

Remarks by Jill Considine

At the joint European Central Bank/Federal Reserve Bank of Chicago
Conference on “Issues Related to Central Counterparty Clearing”

Frankfurt, Germany, April 4, 2006,

Panel III: “CCPs and the Future Development of Financial Market Clearing and Settlement”

Introduction

Thank you, Daniella. Good afternoon, everyone. If success depends on timing, our hosts for this conference couldn't be more successful. Their timing is perfect. Securities clearing and settlement are once again the topic *du jour* in our industry, especially here in Europe.

I honestly don't know what might come out of initiatives the European Commission may take to change the structure for securities clearing and settlement here. What I do know is that, for the last six years, we have been working hard in the U.S. market to integrate our clearing and settlement operations.

Our experience may not necessarily be a model for Europe. There are many differences. The industry here, as well as the regulatory environment and the challenges you face, are hardly the same. But I'd like to think that, as Europe considers consolidation options for its infrastructure, there might be some value in our experience.

So I will focus my remarks on the creation of DTCC, and the effort we've made as a holding company to integrate the key pieces of the U.S. cash market infrastructure under one roof. Let me add that this is still a work in progress. Even six years on, we're continuing to find ways to leverage our capabilities and create synergies that work for our customers and for us.

Consolidation rationale

Many of the reasons behind the consolidation are fairly obvious. We wanted to improve operations, reduce costs, build economies of scale, increase efficiency, lower risks, and create new products and services. We didn't need two or three separate legal departments when one would do. We didn't need separate information technology staffs, or incompatible risk management protocols. We didn't need different pay scales or management structures. And

most of our customers didn't want to deal with three or four separate clearing and settlement companies.

We also come from a history of consolidation and the U.S. structure was never carved from granite nor cast in concrete.

In the past two days I have been asked about the history of DTCC but beware of the saying, two things you don't want to see being made – sausage and legislation – and let me add a third – consolidation of clearance and settlement.

Thirty-five years ago in the United States, clearing and settlement were paper-intensive, labor-intensive and, therefore, expensive activities...conducted piecemeal by vertically-integrated exchange subsidiaries all across the U.S. market. Since then, as you know, the business has changed radically.

The catalyst for change in the U.S. was sharply growing trading volumes. By the early 1970's, share trading had reached 16 million shares per day on the New York Stock Exchange. This is quite a contrast to the average 3.4 billion shares traded today across U.S. markets. At the time, however, a 16 million share volume pushed Wall Street into a paperwork crisis, and the exchanges began to shut down entirely one day a week simply to keep up with processing.

Originally, the exchanges owned clearing and settlement – they were vertically integrated, but to address this challenge of growing volume, the New York and American Stock Exchanges, and NASDAQ, created one depository to immobilize securities certificates, and one equities clearing corporation to automate and standardize the clearing process. In the rest of the U.S., the five regional markets continued to maintain their own clearing and depository businesses.¹ In New York, you had geographic consolidation and, if you wish, the establishment of a horizontal clearing and settlement infrastructure.

¹ Boston, Chicago, Cincinnati, Pacific and Philadelphia

About this same time, major brokerage firms started talking to the U.S. Congress and the Securities and Exchange Commission about the need for more coherent market mechanisms. In order to give traders an opportunity to buy or sell a security on any market where the price was most favorable – and to encourage the price transparency that makes this possible – the regulators took several steps – including a requirement that exchanges establish links to expose trading and pricing information.

Once links were established among exchanges, brokers could have a trade executed on whichever regional or national market offered the best price. The corollary to this was, if a trade could be executed on any market, it could also be cleared and settled by whichever organization offered a more efficient service.

There was never any regulatory mandate for the U.S. securities industry to direct its post-trade business to the newly-created clearing organization and depository in New York. Regulators simply leveled the playing field by offering access and left the decision about where trades should be cleared and settled up to the trading firms.

And the rest of this story is history.

Concerned about redundant systems and rising costs, brokerage firms and banks eventually steered the regional depositories and clearing organizations into consolidation. What helped give the impetus was the need for standardization and risk reduction, the desire for a central collateral facility, and the realization that netting can lower costs substantially.

It was as late as 1997 when the last of the regional depositories and clearing businesses (Philadelphia) was integrated into DTC and NSCC (they were still owned by their exchange). Market forces drove the business into New York. We changed our form, as our customers asked us to take on new and different functions in response to growth, expansion and innovation in the financial services industry.

By 1999, the users were ready for further integration, and it began by bringing under one roof The Depository Trust Company, or DTC, and National Securities Clearing Corporation, or NSCC, which clears and settles trades in equities, corporate bonds, municipal bonds, unit investment trusts and exchange-traded funds. A few years later we brought in two more clearing corporations. One clears trades in the vast market for U.S. government securities, including repos, and agency paper. The other clears trades in the expanding market for mortgage-backed securities. Together, they are called the Fixed Income Clearing Corporation. (It should be noted MBSCC is not a true CCP.)

As a result, we have become the largest post-trade infrastructure organization in the world with our three major subsidiaries receiving Standard & Poors' highest credit rating, AAA/A-1+. Last year, just to give you some idea of the scale of our operations, the value of securities settled through DTCC was over \$1.4 quadrillion, 26% growth from the prior year. In the American counting scheme, a quadrillion is a one followed by 15 zeros. To grasp how many parts there are to a quadrillion, take a shovel with you the next time you're on the beach in Bermuda – they have nice fine sand. Dig yourself a trench in the sand one foot (or a *third* of a meter) wide, one foot deep and one *mile* (or 1,600 meters) long. Then stop and have yourself a big, cold drink, because you'll have to dig 99 more just like that before you shovel a quadrillion grains of sand. (161 km x $\frac{1}{3}$ m x $\frac{1}{3}$ m) of sand = 1 quadrillion grains.

Benefits of Consolidation

The question is, of course, we're big but have we been successful? Has the consolidation brought our customers benefits? Are costs down? Are service offerings up? Is our technology better? Are we a more responsive organization? My answer to all of these is yes, absolutely—and I think there are a number of ways to measure this.

One is just the sheer size of the U.S. capital market and how it's been able to grow when not inhibited by inefficient clearance and settlement.

Another measure, obviously, is in operating and service costs. We have been able to build a reputation among our customers for efficiency, reliability and low costs. As you may know,

while we operate on an “at-cost” basis, our transaction fees are among the lowest in the world. And if we generate fees beyond what we need to sustain our business, we give the excess back to our customers. As an example, just last month, reflecting the high volumes we processed last year, we returned an historic \$528 million to our participants in rebates, discounts and interest for 2005. This follows on the heels of our reduction of \$161 million in transaction fees for services for the current year.

It reflected realization of savings as a result of investments in our Southern Business Center (for backup) insourcing of IT from the marketplace, business continuity planning and a non-recurring capital build. But the fact is, our net participant costs budgeted for '06 for DTC and NSCC are 12.5% lower than '03 actual, although volumes are up substantially.

But equally important, it seems to me, is that the consolidation and reworking of our clearing and settlement companies has brought industry-wide economies of scale and improvements in the key area of how we interact with our customers, particularly at the technology level. In our experience, the consolidation has created substantial benefits for the entire industry in terms of:

- Increased technology efficiency
- Improved business continuity
- New business opportunities
- Clearing fund operation and cross-margining
- Standardized risk measurement and mitigation,
- And the potential for extending the safety and efficiency of clearing services without necessarily extending their credit risk role, à la OTC derivatives.

Let me touch on a few of these, because I suspect they will be key issues here in Europe as well.

Technology

Some of the biggest payback we've derived from pulling our CCPs together has come from a more uniform use of technology. For example, we have built a consolidated and highly-resilient data network that links all our customers and all our marketplaces. If you're on this system, we can link any of our subsidiaries to you. There's no need for separate lines, separate technology

protocols or separate billing structures. Meanwhile, we have also improved the quality and speed of our IT by insourcing technology from the marketplaces and combining the technology staffs from all the separate clearing and depository organizations. The result has been a cross-pollination of ideas and approaches, and the understanding that code used in an application for one business can be reused for another.

At the customer level, we've introduced an Internet-based sign-on for our customers who access our services. No one has to learn to use multiple technologies or software packages. (This has a cascading effect, as it allows our customer greater flexibility in their organization in staffing and business continuity planning.)

Continuity Planning

Consolidation and its impact on technology have brought us benefits as well in planning for business continuity. Because we function as a holding company, we were able to establish uniform rules, customer procedures and testing protocols across all clearing corporations, the marketplaces they serve, and our depository. And because our data network interconnects every entity in the industry, we have a uniform approach that avoids separate protocols for different markets and different organizations.

We've also been able to spend less on continuity planning because we did not have to build and operate separate, redundant backup facilities. Instead, we built a system that allows us to route traffic from all customers to all DTCC subsidiaries via any of our data processing sites throughout the country. In turn, we can operate any of our subsidiaries from our multiple business operations sites. I don't want to suggest that we've been able to implement our business continuity plan for next to nothing. In fact, it was expensive to build. But it cost far less than having to build individual systems on separate specs for each CCP and depository. (The result: a drop in our overall IT costs.)

Responding to Customers

By combining the resources of all our CCPs and our depository within one company, we've also found it easier to focus our attention on and respond to customer needs and regulatory direction

e.g., mutual funds and insurance services. I think a most recent good example of this is our response to the amazing growth...the rapid change...and the new instruments emerging in the OTC derivatives market, especially in credit derivatives that Peter talked about earlier today.

The fact is, our customers recognize our value added is not just from efficiency, but from reducing operational risk in the marketplace. I should add that we launched our OTC derivatives response through a separate subsidiary Deriv/SERV. Although our governance is holistic, we maintain legal separation of our subsidiaries so that risk is not shared across products.

So where are we? A market driven monopoly!

But, let me add that I believe all what we've done is possible and enabled by user ownership. As of 27 March, we are purely owned by our participants who bought out the common shares of the New York Stock Exchange, American Stock Exchange and NASDAQ. We have 20-22 Board members (of whom 2 are from management). NASD and NYSE have one seat each from their preferred shares. We subscribe to public company standards for Board governance, including only independent directors on audit, compensation and governance committees. Our Board and committees also perform a yearly self assessment to make recommendations on how to improve governance and we have regularly-scheduled executive sessions sans management. I'll be happy to discuss this more during the Q and A.

Conclusion

I know I have spoken today mostly about clearing and settlement as we do it in the U.S. I did not do so because I believe consolidation in the U.S. mode offers a panacea or even a universal model. And I certainly don't wish to argue that consolidating to create a monopoly is always in the best interests of industry customers, particularly if the customers do not own or control the monopoly.

Rather, I want to make clear to you that the co-operative model we have for clearing and settlement in the U.S. is the result of customer choice. Rather than a for-profit system, we

operate a highly-efficient cooperative, because that is what our customers want. They had ample opportunity to choose other models – vertical, horizontal, for-profit, etc.

Could we have done things another way? Possibly. But our mandate from the industry in the U.S. market was to press ahead with consolidation. We have done so. And the results have been quite good. Our infrastructure is more efficient, responsive, resilient and reliable than ever before, and it reflects the truism that market forces and customer concerns are what drive change in our industry.

That, I believe, is progress. Thank you.