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The future's bright

Despite the financial crisis, despite the mergers and acquisitions that have taken place in the technology industry and despite the fact that financial services are more automated than ever, this year's Sibos event looks set to be bigger and better than ever.

And it's not hard to see why. For a start, the market downturn has led institutions to make efficiencies and seek extra revenues from anywhere possible within their business. Areas that in the good times may have been virtually ignored are now considered vital to a company's bottom line.

Those institutions who are looking to grow their business have to be able to prove to their clients that they are as efficient as possible, able to offer the best service, the quickest reporting, the fastest trading. And for that, they need the technology to help them. Clients don't expect to have to wait for answers, or for instructions to be acted upon.

The second issue, as it is for everyone everywhere in the financial markets, is regulation. As the authorities tighten up the rules, firms have a two-fold problem. Firstly, that manually processing business leaves room for potentially very costly errors - essentially machines are better at doing much of the work that humans used to do within banks.

Secondly, the increased regulatory burden is adding more and more costs on to an industry that has already been hit hard, so savings need to be made. Some systems may be pricey, but they're generally cheaper than hiring a number of people to do the same job.

Finally of course is the increased requirements to explain and understand the business that is being done, and often how it relates to other business being done in different parts of the organisation. This requires vastly improved reporting tools.

So while the industry as a whole may be just recovering, the technology sector should still be optimistic about its future.

Ben Wilkie
Editor

Canada

Known for its prudent regulation, Canada has managed to weather financial storms coming from the south and across the Atlantic. And custodian banks have been front and centre while riding out the turmoil.

ANNA REITMAN REPORTS

Just as the Canadian economy was recovering, with an interest rate hike expected in September, the country's neighbour had a sclerotic political debt fit and global markets took a dive over sovereign debt concerns in Europe.

This, after Canada's economy had registered a surprising contraction in May, by 0.3 per cent, leading to disappointing GDP figures in the second quarter this year. The Spring decline was largely attributed to a "confluence of negative factors", according to RBC economists, such as natural disasters like forest fires and flooding, and disruptions in industrial production.

In turn, economic growth has been revised downwards across the board. RBC has pegged growth this year at 2.7 per cent compared to a previous forecast of 3.2 per cent.

"Although we expect to see stronger growth in the quarters ahead, the financial market instability and persistent uncertainty surrounding the pace of global growth will keep the [Bank of Canada] side-lined," wrote RBC in a recent report. Most analysts now predict that interest rates will remain on hold until 2012.

Notwithstanding, Canada remains a top safety investment destination. Pimco founder, managing director and co-CIO, Bill Gross, recently advised investors to look at countries with "cleaner dirty shirts" such as Canada.

The labour market is also recovering from the financial crisis with growing strength. A recent survey by PayScale found that wages in Canada in Q2 2011 are up more than 1.5 per cent since the bottom in 2009.

Before the recession hit in late 2008, wages were growing in Canada at a healthy rate of three to four per cent year-over-year in 2007 and 2008. When wages finally tumbled in 2009, they did so for a brief three quarters. As the recession began to ease up, earnings for Canadian workers recovered swiftly. Incomes for Canadians showed significant improvement starting in Q2 of 2010.

In terms of Canada's competitive position internationally, the World Economic Forum's 2010/11 Global Competitiveness Index ranks the country 10th of 139 economies overall and 12th for financial market development. Notably, the country is the top ranking for soundness of banks, second for availability of financial services and eighth for financing through the local equity market.

Regulatory environment

It's certainly no secret that the country is internationally recognised for prudent regulation in the financial services sector, particularly important in the wake of the financial crisis and while investors continue to recoil over sovereign debt issues plaguing Europe.

Canada is the only G20 country without a national securities regulator, instead it remains under the jurisdiction of the 13 provinces and territories

The regulatory environment itself is something that is distinctly Canadian. Canada is the only G20 country, for example, without a national securities regulator, instead it remains under the jurisdiction of the 13 provinces and territories. Politicians under a conservative government has been pushing to change this and the Canadian Securities Transition Office (CSTO) was established to implement and develop a plan in anticipation.

Some provinces are leading the charge to prevent this transition of power to the federal government; in Alberta and Quebec, courts have already said the Constitution forbids national regulation in that area and Manitoba is also strongly opposed. The Supreme Court of Canada heard arguments in mid-April and a decision is pending. Currently, a passport system between provinces is used to ease the administrative burden of filing in multiple provincial jurisdictions. Some banks, like Toronto-Dominion and major asset managers, like the Ontario Teachers' Pension Fund, are supportive of federal coordination, which would further simplify the fragmented provincially-based regime, according to the Globe and Mail.

Financial institutions, however, are regulated nationally, by the Office of the Superintendent of Financial Institutions (OSFI), while a host of other industry and regulatory bodies cover multiple jurisdictions with differing requirements – such as the Canadian Depository for Securities or the Investment Funds Institute of Canada.

Custody market

Investors are not expressing any particular concern over any of the jurisdictional challenges and continue to retain confidence in the safety of the Canadian market, while also requiring expert guidance in the regulatory landscape. As a result, custodians find themselves uniquely positioned to meet the needs of institutional investors facing significant pressure from clients, boards and other stakeholders for increased transparency, risk management and performance tracking.

Though Canada's custody market is growing in absolute terms, in relative terms growth in assets under administration (AUA) may be slowing. At the end of December 2010, the custody market had some CAD$3.5 trillion AUA at the end of last year (pension funds accounting for almost 40 per cent) compared to CAD$3.2 trillion at the end of 2009 and CAD$2.9 trillion at the end June 2009, according to data from Investor Economics.

Looking at these figures over the three half-year periods from June 2009 to December 2010 indicates some volatility, says Juhaina Kabir, an analyst at Investor Economics. "In terms of annual growth in relative terms, it looks like there is a slowdown in that time, but the June 2011 figures are not complete yet," she says.

In other words, it is difficult to identify which way any trend is going until more data becomes available in the coming months, although any wild swings are unlikely.

There are a relatively small number of players in the custody market with four major national providers – CIBC Mellon, Northern Trust , RBC Dexia and State Street - and a small number of regional operations, such as National Bank and Desjardins in Quebec.

CIBC Mellon is the only asset servicing provider (ASP) to focus exclusively on the Canadian market, says Claire Johnson, head of marketing and product. "The custody business is about scale – particularly the ability to build global scale, but at the same time tailored to the specific needs of a given client in a given market,

"Clients' needs are evolving and asset servicing providers are changing to meet these needs by deploying a variety of new solutions...for example, through our parent BNY Mellon's Derivatives360 solution, clients can obtain an entire derivatives servicing solution – including trade execution, lifecycle management, collateral management, valuations, accounting and more. Or, clients can pick and choose to outsource individual components of their derivatives needs," Johnson says.

The driver of clients' changing needs has much to do with anticipated global and national regulatory changes. Canada's regulatory environment is evolving at a rapid pace, notes Johnson, and the onus is on ASPs to provide detailed, accurate information to support clients as they prepare to comply.

In other words, investors want more services, safely, at the lowest price. That might be nothing new, but certainly the competition for clients keeps heating up in a risk averse economic climate.

In turn, custodians are pushed further into the asset servicing space. Whereas institutional investors used to identify the custodian role as back-office, today that perception is changing and custodians are expanding capabilities to include "middle-office" services, which CIBC Mellon defines as including post-trade-execution support, trade matching, trade settlement and reconciliation, performance and risk analytics, as well as various other reporting capabilities..

"The market is demanding this change," Johnson says. "As clients are focusing on their core investment strategies and the market is pushing for more transparent and sophisticated reporting, clients are looking for both expert support and value-added services...asset servicing providers are expected to deliver on a wide range of client needs – from quickly opening new markets, to delivering detailed accounting for investments, to safeguarding client assets."

Moreover, the very notion of "value" changes over time. "What was emerging last year becomes more and more of a commodity this year," Johnson notes. "I can say that CIBC Mellon's move into this space has helped us grow significantly – we surpassed CAD$ 1 trillion in assets under administration in 2011. We are also winning mandates in the alternative investment space, ETFs and in hedge fund servicing."

Clearing services

Just as investors are demanding more of their services providers, so too are custodians looking to their providers for greater transparency, risk management and efficiency.

Evans: what custodians are talking to us about is increased usage of messaging, electronic communication of information on settlement activity

Clearing and Depository Services (CDS) - which processes all exchange and alternative platform trades, money market transactions as well as provides entitlement processing for the securities it holds - reports that custodians are focused on the importance of expanded electronic communications.

"What custodians are talking to us about is increased usage of messaging, electronic communication of information on settlement activity, on entitlement activity and tax information," says Keith Evans, executive director of operations.

"As a result of demand for those services, just recently we implemented SWIFT MT566 messages and that is to complement the MT564 narrative messages which were implemented over the course of the past three or four years," said Stephen Nagy, managing director of business systems development and support at CDS.

In addition to such electronic offerings, CDS is making headway on its immobilisation and dematerialisation strategy. It has reduced the number of physical certificates in the vault by 170,000 in the last couple of years, bringing the quantity of physical certificates remaining in the vault down to 55,000.

"This is a very significant reduction...we have worked with issuers, lawyers and law firms... to permit electronic holdings and I believe that almost all the issues coming into the market are using and allowing for an electronic or bulk non-certificated position to be held," says Evans. "We also developed an electronic closing that permits the underwriters, issuers and transfer agents to [close new issues] in electronic form without the need to issue a certificate."

He points out that there are efficiencies to be gained by the industry going electronic, but the main focus is on risk. Notably, CDS is AA rated with a stable outlook by Thomas Murray in its January report. It is rated AA- for asset servicing risk, with sole exposure identified in payment banks who extend lines of credit to receivers intraday but only receive finality of cash at payment exchange, while operational risk is rated AA+.

When global markets plunged in early August, Canada was hit by record volumes like most countries. The exchange trades being recorded into CDS peaked at just over three million trades per day, compared to an average annual daily volume of some 1.2 million year-to-date .

"We had zero problems in handling that volume. All of the volumes, our applications and delivery times have been met without exception and we are stress tested to just under five million trades a day, so three million was not a concern for us." said Evans, adding that the turmoil presented an opportunity to gather information and evaluate CDS systems. "We certainly took advantage of that."

On the settlement front, CDS implemented real-time continuous net settlement, replacing four intraday continuous net settlement cycles and enabling participants to manage their settlement activity earlier in the day.

This September in Toronto, Canada's financial capital, CDS along with the asset servicing community will get a chance to showcase this and other successes.

President and CEO of CDS, Ian Gilhooley will be participating in sessions focused on the Canadian standards landscape as well as reflecting on the potential lessons that can be learned from the experiences of the US and Canada for the world's securities markets.

US-Canada relations

The US and Canada tend to follow each other in the way in which the back office of the securities industry operates, says Evans, and as such have very similar processes in the clearing settlement and custody business as well as a cross-border relationship with the Depository Trust and Clearing Corporation (DTCC).

"It is primarily a custody, clearing and settlement link that we have with the US and the largest in the world, the most active and the most actively used...somewhere in the neighbourhood of almost 40 million trades per year," says Evans.

And that close relationship translates into asset servicing as well.

There are more similarities between the US and Canadian markets than differences, says Claire Johnson from CIBC Mellon, but the size of the individual mandates tend to be much larger in the US though Canadian clients are equally sophisticated with the same global investment needs as their US counterparts.

And that is unlikely to change soon. With a population of some 34.5 million, around a tenth that of the US, and GDP at $1.3 trillion compared to the US at $14.7 trillion, the Canadian banking and financial services sector will remain a smaller market as well as a more stable one.

In terms of legal implications for ownership, Canadian banks are incorporated under the Bank Act and there are restrictions as to the percentage of ownership by any one person. Subject to specific statutory exceptions large banks, whose equity exceeds CAD$8 billion, are not permitted to have any shareholder own, either directly or indirectly, more than 20 per cent of any class of voting shares or more than 30 per cent of any class of non-voting shares and no person may control such a bank, according to online information from Canadian law firm Heenan Blaikie.

Any person who wishes to hold more than 10 per cent of any class of shares of a bank must be approved by the Minister of Finance who will apply a "fit and proper" test. The minimum capital required to incorporate a new bank is CAD$5 million.

Is Canada boring?

Arguably, it was such laws and conservative regulation that protected the Canadian banking system from the worst effects of the global financial crisis. And protectionist leanings persist - Canada's regulators were recently in the spotlight during a failed bid by the London Stock Exchange to merge with the TMX Group. Overall, there is a definite "risk-off" leaning in the current environment. Though that may make the Canadian investment environment boring, at the moment it may just be what institutional investors are looking for after years of "exciting" crises. **AST**

Bottom line:

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Big interview

CIBC Mellon's marketing head talks to AST about client expectations in a challenging marketplace.

ANNA REITMAN REPORTS

Claire Johnson has held progressively senior roles since joining in 1997 as senior manager of the Investment Funds Accounting Department.

In her current role, Johnson is responsible for the fulfillment of strategic corporate objectives through the development and implementation of the company's marketing, product and client service plans. This responsibility includes the full range of product life cycle, branding and client integration activities that meet the needs of CIBC Mellon's clients and prospects.

SLT: What are some of your observations on the current state of the Canadian asset servicing market as well as outlook for the future?

Claire Johnson: We are cautiously optimistic that the Canadian market will continue its trends of stability and growth. While our country isn't immune to global headwinds in today's interconnected marketplace, high commodity prices and prudent economic policies should help Canada continue to outperform our peers.

Canada has growing employment, a strong dollar that is above parity with the US dollar, and a triple-A credit rating on government debt.

Recent market turmoil notwithstanding, the underlying factors driving Canada's strong performance should continue in the future.

This means more of the world is looking to Canada for both best practices and investment opportunities.

SLT: Is there any particular area in asset servicing where you see growth?

Johnson: Canada is responding quickly to global trends in financial services.

In terms of asset servicing, we expect clients will continue to demand products that are global in scale, but tailored for the specific needs of individual institutional investors.

We anticipate growing client interest in ETFs, alternate investments, collateral flexibility and securities lending. We also expect clients to continue to demonstrate increasing appetite for sophisticated reporting and greater insight into investment activity.

We believe the asset servicing market will continue to evolve, with a focus on global scale with local execution. Institutional investors will continue to turn to asset servicing providers to resolve the business challenges of delivering more and more information to stakeholders, enabling their growth and finding new operating efficiencies. We expect regulators in Canada and around the world will likewise continue to increase scrutiny and transparency requirements for market participants – and we look forward to providing our clients with expert support on this front.

CIBC Mellon will continue to be at the forefront of Canada's asset servicing market, thanks to Canadian expertise backed by the local focus of CIBC and our access to BNY Mellon's world-leading technology and infrastructure. We will continue to extend our market leadership through ongoing and significant investments in technology, people and processes; a continued focus on expert service, regulatory and compliance support for our clients; and ongoing enhancements to information delivery and reporting systems.

SLT: From your vantage point, is there a shift to recommoditisation of custody services?

Johnson: Client expectations for what a custodian can do have evolved significantly over time, which is driving custodians' move into the asset servicing space. What was a premium service five years ago is in many cases now a basic expectation. With the rapid growth of various requirements for information delivery, reporting and execution, clients are increasingly passing their needs along to their asset servicing providers – who can take advantage of scale – rather than building the necessary infrastructure in-house.

In today's market, the question is no longer just "can my provider custody assets and settle trades", but rather "how can my provider deliver mission-critical custodial services, plus support my evolving business and investment needs." Today's asset servicing providers are moving beyond custody and giving clients real time access to information and reporting on the full range of investments and strategies, including shorts, overlays and alternative investment vehicles.

SLT: What issues are driving client demand and expectations?

Johnson: The lifecycle for custody products and services is speeding up, and client expectations continue to increase. In the past, clients wanted reporting in a 30-day cycle. Today, clients are looking for up-to-date information daily or even multiple times in a single day. Where execution and safekeeping were once the focus of service value, they have become basic requirements, with clients looking for their providers to deliver on-demand reporting, transparency, performance and portfolio measurement.

There is an increasing drive to move to a vastly expanded level of accessibility and immediacy. For example, BNY Mellon recently launched a Workbench Mobile application for the Apple iPad to meet client demands for on-the-go access to investment information.

While traditional custodial services have become commoditised to some extent, the shift into the asset servicing space has seen CIBC Mellon deliver robust, tailored services that add significant value and are anything but a commodity.

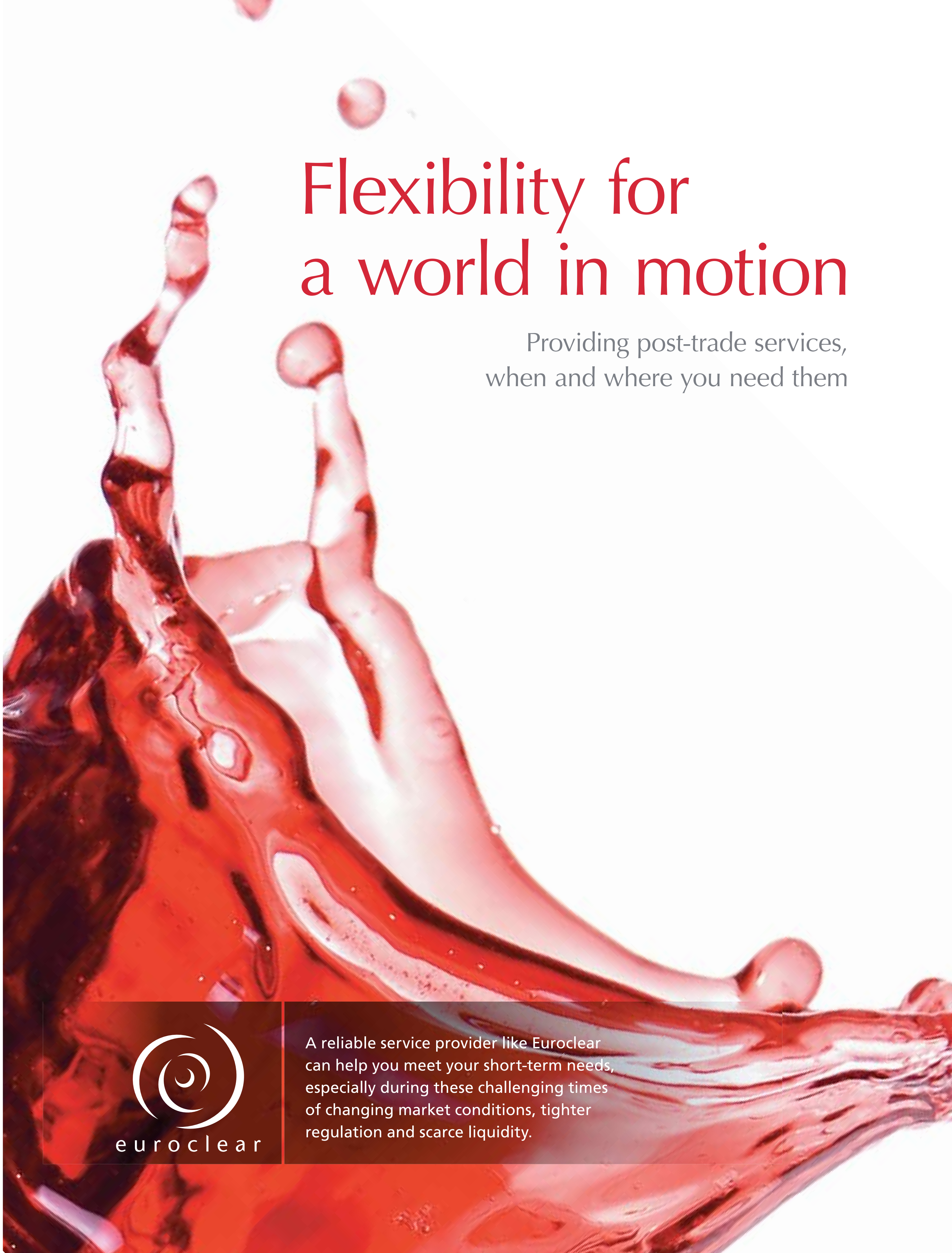
SLT: There have been some regulatory moves to make custodians partially responsible for losses following the Lehman Collapse – how might this impact CIBC Mellon?

Johnson: Regulatory changes may affect financial institutions generally from time to time; we do not see any currently pending changes in the US as shifting responsibility to custodians or securities lending agents. And of course, should there be any regulatory changes affecting custodians or securities lending agents in Canada, we will assess the impact accordingly.

During the Lehman crisis itself, our strong governance, controls and information-delivery helped support our clients in minimizing risk and losses. We received high marks from clients for providing detailed and timely information about their positions and assets during the 2008 financial crisis.

CIBC Mellon's clients with securities on loan to Lehman did not experience asset losses as a result of the Lehman collapse, and no trading restrictions were placed on our clients. Clients also had comfort from assets held separately from our corporate assets. We did not experience any liquidity issues as a result of the Lehman collapse. Our performance during the Lehman collapse is a powerful testament to the strength and effectiveness of our governance and risk management processes. AST

Claire Johnson
Head of marketing, product and client integrations group, CIBC Mellon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Asia

With the eyes of the financial world looking East, Asia's asset servicing industry is going strong

BEN WILKIE REPORTS

For years, investors have been eyeing the Asian market with excitement. Along with the traditional markets, such as Japan, Hong Kong and Singapore, exciting new territories of Vietnam, Thailand and others are offering double-digit growth in a world where growth of any sort seems to be a bonus.

And then there's China. Soon to become the world's largest economy, the country is gradually liberalising its financial markets and attracting funds from all over the world. It's expected to be one of the most important countries in the world.

And within the region, the asset servicing industry has the experience and the expertise to support them. Both Singapore and Hong Kong are long-established hubs - perhaps more on the custody side than fund administration - while Japan's somewhat moribund market is gaining efficiencies. The newer markets are standing on the shoulders of giants by investing in the latest technology and infrastructure to ensure they are fleet of foot and ready for business.

Yet Asia doesn't host that many funds of its own. Asian funds tend to be domiciled in the likes of the Cayman Islands, Luxembourg or Dublin. Domestic only funds stay close to home, but anything with any international element goes overseas.

For some in the industry, this causes issues. "Firstly, we have the time difference. If we want to talk to our managers or compliance people, then we have to get them first thing in the morning or last thing at night," says a representative from one of Hong Kong's larger fund companies. "Reporting isn't an issue because of automation, but if you have a question or want a personal response, you won't necessarily get it answered straight away.

"Then there's the cost - we have to factor in the regulatory costs for more regions and domiciles than we really need to. Especially at the moment, where there are so many regulations coming out of the countries most affected by the banking crisis, the costs for compliance are eating up more and more of our cash.

"And finally it's a case of us being able to do it ourselves now - Luxembourg and Dublin - as well as others - are popular in Europe because Europe has both a large funds market and is a significant destination for inward investment. The same applies to North America and its relationship with the Caribbean domiciles. They are servicing a vibrant market. Well, Asia now has a vibrant market and we need to do something to ensure we have the ability to have our own Luxembourg or Cayman Islands."

This desire is starting to translate into action. A lobby group comprising initially of participants based in Hong Kong, New Zealand and Australia is in the process of being formed, which will work to develop an Asian domicile. Initial plans include work toward the creation of an Asian-style passport and a UCITS-style regulatory structure for Asia. New Zealand has a new regulatory regime inspired by UCITS and other jurisdictions are moving in a similar direction. NZ, however, is a long way away from the major financial centres of Asia, so it's more likely that somewhere closer to home is going to feel the growth.

The catalyst for this is likely to be the rise of China," says Paul Smith, chief executive at Triple A Partners, a Hong Kong-based advisory firm. "If domestic fund domiciliation legislation does get enacted, Hong Kong and/or mainland China will explode as a funds centre."

While that development continues, other firms with an Asian presence are ramping up their operations. Following the hiring of former HSBC executive Colin Lunn to UBS, the Swiss bank has big plans for the fund administration on the ground in the region. UBS currently services most of its Asian fund of funds and hedge funds from centres in the Cayman Islands, Toronto and Europe but, says Christof Kutscher, CEO for Asia-Pacific at UBS Global Asset Management, clients are increasingly demanding a local presence.

"There is a role for a high-quality provider of fund-administration services in Asia," says Kutscher, explaining that the firm is planning on building services to hedge funds, funds of hedge funds, private equity, funds of private equity funds and UCITS-based funds from Singapore, where it already has an operations centre. It is also upgrading its offering for sovereign wealth funds and other major clients in both Singapore and Hong Kong.

As a result of the growing appetite by banks in the region, technology providers are also making a real effort - and because in many cases they have the opportunity to start from a clean state, the new launches in new economies are often absolute best of breed, often at a lower cost to their more established rivals.

It's not just the banks that are seeing the benefits of encouraging more work to be done in the region. The Monetary Authority of Singapore has place a priority on strengthening the city state's attractiveness as a destination for fund administration business, while the authorities in Hong Kong and some of the emerging markets are doing the same.

"In many ways the region has the best of both worlds," says consultant Peter Mariest. "Some of the jurisdictions are long-established and highly regarded, with a strong infrastructure and highly-regarded workforce. They're going to get the business from all corners of the world. Others are still working to implement all the requirements needed to be an attractive domicile, but this means they can look at other regions and pick the best practices from there. They don't have the disadvantage of legacy systems or out of date working practices and they can often offer attractive costs savings that firms who have seen a downturn in their alpha will be attracted to."

Singapore - along with other players in the region - has also made huge strides when it comes to tax treaties with its neighbours, particularly when it comes to taxation of funds. It has an agreement with India, a growing source of hedge fund investment as well as treaties with other important sources of funds. Indian-owned funds based in Singapore are set to be a significant source of growth.

India itself, long a favoured destination for financial firms looking for a destination for their back offices, remains in the mix. Its large pool of a hugely educated workforce, technical infrastructure, low costs and existing reputation as a back office hub means it can never be ruled out.

Hong Kong is always going to be a vital centre, and while Japan continues its recovery from the devastation earlier this year, it doesn't seem to have the ambition to become a major centre for the region - preferring to concentrate on its domestic investments. The new economies of Thailand, Vietnam, Malaysia and Indonesia will play a part, although in some of those countries there remain concerns about the stability of the governments, as well as a relatively short track record when it comes to managing international investments.

But it's the region as a whole that is going to benefit. With Asia now an established and valued investment centre, the subsidiary sides of the business are exerting their strength. The development of the back office in the region may end up being a battle between two or three highly regarded domiciles but as the European and Caribbean models have proved, there is likely to be room for more than once centre. **AST**

Europe

Still recovering from the credit crisis that took hold of both countries and their financial institutions, Europe remains one of the most important markets for most providers

BEN WILKIE REPORTS

The credit crisis hit Europe harder than any other continent. Both Greece and Ireland required bailouts from the European Union, while Spain and Portugal still have significant problems to overcome. In the UK, huge deficits need to be paid back, and Italy, France and the Benelux countries have also seen their economies struggle.

In the banking sector, government intervention to the tune of tens of billions of euros has propped up ailing institutions. There has been no Lehman-style collapse of a European bank, although some German regional providers have fallen - but it was a close run thing. With many of the continent's largest banks now partly or wholly state-owned, the focus has been on tightening controls while aiming to repay the huge debts they have run up.

For asset managers, however, the downturn has not been as tough as they may originally have expected. True, asset values in most European stocks fell, but in most cases, levels have pretty much returned to pre-crisis figures. The increased transparency required across all publicly traded businesses also means that managers now have more information available to them about a European firm's balance sheet and prospects.

Providers

While there is some cross-border activity - most Dutch custodians will also work in Belgium, for example, with the same across Spain and Portugal and the Baltics and Nordic countries are often thought of as a single market, there is wide differentiation in the infrastructure of most countries and providers need to have a significant footprint in each country to be able to call themselves a European provider.

Some of the bigger players - BNP Paribas, Deutsche Bank and Northern Trust for example - are pretty close to offering a pan-European service although in most cases they will still require the services of sub-custodians in some of the smaller markets. But will new regulation change this?

There has long been a move within the European Union to harmonise financial regulation across the continent. But there have always been obstacles in the way - the UK, for example, has never been keen on anything that may harm its status as the dominant financial centre in the region.

The financial crisis, however, has brought countries closer together when it comes to agreeing on a regulatory infrastructure. While Dodd Frank and other legislation from outside the continent is going to have an impact, and Basel III is already being prepared for, moves are afoot to bring the EU countries closer in line. This isn't going to happen overnight, and it won't affect everyone - Norway and Switzerland, for example, are not in the European Union, but it seems that for the first time the political will is there for a harmonised regime.

Not everyone is so sure it will happen, however. "There is a possibility it will happen with the eurozone countries," says one custodian, "but I can't see it happening across the board. And I can also see that right now while the credit crisis is so fresh in people's minds that there is an impetus to do something. But memories fade, and other priorities will come up over the years. I personally don't think a harmonised regime will help European markets and I'm not losing any sleep over whether or not it will happen."

Prospects

Europe is a mature market, and investors will continue to look for opportunities. But most agree that it's not the environment in which large returns are going to consistently be made and the fast growing economies of Asia and Latin America are proving more attractive to asset managers.

But growth will continue, and the infrastructure of the markets keeps the countries as attractive propositions. There is still money to be made from the back office, although many experts predict that consolidation is going to continue.

State Street's chief executive Jay Hooley is looking for further acquisitions in Europe after already snapping up the businesses of Bank of Ireland and Intesa Sanpaolo in Italy. With its European headquarters in London, and having recently won the custody and fund administration mandate from the government-run National Employment Savings Trust -a fund expected to be worth £100 billion within 30 years - Hooley says that there is plenty of opportunity.

"Most growth is tied to GDP growth and economic growth," explains Hooley. "We'd like that, but we are also interested in the evolution of asset pools. As asset pools move from government to company sponsored pension plans... there are more things we can do."

Hooley added that although the financial picture at the moment isn't great, State Street is focusing on the long term, where increasing funds will see more opportunities for custodians. Margins here are slightly higher than in the US, making it a "more exciting" opportunity.

The UK

It's the most advanced market in Europe, and probably the most competitive. But the travails of the financial markets have left parts of the UK's financial services industry battered and bruised. With funds having to work harder to get returns, and less money in the market, the UK's custody providers have had to up their games to gain value and remain established within the market.

Pretty much every global custodian is represented in the UK, with the largest players - the BNY Mellons, State Streets and Northern Trusts - all having large market share. There's not a lot of room for the minnows.

Clients now have far greater focus on risk management and this is filtering down into the due diligence they place on firms. Although the downfall of Lehman wasn't related to its custodial business, the collapse sent a shockwave through the industry and firms want to ensure their provider is financially secure and has the ability to invest in its systems and infrastructure.

But there is one potential spanner in the works. The UK's position as the leading financial services centre in Europe - if not the world - is unlikely to be under threat in the near future, but there is an issue that has some bankers concerned. There are mutterings about a cap on bonuses in the banking sector, and already an added 'banker's tax' on bonuses, which have already led to some firms complaining that they are unable to attract the highest calibre of staff.

Nordics

The separate markets of Norway, Finland, Sweden and Denmark have seen major changes since the crisis, chief amongst them being the introduction of a CCP, implemented in 2009 by EMCF and OMX Nasdaq Nordic.

"[This] has made the market more attractive from a cross border cost perspective,"

Noren continues. "It might also have contributed to a safer and more predictable market even if all current European clearing models leave a few things to be desired on that account. A related effect of CCP is that banks have developed more sophisticated and advanced risk management models, partly in response to the nature of a clearing environment but equally so in response to market supervisory powers requirements and own managements ditto for counterparty risk control. A surprising effect of the CCP introduction (even if apples not necessarily are compared with apples here) is the lowered settlement rates - an issue that is addressed by an informal CSD/Bank consultation process at this very moment."

Nordic custodians are also having to deal with the introduction of the Target 2 Securities regulation, which aims to centralise the settlement of euro denominated securities on a single European platform by 2013. This could mean that competition for custody business will move from an inter-custodian battle to include CSDs as well - again reducing margins. **AST**

Noren: It might also have contributed to a safer and more predictable market even if all current European clearing models leave a few things to be desired on that account. A related effect of CCP is that banks have developed more sophisticated and advanced risk management models

Balance of power

The middle office has come of age, write DST Global Solutions' Graeme Condie and Peter McKenna

WHITE PAPER

There's no time like a crisis to discover new ways of doing things. The current financial climate is a real opportunity to improve systems and processes. In the investment firm of the future, the middle office will enjoy greater prominence and have a new role to play. We predict that the middle office will emerge as the new powerhouse of the buy side.

Although it may be difficult to see beyond the current financial crisis, it is probably a good time to be planning business processes and systems to support the investment strategy of the future. Undoubtedly the new financial order will present opportunities to do different things. But it will also be necessary to do things differently. We suggest that the role of the middle office within asset management firms will become far more prominent and strategic.

Once seen as merely the bridge between the front and back offices, the middle office must evolve to facilitate a real-time choreography of information that includes lifecycle event management, cross-asset position keeping, cash management, asset valuation and pricing. In short, the middle office has come of age and can make a major contribution to the overall performance of an investment management firm.

In this paper we also consider the benefits of a collaborative approach to the challenges facing the middle office and the need to establish best practices for managing over-the-counter (OTC) contracts.

Hard times

There is certainly no shortage of opinion on the current turmoil in financial markets. While some commentators predict a total economic meltdown, others talk of a prolonged period of correction. However, there is one thing on which all agree: the global financial landscape has changed forever. And the new order that rises out of the current chaos will be different by an order of magnitude. What will the asset management house of the future look like?

It is impossible to predict the outcome of the current economic turmoil. But there are some things that we know. The successful asset management house of the future will have to be lean and agile and its managers must be empowered to seize new investment opportunities as soon as they arrive. The increased use of derivatives to improve alpha is likely to continue - and managers will need fast access to more, clean, accurate data and an increasing spectrum of new instruments. But improved investment performance can come at a high price and the increased use of OTC derivatives can quickly overload the available processing infrastructure.

History suggests that this poses a far greater risk to the overall business than poor investment performance, bad choices or the actions of a few over-zealous traders. Buy side firms cannot build a successful future by patching together a network of internal and external communication networks and systems.

Successful investment in OTC derivatives requires increased automation, simplification and control. Now is a good time to be examining current business processes to establish ways of doing things differently. Firms that do so will be well rewarded: and technology has an important role to play.

Start in the middle Investment managers are never short of opportunities to invest in systems offered by sell side firms and a huge range of back-office systems and software is always on offer from software vendors and third-party administrators (TPAs). The market is replete with order management systems, front-office applications and investment accounting solutions.

Over time, many of these systems have extended their reach into the middle office, to the extent that it seems as if the bridge between the front and back offices has been built from both ends. This evolution has created a constant strain on the middle office, which invariably has to patch systems up to make things work.

While this is understandable, it is not desirable. Most would admit that from a systems perspective, the middle office has been overlooked: it is the Cinderella function within investment management.

However, investment managers who ignore the evolving role of the middle office do so at their peril. They are likely to face increased processing costs, higher operational risk and limited benefit from the use of OTC derivatives. A brief look back at history provides a better view of the future.

An accident of history

The middle office is the product of a long evolution. There is, in fact, no universally agreed definition of the term. The middle office also performs different functions within different organisations, so we are probably left with a definition that suggests that 'a middle office is what a middle office does'. That can often include anything that is not done by the front office or the back office.

This goes some way to explain the lack of specific attention given to the middle office by vendors, outsourcers and consultants. Much of the debate has revolved around the positioning of the function: some suggest that it should be outsourced, others advocate streamlining, while many talk of 'repurposing'. But the widespread use of OTC derivatives adds a sense of urgency to redefining the role of the middle office and its prominence within the firm and industry.

After a long adolescence, the middle office has come of age. It has evolved to perform a key role as the gateway between front and back offices for both internal and external parties. Investment management firms need to get to grips with the scope and scale of the middle office to identify and quantify opportunities for operational improvement. The lack of automation and absence of standards within the OTC derivatives market provides the ideal catalyst for change.

A bright future

The middle office can - and will - play a pivotal role in the successful investment management house of the future. Once generally viewed as simply the conduit between the front and back office (or TPA) the middle office has the potential to transform the way an organisation collects, uses and stores vital business information. In doing so, it can transform its own role from that of cost centre to that of a core information hub at the beating heart of the business.

Every asset management house faces the same fundamental challenges regardless of whether back-office processing has been outsourced or not. There is a core business requirement for continual monitoring of trading, accurate valuations and risk management. Recent market events suggest that there will be greater interest in these functions. In addition, there are the 'four Cs': creation of new instruments, corporate actions, cash management and cancellations.

None of these individual requirements is portfolio-centric and there are currently many software and information products available that will do the job adequately. But virtually all products emanate from either the front or back office. None has been designed from the perspective of the middle office - so none fulfils the potential role of the middle office depicted here. This is borne out by the fact that over 50 per cent of OTC derivative transactions are still manually, rather than automatically confirmed. So if we were to begin from scratch, what would an ideal middle office system look like?

In an ideal world…

A middle office product should be able to accommodate any contract that exists or is likely to come into existence. It must include a facility to cancel or correct it instantly, regardless of status, and it must accommodate the wealth of data necessary to support the valuation and risk measurement process. A good test of such a system will be the ability to support a simulated market scenario, (an example might be a drop in UK interest rates to 0 per cent), and assess the impact on valuations, cash flows and returns on client portfolios.

In reality, the typical systems landscape will comprise a mishmash of technology that communicates in different ways; batch oriented administration systems, message based order management systems and portfolio risk management systems fed overnight. It is possible to massage any contract through such a set-up: but it takes a skilled operator to present comparable data to the appropriate systems.

In essence, it is an ad-hoc answer to an ongoing problem. Alternatively, systems can be purchased, usually from the sell side, but these are expensive to buy, require regular upgrades, and may be inappropriate for asset managers with a relatively low volume of contracts. But the real cost may be the disruption and risk to business, plus the need to rip out and replace existing systems which have evolved over a period of years. Is there an easier way?

A community approach

A purpose-built middle office solution would not emanate from the back office or the front office, but from the contract.

The systems architecture should reflect the contract and all the information that supports it. But in practice, this entails bringing disparate information into a standard format. This can be a daunting challenge and it indicates the market's immaturity. However, most market participants face similar challenges, so there is merit in adopting a community approach to this shared problem.

A collaborative, community approach will accelerate progress and allow information to be captured for the entire community. Having a single source of data available in a standard format would be a great step forward. If brokers, asset managers, custodians and TPAs all used a single system with a single source of price and asset data, the majority of reconciliations would be unnecessary.

In this utopian state, risk managers and compliance officers would have the support they needed for performing the roles for which they are paid: managing investment risk and monitoring client portfolios for breaches of compliance.

Over time, market standards will evolve and a wealth of information could be made available through a 'single pipe' and in a standard format. This seems an intuitively appealing answer to a shared problem, but is it feasible?

Getting started

Investment managers must first understand their own strategic objectives in relation to where they are now. Once the strategy is agreed, an appropriate operational business model can be constructed. This must consider systems that are already in place; services that are - or should be - outsourced; and the organisation's technology strategy.

Decisions can then be made regarding the reengineering of business processes to improve efficiency and productivity. In most instances, there is likely to be scope for increased automation within the middle office. This exercise should also provide an indication of the overall appetite for change and the willingness to strive for improvement.

In addition to its core functions, the middle office often provides input into new product development, marketing and new client take-on and implementation. Each of these functions must be considered in the light of the anticipated workload associated with a change management programme.

The role of vendors

The current economic climate means that investment managers must not only consider the role and structure of their internal departments but should reconsider their relationship with third-party suppliers and partners. Vendors and service providers must understand the current needs of their investment management clients but also their strategic intentions. They must also empathise with the need to minimise or avoid disruption to business during any systems implementation.

Just as importantly, vendors must respect the investment already made in systems and processes and must be able to quantify the benefits of any proposed investment in technology. The investment management community has become very aware of inherent risk of replacing systems and increasingly looks for new solutions that work in tandem with those that are already installed, proven, and possibly paid for.

Vendors also have a role to play in respect of the regulatory environment. Recent events will drive clients, not just regulators, to demand greater transparency, particularly when it comes to demystifying OTC instruments. So if vendors can build systems that help clients to neutralise 'regulatory risk', they are likely to be pushing on an open door.

Best practice

As previously mentioned, this paper favours a collaborative approach to the challenges that face the middle office. Apart from developing appropriate systems, vendors and partners can play an important role in establishing and proliferating best practice. But the role of the middle office is likely to evolve quickly, as market conditions change constantly and new investment instruments appear. Vendors and partners must evolve in parallel with the firms they support. A new flexible approach is required and vendors will need to work more closely and adapt to the evolving needs of their investment manager clients.

Conclusion

The role of the middle office should be reconsidered in the light of its evolving strategic significance. The current financial crisis provides the right catalyst for change.

The key consideration for investment managers is not whether services are outsourced, but whether the components are truly integrated. The middle office serves many functions and these vary between organisations, but in all cases, it is strategically positioned to identify, report and resolve operational irregularities before they affect the whole business.

Prevention is always better than cure. The new order that emerges from the current market chaos is likely to favour those firms that adopt a systematic approach to information management.

The middle office is uniquely placed to offer a consolidated view of the financial dynamics of the business, based on information from internal and external sources.

The investment management firm of the future will require real-time monitoring of trading, accurate valuations and risk management analysis. The current lack of automation in the processing of OTC derivatives makes this a real challenge, and the absence of market standards makes progress difficult. We suggest that a community-based approach will accelerate progress and establish standards simultaneously.

Investment management firms that identify the strategic importance of the middle office are likely to be able to control costs, manage risk and realise the benefits of economies of scale simultaneously. Now is a good time to invest in the right systems and processes to achieve these goals. **AST**

Business processes

A new White Paper from Merlin Securities discusses the importance of automating processes such as performance, risk, and attribution reporting within a hedge fund at all stages of development

TECHNOLOGY FOCUS

Over the past two years, Merlin has published several white papers that are designed to highlight and help managers implement industry best practices – from shoring up their business model to identifying their target investors based on the development stage of their fund.

In continuing with this theme, our latest white paper discusses the importance of business process automation within an asset management firm at all stages of development and how these organisations can measure their current processes versus investor expectations.

It is critical that business process maturity and automation evolve over the life of a fund in a disciplined and forward-looking manner as they are key components to maintaining a scalable business. As a firm grows, processes that are maintained manually or with home-grown spreadsheets will stress and may break, adding business risk and overhead to a firm's operations. This concept is especially important for fund managers because they cannot afford distractions and errors caused by broken or manual processes that affect the viability of the fund.

The importance of automation

Managers, investors and due diligence teams all analyse and measure the business risk and process maturity of a fund. Funds must continually review both their organisational structure as well as the level of automation resident in their systems and procedures. For example, it is easy to see key-man risk if only one person holds all the senior positions in a fund (chief compliance/operating/risk/financial officer, portfolio manager, trader, head of marketing, etc.) versus each role being occupied by a distinct experienced professional. Business process risk is as critical, but can be more difficult to identify. Manual processes, for example, are present in one form or another at all hedge funds. Some of these processes are obvious; trade reporting and position monitoring are done on paper or a home-grown spreadsheet or an operations person is tasked with pulling together reports each night by collecting data from disparate sources such as emails, the web and prime brokerage reports. Many times, performance, financial, research and investor information are stored in ways that increase the risk of data corruption, loss or simple human error.

The risks

A hedge fund's assets, number of strategies, the number and type of its investors, and the amount of people required to run a fund, invariably strain the original processes a fund used when it was a startup. At some point, legacy processes, lack of automation and the lack of delineated roles pose significant operational risk and often impede a fund's ability to scale and succeed.

For example, the use of spreadsheets to track positions, manage investors and calculate performance/risk/attribution, etc, is risky even when a hedge fund initially launches. In fact, because spreadsheets are so powerful – they are visual, quick, iterative, flexible, well-known and inexpensive – many hedge funds erroneously believe they have the same functionality of mature systems and as such become embedded. However, as a fund grows and its investors become increasingly institutional, the reliance on spreadsheets can be cumbersome and appear unprofessional. Existing investors may ask why their reports seem to be prepared manually and, in the worst case scenario, errors caused through spreadsheet use can seriously jeopardise a fund's credibility.

Furthermore, the sophisticated investors a fund seeks to attract as it grows expect a certain level of process maturity. Investor due diligence will quickly reveal where a fund comes up short. Due diligence teams and investors not only want to see scalable businesses and repeatable performance, but also want to see automated systems, processes and tools that are being used by sophisticated professionals.

As funds grow it is imperative that their business processes have the rules, controls and a level of automation that is commensurate with the growth of the fund and the type of investor being serviced. Funds that ignore the natural progression of process maturity will do so at their peril.

Measurement

Merlin has created a score sheet for funds to assess and measure their process automation risk. We call it the Process Automation Score Sheet, or PASS.

The PASS analysis extends to:

- The processes and procedures for keeping track of a fund's critical information (performance, attribution, risk, investors, multi-primed assets, etc.); and,
- Reliance on either manual spreadsheets or automated tools that are scalable and not dependent on specific individuals.

Some funds may be perfectly content managing a limited amount of capital for a fixed number of investors. For them, the business process automation analysis is perhaps irrelevant. However, the majority of fund managers aspire to attract larger, higher-quality institutional investors. In order to do that, funds must build out certain processes today that will attract the investors it wishes to have tomorrow. A process that is tolerated by investors in the early stages of a fund's lifecycle will likely not be acceptable to investors in later stage funds and will almost certainly be disallowed by the institutional investors who allocate to mature, successful funds.

Knowing when to upgrade processes and technology and when to hire additional people is a common challenge for all businesses. The Process Automation Score Sheet (PASS) is a simple tool to help managers identify their current stage of automation across 10 high-level process components.

> At some point, legacy processes, lack of automation and the lack of delineated roles pose significant operational risk

Once a fund fills out the score sheet and receives its PASS score, that score is placed on the Automation Sweet Spot chart. Managers can then see whether they are ahead of or behind the curve

Challenges

The remainder of this paper examines the strategic approaches managers can implement to get their business into the Sweet Spot.

There are three basic ways a fund can institutionalise processes:

- Build new systems in-house;
- Buy prepackaged solutions, integrate and customise them to meet its needs; or,
- Outsource to a third-party technology provider.

Most funds will be guided by a general bias toward one of these options, however, a fund can, where appropriate, utilize a mix of solutions to create the optimal process. The most cost-effective way for smaller and mid-size funds to implement mature processes is typically through outsourcing. Larger funds, on the other hand, with significant assets, strong recurring revenues and an existing technology infrastructure, may be best served by building their own process solutions alongside the proprietary systems they already have in place.

Even for very large funds, however, the case for third-party solutions is compelling. They can represent a variable rather than fixed cost and can scale in capacity as needed without additional servers and data center space. Funds can also use third-party solutions to lower their overall technology

Conclusion

The business landscape has changed dramatically for both hedge fund managers and the investment community over the past several years. The industry has matured to the point where managers must cater to the needs of institutional investors in order to grow and thrive. In addition, new risk, reporting and regulatory requirements, along with volatile markets, make having reliable automated processes essential components to running an efficient hedge fund. Manual work, key-man risk and a reliance on spreadsheets will be clear red flags to investors and prospects alike.

As a result, possessing the optimal levels of process maturity and automation are no longer just a luxury. Rather, hedge funds seeking to retain institutional assets, grow their AUM and attract more sophisticated investors must look ahead and be prepared to invest in and proactively deploy long-term solutions.

To successfully accomplish this, managers must truly understand where the current and future gaps exist in their businesses' process maturity and automation and what technology solutions they will need to remedy those gaps. Understanding this through the PASS analysis, and then striving to remain in the Automation Sweet Spot, gives managers a navigable plan as to when to commit the capital and resources required to achieve the process maturity and automation that is commensurate with both the current stage of the fund and where they wish to be in the future. **AST**

The risks of ignoring business process maturity and automation

Below is a partial list of the many risks a fund faces when it ignores process maturity in terms of procedure, workflow, roles, responsibilities and data:

- Lack of scalability
- Lack of security
- Vulnerable to inputting errors
- Inefficiency
- Difficult to collaborate
- Lack of version control / auditability
- Lack of timeliness
- Compounding of errors
- Negative investor perception
- Difficult to manually build workflow and rules
- Unreliable/ungoverned technology
- No third-party validation

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Stepping up

Clients are increasingly focusing on squeezing the best return from all their activities, including collateral management

LYNN STRONGIN DODDS REPORTS

Given the focus of the Dodd-Frank Wall Street Reform and Consumer Protection Act and European Market Infrastructure Regulation, collateral optimisation has become a buzzword after collateral management. It is no longer seen as an arcane operational function, but a critical tool for risk mitigation, liquidity management and revenue enhancement.

In fact, a sponsored report published late last year by Finadium and sponsored by SunGard shows that collateral optimisation - including managing cross-product netting and the use of central credit counterparties - will be a major focus. The drivers behind the increased emphasis have been well documented. Although the regulations are not finalised, there is no doubt that there will be a mass migration of over the counter products onto exchanges and through central clearing. While the ink is still not dry on the final version, the result will be a significant increase in the use of collateral and providers are already leveraging their infrastructure around listed products to provide a similar service for centrally cleared OTC products.

One of the issues is that optimisation can mean different things to different people. For example, it could cover rolling back and rebalancing assets on a daily basis or simply fine-tuning the movement of collateral across different transactions or structures to make better use of the collateral. However, the increased need to collateralise will put pressure on providers to use the collateral inventory as efficiently as possible to avoid constraints on the balance sheet. For many firms, this means employing stricter eligibility requirements to ensure the collateral received can be re-used easily. It will also require firms to analyse the inventory more regularly in order to use the most optimal assets to meet various obligations and avoid funding additional collateral, which can prove to be an expensive proposition.

As with any change, there are opportunities as well as challenges for service providers. According to data from Calypso, these include presenting a single and consolidated view across the different collateral positions as well as capturing and fulfilling all collateral obligations. It also means being able to model all the legal agreements and eligibility constraints so that collateral flexibility can be exploited. Last but certainly not least are employing advanced risk and scenario analysis tools to explore alternative ways of meeting obligations and optimising collateral use and exploring revenue generating opportunities based on collateral trading and optimisation.

Although all are important, breaking down the walls of the silos ranks as one of the highest priorities. The Finadium study, which canvassed 122 industry participants, found that over 60 respondents believed a cross-silo view will be one of the keys to better management of collateral and optimisation. Historically, firms have slotted their asset classes into different prisms such as fixed income and equities, each with their own operating procedures, technology and organisational structures. The situation has further been exacerbated by having not only vertical product but also horizontal regional silos which means there are geographical, currency and settlement issues to be taken into account.

From an optimisation point of view, managing collateral across this type of landscape is challenging because the assets pledged must continually be monitored while the profile changes in different market conditions. Portfolios must be regularly viewed to see what has been pledged out already and to assess whether it is the most optimal assignment of assets to meet that obligation or if assets should be substituted to reduce the overall collateral cost. This ongoing calculation requires the various details of the collateral, including eligibility and haircuts across all asset classes to support the constant recalculation of asset assignment. Other factors to consider include settlement timings, failure and transfer processes which will vary depending upon if the collateral is included in a bilateral or CCP trade or if managed on a tri-party basis.

According to John Rivett, global head of collateral management at J.P. Morgan Worldwide, "Increasingly clients will want an integrated approach and have a broad picture of all of their exposures. At the moment, firms have sets of inventory held in different silos and this is not optimal. Collateral optimisation should also be about fulfilling counterparty needs and having the flexibility to quickly substitute specific securities wherever they may be located but without ramping up the costs. We think the tri-party model is the one of the best ways because it not only enables firms to optimise inventory multiple times a day but to do so very quickly. Also it has been around for a long time and clients are comfortable with the way it works."

Olivier de Schaetzen, director & head of product solutions global markets in Euroclear's commercial division, also "believes that optimisation of collateral allocation on a daily and inter-day basis is increasingly important. We are also seeing an increase in the demand for granular and more detailed reporting as a direct effect of new regulations coming into force. One of the main attractions of the tri-party arrangement is that clients benefit from having as much business as possible conducted under one roof. This requires a continual investment in the infrastructure and the ability to deliver new features."

Kurt Jarnagin, head of collateral optimisation at Royal Bank of Scotland, which offers clearing and collateral management services, says "collateral optimisation is not just about posting the cheapest-to-deliver collateral and fulfilling the obligation in the fastest time. It is to also about being able to address the different requirements such as the upgrade trade and the "what if " scenarios under the new regulations. Clients also want to mitigate settlement risk and have more detailed reporting on their collateral positions."

Tri-party though is not the only route. Nicholas Bonn, head of the securities finance division of State Street, sees merits in the unilateral banking model. "We do offer tri-party arrangements but we feel that clients can move assets around markets much faster and cheaper through straight through processing."

There are also technology vendors who are hoping to make their mark. For example, Calypso Technology has been at the forefront in the collateral optimisation arena and recently developed a collateral optimisation solution designed to help buy and sell side firms adapt to shifting regulatory requirements for OTC derivatives. The offering includes a proprietary algorithm that allows users to manage the collateral allocation process. Optimisation strategies are deployed based on substitution rules, targets, constraints and real-time information defined and governed by traders. Users may also plug in their own algos. The system provides overviews of positions, collateral requirements and allocations. It also enables analysis of the cost of funding/collateral at the trade level, allowing users to reduce operational costs.

According to David Little, director, strategy and business development at Calypso Technology. "Under the new rules, many buy side firms will have to pay initial margin whereas previously this was not the case. With many counterparties to a transaction, it becomes a difficult conjuring act to fit together the best possible allocation versus the new obligations. Calypso's solution looks carefully at the user firm's inventory, examines its obligations, and then chooses the best way to fulfil those collateral requirements."

As for the future, it is no surprise that regulation will be the main challenge. At the moment market participants are waiting with bated breath to see how exactly the details will be hammered out. The main thrust will remain the same and all agree that there will be much more emphasis on the collateral that can be posted.

According to Rivett: "Before there was a much wider classification but that will not be the case going forward. Also, clients will be looking at the collateral in a much more granular because they want a much more detailed understanding of the underlying assets."

Bonn of State Street agrees, adding: "When the regulations are introduced, there will be a lot of assets that are currently used as collateral such as high yield and investment grade corporate bonds that will no longer be eligible for collateral. We expect that there will be an increase demand for sovereign debt and US Treasuries. The view on Treasuries is that the supply will be scarce and spreads will narrow but we believe that will not be the case and spreads will widen, creating opportunities. The other trend for collateral optimisation that we see is the growing importance of cross asset class margining across all transactions which can help firms reduce margin requirements and related collateral funding costs." **AST**

Historically, firms have slotted their asset classes into different prisms such as fixed income and equities, each with their own operating procedures, technology and organisational structures. The situation has further been exacerbated by having not only vertical product but also horizontal regional silos

The jigsaw puzzle

Charu Kirti Jain, product manager for Information Mosaic, examines the new pressures facing global asset managers, post-crisis.

FUTURE FOCUS

The day that Lehman Brothers filed for bankruptcy changed the investment servicing landscape forever. In some cases, due to the complex nature of counterparty relationships across the industry and the distinct lack of visibility in this area, it could take months before an institution fully understood its exposure to the crisis. The complexity of some structured products and derivatives left end-investors unaware of both the number and nature of counterparties involved in their transactions and investments. Each time an institution defaulted, there was a trail of unsuspecting, but ultimately exposed, investors left in its wake. In examining contributors to the economic crisis, authorities have pointed to opacity in the financial systems as a major factor. Indeed, in a 2010 speech, Murilo Portugal, deputy managing director, IMF stated that a “lack of transparency and limited disclosure of information on the types and locations of risks made it difficult to assess the extent of exposures and potential spillovers.”

Since the Lehman crisis there has been no shortage of attention to this issue and certain remedies are enshrined in legislative form via The Dodd-Frank Wall Street Reform and Consumer Protection Act and the proposed EU reform under European Market Infrastructure Regulation (EMIR). Yet while these mandates may satisfy regulators’ need for more data, they do not necessarily satisfy the need of market practitioners both in terms of scope and context. If anything, the continued economic uncertainty, the recent political unrest in the Middle East and North Africa and natural disasters such as the earthquakes in New Zealand and Japan, have focused even more attention on the importance of timely, accurate and complete information, and how far we need to go. The upshot is that all market participants are under increasing pressure to provide detailed information about financial assets, ensuring visibility across multiple dimensions through exposure concentrations, inter-linked entities, regulatory compliance, and risk-aggregations.

For asset managers, a key focus area is ensuring the safety of their assets and controlling the risks that lie within post-trade process. The types of risk involved include:

- Country risk – the situation in Greece, Ireland, Portugal and Spain has underlined how the creditworthiness of sovereign states has come under greater doubt since the financial crisis, therefore country risk will play a greater role in firms’ overall credit risk management.
- Depository risk – this is the greatest area of focus for firms as they look to ascertain the financial integrity of these entities.
- Liquidity risk – settlement obligations not met on the due date can have a devastating domino effect on the market and investor confidence.
- Type of funds and security types – fund of funds have grown in popularity over recent years but their structure greatly increases the complexity of assessing counterparty relationships and tracking the underlying assets. It is a similar case with the asset classes involved, particularly where sophisticated structured products are involved.

Asset managers want to be able to measure the stability and creditworthiness of their custodian relationships, and to model scenarios that could affect asset safety. They want to understand their aggregate exposure to each market especially for assets that are held across multiple custodians. To the institutional manager, who may have upwards of 100 direct custody relationships, such analysis can be a daunting task.

Interestingly, it may be the custodians themselves who hold the key. Custodians, as the name suggests, are the designated guardians of investors’ assets and have forged their reputation on the ability to safeguard these investments. Despite the repercussions of the financial crisis, the industry’s reputation has, with some exceptions, largely remained intact.

And the timing couldn’t be better as custodians are seeing their traditional revenue streams being placed under significant stress by a shifting business landscape that threatens to redefine the entire custody model. Custodians face threats from several different fronts, not least of which is an over-reliance on market based revenue sources. In a low market cap, low interest rate environment such as we are in, ad valorem and net interest earnings are depressed significantly.

At the same time, custodians have to cater for a structural shift in the clearing and settlement process. The European Commission’s Target2Securities (T2S) are designed to reduce the cost of cross-border settlement by establishing horizontal integration of the central securities depositaries (CSDs) operating predominantly in Europe. Custodians face a costly bill in making the changes in order to operate in the European market while losing settlement fees in the process. A further consequence of T2S and central counterparty initiatives is that CSDs are reacting to their own reduction in revenues by undertaking traditional custody business, such as asset servicing. Add to this the onerous tiding of ending AIFMD regulation and the outlook for custody looks grim.

Despite the daunting array of challenges that lie before them, opportunities abound for financial institutions to alter current business models and capitalise on the recent industry trends with a focus on information-based services. Custodians that can leverage their network data flow to monitor post trade market risk, and provide risk assessment tools and services will find a ready audience.

It is the ability to provide this information in near real-time that asset managers and investors are seeking today. For their part, financial institutions need to achieve a granular and timely view of the dynamic information involved in all transactions (both settled and unsettled), covering all asset classes and fund types, and give asset managers and asset owners a portfolio-wide view of all trades and positions at multiple levels. Offering this service on a third-party basis for non-held assets raises the bar yet another level.

However, this is not an easy task as creating a system that provides a meaningful assessment of each trade and the settled positions requires integration with multiple sources of data, both client- and market-specific. Additionally, the system needs to derive information from disparate sources and then be able to process and aggregate this information in order to produce a tangible and actionable benchmark. Clients can then use these values to build a rules-based assessment of their various risk parameters and be able to define and refine these parameters according to their specific risk requirements, reflecting their risk tolerance and appetite.

For all financial institutions, the innovation that this type of service represents will give competitive advantage at a time when clients are evaluating their relationships with their service providers. By approaching this challenge in a committed fashion, and putting surveillance and transparency at the core of the services on offer, firms will be able to present themselves as not only the trusted and established administrators of assets but also the sophisticated providers of highly visible, deeply granular and event-driven, risk services. This is a unique opportunity to reinvigorate an increasingly commoditised business. **AST**

Charu Kirti Jain
Product manager
Information Mosaic