Office, sat down with DTCC Connection to discuss some of the key findings from the paper.

Michael Leibrock
DTCC Managing Director, Credit and Systemic Risk

DC: IN THE DECADE FOLLOWING THE FINANCIAL CRISIS, THE FINANCIAL INDUSTRY HAS MADE SUBSTANTIAL PROGRESS IN STRENGTHENING GLOBAL MARKET STABILITY AND ENHANCING RESILIENCE. WHAT ARE SOME OF THE KEY CHANGES THE INDUSTRY AND REGULATORS HAVE PURSUED IN RESPONSE TO THE CRISIS?

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Supervisors around the world have dramatically increased legislative and regulatory requirements designed to create a more robust financial ecosystem. In the United States, for example, the Dodd-Frank Act of 2010, fully known as Dodd-Frank Wall Street Reform and Consumer Protection Act, introduced a comprehensive set of new regulations specifically designed to mitigate systemic risk and help prevent another

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Great Recession from occurring by tightly regulating key financial institutions.

Financial firms have deleveraged significantly and banks have strengthened their capital structure. Banks' liquidity buffers have also been enhanced considerably, largely thanks to the introduction of the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR). In addition, the Principles for Financial Market Infrastructures (PFMI) have been a key driver of significant enhancements by CCPs and other market utilities around the globe in areas as varied as cybersecurity, recovery and resolution, stress testing, loss allocation models, capital structure and governance.

Lastly, central bankers have skillfully applied monetary policy tools to mitigate the impact of the crisis while keeping inflation in check.

DC: THE FINANCIAL ECOSYSTEM – AND THE WORLD AT LARGE – HAS CHANGED CONSIDERABLY OVER THE LAST 10 YEARS, GIVING RISE TO NEW AND EVER-CHANGING THREATS. WHAT NEW SYSTEMIC RISK CHALLENGES HAVE EMERGED SINCE THE CRISIS AND HOW CAN THE INDUSTRY MITIGATE THOSE RISKS?

AVL: In the wake of the crisis, new systemic risk challenges have emerged with respect to the macroeconomic environment, market-related risks and concerns related to technology.

One example that pertains to market risk is the growth of exchange-traded funds (ETFs). Over the past decade, the range of underlying ETF assets has expanded significantly and now includes commodities, cryptocurrencies and other non-traditional asset classes. At the same time, ETFs with leveraged and/or inverted structures have come to market, further expanding and diversifying the risk profiles of these types of products. The proliferation of certain increasingly esoteric ETFs presents a new challenge, as some of these products can have very complex payoff structures and their associated exposures should be managed very carefully.

With respect to technology-related risks, we believe that cybersecurity concerns, capabilities and plans should continue to be prioritized, emphasizing resilience and recovery as much as prevention, incorporating tabletop exercises and promoting public-private partnerships. We also feel that, while fintech developments do not pose a systemic threat at present, they should be carefully monitored and thoughtfully supervised to balance the associated risks and rewards.

In addressing macroeconomic concerns, we promote a holistic approach to managing risk which includes cross-disciplinary experts to tackle an ever-widening array of interconnected risks.

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Adrien Vanderlinden
DTCC Executive Director, Systemic Risk Office

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DC: **WHAT IS DTCC'S ROLE IN SUPPORTING THESE INITIATIVES?**

ML: While the tools to implement these opportunities are not all under DTCC's control, we are developing several initiatives that are designed to promote, or support, some of their underlying objectives.

For instance, we see additional opportunities to optimize and accelerate the U.S. equity settlement cycle beyond T+2 to further reduce the exposure associated with unsettled trades.

The sharpened focus on cyber-resiliency is evident across the industry. Cybersecurity is consistently ranked as the number one risk facing the global financial system in our Systemic Risk Barometer, and industry players are actively collaborating to develop cybersecurity standards and best practices to improve firms' defenses while fostering innovation. An example of this is the establishment of a new World Economic Forum consortium led by DTCC, Citigroup and Zurich Intelligence that will look closely at bolstering cybersecurity across fintechs.

Our GMEI utility continues to play a significant role as new financial regulations globally increasingly mandate the use of LEIs to help regulators and market participants aggregate and better understand exposures, enhance market transparency and significantly improve the analysis of systemic risk.

DC: **WHAT ARE SOME OF THE FORWARD-LOOKING OPPORTUNITIES THE FINANCIAL SERVICES INDUSTRY SHOULD PURSUE TO ENHANCE SYSTEM-WIDE RESILIENCE?**

AVL: There's been considerable progress to enhance the financial sector's resilience. However, further work remains to be done to fully address some of the vulnerabilities that triggered or exacerbated the financial crisis, as well as new risks that have emerged over the past decade.

First, centralized clearing for both cash and derivatives markets can be further expanded to more fully leverage the risk management benefits provided by central counterparties. Second, increased regulatory harmonization and cooperation among all stakeholders is essential to harness the full potential of derivatives trade repositories as early warning signals for the buildup of systemic risk.

Third, the use of Legal Entity Identifiers (LEIs) in regulatory reporting should be globally mandated to increase market transparency. Lastly, enterprise data management capabilities should become foundational to financial firms' risk management frameworks.

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