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CDS market - CCP and clearing

Pension Custody - The Italian jobs

Panel - Corporate Actions

New priorities

What the decline of transition management says about banks' 'core' services

Valuation - US bank rescue
Profile - Maureen Miskovic, State Street
Class Actions - Madoff and other dramas

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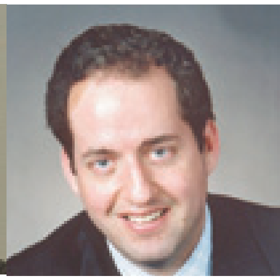

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P.06 News

The last month of updates in custody, clearing and settlement, securities lending, legal and compliance and technology.

It's All Over Now, Baby Boom

The decline of the FTSE100 is not happy reading for UK pension funds and retirees. In three months since the start of 2009 the index has dropped 12.5% from 4,638 to 3,693, hitting hard funds heavily weighted in equities. It is estimated that UK pension funds own 15% of the index.

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Editor's letter

Lost in transition

Tough decisions are part of running a financial institution, but rarely have they needed as frequently as now.

With the first quarter of the year down and the cruellest month of April soon to herald outflows of taxes and dividends, most banks will cut certain operations – not to mention staff and geographical outlets - to maintain balance sheet. Asset servicing will not escape this cost cutting, and even profitable services may be reduced to make up for the losses in other areas.

Transition management is one such line of business to cease in a number of institutions. The proposed cost-savings to the client that caused firms to offer this service has been overtaken by the cost-savings of the firms themselves. For those still in this industry, a debate over which model – fiduciary or broker-dealer – continues. Most interesting is the prediction of a breakdown in long-standing business relationships as institutional investors 'carousel' funds from one set of managers to another in frantic attempts to stem losses.

The desperation – from both the investors and the banks they give their money to - is understandable. Institutions can only work within limits, even if the losses seem limitless.

This is highlighted in our feature on pricing bank assets whereby infrastructure providers have only a limited capacity to model the "second and third-wave impacts" of blue chip companies failing. (Page 26.)

Co-ordinated action between governments has yet to materialise, despite highly publicised meetings. A rescue of the CEE region remains a divisive issue for the rest of Europe. The hedge fund industry still resembles a schoolboy sitting outside the headmaster's office, waiting to be sternly told what he can and cannot do. In such fragmentation and uncertainty, it is forgiveable to take a short-term view but this may prove too hasty.

Issues surrounding corporate culture and responsible oversight will continue to dominate the agenda. The case of Bernard Madoff is closed but the case in London of the MF Global trader suing his account manager for deliberately covering up his losses to gain commission, is taking its place in the wider press.

Independent fund administration has, at least, made progress, and a number of industry experts pen their thoughts on what this means to the Irish fund market. Elsewhere we cover the risk-averse world of Italian pension funds, profile securities lending in the UK and get some trenchant insight on the state of corporate actions from our panel debate. ■

Ben Roberts, Editor

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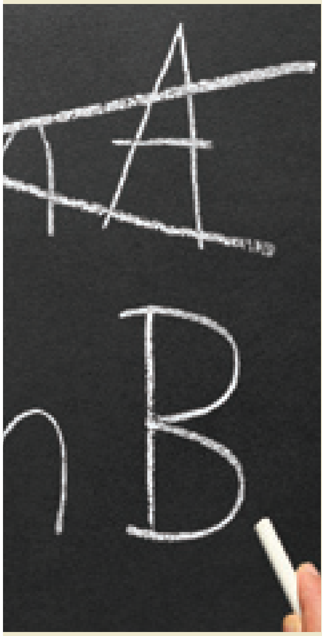

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Letters

Dear ISJ

China has been blamed for contributing to the growing US trade deficit by continuing to support its export sector through unfair practice such as the artificially low yuan and direct government support to export oriented companies. On April 2, the next G20 meeting will take place in London. US president Obama is under pressure to discuss a future appreciation of the Chinese currency with president Hu Jintao. Currently, it is the assumption that the trade deficit with China is hurting US jobs and manufacturing. Consequently, an appreciation of the yuan will help the US economy. However, the view that this trade deficit with China is extremely negative for the US economy, is blurred by too much focus on national borders in trade discussions. Furthermore, the trade discussion is overemphasising the value of the product, instead of the money flow associated with it.

First, in today's world, export is driven by location decisions of multinational enterprises. Statistically, all export from China is measured as Chinese export, but in practice, more than 60% of all Chinese exports is produced by foreign affiliates in China (2007). For example, look at the trade deficit of the US with China: it has been calculated that 10% of this deficit can be attributed to Wal-Mart. If Wal-Mart were a country, it would rank in the top 10 of China's main trading partners.

Most of Wal-Mart's Chinese production is exported to the home country, so its low production costs in China are essential for their low price strategy in the US.

Further, there are also major profit flows from American companies in China back to the home country.

Secondly, people tend to overemphasise the value of Chinese export to the US.

A large share of China's export consists of imported components and materials.

In most cases, the total value added in China lies in low-cost assembling – the larger share of the final export price consists of expensive components which are also imported from the United States and used in the production process in China.

While focusing on the total value of China's export, we miss the positive spill over effects for American industry.

The bilateral trade deficit discussion in the United States is onesided. Although, an appreciation of the yuan will have an advantage for the US trade deficit, it will also negatively affect the US consumer, due to higher prices and companies such as Wal-Mart that will achieve lower profits. Therefore, the appreciation of the yuan will also hurt the US economy. Obama and his advisers should keep this in mind when they meet Mr. Hu Jintao in London.

Prof. Dr. Haico Ebbers,
chairman Europe China Institute, Nyenrode Business University

Dear ISJ

The ETF market has witnessed significant growth in recent years as their value and use as both an investment product and a portfolio management tool increased.

Consequently as the primary and secondary markets for ETFs have risen so has ETF lending supply and activity. Like the ETF market itself ETF lending activity is heavily US-focused at present but we've seen liquidity in European ETFs expand as well.

It's a trend we expect to continue as a lending facilitates greater liquidity in secondary markets and greater usage of ETFs will stimulate further growth in lending demand.

The general shifts have been towards accepting higher quality collateral, more non-cash collateral and increasing margins. However, not all lenders and beneficial owners were accepting the same asset classes as collateral previously, so whilst for some there has been significant changes to their collateral parameters, for others, the changes, if any, have been much less.

Blair McPherson
Global Head, Technical Sales
Global Market Products &
Services division,RBC Dexia

Dear ISJ

Spreadsheets are one of the most common tools used to manage critical data and make strategic decisions. The attributes that make spreadsheets so beneficial also create an inherent level of risk.

Because spreadsheets are managed and manipulated almost solely by end users, the input is highly susceptible to human error and fraud. Horror stories range from bank tellers "skimming" by manipulating spreadsheets used to track large deposit amounts to a CFO disguising commission amounts by simply hiding cells. If spreadsheets are highly susceptible to manual errors and fraud, why do most organisations only have rudimentary spreadsheet audit and controls in place?

Regulators will not allow this lack of audit and control to continue. Many organisations will face the challenge of cataloging and measuring the materiality of spreadsheets. Others who have already performed this function are left with the question - what next?

Spreadsheets are a permanent fixture, but organisations must adopt stronger spreadsheet controls and policies in order to protect the bottom line.

Nolan Gesher
Senior Product Manager
Financial Control Solutions,
Fiserv

To express your views, write to ben@2ipartners.com or write a blog at www.ISJ.tv

Custody

MILAN - Reform to the pension system in Italy, whereby employees will be able to switch between a state plan and a private plan, "might never happen", warned Massimo Cotella of SGSS. Educating employees about their pension choices is also greatly needed, he told ISJ.

LONDON - **Northern Trust Global Investments** hired Kai D. Leifert as head of Risk Management.

Mr Leifert, who joined from **Credit Suisse Asset Management** where he was head of investment risk management UK, will oversee all risk management activities at NTGI across Europe and Asia Pacific.

In the profile of Mark Kerns of **Standard Bank** in issue 35, some facts were wrong; Mr Kerns was born in London not Shrewsbury, where he was educated, he was the sales and marketing director at the WM Company on the fund manager services side, he is not an accountant and was not responsible for automating Datastream administration - he bought their services and he was a not a director of Datastream. BNY's global custody "link" with Standard Bank was made in 1998, Mr Kerns was responsible for establishing it from the BNY perspective. Apologies to Mr Kerns.

Technology

StreamBase Systems, the software provider, extended its capital markets frameworks to include low latency data from Interactive Data Corporation's Real-Time Services business. StreamBase's Market Data Management, Smart Order Routing, and Real-Time Profit and Loss frameworks allows customers of StreamBase and Interactive Data to access market data delivered by PlusFeedSM, Interactive Data's consolidated high-quality, low latency digital datafeed that powers algorithmic and electronic trading applications. PlusFeed delivers low latency data on over six million securities from more than 450 sources around the world.

Also, the firm's software has been extended to connect to the trading platform recently launched by Alpha ATS L.P. ("Alpha").

The launch of the Alpha trading system provides an innovative new venue for trading Canadian listed equities, and the StreamBase connectivity, released as integrated CEP platform adapters, allows firms to gain first-mover advantage by providing "drop-in" connectivity.

NEW YORK - **Asset Control** expanded its Fitch Solutions data coverage as part of its AC Plus data management software solution. The Fitch Solutions Ratings Delivery Service (RDS) data feed is provided as an off-the-shelf AC Plus interface to help financial institutions obtain improved insight into credit risk and performance of financial instruments and issuers.

The RDS data feed facilitates credit analysis from Fitch's rating data, as well as monitoring and compliance. Fitch Ratings information is provided to Asset Control's AC Plus on a daily, monthly and intra-day basis providing customers with updates every 15 minutes throughout the day.

StatPro, a portfolio analytics and data provider, has launched a new service providing key financial indices to investment managers through a standardised platform.

The company began retrieving, packaging and disseminating the FTSE/JSE index data as a service to clients in South Africa. The firm is now expanding this service to include FTSE UK and Global, S&P US, iBoxx, Russell US & Global, JP Morgan and Stoxx indices. Over the next few months, roll-outs will include the S&P Emerging/MIB/ASX/Global, Deutsche Boerse DAX, and Dow Jones indices.

Cadis, a provider of enterprise data management (EDM) systems for buy-side institutions, has integrated the London Stock Exchange's Datalect product suite into the Cadis EDM Suite. The integration includes the LSE's global SEDOL Masterfile service.

The Cadis adaptor will enable clients to maximise the value of the data that the LSE provides and integrate this data into their OMS, EMS, Compliance, Risk, Performance and Reporting applications rapidly and cost effectively.

Trayport's Exchange Systems Business has joined FIX Protocol Limited (FPL).

It is now able to work collaboratively with FPL in defining and supporting the extension of FIX messaging across the broader derivatives asset class. Over the past two years Trayport's standard equity based FIX 4.4 gateway has been deployed across its equity exchange clients. However, an increase in the need to cater for all exchange clients has become increasingly apparent and Trayport is now looking to extend its FIX capability.

LONDON - **Calastone Limited**, the independent cross-border transaction network for the mutual funds industry, announced today that wrap provider Nucleus has signed an agreement to become a member of Calastone's transaction network.

Regulation

The **International Securities Association for Institutional Trade Communication (ISITC)**, the transaction processing industry trade group, has released two market practice recommendations.

ISITC periodically releases market practice paper via its reference data and securities lending working groups, to help industry participants better implement best practices in trade processing and related communications.

The Reference Data Working Group's 'Market Practice Recommendation for the Communication of Standing Settlement Instructions' aims to enhance the consistency and overall efficiency of the processes used by investment managers to set-up and maintain custodian and broker standing settlement instructions (SSI).

The Securities Lending Working group's paper, the 'Market Practice Recommendation for Re-Allocation Instructions', aims to benefit the process in which a re-allocation instruction message is sent by a third-party lending agent to the custodian in order to alter the loan assignment (or a portion thereof) from one fund to another fund.

The UK's **National Association of Pension Funds (NAPF)** updated its Corporate Governance Policy and Voting Guidelines ahead of the 2009 annual general meeting season.

Amendments to the policy include combined chairman/ CEO guidelines, the role of the chairman in maintaining corporate governance standards and waivers of Rule 9 of the Takeover Code

The voting guidelines are designed to assist shareholders and others in interpreting the Combined Code, on which the guidelines are based, when considering voting at company meetings.

Changes and clarifications are in the areas of : Non-audit fees, voting for a combined chairman/ CEO, the event of continued material non-compliance, investors may consider an actively withheld vote or vote against the re-election of the Board chairman.

Rule 9 waiver – rule 9 of the Takeover Code requires an offer for all the shares in a company when an individual, or group of individuals acting together, acquires over 30% of the voting rights in a public company.

Clearing

LONDON - Interoperability between clearing houses and central counterparties is “not an argument that holds water”, according to **BT's Hugh Cumberland**.
The products strategy director told ISJ.tv that the success and cost-competitiveness of the US - with a single, commoditised infrastructure for clearing and settlement – cannot be matched if Europe has thirty more systems interlinking and claiming to sustain the same level of risk oversight.

A research report by **TABB Pinpoints™** - “Credit Default Swaps: Industry Projections” – found that although the outstanding notional value of the CDS market has declined dramatically largely due to trade compression, CDS market revenues from central clearing, electronic trading and existing trade migration will grow to USD174 million, growing at 12% CAGR (compound annual growth rate) through 2011.

Climate change and carbon disclosure is climbing the list of priorities for many investors when allocating assets, according to a report.

Mercer, the US investment consultant soon to merge with Callan Associates, found that 77% of respondents indicated that they factor climate change information into their investment decisions and asset allocations. Of these, more than 80% indicated that climate change is a very or somewhat important factor.
A boost to this area of consideration is found in the Carbon Disclosure Project (CDP), an independent not-for-profit organisation holding the largest database of corporate climate change information in the world.

Mercer also estimated that the funded status of the pension plans of S&P 1500 companies held steady in February despite further falls in the value of equities that month. Based on these estimates, the aggregate deficit of pension plans sponsored by S&P1500 companies was USD373 billion, virtually unchanged from USD380 billion at the end of January and down from USD409 billion at the end of December 2008.

Securities Lending

The short selling ban in Australia was extended to 31st May 2009.

The Australian Securities and Investments Commission (ASIC) imposed the ban on the short selling of non-financial securities on 21st September and lifted it on 13th November. It had a provisional date for the lifting of the ban for financial stocks on 27th January, but advised the market six days before that 6th March would be the new deadline.

The daily reporting of gross short sales will continue as will the publication to the market of aggregate short sales the day after trading.

A survey by the **International Capital Market Association** found that the repurchase, or 'repo' market - money lent in exchange for bonds - dropped 28% from June to December as hedge funds and banks sought to deleverage their balance sheets and money lending reduced in the wider credit freeze. ■

Latest mandates

Month	Winner	Client	Location	Assignment	Mandate size
February	JP Morgan	Royal B'gh of K-upon-T	London	Global Custody	GBP323 billion
February	RBC Dexia	Creststreet Ass't Man.	Toronto	Custody/fund services	n/a
February	L&G Investmn't Man.	Oxfordshire Co. Council	London	UK Equity Portfolio	GBP850 million
February	Sage Advisory Servs.	Texas State University	Austin, TX	USD12 million	FI core strategy

Court in a trap

International variations and legal technicalities have hampered an investor's ability to recoup losses through class actions

The business media is awash with court room drama. While judicial bodies chase down such financial villains as Bernie Madoff, Alan Stanford, and at least, according to the US government, Switzerland, disgruntled investors are wondering who to blame for the annus horribilus of 2008.

It would be simple to assume that the US, where litigation is a man's best friend, would see first progress. Class actions, a form of lawsuit where a group of people collectively bring a claim to court, originated in the US, and remains a strongly American ideal.

In Scotland, the home of one of the biggest casualties of the credit crunch, RBS, class actions are simply not possible. A senior Scottish lawyer, Richard Keen, QC, the dean of the Faculty of Advocates, has called for the restriction that bans class actions in Scots law to be scrapped. HBOS, with its shiny headquarters on Edinburgh's mound, and RBS - out in its giant campus at Gogarburn - must be watching these developments closely.

In February Tavish Scott, a member of the Scottish parliament, has called for the Serious Fraud Office for an investigation be carried out regarding RBS's rights issues in 2008. In April 2008 investors paid GBP2 a share for new stock. A second rights issue in November failed and forced the government to underwrite the GBP15 billion issue. At the time of writing, RBS share-price is around GBP0.12. Richard Keen hopes that changes to the law will mean that groups of shareholders will be able to hold financial institutions to account over the lack of financial information that was made available. Changing the law is a delicate and drawn out business, so it is unlikely that much will happen to RBS in the near future.

In England, the Civil Justice Council (CJC) set about to enable consumers greater ability to bring collective or multiparty claims. This ruling in early 2008 followed an 18-month report that found that consumer claims were generally being ignored. According to the report: 'Access to justice is… still disproportionately weighted against claimants, whether they are groups of consumers, small businesses, employees, or victims of mass torts... This has resulted in few claims being brought and, significantly, demonstrates that a number of meritorious claims simply have not seen the light of day.'

This ruling has not helped David Greene, head of litigation at Edwin Coe and president of the London Solicitors Litigation Association. Greene is representing 150,000 private Northern Rock shareholders who are challenging the compensation package offered by the UK government. The Northern Rock shareholders dispute has been dismissed by the Divisional Court at the Royal Courts of Justice, and is now heading for appeal.

Even those who look set to benefit from class actions are not overly enthusiastic. Sir Nigel Knowles, chief executive of DLA Piper, the largest law firm in the world, recently stated that 'talk of a "wall of litigation and class actions" is rather overdone'.

This is not to say that the courtroom will not be the stage for investors desperately seeking some form of return on their investments. Martin Cornish, partner at law firm Katten, Muchin Rosenman, says "It does seem the credit crunch/recession is uncovering various financial operations which were either unsound or in the case of Madoff and now Stanford, allegedly fraudulent. So it seems likely there will be further collapses and it is likely investors will seek compensation through the courts as their only avenue where the institution itself in bankrupt."

Getting results in the courtroom remains the most crucial part of any class action. In more clear cut cases of financial fraud, some form of compensation may seem like a given.

This is a slightly naïve presumption. The American courts over the past decade have tried hard to change the conception that the country is 'litigation happy', and as many of the feeder funds that lost investors money by investing with Madoff and Stanford are based in New York and Connecticut, many class actions look to stand and fail in American courtrooms.

The reasoning behind this is the Private Securities Litigation Reform Act, passed in 1995. Its aim was to cut down on 'frivolous' securities lawsuits in federal courts. Unless financial fraud was undeniable, it became very hard for class actions to retrieve any capital as the funds in question will cry 'mea culpa'. As losing money through laziness isn't a criminal offence, it is unlikely that we will see many feeder funds handing back money to their clients.

It gets better. In 1994 in the case Central Bank of Denver v. First Interstate Bank of Denver, the Supreme Court ruled that investors can't sue advisors that aid securities fraud, as the advisors (be they investment banks, consultants or feeder funds) may simply be wrong in their advice, with no malicious intent. Unless they are directly linked in misleading regulators and investors and committing fraud, then they cannot be held accountable.

The feed funds to Madoff got it wrong. It is their job to conduct due diligence to ensure good returns for their investors, not to act as a safe house for their investors money. This means that the vault, or in this case the custodians, is where the class actions will head to next when they run out of luck with funds and investment banks. For some, the courtroom will be the only hope of solvency.

Cornish explains: "In good times when everyone is making money people tend not to worry about conflicts. When they lose money they look to recover through all available means - enough people have lost enough money not to be able to ignore the possibility of recovery and in some cases recovering through third-parties may be the only way they can survive."

In a massive contradiction by the advisory bodies, institutions such as pension funds have been told they have a duty in recouping losses resulting in securities fraud. It its publication 'Securities Litigation – Questions for Trustees', the National Association of Pension Funds in the UK stated: "It seems self-evident that trustees have a duty to protect the assets in their scheme and that they should therefore at the very least not neglect opportunities to recoup losses."

The US Government Finance Officers Association has also put forward a similar recommendation in "Developing a Policy to Participate in Securities Litigation Class Actions", explaining that "Public pension governing bodies and chief administrative officers have a fiduciary obligation to recover lost funds lost through investments in public securities as the result of corporate mismanagement and/or fraud."

So while lawyers and advisory bodies seem wonderfully enthusiastic about the prospect of class actions, it seems that the possibilities of success are stacked against the investor. While there may be a trophy case that succeeds, 2009 holds little hope for investors hoping to recoup their losses. ■

Carne Global enters Dubai

Consultancy bucks exodus trend

Never say never in financially incredible times. Carne Global, a leading consultancy for asset managers and their service providers, has opened an office in Dubai, just as the bailout from the UAE central bank is confirmed and news of the Emirate's burst property bubble and fleeing investors becomes known globally.

The Dubai office will offer the full range of fund lifecycle of services and expertise already available from Carne's other offices in Dublin, London, Geneva, Luxembourg and the Cayman Islands.

For Gary Shelley, who will oversee business development in the region, the new office is just the beginning, and will give on-the-ground presence for the firm in servicing both fund clients domiciled elsewhere and its local families making the structural transition from private wealth to asset management houses.

"Dubai is the hub for the entire region and we've seen activity regionally," he told ISJ. "Dubai was never an economy based on oil so it has big potential for its asset management and financial services. It's important to have on-the-ground presence and to be an ancilliary service provider with a licence from the DIFC."

One client is a Saudi family launching a regulated asset management operation. "We have worked with them for around two-and-a-half years, and I have worked on the implementation of compliance and middle office operations and IT since last August," he says.

"The focus is on bringing the family offices to be regulated and compliant with things such as money laundering laws. Asset manager start-up businesses would be a focus, though this may not be too active at the moment. These families have many advisers, so it's a lot like traditional wealth management."

The region is a few years behind Europe and the US for IT and other middle to back office operations, he says, but he is seeing growth in this area. The region is also showing significant interest in exchange traded funds and UCITS funds, he adds.

The growth in European and US custodians in the Middle East – as documented in the last issue of ISJ – will be beneficial for more competitive fees. He says one fund client domiciled in Cayman could not fulfil its desired exposure to the region because the fees were too high.

Robert Law has been installed as managing director, joining from ICM Asset Management, an advisory firm, having held the positions of chief compliance officer, general counsel, director and executive vice president in a fourteen-year stint.

John Donohoe, CEO of Carne Global, commented: "Carne has had a presence in the Gulf region for some years, advising key investment industry clients, private banks and family offices. Due to increasing demand for advice on all aspects of establishing fund structures, now is the right time to establish ourselves here on a permanent basis."

The market of course has not been saved by the credit crunch, says Shelley. "People think there's a lot of money flying around here because the market over the last 6-7 years has just gone up. But the issuance of 20 billion debt from the UAE central bank, with 10 billion of that taken up by Dubai, has helped. We're excited to be here." ■

The game of risk

Maureen Miskovic, chief risk officer at State Street, explains the strategic side of her role to Ben Roberts

It seems counterintuitive to step down from a board of directors at one of the biggest financial institutions to take on an arguably bigger job. But Maureen Miskovic, State Street's chief risk officer, did just that in April last year. The transition from board to the senior management means she has a first-hand view of the link between the two sets of decision makers – vital communication for banks to survive and thrive today.

Communication should come as second nature to a King's College, London graduate with a BA in Russian and German. Miskovic's experience of boardrooms at Lehman Brothers, NRG Energy and Eurasia Group among others gave her the impetus to step up to the top table at State Street in 2006. "I enjoyed the board experience previously - at the time I really wanted to get back into it," she says.

The difference between the two is marked, she adds, with more hands-on control of the company coming from her current role. "A board of directors obviously has the shareholders in mind but is not necessarily deeply involved with the systemic operations of the bank. The senior management team is, and there are nine of us at State Street meeting daily. Ron Logue [chairman and chief executive officer] is the link between the senior management and the board of directors, so any of the key issues flushed out at the senior management meeting go through him to the board level."

Miskovic seems to have an intuition for interconnectedness. Since August 2007, the ripple effect of the credit crunch that engulfed banks and lenders before the wider economy could be foreseen, she believes, and any expectations that the lending freeze had limits were misguided.

"I never bought into the idea that this ever was just a banking system problem, and never thought that Asia could properly decouple from the West"

The realisation came in the "dying days" of 2007, she explains. "I had this real sense of the significance. I never bought into the idea that this was ever just a banking system problem, and never thought that Asia could properly decouple from the West, which was supposed to be the initial reaction. China's growth is at around 6%, which to them is a recession of sorts from the 14-15% we've been seeing. I didn't believe anything was isolated, I didn't think investment banks could survive as we'd known them – as well as Fannie Mae and Freddie Mac."

Eighteen months since, the industry has undergone "a revolution in financial services".

She began her career trading commodities and derivatives, which brought her onto the London Metal Exchange in 1979. "If it moved, I traded it," she says. Since then her corporate experience is a local map of Wall Street's and the City's blue chips. She was client liaison executive at Triland Metals; head of institutional option sales and Quilter Goodison & Co.; director of stock index proprietary trading at Morgan Grenfell & Co.; executive director, group risk manager and Treasurer, at S.G. Warburg & Co. and executive director, European Treasurer, Morgan Stanley. She even found time to write a book, with 1988 seeing the release of 'Futures and options: a handbook for institutional investors'.

In 1996 she was appointed managing director, head of risk management of Lehman Brothers, New York. She was also a memeber of the group's Investment and Diversity committees. In her six years at the bank her star rose considerably and was snapped up by Eurasia Group in 2002, a research and consulting firm that advises institutions on the political landscape for each new country they expand into, where she acted as senior advisor. She also acted as the principal liaison for its joint venture with Deutsche Bank, which includes the DESIX, the first global political risk index on Wall Street.

In September 2005 she was appointed to the board of directors at NRG Energy, an acquirer and manager of a number of electricity generators and providers around the US, this year celebrating its 20th anniversary.

If it seems a tangential move, the company overview explains that it has "a diverse portfolio of electric generation facilities in terms of geography, fuel type and dispatch levels, which helps us mitigate risk". It was indeed her risk credentials that landed her the position.

"Risk is seen as defensive, but it can also be strategic," she says, "the important thing to know also is how risk management is both quantitative and qualitative. There is a department of 250 people at State Street working within this area, including those with deep, long expertise."

State Street has an audit committee meeting approximately 15 times a year. Meetings with the executive and risk committees happen more than 10 times a year, with the operations team meeting daily. Though the meetings with the board will be detailed in terms of market trends and considerations – from liquidity to structured products and counterparties – the board itself is "well informed".

A mix of people with different backgrounds makes up an effective committee, she adds, and mentions Amelia Fawcett, the lawyer turned ex-Morgan Stanley executive and fundraiser who joined the State Street board the same year as Miskovic (2006), as an example.

Miskovic's own experience of working in different sectors is one that has asked for different skills. "Being on the board at NRG is completely different. It looks at projects such as power generators as well as issues such as natural gas and assessing the availability of supply."

Returning to banking, it is difficult, as everyone thinks, to predict the outcome of company restructures and government intervention in 2009 – or how the sector's reputation can be reconstructed. "One of the biggest risks is the actions of well-intentioned politicians on the back of a public call for retribution," she says. In the meantime, she adds, a key difference will be that "people won't consume at the same rate".

She is enthusiastic as to the make-up of the team around here after almost a year in the job, which was newly created when she stepped down from the board. "There is a cohesive, committed group," she says, "that is proud of State Street's achievements as an asset servicer as well as an asset manager." ■

"Risk is seen as defensive but it can also be strategic. The important thing to know is how risk management is both quantative and qualitative"

The profile

Maureen Miskovic has had a diverse career, principally working between New York and London.

2008: State Street Chief Risk Officer

2006-08: State Street Board Member

2002-08: Eurasia Group
Senior advisor (2007-08)
Group chairman (2006-07)
Group COO (2004-06)

2005: Joined as member of the Board of NRG Energy

1996: Lehman Brothers
Managing Director and Chief Global Risk Officer

Morgan Stanley European Treasurer

SG Warburg (8 years in London)

Morgan Grenfell & Co.

Quilter Goodison & Co.

Betty Ford Foundation: Chairman's Council

Author: 'Futures and Options: A Handbook for Institutional Investors' (1988)

New priorities

Transition management has become a dwindling service as banks reassess their 'core' offering, writes Brian Bollen.

Transition management is itself undergoing a period of transition. The recent departures from the market – voluntary or otherwise - by Bear Stearns, Citi, Credit Suisse, Lehman Brothers, Royal Bank of Scotland and Union Bank of Switzerland have changed the face of the industry.

Some of the survivors, such as Sam Lundqvist, head of transition management, EMEA at Russell Investments, argue strongly that the investment banking broker-dealer model of transition management is dead, and that fiduciary agency will be the new dominant model. "You get more fiduciary protection from an investment manager than from a broker," he says,

Others take the opposing line: the broker-dealer model can continue to thrive. Morgan Stanley, for one, is in for the long haul, insists Gary Spreadbury, executive director, head of transition management services, Europe, Middle East, Africa. As proof, he points to the firm's appointment of Richard Surrency as a Singapore-based executive director in the consolidated equities division with responsibility for the transition management product in Asia Pacific.

Scott Field-Marsham, Hong Kong-based Global Head of Transition Management at Morgan Stanley, adds that the bank has a successful 20-year track record in global transition management. "We see this business as a strategically important means of working with our client base."

This immediately raises the question of whether trends in Asia differ greatly from those seen and experienced in Europe and the US. John Moore, director of Investor Services, Australasia, at Russell Investments in Sydney says that Asia lags some years behind.

"[Asia is] where we were in 2002-03,

While the trading process could be opaque, many clients were attracted to the low explicit commissions offered

very much in the educational stage," he comments. "They still ask: 'why use it? What is the importance of transition management?' But some investment funds are starting to grasp the principles and we are seeing a few more agency models coming to market in Asia. They have certainly gained ground in Australia over the past three years."

But others question whether the broad perception that Asia is always playing catch-up is accurate. "I would say that while there are fewer large pots of institutional investment money in Asia, they are no less sophisticated [than the west] in the demands they make of transition managers," says David Goodman, head of transition management at State Street. "Some clients are very sophisticated indeed, making demands that go beyond trading into risk management and implementation."

Sovereign wealth funds and various government-sponsored funds makes up for the lack of defined benefit schemes in Asia seen widely in Europe and the US, adds Mark Keleher, CEO of Mellon Transition Management Services. He believes that a great period of portfolio rebalancing lies ahead for those funds, just as for other investors.

"Every client in the world is currently aggravated with every asset manager around the world. There will be a lot of 'carousel' transactions: people will make moves from one asset manager to another, or from one asset class to another, just to give the impression that they are doing something in response to recent economic events globally."

Some observers believe that certain institutions will live to regret decisions on hasty service cutbacks, without proper consideration of the risk-free capital-efficient returns that transition management can deliver. But there are other issues to consider, including the exact constitution of a 'core' business.

"Commercial banks, investment banks, and asset management firms around the world are facing diminished asset bases, lower equity valuations, and a grim outlook for economic activity," observes David Rothenberg, a managing director at Russell Investments. "Many are responding by determining what their 'core' business functions are, and retreating from those areas not seen as essential."

Asset management firms that must provide transition services for their own managed funds consider it a core competency, he says. "This is the case with Russell Investments and the handful of other major providers remaining in the business. Those firms for whom transition management is not a core function have cut capacity or withdrawn altogether from the business. Two investment banks had the decision made for them. A handful of other major players recently announced a reduced footprint, or outright retreat, from the offering of transition management as a standalone business."

To understand this better, he says, it is necessary to differentiate the business models that once populated the transition management landscape. The pioneers of transition management were first required to develop the risk management techniques and portfolio level strategies for transitioning their own internal funds. With significant investments in the construction of trading platforms, and the work done to establish trading relationships with broad sets of liquidity sources, these first movers looked to broaden the base on their infrastructure investments by offering services to outside parties. It was a simple matter to extend this level of fiduciary care to clients' funds.

Investment and custodian banks eventually offered transition management to increase trading volumes and order flow, and to enhance offerings to relationships built around other services. They offered asset transition as a brokerage exercise, promising trading expertise and access to liquidity as the reason why clients should trust them with their assets.

Through their ability to extract value from counterparty trades, or to pair off against their own internal trading needs, investment banks were able to offer commoditised rates for transition services. While the trading process at times could be opaque, and the outcomes not necessarily optimal, many clients were attracted to the low explicit commissions offered. If anything, lower fees are easier to justify to a board.

As more competitors entered the transition management industry, traditional 'transition management as interim asset management assignment' fiduciaries either trimmed commission rates or lost business to lower-cost brokerage. This created a downward pricing spiral, led by firms with poorly articulated value propositions outside of lower explicit costs. The result was a perception of commoditisation, even among some consultants, though the need for risk and portfolio management capabilities was – unawares to many - on the rise.

"The old school of transition management saw this trend and realised that customers were not well aware of the true costs or risks of transitions," says David Rothenberg. "To address this plan sponsors adopted the T Standard, which spread quickly as a means of better assessing the impact of the transition on overall portfolio value. Another advancement was the T Ratio, a means of evaluating the quality of risk estimation on the part of the transition manager. Effort was made in the UK to bring about a common standard of practice for transition management with the T Charter. In 2008 the Pension Benefit Guarantee Corp (PBGC), the US government plan manager of last resort for troubled pensions, produced a standard of practice for transition managers that offered remedy for many

"Those firms for whom transition management is not a core function have cut capacity"
David Rothenburg, Russell Investments

of the areas of opacity when assets are traded and how results are reported. This standard effectively cast light on aspects of a transition that potentially diminish the attractiveness of transition management to broker dealers looking to put the client's trade flow to work."

Russell defines transition management as interim portfolio management (IPM), he continues. "More than just an exercise in execution, IPM requires the level of fiduciary care that asset managers provide for their investors. And the provider of these services should have the credibility of long tenure.

"Clients routinely express the need for stability, longevity, and consistency of service from their IPM providers. As was pointed out in recent press on

Transition: cost benefits

Let's assume a client needs to terminate two segregated active European equity managers (total assets EUR350 million) to fund a passive European equity fund. Without a Transition Manager, it's likely the client would instruct the legacy managers to sell. These proceeds would then be used to purchase units of the index fund (Scenario A).

A transition manager, however, can assume control over the legacy assets and work with the index manager to construct their desired portfolio using as many of the legacy stocks as possible. That portfolio would then be transferred inspecie to the index fund in exchange for units (Scenario B).

As a large proportion of the legacy securities are often acceptable to the index manager, the required trading is significantly reduced. Thus Scenario B manages to minimise the cost of selling the legacy assets and avoids the cash subscription charges of the index fund.

Scenario A
Liquidation of legacy assets (commissions, taxes, market spread/impact):€UR 700,000
Cash investment into index fund (anti-dilution levy): EUR 850,000
Estimated transition cost:
EUR 1,575,000

Scenario B
Liquidation of unwanted legacy assets, purchase of required target assets (commissions, taxes, market spread/impact): EUR840,000
Inspecie security transfer to the index fund: €0
Estimated transtion cost:
EUR€840,000

Source: Russell Investments

the subject, clients don't want their manager disappearing mid-transition. With several high profile exits from the business, it seems that the available selection of transition management providers has narrowed. Interestingly, the field seems to be contracting back to the same pioneers. We expect that the institutions with weaker offerings will return to the industry at some future date, coming back when the volumes of business and hoped for margins return."

There will be a lot of 'carousel' transactions: people will make moves from one asset manager to another"
Mark Keleher
Mellon Transition Services

Despite fewer providers, many still-active participants believe that this will have no negative impact on the quality of service provided to clients, or the fees charged. "The quality of transition management will remain high," says Mark Keleher. "This is a very competitive business and clients look for very, very high standards. In terms of fees, there are still enough large well capitalised players around to ensure it will remain competitive, and that fees will not go up." Gary Spreadbury, meanwhile, says there is no reason for any drop in service quality.

Tim Wilkinson, currently on gardening leave after his post as managing director, global transition management at Citigroup was scrapped just before Christmas, takes a different view. "In some cases, with the range of choice reduced, and the number of different pricing structures reduced, costs will rise," he predicts. "In certain transitions, compensation was far too low relative to the quality of service and added value being provided, although some clients have already been paying higher commissions over the past 12-18 months."

John Mindereides, global head of a 30-strong transition management team at JP Morgan, including six recruits from Bear Stearns, adds: "I don't think quality will drop and prices can continue their rise. That's a trend that has been happening anyway. Suicidal pricing has gone as investors have come to see the value proposition we bring, and are increasingly prepared to agree that we merit a proper return for a proper job."

David Goodman warns that agency providers should not assume that all the market share now up for grabs will go to them.

"Clients were dealing with those organisations did so because they saw a valid reason to; they wanted access to markets, access to trading technology and access to risk management expertise," he says. "The winning transition managers will be those agency providers who can demonstrate they have invested enough, wisely enough, to deliver that same package."

Lachlan French, head of transitions at Barclays Global Investors (BGI), says that some form of consolidation was overdue. "I have commented for some time that there was likely to be consolidation within the industry," he says. "Recent events have accelerated that process. Those who have left either never reached the necessary scale or, for the investment banks, it was never really a core part of their business. For an asset manager like BGI, moving assets around efficiently is part of the core value we provide to our clients; whereas it doesn't sit sensibly with investment banking. For the top tier providers transition management is a core client offering and I expect them to continue to compete in the market place." ■

Domicile report: Mauritius

By Malcolm Moller, managing partner, Mauritius office, Appleby

Since independence from Britain in 1968, Mauritius has diversified its economy by developing industrial, financial, and tourism sectors. For most of the period, annual growth has been in the order of 5% to 6%. The government has successfully encouraged the introduction of external financial institutions to stimulate investment and diversify the economy. Mauritius now has more than 30,000 global business company registrations and 460 registered global funds with a Net Asset Value in excess of USD35 billion.

The global business industry in Mauritius is active mainly for inbound investment into India, Africa and China. Mauritius is a member of the WTO, the Common Market for Eastern and Southern Africa (COMESA) and the Southern African Development Community (SADC), and has the effective commercial and legal infrastructure required to support the development of a global business network. Mauritius has become number one in providing Foreign Direct Investment in India, due to the favourable treatment under a double taxation treaty between the two countries, among others. Many investment and hedge funds are incorporated in Mauritius for the specific purpose of investment in India. Capital gains derived from the sale of securities held by a Mauritius fund and any dividends and proceeds paid by a Mauritius fund to the shareholders, will be exempt from Mauritius tax.

As is with any tax favourable jurisdiction, the media sporadically reports on possible challenges to the tax status Mauritius has with India. However, unless and until the two nations renegotiate the treaty, Mauritius will be a recommended and effective jurisdiction for access to, and no doubt will continue to be the number one jurisdiction in providing Foreign Direct Investment into, India.

So whether utilising a collective investment scheme, a closed end fund or a myriad of other investment vehicles, Mauritius is the offshore jurisdiction for dynamic opportunities for investment in the African and Asian markets. ■

The Republic of Mauritius, established in 1992, is a parliamentary democracy modeled on the British system. The separation of powers within the Government is embedded in its constitution. The President is the head of state while the Prime Minister has full executive power and is the Head of Government and the National Assembly is determined through parliamentary elections. Mauritius has a composite legal system consisting of British common law practices and the French Napoleon Code. The country is still a member of the Commonwealth and the Privy Council in London is the highest court of appeal.

Tax treaties: India and China

Mauritius has no capital gains tax. As gains from the sale of shares of an Indian company by a hedge fund or other global investor using a Mauritius company can be taxed only in Mauritius, the proceeds from the sale of shares may be distributed tax-free as dividends to shareholders. The Mauritius-China tax treaty includes a similar provision, but tax exemption does not apply if the Chinese company whose shares are being disposed of holds assets consisting primarily of real estate or other immovable property.

(Summarised from 'Mauritius: The ideal investment platform for hedge funds' by PricewaterhouseCoopers)

New wisdom for old mindsets

A pension fund revolution in Italy provides plenty of challenges and opportunities for custodians, writes Ben Roberts

Timing is often everything in finance – for better or worse. In Italy, an overhaul in the pensions market that would see more employee contributions move from company savings to market-exposed private funds occurred just two months before the first signs of the credit crisis in August 2007.

This movement has caused many to cover their eyes over the last year as around EUR300 billion was wiped from the balance sheets of these schemes. For a traditionally conservative country that has eschewed many of the debilitating structured products, this has been hard to take.

To begin at the beginning. Traditionally the majority of Italian pension payments had been tied up in a TFR state scheme where an employee's monthly payment would be exchanged when they retire for a high percentage of their final salary, occasionally up to 80%. In 1993 a reform was introduced whereby the scheme would mimic a funded system and the pension of each retired employee was based on the contributions they made during work.

Since then, the lump sum payout of the TFR scheme has declined, sometimes by as much as 40%, as the Prodi government of that year encouraged a transition from state-run to private funds for pensions. Up until then, private schemes were the preserve of professionals such as lawyers – known as Casse di Previdenza.

Then in June 2007, employees were faced with an irreversible choice: stay with a low-return state scheme, or funnel the money into a private plan. "The market expected the market share of pension funds to increase as the number of participants in the funds would increase dramatically," explains Massimo Cotella at Societe Generale Securities Services. "The decision was made before the stock exchange went down."

Though only around 10% of private sector workers made the switch by the June 2007 deadline, the inflexibility of the law became a prominent issue. "This is a fear a lot of people have," continues Cotella, "there is talk at the government level whether this can be modified and made reversible. It's a huge mess - unfortunately this is beyond the custodians."

Employees faced a rock and a hard place – private funds exposed to potentially volatile markets, or state run cuts in their final payout.

The private funds – often open-ended schemes promoted by insurance companies – comprise the majority of custodians' pension books. A pension fund's board elects a custodian that acts as both depository and compliance watchdog to ensure the asset management is fulfilling the mandate. These mandates are often narrow, explains Stefano Catanzaro of BNP Paribas Securities Services, with a strong weighting in fixed income. He adds that in the last year there have been some mandates that include exchange-traded funds and exchange-traded commodities. There are now more than 300 ETFs and 47 ETCs listed on Borsa Italia.

Cotella adds: "The original number of people who elected to go into the pension fund was perhaps 25% on average, but when I look at the pension funds that work with us, it has been some 25-40%. So it's growing. From a marketing point of view, 2008 and 2009 certainly are not years in which people try to join at any great rate." He adds that it is fair to assume people join capital guarantee funds, whereby 100% of the investment is insured.

But the education of new entrants into schemes is a crucial problem. The halcyon days of a generous defined benefit lump sum under the original TFR scheme has not diminished in people's minds, and the younger generation entering work in particular need to consider the private schemes to top up what they are losing as a percentage of their salary in three decades' time, says Cantanzaro.

"There was a lot of emphasis on the new pension fund industry in Italy when it was launched after the 1993 reform, but it didn't really take off because of the mindset of the population. They were all happy with the government paying 75% of final salary, which is now not the case, and is difficult to explain. So basically you need to look for your replacement [of pension payout]," he says.

But the mutual funds industry remains curtailed by uneven regulation. Funds domiciled in Italy are taxed daily based on their net asset value; funds domiciled elsewhere are only taxed when the holding in the fund is sold up – effectively a capital gains tax. This puts the domestic funds at a key disadvantage, and the daily tax has two effects. Firstly, reporting performance that already factors in the tax often makes them lower in return than foreign domiciles; secondly, a lower performance amid a sour market means the fund is propped up with tax credits. These credits are not securities and cannot be traded, meaning a smaller proportion of the portfolio is available to generate alpha.

"Let's say the NAV is 100 and your benchmark gives you a 4% return in one year and you have to either beat the benchmark or replicate it," says Cotella. "If your 100 of NAV is determined 60% in tax credits, then you can only buy and sell securities for the remaining 40% and you have to make a performance on that 40%. Then the gain is divided over 100."

These performance pressures have resulted in a lot of consolidation among funds, he says. "The Italian mutual fund industry is very much a catalyst for the retail; if the retail is scared they may want to buy Treasury bill. MiFID can help, it is creating a level playing field."

"From a marketing point of view, 2008 and 2009 are certainly not years in which people try to join at any great rate"
Massimo Cotella, SGSS

"Customers are coming up with their own passive mandates right now"
Stefano Catanzaro, BNP Paribas

INTESA SANPAOLO

Riccardo Lamanna, head of transaction services

I'm currently the Head of Transaction Services at Intesa Sanpaolo, the leading Italian bank in the sector. Beside my corporate responsibility, I have co-operated with Monte Titoli, Banca d'Italia and Borsa Italiana on the creation of the Italian Securities Settlement Systems, Express II, and its developments. I have been part of the COGESI at its early stage and represented Banca IMI at the European Securities Forum Association.
In 2004, I have co-operated with Professor Banfi of Università Cattolica in Milan in the production of a volume on markets and financial instruments. Finally, I have been a member of the first T2S Advisory Group representing Intesa Sanpaolo.

Within my previous role 1999-2006, I was responsible for back office and middle office functions of Banca IMI, the investment bank of the former Sanpaolo IMI banking group.
At Banque Paribas, based in Paris (1998-1999), I covered the product manager role for Multi Direct Custody and Clearing, following the activity of the different branches of the bank providing securities services in Italy, Germany, Spain, France, Belgium.

Finally, as a first experience (1991-1997), I worked at JP Morgan in Milan, London and Paris within operations serving proprietary activity of the bank and custody and clearing services for third party clients.

Changes in the last few years to domestic investment via foreign pensions could also boost the country. In September 2007, Northern Trust became the first custodian to secure reduced withholding tax from the Italian for its pooling method of its pension funds wanting to invest in Italian equities, in this case the Irish Common Contractual Fund.

Aaron Overy at Northern Trust explains that a large pension fund, such as Unilever, can have different management teams around the world, making each strand almost a pension fund in itself. As such the fund overall is not leveraging the scale they have as a corporate. The solution is to pool parts of the separate plans where, he says, "you can achieve that scale and negotiate better rates with investment managers and get access to a wider range of asset types".

The withholding tax reductions are in respect of dividend income arising from investing in Italian stocks, which the bank estimated could increase investors' revenue by as much as 40%. Northern Trust provides custody and fund accounting of that fund. Crucially, he says, the fund has to be tax transparent. "Historically, the problem was that there were withholding tax implications on the underlying income for the securities," he explains.

"With a tax transparent pooling vehicle, you are giving the underlying investors what they should be achieving in terms of their tax status. So if you are a UK pension plan investing in Italian equities there is a double taxation treaty between these two countries."

Proof of this transparency eventually won over the Italian authorities. "The Italians accept the investment coming in from a pension fund, which in itself is seen as safe. In return they don't charge withholding tax for pension funds."

This was the first time Northern Trust had structured the fund (the private information) with the correct form for the Italians to agree that it was tax transparent, he adds. "Once you get that precedent, it's likely you can repeat that, not only for the Irish fund but the Irish and Dutch transparent funds."

This structure has been in design since 2001, says Overy, and it took some years to prove this works, get tax rulings, to build up the investor base and to get the correct documentation and system to do this. In 2005 the firm applied for a patent for the processes undertaken to achieve tax transparency.

The game plan for this year among pension funds - like the famous 'catenaccio' style of its football teams – is one of patient building, a conservative approach to asset allocation. Catanzaro sees a trend where the pension fund would divide its operations between core and 'satellite' investments, with the core often being a passive mandate that replicates an index.

The size of the fund often dictates whether ETFs would be used to do this, with the smaller schemes more likely than those bigger. For example, if the scheme is directly invested in S&P 500 stocks, the investmenty manager would attempt to replicate this index as closely as possible.

"Customers are coming up with new projects to start their passive mandate right now," he says. "I've not seen a lot of flight to aggressive investment in the pensions world."

He adds that the equity portion in old investments did not dominate the portfolio, so Italian pension funds – although having incurred losses - have suffered less than their equivalents around the world.

But the slow changes to legislation – as in the case of the daily NAV taxation for local funds – is considered by some a difficult obstacle to boosting the overall investment industry in Italy. The irreversible nature of the pension choice – either private or public – may never change, according to Cotella, and market turmoil has pushed the issue even further back.

Education of beneficial owners remains the key issue for many custodian banks. "They [employees] don't realise they also have to build another part and work privately through the pension fund to compensate for the missing part," he says. "So until that education is completed, the number of people who will choose a pension fund will grow but very slowly." ■

Lending in the UK

Ben Roberts gauges the appetite and outlook for stock lending as risk aversion takes hold in 2009

Financial markets and company balance sheets in the UK predominantly headed south for much of 2008, but the size of its lending market remained strongly competitive in Europe.

Though Data Explorers, the stock lending analyst, identified in its yearly report the pressure on UK government bonds following successive cuts in the interest rate, it also found a rise in return for UK equities, up 1.55 basis points (bps) on 2007 levels. It also found an increase in lenders handing over shares against cash collateral – the traditional method of the US – by 14%.

This last statistic may surprise some in the wider European context of dwindling cash supplies. A survey by the International Capital Market Association found that the repurchase, or 'repo' market - money lent in exchange for bonds - dropped 28% from June to December as hedge funds and banks sought to deleverage their balance sheets and money lending reduced in the wider credit freeze.

Simon Lee, Senior Vice President of Business Development at eSec Lending, a third party securities lending agent, identifies the decline in equity markets as a likely reason for this. As the value of securities on loan decreases, the margin on cash collateral held effectively increases, resulting in margin calls from borrowers. This further strains the liquidity of an agent lender's cash pool. "If the cash pools hold impaired assets, or have made long dated investments," he says. "There will be a frequent need to raise new liquidity."

Agent lenders therefore need to ensure they hold sufficient liquid cash positions to make these margin calls. "What you're probably seeing," adds Lee of the Data Explorers statistic, "are agent lenders lending securities with little or no intrinsic value, purely for the purpose of raising cash collateral from the borrowers to maintain overnight liquidity in their portfolio. So effectively, you have an artificially inflated loan balance, and the liquidity which that provides is used to manage the daily mark-to-market process."

Many connect cash collateral with additional reinvestment risks – making it the last thing that many pension funds would intuitively engage in.

Some agent lenders have the majority of their programs for their pension funds in fixed income for this very reason. "It is now understood more than ever before that cash reinvestment is a separate discipline to securities lending," says Blair McPherson at RBC Dexia. "Securities lenders do not have to accept cash and for those that don't, by extension, reinvestment risk does not occur."

One pension fund that has retained its conservative line is the RPMI, which grew out of the old British Rail pension scheme. Joyce Martindale, head of investment operations at RPMI, says at a time when counterparty solvency cannot be relied upon, a pension scheme must entertain the worst case scenario where it is left with a defaulted party's collateral. "We try where possible match the collateral to the loan. If something happens to the person borrowing from you, you are left with the collateral. We didn't want to have, say, a bond fund that only invested in government bonds and end up with collateral that wasn't appropriate to that portfolio."

Receiving cash also throws up questions about the additional management needed for its reinvested, she says. "The issue will be a manager, who might have been appointed by the custodian, who's taking cash on your behalf. There has to be a manager to manage the cash and generate the returns you need and [you must ask] – are you happy with their investment process, do you know the risks they are taking?"

Simon Lee believes differently on this score. "The cash would be managed within the lender's existing reinvestment guidelines," he says.

"While loan balances and counterpart exposure would increase, the risk of being forced to sell illiquid investments substantially decreases."

Last year the Financial Services Authority was one of the first institutions to force disclosure on short positions, and on 19th September imposed a ban outright on short selling. On 16th January the ban was lifted, but disclosures on positions over 0.25% of a company remained. The debate surrounding the effectiveness of the ban dominated newspaper columns and airwaves, and for the securities lending community questions were raised as to the damage to the number of participants in lending schemes.

Timely support for the practice came from Chris Hitchen, chairman of the National Association of Pension Funds. At the OPDU Annual Conference on 15th January, he told the audience: "Don't abandon your securities lending programs. Having stock to lend and borrow is crucial for efficient markets."

Blair McPherson believes that many beneficial owners will heed this advice. "The recent comments… were very welcome and should provide a lot of additional comfort to his [Chris

"Don't abandon your securities lending programs. Having stock to lend and borrow is crucial for efficient markets "
Chris Hitchen, NAPF

Hitchen's] members," he says. Simon Lee also credits the potential benefits to the volumes of securities lending participants on the back of Hitchen's comments, though adds that the situation may require an enhancement of beneficial owners' involvement in such areas as securities lending. Lending itself, he argues, should be viewed as a management discipline, and an investment aspect that is as important to any other.

As part of this greater involvement, most pension funds should be able to provide their agent lender with a list of borrowers that can be lent to, says Martindale. This would partly reduce counterparty risk. "The list you produced 18 months ago would be very different to the list you might produce now," she adds. Further, counterparty risk could be minimised by asking for a higher haircut. "As long as your haircut and margin are calculated frequently to make sure you always have collateral plus a haircut to cover your positions."

McPherson at RBC Dexia agrees that an increased involvement needed from the beneficial owners. "Beneficial owners should also be asking how their cash is managed in relation to other clients in their lender's collateral pool," he says. "If it's commingled then there is the risk that the actions of one client withdrawing may have a detrimental impact on the pool for the clients remaining."

But pension funds will only enhance their knowledge and input on the back of better and more synchronised communication from many factions connected with the industry. "Beneficial owners may tailor their programmes to precisely complement their own risk-return appetite. Communicating these benefits in an improved manner

"Beneficial owners should also be asking how their cash is managed in relation to other clients in their lender's collateral pool" Blair McPherson, RBC Dexia

to beneficial owners is an industry challenge and is the responsibility of all participants in the markets as well as regulators, exchanges and finance ministers."

With an industry at a crossroads, what paths could it take this year? Simon Lee at eSec Lending believes that beneficial owners will increasingly view securities lending as an investment management decision, and will place their programmes, and lending agents under the same level of scrutiny they would for an asset manager.

The idea of 'unbundling' securities lending from custody will be more prevalent as beneficial owners look for increased levels of pricing transparency and no longer view securities lending revenue as an offset to custody fees. As Lee says, "the increased focus lenders have placed on risk management, transparency, and performance, will benefit the securities lending market in the long run".

Outsourcing the lending activity has the benefit of returns and price transparency. In a Vodia Group study last year comprising interviews with 40 institutional investors, the difference between using a specialist lender to a custodian could be as wide as 0.48 compared to 0.33. Respondents also found that a bundled service from a custodian meant convoluted fees, with 56% revealing they didn't know what they were paying for.

But confidence, as ever, remains the ultimate gauge of the industry's value. "There has been much noise and rhetoric written about securities lending in the last twelve months," says McPherson. "Securities lending suffered to some extent by its association with short selling and then there have been some high profile cash reinvestment losses."

A decline in demand is the second critical factor. The UK is still one of the globally reknowned homes for hedge funds, the principal borrowers. Pressures on the sector from falling asset values, necessary deleveraging, investor redemptions and regulatory scrutiny have changed its outlook for this year.

"Securities lending has experienced 10-20 years of near-unbroken exponential growth but in 2008 the demand landscape witnessed unprecedented change as the credit crunch enveloped investment banks, prime brokerages and hedge funds," says McPherson. It is not doom and gloom, however, he adds, but it will "take some time for the levels of activity witnessed during the mid-2000s to return". ■

Point of low return: lending in 2008

	Lendable assets	Total balance	Utilisation (%)	SL fee (bp)	Sec Lending return to lendable (bp)	Total return to lendable (bp)
UK Equity	384,166.8	38,496.30	8.66	33.19	2.68	3.08
UK Equity (FTSE100)	322,998.1	26,155.50	7.36	23.03	1.63	1.91
UK Equity (FTSE 250)	34251.1	8,104.60	18.75	51.18	8.58	9.34
UK Equity (other)	26917.6	4,236.20	8.97	55.74	4.77	5.87
UK Government Bonds	213,613.7	104,335.04	63.94	8.46	5.51	8.87
UK Govt Bonds (I/L) domestic	60,080.10	21,937.60	55.72	8.07	4.79	6.84
UK Govt Bonds (non-I/L) domestic	153,208.70	82,350.10	67.4	8.55	5.81	9.72
UK Govt Bonds (Non-I/L) international	324.4	47.6	22.62	3.84	0.93	5.39

Source: Spitalfields Advisors

GSL Summit | Global Securities Lending

DATE
Thursday, 30th April 2009

LOCATION
Four Seasons Hotel, Canary Wharf

1:30 PM
Registration/Coffee

5:00 PM
Drinks Reception

Lending for Liquidity

In parched markets, liquidity must be widely sought, and securities lending can be a vital source. Beneficial owners (pension and insurance funds in particular) can only understand the wider benefits of this liquidity if they are fully engaged with the lending process and understand the potential, the risks, and have opportunity to voice their concerns and views.

GSL invites readers to an informative afternoon to discuss this topic along with wider issues of transparency, risk and returns at this crucial time.

The event is free of charge to attend but by invitation only.

For speaking and sponsorship opportunities please contact:

Catherine Kemp
Catherine@2ipartners.com
Tel: +44 (0) 20 7299 7714

Please go to GSL.TV to register

1:30 pm Registration / Coffee

2.00 pm Speaker: The state of the industry
Data analyst provides insight into the major trends in the industry.

2.20 pm Speaker: Academic view
Economist delivers research on how securities lending provides health liquidity to the markets and provides insight into the impact of short selling bans on the market.

2.40 pm Panel Debate: Securities lending - a front office investment?

The relationship between beneficial owners and agent lenders has been highlighted by recent market events. Cash reinvestment and yield enhancement trades are under increased scrutiny, and volumes and returns are down. Some see lending as more a front office investment than an add-on to custody services. Two key questions for beneficial owners are whether the returns are worth the perceived risks, and what more agent lenders can do to assist them. Followed by Q&A.

3.30 pm Coffee

4.00 pm Panel Debate: Regulation

Regulation and transparency are central issues within the securities lending industry, and the introduction of disclosure rules and short selling bans - both temporary and permanent - on financial stocks have caused huge debate. Recent calls for heightened regulation of the shadow banking system and a clampdown on tax havens, impacting hedge funds, are also pertinent to the industry. The panel will question whether increased regulation is inevitable and what forms it will take. Will it simply overload the industry with unnecessary bureaucracy? The panel will also examine the extent the industry itself is promoting transparency. Followed by Q&A.

4.40 pm Conclusions

5.00 pm Drinks Reception

Pricing the crisis

Government bailouts of unthinkable sizes still leave the headache of deciding how much financial institutions are actually worth, writes Anthony Harrington.

By mid March 2009 the global financial system is still by no means out of the woods. AIG declared a staggering loss amounting to more than USD60 billion, just days after the UK's Royal Bank of Scotland declared the UK's biggest ever corporate loss of GBP24 billion. Swiss Re decided to scrap its US business, calling the whole affair "disappointing", with the loss of 6,000 jobs. Write-offs and losses continue with an uncertain surrounding collaboration between governments for a collective response.

Some idea of the scale of the losses so far is contained in the report setting out a reform agenda for the European financial supervisory system, by the former Banque de France governor (and IMF managing director) Jacques de Larosière.

His report, the work of an expert panel he chaired, estimates the spate of write-offs and write-downs by banks and insurance companies around the world to be worth EUR1 trillion. However, as he points out: "Even now, 18 months after the beginning of the crisis, the full scale of the losses is unknown".

What is known, he says, is that since August 2007 "falls in global stock markets alone have resulted in losses in the value of listed companies of more than 16 trillion euros, equivalent to about 1.5 times the GDP of the European Union".

If you make enough dire assumptions about bank failures, you wind up with a domino effect where the only insitutions left are central banks

These numbers demonstrate something of the scale of the "wobbles" that have afflicted the banking sector in particular. What makes matters more complex still is the immense difficulty of pricing some of the assets that continue to constitute a large part of the asset portfolios of many banks. If we were talking about a few million here or there invested in these toxic debt vehicles, it would not matter, particularly. But the scale of the problem is large enough to pose its own systemic risk.

Research by JPMorgan Chase and Wachovia estimates that of the USD450 billion of CDO of ABS issued in a fertile 18 month period from late 2005 to the middle of 2007 - roughly until the start of the current crisis - some USD305 billion are in a formal state of default. (Larosière notes an increase in general US ABS securities from USD337 billion in 2000, to more than USD1.25 trillion in 2006, a period overlapping the start of the huge leap in CDOs of ABS. We have yet to see the total ABS figures for the end of 2007 but they are likely to be enormous.)

What a particular bank is now 'worth' is a concept more than a little challenging. Yet for the infrastructure providers who have banks as their prime customers, the show must go on. How then, are they coping? What measures can they deploy to ensure that, come what may, the system will keep on functioning and securities deals will continue to be settled on a delivery-versus-payment (DVP) basis?

As John Trundle, an economist and ex-head of the Bank of England's Oversight division, now managing director and head of risk management at Euroclear, observes: "What is happening now is bigger than any of us have ever experienced in our professional lifetimes."

In his role at the BoE it was part of his daily job to think about the risks in the capital markets and how well the markets' infrastructure providers were insulated against those risks. However, some of the core assumptions of that era do not seem to be working at present.

"As an economist, when prices fall sharply you start to ask yourself where the real value lies and you expect to see investors tempted back to investing in equities and bonds when prices offer long term value on the basis of fundamentals. However, the market has fallen so far, and so fast, that very few investors are willing to take a contrarian position – so now it is only governments' actions to support the system that can put a floor under falling prices," he says.

Trundle's analysis works through three phases. First, there were the sub-prime mortgages. "There was a problem with where the bad paper was being held, but then it did not seem to be a globally systemic risk. Second, there was the severe inter-bank liquidity issues which rapidly impacted the real economy. Third, a full blown credit crisis. The depth and breadth of the crisis has surprised many market commentators. One area which has remained resilient throughout, however, has been the market infrastructures, such as the CCPs and the securities settlement providers."

So what is the likelihood that all this bad news will culminate in one or more major banks being allowed to fail? And what would that mean to the settlement infrastructure?

"If we had multiple instances of Lehman Brothers-like failures occurring, there would be an impact across a number of dimensions. We need to make sure that Euroclear, as a systemically important piece of the capital market infrastructure, is physically capable of handling multiple events in parallel," he comments. Careful strategic planning and frequent stress testing exercises simulating the failure of large clients keeps the organisation in a state of preparedness and helps to generate confidence in a crisis.

When Lehman Brothers actually failed, Euroclear's response systems swung into play very quickly and the matter was dealt with according to plan. Collateral pledged by Lehman Brothers to guarantee credit lines from Euroclear Bank was liquidated and pending unsettled Lehman trades were managed in accordance with local regulations.

As Trundle points out, not being a traditional bank serves Euroclear Bank very well in moments of crisis. The types of risk Euroclear Bank takes are very different from a commercial firm. The credit it provides to its clients is solely to assist them with their securities settlement obligations. Moreover, the vast bulk of this credit is granted on an intra-day basis, with very little of it being overnight. Almost 100% of all of Euroclear's exposures are fully collateralised. Furthermore, Euroclear Bank employs a very conservative method of pricing the securities it accepts as collateral. For example, it did, and does, accept some high quality ABS type for collateral purposes, but such securities would be given very severe "haircuts", down to about 50 percent of market value, and would be a very small proportion of the collateral portfolio. "In our 40-year history, we have never taken a loss on our financing of clients, but that certainly does not mean that we have grown complacent about credit risk," Trundle says.

"It is only governments' actions to support the system that can put a floor under falling asset prices"
John Trundle, Euroclear

Another thing that protects the infrastructure provider is that when it is advancing credit to an institution, that institution is buying securities, not selling them – and if it was about to go bust it would be frantically selling securities to raise cash, not buying them. So the days when it is advancing credit to clients tend to be when the client is doing all right. Second, Euroclear is a structurally long financial institution. Other institutions want to keep their cash with it, so it has cash flowing in and liquidity would not be a problem in the short term.

Of course, as Trundle points out, if you make enough dire assumptions about bank failures, you wind up with a domino effect where the only institutions left standing are the central banks. If that worst case scenario happened, Euroclear and most of the other infrastructure providers would still be intact and would be working with the central banks to find ways of resolving the crisis.

"If we got into those extreme sorts of problems, it would be the system as a whole that would be in ominous trouble. Our scenario planning stops short of this. The key is to know how to manage the situation right up to the tipping point where it then becomes impossible to forecast future events," he says. "It is actually incredibly difficult to model second and third-wave impacts in regard to multiple simultaneous failures of leading financial firms."

Infrastructure providers have to monitor the capacity of their systems to absorb the sudden huge peaks and spikes in transaction flows caused by unprecedented market volatility. On one particularly dramatic day in October, Euroclear UK & Ireland – the CSD for the London and Dublin exchanges – processed 1.6 million securities transactions, as against an average day's transaction load of 300,000. "We saw a spike that was over five times our normal workload and it was still within the capacity of our processing systems. However, this event prompted us to invest in further capacity, in case the next peak is even more demanding," he says.

Mark Gem of Clearstream agrees that the world's financial systems have moved into what he terms "very strange territory". However, he says that Clearstream has been putting a great deal of thought into the consequences of systemic risk, beginning way back in 2003. However, since, unlike Euroclear, it did not have Lehman Brothers as an international client, and it has yet to experience a major client failure.

This does not mean though, that it has not had its worrying moments. "We had days in September where the situation in Benelux, for example, raised serious challenges," he notes.

"In the case of Iceland we moved to a strict, cash-only settlement, with the Icelandic authorities arranging for us to have an account with the Icelandic central bank so that we could continue settlement. In that instance, it would not matter if the Icelandic Krona was worthless, since Clearstream would still be in a position to repay one Krona for every Krona put forward by a customer," he adds.

One of the difficulties an infrastructure provider faces is that it cannot be the one that precipitates a client's failure by being "aggressively cautious". "You have to be very mindful of the possible impact of your own actions," Gem says. Clearstream's solution for handling this kind of problem was to ensure that it could put all the key decision makers and all the people with the information on the situation in one room, several times a day if necessary, to make the critical calls.

"This is really a multi-dimensional challenge. With a house like ours, your relationships with customers are multi-lateral. The credit facility has collateral against it, and the customer may also be an issuer of securities in the system, or they might be a paying agent on securities issued in the system, or a counterparty, or a custodian, a money markets participant or a depository. What you have to ensure is that, holistically, you are covered and that you can see your way across all those dimensions to clear water, not just for the customer in question, but for all the other customers that you are dealing with," Gem says.

" What you have to ensure is that you are covered and that you can see your way across all those dimensions "
Mark Gem, Clearstream

Clearstream has traditionally been a buy-side house so it deals with customers who are cash long, which helps. After the breakup of Fortis, the safe haven provisions arranged by governments helped substantially and there was not that much concern from counterparties at the time.

With Clearstream's triparty collateral management services, as far as valuing ABS collateral, the art has been to work with parties to strike a price that works. "You have to find a middle course between saying these assets are valueless and according them a value that might turn out to be wildly optimistic," he says.

If that sounds like a difficult juggling act, it's because it is. Of course, in these arrangements Clearstream acts only as an agent and it is up to the client as to whether they accept such collateral.

One of the problems that concerns Gem and his colleagues about possible bank failures is not so much from a settlements standpoint. Instead the issue has to do with complications over which legal entity is in default. "This is something that the authorities can help with, and working parties at various levels are trying to solve this question as we speak. Fuzziness over ownership causes issues about whose collateral you can liquidate in a default situation," he notes.

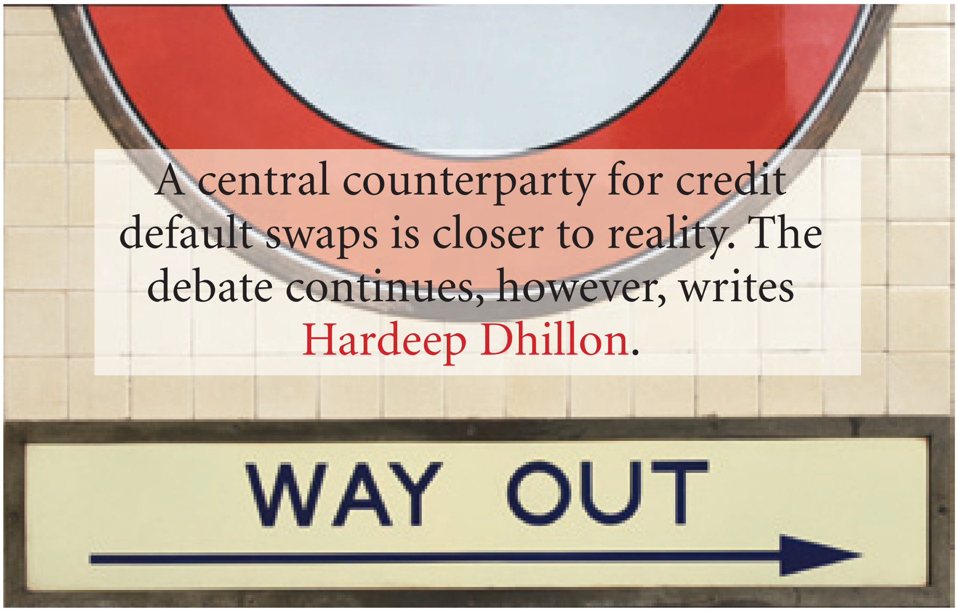
Multiple bank failures would also entail identifying troublesome concentrations in advance of problems. For example, if you have holdings in corporate bonds being deposited as collateral, all bank issuer paper would be fairly worthless immediately after multiple bank defaults.

There is another theoretical difficulty, namely trying to imagine what would happen in the unlikely event that some of the major banks that process the payment flow of fixed income securities failed. "What would the income flow be on the remaining securities of issuers who were still solvent? How would that income flow proceed? You would have a total freeze in the credit markets.

In conclusion, there is no doubt that a point would be reached, with multiple bank failures, which would cause systemic failure across the globe's financial infrastructure.

However, the shocks the system has taken so far have not dented established settlement systems, even if they have given the people who run the infrastructure some bad moments. Large sections of the banking community might have lost their grip on prudence, but that contagion did not reach down to the infrastructure providers, who, fortunately for all of us, never lost their grip on the essentials. ■

Taking the central line



A central counterparty for credit default swaps is closer to reality. The debate continues, however, writes Hardeep Dhillon.

The establishment of a clearing house to reduce counterparty risk in the over-the-counter credit default swap market is coming closer to fruition. On February 19, nine major credit default swap (CDS) dealers agreed to use an European Union-based central counterparty clearing for CDS in Europe by the end of July 2009.

European Commissioner Charlie McCreevy welcomed the agreement, arguing that central clearing of CDS is particularly urgent to restore market confidence. Thomas Huertas, director of banking regulation at the UK's Financial Services Authority (FSA), has also endorsed a clearing house for CDS on European companies to be based in the European Union.

Regulatory pressure for CDS contracts to be processed through a clearing house to reduce counterparty risk has beenevident on both sides of the Atlantic, and a global framework for co-operation among CDS central counterparties (CCP) regulators is being proposed.

CDS CCP regulators plan to host a workshop with representatives of other interested regulators and governmental authorities, which may include the US Federal Reserve, Commodity Futures Trading Commission, UK Financial Services Authority (FSA), the German Federal Financial Services Authority (BaFin), Deutsche Bundesbank, the New York State Banking Department, the Securities and Exchange Commission, and the European Central Bank and the Hungarian FSA in their roles as co-chairs of the joint ESCB-CESR Working Group on Central Counterparties.

Information sharing and other methods of cooperation and support between the representatives from CDS CCP regulatory agencies may be discussed in these talks, as well as applying consistent standards and public policy objectives and oversight approaches.

A number of firms from the EU and the US have been positioning themselves as a clearing hub. Liffe's BClear service, launched on 22nd December, is the only centralised clearing facility for CDS index trades, covering the Markit iTraxx Europe investment grade, Crossover and Hi-Vol indices.

However, the platform has yet to clear any trades, citing the uncertain regulatory landscape in Europe. Nonetheless, it is understood the firm plans to launch a Paris-based CDS clearing service by December 2009. Eurex – the derivatives exchange - plans to offer CDS clearing in first half of 2009 and IntercontinentalExchange through a new entity called ICE Trust Europe by July. The Chicago Mercantile Exchange (CME) is also looking to provide clearing services in Europe and is currently in discussions with the UK's FSA.

US authorities have already persuaded exchanges and the industry to devise a CCP clearer for the USD28,000 billion CDS market. The four exchange-led groups are the CMDX platform, CME's joint venture with Citadel Investment Group; ICE and The Clearing Corporation; NYSE Euronext and LCH.Clearnet; and Eurex.

Imposing a CCP model is vital to rebuild trust and confidence in the market so liquidity and transaction volumes can return, says Kevin Rideout, Global Head of Market Infrastructures Group at Citi. "We want to remove as much risk as we can from the system and this has created a groundswell and

"Even in the OTC market without a CCP, the risk is shared among market participants"
Axel Pierron, Celent

focus on CCPs and clearing houses, broadly across all asset classes," he says.

Jochen Felsenheimer, co-head of credit at Assenagon Asset Management believes a clearing house function is a prerequisite, both from a regulatory perspective and to facilitate a transparent and liquid market. "A CCP provides an opportunity for the whole CDS market to benefit, as it would bring in new players and greater range of standardised products," he says. "You can clear trades without the exchange-traded link, but I believe it is very important to put the two together."

A clearing house would allow a greater range of counterparties to trade, adds Tim Brunne, quantitative credit strategist at UniCredit Markets & Investment Banking. "Smaller clients would only need an ISDA master agreement with the clearing house, and so be able to trade in the classical way and settle with the clearing house. This takes away some of the complexities of trading, while widening the use of CDS in the market," he says.

The level of acceptance the proposed solutions receive from the major investors and dealers, who gains access to the clearing house - and how - are all key in determining which of the services ultimately succeed, notes the Chief Operating Officer at an interdealer-broker. "If you break down each one of these initiatives, the access is slightly different and those with the most open access will have a greater chance of success," he says. "I hope multiple execution venues will link into the clearing houses, which will result in more transparency and more liquidity."

The COO says that interoperability of clearers would force the price of clearing down, but views it is a concept that has not yet proved successful. "There has been cross margining between clearers in the past and we all would love to think that we can clear wherever we want but it has not happened," he says. "Firms they say they are going to do it they don't really, as they are rivals."

The Securities and Exchange Commission has mandated interoperability in the US, while the European Commission's Code of Conduct states that CCPs should interoperate, though this has not always been the case, says Citi's Rideout.

"Though there is a principles-based regulation that CCPs should interoperate, if firms can find any business reason why they effectively cannot interoperate, then they will prefer not to have to interoperate," he says.

When counterparties deal bilaterally, they deal with each other's payment systems. However, complexities develop when dealing between different clearers, says Jitz Desai, director at financial services think tank JWG-IT. Standards are required to make sure the clearing firms can net off their margins and make sure the risks are appropriate between them. "There is a long way to go before siloed models mature, which is why interoperability hasn't really come to fruition as yet," he says.

There are few instruments that lend themselves to clearing and a clearing house would only ever attempt to clear the most liquid contracts, notes the head of global policy at trade association for OTC derivatives. He believes it would be dangerous for a CCP to take on any form or a greater number of risks as an illiquid market could create a moral hazard. "To encourage more risk defeats the object of setting up a CCP and a greater number of risks does not necessarily diversify you and so a CCP might not have control of where concentrations may build up," he says.

Mark Schibli, CEO of Finergy Capital Services, views the development of a hybrid solution: a clearing system on more liquid well established CDS indexes and most single names; with the continuation of bilateral operations for less liquid credits, new emerging credits and structured CDS. "This way the evolution of the CDS market can continue with sensible innovations of the product that encourage banks to provide credit solutions for both the borrower and investor," he argues.

This hybrid solution between a new clearing system and the bilateral settlements will come from industry initiatives, he adds. The policies that will guide the industry going forward will continue to take some form of self-imposed regulation with oversight. "While much work has been done in this area, more is needed in order to provide a sustained discipline in both public policy and private initiatives," he says.

The OTC market for bespoke derivatives may be more strictly regulated, which could be economically prohibitive, says UniCredit's MIB's Brunne. Some bespoke CDS may not fit into the stringent documentation framework that is required by the clearing house.

Such CDS must therefore remain OTC trades.

There is also the question is whether it is reasonable to have single name CDS or possible to novate all credits into a clearing house. There will be many trades where clearing houses would have to closely examine the documentation and judge whether these equate to current contracts. "There is a lot of work to do from a practical point of view as it is not easy to implement such a shift," he says.

Nonetheless, he views the trading of standardised CDS to potentially increase in volumes, as with equity options, after that market shifted towards an exchange-like trading model from trading OTC. A similar development in the CDS could benefit dealers, as they would be able to profit from increased turnover and higher fees.

"The bottom line is there is going to be some sort of clearing house in the future, which could take a market share of between 10-30% of total volumes by the end of 2009," he says.

PJ Di Giammarino, chief executive officer of JWG-IT, adds that trading of illiquid instruments will have to remain bilateral but the clearing could be centralised. He notes the development of a new regime in Italy that defines the illiquid instrument comparators on a regional basis and how to undertake best execution for illiquid instruments. "So while it remains bilateral, the rules around how that bilateral price is constructed, discussed in the contract and agreed could become a lot more prescriptive," he says.

Citi's Rideout notes that challenges for clearing houses will relate to the margining and cost benefits of entering that market. "The problem of CDS is that the margin CCPs will have to place could be exemplary and largely as an industry, we are working through that at the moment," he says.

However, Axel Pierron, a senior analyst at a financial services consultancy Celent, is surprised there is a little debate about the use or value of bringing a CCP into the CDS market. Others add that a CCP for the CDS market would have lessened the crisis that hit Lehman Brothers and Bear Stearns.

With a CCP the risk of default is shared among the members, but the analyst states that this is exactly what happens in the OTC market, as it is very unusual that a market participant - a sell side bank – has a single counterparty. "These institutions are trading with one another the whole time. So even in the OTC market without a CCP, the risk is shared among market participants because they are all counterparties to one another," he says.

The CCP model is valuable for a specific set of instruments, he adds, but is concerned that it seems that CCP and clearing houses are the key words that will prevent market failure. "I think that is too simple an answer to be valid," he says.

James Davies Trayport's Head of Trader Systems Business, feels that regulatory pressure to move the market to a clearing model, almost by default means shifting everything from OTC onto an exchange. 'This will not fix the problem and focusing liquidity on a few products could harm the market," he says.

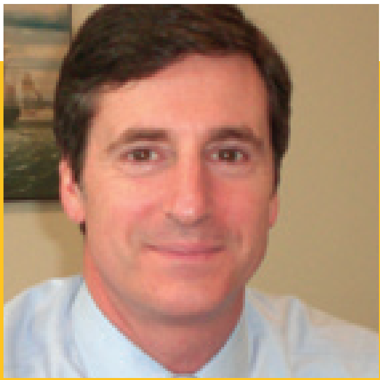
Voice trading for illiquid markets is critical, he adds - without which a lot of market will not operate. Moving to exchanges would focus liquidity on a few products, he warns, as market makers would not be prepared to quote electronic prices in every single instrument.

An exchange has to be about product development, and ensuring the contracts are an accurate representation of the market risk of their market participants. He believes that the markets should be able to choose whether individual instruments are liquid enough to trade on an exchange in an electronic form or whether they need to trade OTC. "Let the markets compete in an open environment. There is no reason why OTC and exchange can't exist alongside one another," he says. ■

"We want to remove as much of the risk as we can from the system"
Kevin Rideout, Citi

"A CCP provides an opportunity for the whole CDS market to benefit"
Jochen Felsenheimer, Assenagon Asset Management

Corporate actions



Richard Stumm is vice president, Business Development at Broadridge Financial Services (questions five and six answered by **Elizabeth Maiellano**, Senior Director, Investor Communication Solutions).

The ISJ Panel

Alan Parsons, Securities Product Manager at Investment Services from Fiserv.

Laura Pollard is responsible for the overall leadership and management of Fidelity ActionsXchange. A 20-year Fidelity Investments veteran, Pollard has served in a variety of leadership roles in the firm and in Fidelity Charitable Services.

Paul Hewitt has worked as Business Development Manager for Manifest, the global proxy voting agency, for more than 5 years, working with insitutional investors, custodians and regulators in delivering straight through automated vote processing.

Paul Phillips, Business Development Consultant, SmartStream Technologies.

Shareholder responsibility will be under the microscope at the start of proxy voting season. High time for ISJ to quiz the experts.

1. Why has election processing side of corporate actions lagged behind the announcement side when it comes to automation?

STUMM: The announcement side has made progress in putting standards in place (i.e. ISO 15022), but the function is largely a back office process that is not exposed to the end consumer.

The election side has not experienced the adoption of the ISO 15022 standard and the actual gathering of elections is a client-specific solution that is determined on a client-by-client basis, with customisation required to comply with the service levels and touch and feel of each individual client.

PARSONS: While it may seem

"There has to be a realisation that full STP is unachievable by companies attempting automation in this area"
Andy Parsons, Fiserv

like a simple process, the complexity and lack of messaging standardisation has caused delays. The industry is struggling with partial decisions, splits, position changes and election changes. This, coupled with the differing deadline dates within the corporate action options as well as balance types held with different parties, also adds to the complexity.

With instructions, a number of other issues arise. As the majority of custodians and members of the buy-side community do not use SWIFT, instructions need to pass through proprietary links, emails and faxes. Geographical location and various business verticals also have differing needs for election processing – the workflow model required by a custodian is vastly different to that a wealth manager.

Data matching and cleansing is not as simple as first envisaged. When the complexity of gathering positions and transaction data to produce meaningful reconciliations is taken into account, it is easy to understand why few organisations have progressed towards the election processing model.

POLLARD: Clearly, the lack of global standards and communication protocols contributes to the difficulty in achieving greater automation of election processing. Increasing volumes and complexity of corporate actions further hinders automation ultimately leading to increased risk.

HEWITT: From a processing perspective, voluntary corporate actions (CAs) are fiddly to manage. They involve the unknown aspect of whether the investor chooses to take part or not, as well as the consideration of a wide range of often complex data. Mandatory CAs are a repeatable process with a defined output (for example, a dividend paid into the account of a shareholder) which eliminates the 'will they / won't they' question about participation by requiring no interaction by the shareholder. Mandatory CAs are therefore simpler to automate, so the Corporate Actions world has automated the easy bit first.

Mandatory CAs also normally have a direct or obvious potential financial value to them, which gives an added incentive to automate processes, because manual processing is of course much more risky and error-prone.

Risk and error are not words investors like associated with the financial value of their investments when they are not the ones managing it, so there is therefore an onus on the intermediary to ensure they process the financial interest correctly. Automation is therefore the safest way to go, to minimise risk and to ensure that the intermediary can also easily take their cut. Voluntary CA's may have a financial importance, but generally less so. There is therefore less urgency on the part of intermediaries to automate - in fact, nearly all of them pay a third party provider to process them for them (especially in the field of proxy voting).

PHILLIPS: The very nature of voluntary and choice events requires a will to participate in the event and of a need to determine the favoured benefit one wishes to receive. This can be accommodated in most cases by a default action or standing instruction but occasionally there will be a desire to deviate from the traditional path. It is this "possibility" of human decision-making that challenges the ability to fully automate the election process 100% of the time

2. Can election processing be simplified?

STUMM: Election processing can be simplified by adoption of a standard but, unfortunately, that will not eliminate the need for client-specific solutions to gather the elections (client-specific touch and feel).

PARSONS: One could argue that with the ever-increasing complexity of corporate actions and instrument types, the elect process is likely to become more complex. While the options are available, fund managers will elect on them, which makes simplification highly improbable.

Ideally, there has to be a realisation that full STP is basically unachievable by organisations attempting automation in this area. There are mechanisms available that significantly reduce risk, however there will always be the need for manual intervention. The key is ensuring that automation still retains the level of control required through the election and instruction process, keeping losses to a minimum.

POLLARD: Yes, election processing can be simplified with standardised processes including highly controlled and fully documented election, correction and rescission processes which are monitored and controlled throughout the complete lifecycle of the event. It is also important that these processes are readily integrated within often multiple internal and external accounting systems which further impacts related liabilities generated as part of the corporate action.

HEWITT: Yes they can. But it needs participants to facilitate simplification. There is some desire and the technology to simplify processing now, but it's generally not enough at the moment for anyone to actually put it into practice other than in a few small pockets - and they are certainly reaping rewards.

Unless investors put market pressure on their custodians and their providers to innovate, there's no impetus to do so and nothing will change. Even where investors do so, they are often met with intransigence by their custodians who are generally unwilling to change their existing processes unless they decide they want to. Unless custodians also facilitate fair market access to the market for processing voluntary CA's, then innovation will also suffer.

In the context of proxy voting, many investors do not appreciate or value the link between the way in which they choose their account structures and the ability to give a truly clear voting process with legal certainty.

If they vote through a pooled nominee, nobody really knows whose shares are actually being voted because the instructions are simply aggregated.

Custodians can do this safe in the knowledge that no-one will (probably) ever know if, for example, a trade doesn't go through and the investor in question votes on the new traded position - they can just make it up with shares from somebody else who hasn't voted. But when it goes wrong (eg, when there's over-voting) then it is incredibly complex to pull apart and sort out. All of a sudden processing is carried out on a 'best efforts' basis.

Custodians don't make money from voting - that's why most of them include it as one of their 'bundled' services, so they don't have any incentive to do it better. Thereby investors may place greater value in the process than their custodian but be powerless the change it unless the custodian facilitates the client choice of 'best execution'.

PHILLIPS: In the majority of cases, yes it can. More efficient processes that link standing instructions with core static data such as counterparty and custodian/depository contact details and communications preferences can allow automated instructions to generate electronic elections automatically without the need for human interaction.

These instructions can be defined in a format that satisfies the required structural integrity of the outgoing message format, which in turn significantly reduces the need for manual validation.

3. Has the recent retreat of US investments to its own shores recently reversed the development of a cross-border solution for the country?

STUMM: A cross-border solution is still required as there is an interest in portfolio management to mitigate domestic risk by investing globally.

PARSONS: For the full impact - only time will tell. What should be remembered is that the US already has a high percentage of corporate actions communications taking place outside of the SWIFT arena and therefore all corporate actions solutions need to be flexible in order to deal with this.

POLLARD: In our experience, we are seeing more of a shift in asset classes than any move away from global investing and we continue to see this as a fundamental requirement for sound diversification. Current market conditions are driving the need for greater access, disclosure and transparency of information and we believe that efforts underway to address these needs support the continued development of cross-border solutions.

HEWITT: On the contrary, I think this should help put a sharper focus on what is a broken system. Among the main complexities of cross-border transactions is the need to have to deal with idiosyncrasies in the local market. The aspects of the US system which do not work will therefore come under greater scrutiny as domestic investment grows. It's often easier to effect change from within than from without anyway, so I would hope that this would improve the opportunity and desire to effect change

PHILLIPS: No it hasn't. Any short-term desire within the around the current economic climate and its effects on investment placement does not dilute the pressing need or obvious desire to develop cross-border solutions that allow the US to better integrate with the wider world.

4. How will the wider spending cuts among institutions affect the investment in corporate actions technology upgrades - for example, in the continued gradation to standardisation?

STUMM: Technology upgrades will be viewed against their ability to provide expense reductions. As an example, an outsourced solution would be a means for firms to achieve a technology upgrade while containing cost.

PARSONS: Corporate actions have always been low down on the priority list in investment terms as most businesses see it as a cost rather than a benefit. The current economic climate is only likely to make this worse. Financial controllers prefer to direct spending towards revenue generating areas rather than to administration tasks.

Obviously there will be a knock-on effect from this in the drive towards standardisation. But we need to be realistic about standardisation. While there is no compulsion to use the standard, there will always need to be flexibility in the provision of solutions. Currently, most standards have been adopted by the larger global organisations and custodians. The focus now needs to be on making the standards more effective for the clients of these organisations, in particular the buy side community. In the current economic climate this will only occur if the entire process is deemed to be more cost effective.

POLLARD: Spending cuts have affected nearly every function across all firms, including corporate actions.

Organisations are becoming increasingly aware of the role that corporate action processing plays in reducing their risk and exposure and understand the importance of finding the appropriate balance between reducing costs and mitigating this risk.

Recognising their resource and cost limitations, firms are looking toward external providers that

"Many voters do not appreciate or value the link between the way in which they choose their account structures and the ability to give a truely clear voting process"
Paul Hewitt, Manifest

"Current market conditions are dricing the need for greater access, disclosure and transparency of information"
Laura Pollard, Fidelity ActionsXchange

have the expertise and experience to help them address the growing volumes and complexity of corporate actions. We continue to receive strong interest in our products and see an opportunity for broader partnering with industry specialists who can help organisations achieve greater operational efficiency and cost controls, while at the same time improve risk management practices. ActionsXchange is sensitive to the current economic situation and we continue to work closely with asset managers, broker-dealers and hedge funds to come up with value-added solutions to address their corporate actions needs.

HEWITT: I anticipate it will sharpen the market, both on the part of providers and users. The market will of course be shrinking as budgets shrink and mergers take place, meaning providers will need to be more competitive in terms of price but most importantly offering. At the same time, where institutions are investing in upgrades but with less money, they will most likely invest it more carefully taking into account opportunity cost over headline fees. The field of voluntary corporate actions has not been very high up the risk management scale, and therefore may drop off the spending radar for some 2009 budgets. Where it doesn't, providers will need to be on their toes to ensure service provision is optimum or they will lose business.

The current conditions may therefore act as a catalyst towards standardisation in some areas, because technology adaptability will be key.

PHILLIPS: Financial institutions are still losing many tens of millions of dollars per year on inaccurate and ineffective corporate actions processing. It is proven beyond doubt that today, more than ever before, it is imperative that the fundamental requirements for corporate actions correctly are in place and are being met with a significant investment in quality resources and technology to assist those resources in undertaking this challenging work. With the heightened economic uncertainty the number of complex events that will be initiated will also significantly increase

5. How would you assess the contribution of the ISO 20022 to the efficiency of corporate actions – should it have increased STP further?

MAIELLANO: The proxy voting suite of messages is designed to eliminate free formatted text. Complete STP is achievable with these messages provided the entire community adopts usage. Until then, the co-existence of the 15022 and 20022 messages will prohibit maximum efficiency.

PARSONS: As the use of ISO 20022 messaging has been largely limited to voting activities, we haven't seen any meaningful impact of the new standard on corporate actions processing. Voting activities have not necessarily been core to automation solutions within a large number of financial organisations. The focus has been on capital events or income processing and it is likely we will see a bigger impact on these activities as ISO20022 messaging expands into these areas.

POLLARD: Once fully implemented, ISO 20022 will help increase STP of corporate action processing by allowing for greater flexibility of the messaging structure (XML). Critical success factors of ISO 20022 will be clearly defined and accepted rules for the "tagging" of data elements and enforcing an established industry-accepted cross-over date from ISO 15022 to 20022 messaging. Having to maintain two versions of ISO messaging for any period of time is costly both from a risk and dollar perspective, therefore all efforts should be made to streamline the transition process

HEWITT: Standardisation and sophistication of messaging is key to delivering more flexible processes which are fit for purpose. A tremendous amount of work has gone into the development of 20022 in a rather fluid regulatory landscape, and the end result is potentially very good indeed - if people use it.

No matter how good the messaging is from A to B, if the recipient does not also raise their game, then the improvements offered by 20022 will be lost.

It is up to the market to use them and make them work now, that will of course be the acid test. With much more sophisticated field cascades and investor/intermediary identification methods, for example, the potential time saving at the user end is huge, provided the systems investment is there.

The need for understanding of the significance of complex message content that previously has simply been shipped on by email, fax or even as free text also demands investment in expertise. Recent experience suggests there is some way to go here.

20022 messaging will enable the realisation of some processing benefits which were previously less easy to promote, and in that sense we hope to see some short term gain. Long term, the real gains are, as ever, down to the users to realise. Open standards therefore also demand open market access - let's seize the opportunity

PHILLIPS: The significant step forward in automating the process has already been achieved with ISO15022. The publication of Option Types is a central element of ISO15022 messaging and in the past has been a barrier to automation. With a better understanding of expected Option Types for each event type is providing greater standardisation when generating notifications.

The new directive is merely the natural technical progression with the wider adoption of XML based messaging. It is hoped that by utilising this standard it will be easier for organisations to utilise the strength of the standard already in place.

The work of both the SMPG and ISITC release of the Equivalency Matrix to support harmonisation of Option Type associated with different event types has also helped to move automation forward. Their work shouldn't be forgotten within the wider debate around corporate actions automation.

6. Do you anticipate a greater scrutiny of fund managers from their investors as to their voting activity, and what does it mean to providers of corporate actions?

MAIELLANO: Investor desire for information regarding fund manager activity continues to grow, whether due to regulatory changes, increased corporate governance awareness or a combination of both. There does not appear to be a decline in interest.

The new proxy voting messaging standards allow for increased transparency and efficiencies that will benefit the ultimate investor. The flow of information is enhanced to include instruction status updates, voting confirmations and meeting results. Fund managers, as the voting entity, will be in a position to receive those details and then forward on to the investors. The availability of voting statuses will no doubt influence investors' interest in receiving other corporate action statuses.

PARSONS: Regulation around voting is likely to create a bigger impact than investor scrutiny. Most of the larger investors already have reasonably pro-active stances towards voting activity.

From the solution provider's perspective, it is reasonable to say that voting activities have never been at the top of the agenda in functionality provision. This is mainly because of the seasoned alternatives that are already available.

The move towards election processing solutions in the market means that there will be a greater provision of voting activity solutions available from providers of corporate actions processing systems in the future.

POLLARD: As investors and regulatory bodies push for greater transparency into investment strategies, corporate actions and related corporate announcements, activity surrounding voting will be another area in which investors will value highly transparent processes that can track, control and account for election decisions across all stages of an event cycle.

HEWITT: Undoubtedly the pressure on fund managers to be held to account for their voting is growing, especially in the area of bespoke voting policy demands where pension funds previously left voting decisions to their fund managers but are now more interested in holding them to account.

In the current climate of course this is a very hot topic.

On the other hand, the architecture of cross border voting is often still very complex, and as I said before investors don't often understand the relationship between clarity of ownership and the custodial account structures through which their right to vote is established,exercised and reported.

A fund manager can only be comfortable being held accountable for what he is certain of. If he cannot be certain that his votes got through, he cannot be comfortable about his vote reporting but will get away with it unless the investors ask the right questions (such as 'show me where the company confirms my votes were received and counted').

If those right questions are asked by investors and fund managers then the ability of corporate actions providers (in this case proxy voting service providers, or VSP's) to deliver reliable vote reporting is key.

That again demands open market access,contrary to the closed market thanks to the insistence of custodians at the moment.

If VSP 1 is forced by the custodian to vote through VSP 2, neither VSP is incentivised to own up if the vote does not get through, and VSP 1 is restricted by the limitations and inadequacies of VSP 2 (such as less sophisticated vote reporting, opacity of process, tight and movable deadlines, faulty voting ballots etc).

This happens on a weekly sometimes daily basis in the processing of voting instructions and will no be dealt with until investors demand change. Until then, proxy voting will continue to be a murky, cumbersome process.

PHILLIPS: Yes, indeed this is already being observed in some markets, such as Australia, where voting is mandatory. The voting process needs to be more transparent and any pressure by regulatory authorities to make this process easier to interpret and the results easier to digest can only help investors feel comfortable that the vote they make is the vote that will be made on their behalf.

There is also a need for investors to become more active in voting when required, taking a responsible approach to understand the resolutions being tabled and the effect their vote can have. From a vendor perspective this opens up a new market segment that is current closed to all but a few specialist service providers and will provide much needed competition to a badly regulated and badly serviced area of financial services. ■

Next issue: Benelux fund administration

"Any short term desire around in the current economic climate does not dilute the pressing need to develop better cross-border solutions"
Paul Phillips, SmartStream

Analyse This: Irish Funds

What is the investor appetite for alternative funds in the current climate? Pete Townsend, head of global fund services operations for alternative investments, BNP Paribas Securities Services

During the last quarter of 2008, we witnessed a shift in capital away from alternative funds to less volatile asset classes such as treasuries and cash funds. Investors in alternative funds have historically accepted the higher volatility that can accompany higher returns than traditional funds. However, with the market volatility of recent months, many alternative investors have decided to put their money on the sidelines until market stability has returned.

This cautious approach is more marked among high net worth individuals (HNWIs) than institutional investors. Many HNWIs were advised by their private bankers or by consultants to seek so-called 'safe havens', such as cash funds. The average HNWI probably has a higher proportion of alternative assets in his portfolio than the average HNWI of five years ago. As the alternative funds industry nearly doubled from 2003 to June 2008, there were simply many more alternative assets available for movement to a safe-haven by HNWI.

Institutional investors have also reduced their appetite for alternatives, but to a lesser extent, as institutions tend to take a longer term view than individuals. Unlike the complete withdrawals undertaken by some HNWIs, many institutions have re-allocated their assets to the better-performing alternative managers, and have the internal capabilities to properly assess these managers.

This pattern typifies the last three or four months. But we are now seeing institutional investors' hunger for alternatives return, with new fund launches in some of the key buying centres such as Hong Kong, New York and London. Perhaps they sense the bottom of the cycle. They may also believe that those hedge - and funds of fund - managers who have weathered the storm will be best suited to achieve higher absolute returns

At the same time, investors' infrastructure and reporting needs are changing. Institutions are taking a closer look at the choice of fund domicile, with those offering increased regulatory oversight, such as Luxembourg and Ireland, being favoured over those with a perceived lighter touch. Service providers that run regulated UCITS product on the same systems as alternative products are best positioned to add value, as fund managers and clients receive the same reporting regardless of fund structure or domicile.

Similarly, US funds are likely to catch up with what is already happening in the rest of the world, by accelerating the outsourcing of back and middle-office functions to third parties. After all, independent reporting and expert valuation have their advantages. ■

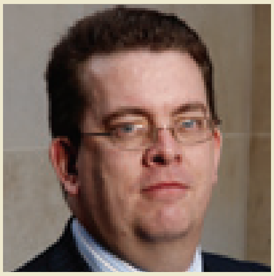
Post-Madoff, why is Ireland ideally poised to benefit from the demand for independent administrators within the hedge fund industry? Karen Jennings, Partner, Dillon Eustace

The Irish alternative investment industry has long championed the use of regulated structures to replicate the hedge fund strategies employed in traditional low-regulation or unregulated offshore centres.

As a result, the majority of Irish hedge funds and a large number of private equity vehicles use Irish regulated fund structures – some UCITS models but more typically Non-UCITS professional investor funds or qualifying investor fund – which are subject to, among other requirements, independent administration and custodial requirements and annual audit requirements. This is contrary to the position for many US hedge funds, which may not use independent administrators as a matter of course.

Following the Madoff scandal, the importance of the establishment of independent administration relationships for hedge funds and managed accounts has been called into focus. Third-party administrators for hedge funds perform back-office operations including valuing infrequently traded securities, calculating net asset values, and preparing account statements. The need for frequent reconciliations between the various confirmations, statements, reports and records of these entities makes concealment of a fraud much more difficult.

It is anticipated that following the Madoff scandal, there will be increasing demand from investors to ensure that hedge funds and managed accounts utilise the services of fully-fledged independent administrators. Ireland is ideally poised to take on this role, with the ability to offer fund servicing by blue-chip administrators with strong balance sheets, industry pedigree and experienced employees. ■



Where can regulation improve when market confidence returns? Ian Headon, head of alternative product management Northern Trust

The global financial services industry is reeling from recent high profile financial failures and frauds, with knock on effects in the funds industry.

The political and regulatory community are looking to impose greater scrutiny and oversight on banks, hedge funds and depositaries as public disquiet grows over perceived regulatory failure in the financial industry generally.

The Irish funds industry is clearly not immune to such pressures – typically the funds industry, particularly the asset servicing industry, thrives when our clients succeed the corollary is also true.

2008 has been a struggle for many asset managers with pressure on performance and asset flows presenting commercial and survival challenges.

However, we are seeing evidence that some confidence will return towards the end of 2009 and while there is a requirement for regulatory improvements, it remains a concern that we may see an over-reaction.

Firstly, the phrase hedge fund is not defined. None of the major regulatory centres observes the official term "hedge fund" as part of its governance processes – Ireland has the Qualifying Investor Fund, Jersey the Expert Fund, Luxembourg the SICAV and SICAR. Thus, any attempt to regulate "hedge funds" must be seen in that context.

Secondly, the European hedge fund space is already highly regulated. Most hedge fund managers are located in the UK, most prime brokers in the UK (both regulated by FSA), administered in Ireland or Luxembourg (IFSRA / CSSF), listed on the Irish Stock Exchange and audited by a major international auditing firm (various international bodies). In addition, many funds are domiciled in regulated centres such as Ireland, Luxembourg, Jersey etc where an additional layer of regulatory coverage is mandated via the appointment of a trustee/custodian.

Admittedly many of the funds are domiciled in so-called 'light touch' centres such as Cayman or Bermuda but those centres are not unregulated – more precisely, they are lightly regulated.

It remains a source of interest to us that the governance culture in Europe differs from that in the US. It is absolutely standard in Europe for a European-managed hedge fund to appoint an administrator whereas in the US, many funds self-administer.

There is nothing inherently wrong about self administration – and the appointment of an administrator does not guarantee fraud prevention. But international best practice dictates that the appointment of quality independent service providers is a key part of a quality governance framework. ■

What is a director's responsibility? By Gavin Gray, managing director of Phoenix Fund Services' offshore operations'

In recent years we have seen, in particular with European clients, an increased focus on corporate governance with respect the funds to which they provide investment management services. These funds are primarily offshore and domiciled in jurisdictions such as Cayman and Bermuda.

This focus on corporate governance was initially tax driven to ensure that "central management and control" remained offshore and so mitigated the potential of a fund being brought onshore for tax purposes.

Increasingly though, form was replaced by substance, with funds holding regular board meetings to consider the operations and performance of the fund. At the same time, the composition of the boards changed from 1) the use of directors connected with the investment manager

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International Finance Centres

British Virgin Islands International Finance Centre

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