FTfm Asset servicing

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Illustration: Bill Butcher

Custody model undergoes a fundamental adjustment

Overview

An increased interest in outsourcing and a broadening of the client base means bright prospects despite a difficult environment, writes **Brian Bollen**

Is the custody business model broken? It is probably too strong to say that argument is raging in this increasingly diverse and arcane niche of financial services, but disagreement certainly exists.

The polarisation of opinion was on display at a recent custody summit in London. In one corner stood Paul Stillabower, global head of business development, fund services, at HSBC Securities Services. In the other were representatives of financial institutions that feature prominently on anyone's short list of top providers, which possess banking licences but do not take deposits in any significant numbers.

Mr Stillabower is vehement in his belief that the traditional scale-driven model based on low cost or even free services is indeed broken and utterly discredited. Through the boom years custodian banks became expert in offering additional services for free, relying on the sheer scale of volume of assets under custody to generate revenue from foreign exchange transactions, securities lending, and the investment of idle cash.

In recent economic conditions, earnings from those sources have been less robust than in the past, thanks to lower foreign exchange volatility, the drop in securities lending activity in the wake of the Lehman default in September 2008 and record low official interest rates.

"A model based on squeezing assets is very much yesterday's model," says Mr Stillabower. "The only thing to save it would be another extended bull market. Would you put your pension on another extended bull run?"

In this view of the world, the Reaganomics-driven bull run will come to be seen as an aberration rather than a new normal, he says.

Tomorrow in the asset services world belongs to the universal banks, he states with certainty. A strong balance sheet is the key to how the industry will inevitably reshape itself over the next three to five years, he adds. The universal banks can look forward to that future and a focus on transaction-based banking rather more confidently than they might have done a decade or so ago.

The custody model has in any case been changing over the years in response to a number of factors, including regulatory environment, transparency, clients' needs to concentrate on their core activities and the changing infrastructure the industry has had to adapt to, notes Alain Closier, the head of Société Générale Securities Services.

"There have also been changes due to the Ucits development and AIFM [alternative investment fund managers' directive] recommendations and clearly we have to be ready for T2S [Target2-Securities] and its implications on our custody model," says Mr Closier.

> 'The only thing to save it would be another extended bull market. Would you put your pension on another extended bull run?'

Conrad Kozak, chief executive of JPMorgan Worldwide Securities Services, disagrees with the proposition that the asset services business model is broken. Although stresses and strains do exist, custodians and asset managers must address these collectively and work through the underlying issues together; if they do not succeed, there will be a mismatch between what the custodians offer and what the clients need.

"As part of the outsourcing process, risk gets transferred to us. That's fine, since we're in the business of managing risk, but we should be compensated accordingly for assuming that risk," says Mr Kozak.

In any event, the prospects for custodians and other providers of asset services in some ways look unusually bright.

Custodians report not only an increased interest in outsourcing from fund managers but also an increase in the conversion of broad interest into hard transactions. JPMorgan WSS, for instance, acquired the Bermuda- and Guernsey-based fund administration of Schroders in February this year.

"This is part of the acceleration of the ongoing evolution of our industry which we have experienced in the past couple of years," says Mr Kozak.

"Asset managers have been reconsidering their infrastructure needs. They are asking whether they need to spend scarce capital on building their own middle and back offices, increasing their fixed costs, or to outsource those functions and invest the money saved in product development instead."

Against this backdrop, he is predicting a boom in outsourcing by larger players.

Penelope Biggs, head of the institutional investor group, EMEA at Northern Trust, says the industry is suddenly abuzz, especially in the UK, the Netherlands and the Nordic markets.

"It's as if someone has flicked a switch after a prolonged quiet spell," says Ms Biggs.

"It has moved from fund managers asking about outsourcing their back office, to pension funds and insurance companies also making enquiries."

Potential new clients are, however, testing the waters in terms of purchasing "component" outsourced services.

Steve Smit, executive vice-president and head of State Street's global services business in the UK, Middle East and Africa, says: "Very few requests for proposal coming to the market do not include some component of middle office outsourcing.

"Demand is very strong. The challenge is structuring transactions that are mutually profitable. Asset managers need to cut their expenses base; a recent study from McKinsey shows that while asset values have recovered to

Continued on next page

Contents

Outsourcing
The growth in farming out more office functions........4

Transfer agency
Managers see the activity in a new light......................4

Depositories
The AIFM directive responsibilities are less onerous than draft plans..6

Profile
Citigroup identifies three important trends................6

Risk management
The value at risk model must be used correctly.....7

Fund clearing
The long road towards a single, US-style model for Europe..................................8

ETPs
A spurt in market growth has increased demand for asset servicing...................8

Counterparty risk
Management of collateral is increasingly seen as a buy-side issue....................9

Outsourcing
Fund managers refocus on making money..................10

Ucits IV directive
The EU regulations offer opportunities for those who move quickly.............11

Regulated funds
Newcits present monitoring challenges......11

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Size matters as do satisfied clients

Winners

A global service is seen as key, but there's room for niche players, says **Chris Newlands**

The credit crunch has changed much in the asset servicing market but the age-old debate over whether big is best remains.

The market's giants continue to extol the virtues of scale, while the minnows point to their agility and attention to detail.

Size, it seems, does still matter but what has really come to the fore is customer service. A firm's ability to make its clients feel special will, according to experts, separate the winners from the losers.

"Clients want to feel valued and are not now prepared to accept second-rate service," says Richard Hogsflesh, managing director of R&M Consultants, which ranks custody houses in terms of client satisfaction. "Customers want to have a closer relationship with their providers and want to be sure those providers are truly committed to the market. Firms must now be a genuine source of expertise."

According to Patrick Colle, chief executive of BNP Paribas Securities Services, this was at the heart of why the group overhauled its management structure last month.

It introduced four new business lines, six client segment heads, and eight regional chiefs to increase its "agility" and respond to its clients' "global needs".

"Our clients were a key driver in the reorganisation. We knew we needed to get closer to our customers because in turbulent times they need more advice, more support and tailor-made solutions," says Mr Colle.

The overhaul, however, was announced just days before BNP fell from second to last place (sixth) in an annual R&M ranking of administrators. The results were based on the client-satisfaction responses of 48 UK asset managers.

Mr Colle, however, is quick to point out that company progression – rather than poor performance – was behind its restructuring. "The change is absolutely not an admission that the previous structure wasn't working," he says. "It is about moving the business to the next level. We are the number one player in Europe and want to compete with the top four internationally. The restructuring is about us taking the next step in achieving that."

Mr Colle is not alone in putting an emphasis on a firm's global capabilities. He and many others believe having a global offering will also clearly separate the market's best and worst providers.

"Those providers that only concentrate on their domestic markets and only service local clients will get hurt," says Michael Wilson, global head of corporate affairs at RBC Dexia Investors. "Our clients are becoming more global and so must we."

Mr Colle adds: "You need to be pan-European as an absolute minimum these days to survive. If you are not, it is likely you might get bought."

That appears a fair assessment, and the one firm doing most of the buying right now is BNY Mellon Asset Servicing. In February the custody giant announced it was to buy Delaware-based PNC Global

> 'I expect to see more consolidation, especially in Europe'
> **Nadine Chakar, BNY Mellon**

Investment Servicing for $2.31bn, while in August it completed the acquisition of BHF Asset Servicing from BHF-Bank and Sal Oppenheim for $343m.

Those deals brought an additional $3,000bn of assets under custody to the firm on top of the $21,800bn in assets it already held, and there may be yet more to come.

BNY Mellon's financial institutions group head Nadine Chakar says: "I expect to see more consolidation, especially in Europe.

"Forthcoming regulation will impact smaller providers and their longevity in the market will depend on how they adapt to those regulatory changes. If they don't keep up, they will get acquired."

She adds: "If we see the right opportunities we will take them, but right now our priority is the integration of PNC and BHF."

BNY Mellon climbed one place to joint third in the same R&M annual ranking of administrators that found BNP to be wanting. HSBC and Northern Trust were first and second in that list respectively.

One of the 48 asset manager respondents to the survey said of BNY: "Our overall relationship with BNY Mellon has improved over the last 12 months. The number of errors across the business has reduced and NAV [net asset value] errors in particular have reduced. A focus on the client relationship and the establishment of an embedded risk team has improved the overall offering."

Mr Hogsflesh says these types of comments suggest there will always be room for smaller players.

"Clients want to feel valued whether they are big or small but unfortunately those smaller customers tend to get lost at the big firms. There will always be a place for certain niche providers."

Ms Chakar agrees niche firms will always have their place but says being big does not equate to bad service:

"This market is not just about being big, it's about being good. We are constantly investing in our business because it's important to BNY Mellon. Asset servicing makes up 35 per cent of revenues at BNY Mellon and that, I think, is really telling."

BNP has fallen from second to sixth place in rankings Bloomberg

Custody model undergoes fundamental change

Continued from Page 1

pre-2007 levels, revenues are only back to approximately 70 per cent of those levels."

Against this backdrop, Mr Kozak is predicting a second wave of outsourcing to follow that seen in the mid-2000s.

Rob Wright, global head of products and client segments at RBC Dexia Investors Services, reports that his company's own global business model is changing, with more resources dedicated to doing much of the NAV calculation in advance so that fund accountants can spend their time reviewing and validating, rather than processing.

Tim Keaney, chief executive at Bank of New York Mellon Asset Servicing, has strong views on the need for custodians to stretch their own value chain if they are to remain effective and viable.

"If you have the same products as two years ago you are already obsolete."

Fund managers want to undertake more business with fewer providers, he adds.

Mr Keaney also forecasts a new round of consolidation as single country providers reach a tipping point in terms of their commitment to the business (he cites as examples BNY Mellon's purchase of the custody business of BHF in Germany and State Street's acquisition of Intesa's in Italy), and as capital-hungry parents are being forced to sell off their custody business units (BNY Mellon's purchase of the PNC custody business).

"Adding to the momentum is the sea change that has taken place at senior executive level in banking over the past three years or so," he says. "In some cases, entire management teams have gone; their replacements will want to conduct their own top-to-bottom strategic reviews with no preconceptions."

In Asia, meanwhile, Giles Elliott, global product head of securities services, transaction banking at Standard Chartered in Singapore, identifies several more or

> 'If you have the same products as two years ago you are already obsolete'

less familiar themes that will have an impact on the asset services industry.

First, he points to the broad change in the flow of money from the west which is leading to increased Asian representation in investment portfolios.

Second, global intermediaries such as broker-dealers are re-examining their own operating models, before deciding whether to have a direct local presence or to settle for remote access.

Third, global fund distributors are looking for partners.

Mr Elliott also raises the question of regulation, a recurring and painful theme for custodians in the west, who are balking at the sheer volume of regulation threatening to engulf them, and complaining about the lack of certainty surrounding its content.

"We haven't seen the waves of regulation in Asia that we have seen elsewhere," he says.

"There could be two reasons for that. Either Asia is watching how the revised regulations pan out in the west before following suit. Or maybe Asia's more controlled approach was already a suitably balanced model."

In the doldrums, but hopeful for a breeze

Securities lending

The market may be stagnating but it is bracing for a surge in popularity, writes **Brian Bollen**

These are difficult times for the securities lending market. One market participant sums up the prevailing environment: "It is not too strong to say there has been a collapse in demand as proprietary activity has slumped. What we have seen is in fact a reversal of the positive trends of the past five years or so that drove the market."

A recent report by industry experts Zimmerhansl Consulting and Howieson Consulting, on the introduction of central counterparties to securities lending, draws attention to the estimate that at year-end 2009 lendable equity assets were put at $5,300bn globally. "While still substantial, these numbers reflect a reduction of almost 50 per cent from the lending market peaks experienced, in 2007," noted the authors, Roy Zimmerhansl and Andrew Howieson.

The reasons are relatively clear. The major driver of all growth in the previous few years was the increase in hedge fund demand. As the performance and reputation of hedge funds suffered, so demand for stock fell, exacerbating a long-standing problem of excess supply.

The market is much smaller than it was, says Mark Faulkner, founder of specialised data provider Data Explorers, whose short-selling data now feature on www.ft.com. "At the peak we saw $4,000bn of different kinds of assets out on loan. Today it is barely half that level."

This is reflected in revenues. Data Explorers calculates these are down from $20bn or so annually to below $8bn today.

"The pie is a lot smaller, and is sliced differently and its ingredients have changed," says Mr Faulkner. "There are two ways to make money with securities lending. One, rent out securities and take non-cash collateral. Two, rent out, take cash as collateral and reinvest that cash in the markets to generate extra revenue. It is the second of these methods that has led to trouble and lawsuits."

One of the most significant developments in the past three years has been the widely publicised losses experienced in some lending programmes as a result of an aggressive reach for yield on cash collateral reinvestment. It is critical for beneficial owners (the stock lenders) to understand what portion of their return is derived from intrinsic value rather than from cash collateral reinvestment. Mr Faulkner welcomes the recent change that means most income now comes from pure securities lending. "It is a better, safer business."

Blair McPherson, global head, technical sales, market products, at RBC Dexia Investor Services, adds that the supply side in the market has shown increasing signs of improvement.

> 'The pie is a lot smaller, is sliced differently and its ingredients have changed'

Lenders that had suspended their lending programmes during the credit crisis have returned after adjusting programme parameters to better suit their risk-reward profile, while there is growing interest in lending from new funds, he says.

Beneficial owners are also requiring a greater level of transparency across their portfolios. They want to know not only what the return was, but also where it came from and what risks were taken in its generation.

Kathy Rulong, executive director, global securities lending at BNY Mellon Asset Servicing, confirms that lenders have reviewed the risk profiles of their lending programmes and a number have since made significant changes. "There has been a move away from the commingling and reinvesting of funds and towards separate accounts," she says. "Clients want to see a more customised approach to their programmes."

Enhancing the optimistic tone about the future, Nick Bonn, executive vice-president and head of State Street's securities finance business, says more and more governments and multinational agencies recognise that securities lending enables capital markets to develop and advance.

"Emerging markets are increasingly adopting regulations to support securities lending. In just over 10 years, almost half the markets in the Asia-Pacific region have developed strong securities lending programmes, including Australia, Japan, Korea, Singapore and Hong Kong," he says. Analysis of a recent survey by Data Explorers highlights that Asia's contribution to the global market has increased from 14 per cent to 18 per cent in the past year.

For Keith Haberlin, head of securities lending, EMEA, at Brown Brothers Harriman, the most important trend in the industry is the renewed caution and risk awareness of beneficial owners. In general beneficial owners have made substantial changes to their risk management and programme oversight practices and are placing greater importance on the transparency between lending agents and beneficial owners, as supported by ongoing communication and open dialogue.

"This is an extremely positive outcome for the industry and something we expect will become a permanent part of agent-client interaction," says Mr Haberlin.

Brian Staunton, head of securities lending, Citi, EMEA, echoes this sentiment, saying that in many cases the responsibility for the beneficial owner element of the product seems to have shifted. "There is now a realisation that there is risk, and it has to be understood, assessed, calculated and priced appropriately – and the front office seems the most logical place for that to be done, rather than the back office," he says.

However the future unfolds, Anne France Demarolle, head of liquidity management at Société Générale Securities Services, stresses that participants will have to prove themselves able to adapt to new regulations, including Basel III and the financial regulatory reforms occurring in major countries. She too is bullish in her assessment of the landscape.

"Even though securities lending was accused of being responsible for inappropriate short selling, we believe the financial community has reassessed the importance of stock lending," she concludes.

"Stock lending is now a more mature product and as participants are more knowledgeable, they should be better equipped to accept the embedded risks."

Emerging markets such as South Korea are increasingly adopting regulations to support securities lending Alamy

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Managers farm out more activities

Outsourcing

Cost concerns are pushing the use of third-party service providers, says **Ruth Sullivan**

Asset managers are handing out more of their back, mid, and even front-office work to service providers as the industry comes under pressure from increasing regulation, the need to update support technology and to keep costs down in an uncertain environment.

"There is a need to continually upgrade technology to keep up with the pace of change. Some asset managers also want to diversify, investing in hedge funds and real estate so stretching support in mid and back office," says Susan Ebenston, head of global fund services at JPMorgan Worldwide Securities Services. As a result "we are seeing growing demand for back and mid-office services", she adds.

Traditionally back-office activity such as fund accounting and custody has made up the bulk of asset servicing providers' work but "now that is shifting to mid-office outsourcing, which is happening globally", says Lou Maiuri, head of outsourcing at BNY Mellon Asset Servicing.

"New products and ways of distribution are also putting pressure on infrastructure, leading to more outsourcing," says Jeff Conway, head of State Street investment manager services.

During the boom years leading up to 2007, many of the small and mid-size asset managers expanded too fast and are having to rethink their business model. Managers have grown "in size and function" and also have to meet new regulatory as well as technology demands, he says. They have to "shift some of the burden", Mr Maiuri adds.

A recent report* by Fitch Ratings on the pressures facing the European asset management industry says it needs to adopt a more flexible cost structure by outsourcing more activities.

Aymeric Poizot, a senior director and author of the report, sees small niche asset managers becoming "leaner and focusing more on managing the front office efficiently", outsourcing mid-office operations.

"It is cheaper for specialist asset managers such as equity or credit houses to outsource all their mid-office activities to a big provider, rather than retain in-house staff," says Mr Poizot.

Handing out such activities means in a few months the headcount is reduced as in-house staff are no longer on the payroll. "It is all driven by the profit and loss account," he adds.

Emptier offices: outsourcing cuts the wages bill Alamy

He believes the number of specialist asset managers retaining all services in-house is "getting close to zero" as providers "offer services at competitive prices".

However, he emphasises the need to have a "well-designed financial agreement in place with the contract provider".

He believes outsourcing mid-office operations does not work for big houses where activities are spread across a range of asset classes and operations are more complicated and can take several years to stabilise. Some big houses that outsourced reporting and performance analysis have been unhappy with the process, taking the activity back in-house, he adds.

In addition to specialist asset managers, providers are seeing an increase of start-ups – where employees have left big companies – seeking mid-office support. "Start-ups do not want to spend money on mid-office operations and we can do it cheaper," says Mr Maiuri.

Some front-office activities are also being outsourced, such as mandate monitoring to make sure pension funds' commitments to sustainable investing are being met, and calculating the performance of funds. While such activities are not visible to clients, they are fed back to the asset manager's front office.

The size and effect of the Madoff scandal has also driven more asset managers to outsource their pricing, auditing and accounting as investors and regulators demand more transparency and governance.

A batch of pending European Union regulations, such as the alternative investment fund managers directive and Ucits IV, is also pushing asset managers to send compliance tasks out of house, say asset service providers.

Not all asset managers are keen to outsource but to maintain operations in house "economies of scale are essential", says Jeff Conway, head of State Street investment manager services. He agrees with Mr Poizot that smaller players will not be able to extend themselves to handle all their operations in a cost-efficient and effective way.

One of the main drawbacks asset managers see in putting operations out of house is loss of control, says Mr Conway.

Some of those that have doubts try but "it takes at least a year or so to adjust", says Ms Ebenston. Some managers also worry about stifling initiative and creativity, whereas she believes outsourcing "forces more discipline" into areas of asset management, particularly the front office.

"Once a contract has been signed a fund manager cannot wake up one morning and start a new fund," she says.

Asset managers, like financial services in general, have endured a difficult few years, while asset service providers have benefited from an increase in business.

The outlook for asset management is not rosy. so service providers expect the next few years to yield more business. "It is an area of big growth that we expect to continue," says State Street's Mr Conway.

* *European Asset Management: an industry under pressure*

Back office function comes to the fore

Transfer agency

Managers are viewing the activity in a new light, says **David Ricketts**

The often overlooked and unloved function of transfer agency is currently undergoing something of an image makeover.

Once considered the poor cousin of the back office, dealing mainly with unglamorous administrative functions such as investor record keeping and shareholder voting habits, managers that are eager to expand their footprint globally are viewing transfer agency in a new light.

A majority of fund houses have already outsourced their transfer agency functions to third parties, as companies continue to grapple with rising costs and attempt to focus on their core competency of managing client assets. "Managers realise they are not creating a competitive advantage by doing this [transfer agency] in-house, and they don't have the scale of the large transfer agents," says Simon Hudson-Lund, chief executive at Interactive Financial Data Services.

Henderson Global Investors was one of the latest managers to outsource its investor record keeping and transfer agency to IFDS this year after its integration of New Star's UK retail book.

Henderson joins other UK managers, including Axa and Jupiter, that have ceased in-house administration and the upkeep of investor records, having outsourced such functions to third parties.

However, some still perceive transfer agency as part of their core offering, says Mr Hudson-Lund, who points to Fidelity as an example of one fund house still continuing this function in-house. As European fund houses look to export the global brand of Ucits to new markets, asset service providers argue transfer agency is becoming more important in boosting distribution.

"Transfer agency is part of a manager's cost base they need to keep an eye on, but distribution is now a key word on everyone's lips," says Mr Hudson-Lund.

"Asset managers are grappling with how they can keep a foot in the distribution camp, which ultimately means transfer agency. After all, we are the link with the distributors."

Richard Willis, global transfer agency product manager at BNY Mellon Asset Servicing, acknowledges the increased role transfer agency is playing in a firm's relationship with its distributors.

He says: "We don't talk about transfer agency on its own today. A lot of work is around servicing the global distribution of our clients.

"The growth and emergence of distribution is driving demand and in some cases we interact more with distributors than our asset manager clients."

But while technology in other areas of investment management has succeeded in creating greater efficiencies, transfer agency is still plagued by countless faxes and manual processes that cloud any hopes of fully automating this function.

Karen Hamilton, head of product development for fund administration at Northern Trust, argues automation of transfer agency is making progress.

"Around 10 years ago fund managers would have had their own sales force speaking with IFAs, but as managers look to distribute funds from a global perspective, to communicate automatically is increasingly important."

> 'Transfer agency is part of the cost base but distribution is now a key word on everyone's lips'

Unlike the US market, which operates a single standard for automated messaging – known as NSCC – Europe has a series of different formats including Swift, EMXCo and FundSettle.

While distributors have made moves to become more automated, the plethora of different messaging systems used means service providers often have to bear the brunt of improving systems to cope.

Ms Hamilton says: "We recognise that we can't just have one solution to fit everyone, so Northern Trust has spent the last three years enabling our systems to receive automated deals in as many formats as possible."

Four years ago the automation of deals – or straight through processing – at Northern Trust stood at 0.1 per cent. Now more than 70 per cent are fully automated, says Ms Hamilton.

While there is little optimism that a 100 per cent automation rate will ever be achieved, the eventual aim for now at least is a wider adoption of the so-called ISO standard to further reduce reliance on manual processes.

BNY's Mr Willis says: "The problem with Europe is that each market is different. Italy is highly automated in terms of cross-border automation, while Germany is still relatively low. We have to deal with each independently.

"In Asia, distributors in Taiwan are delivering thousands of faxes back into the asset servicing world, and asset service providers have to have systems in place to channel those into electronic messages.

"It is down to the individual distributor to improve automation," he adds.

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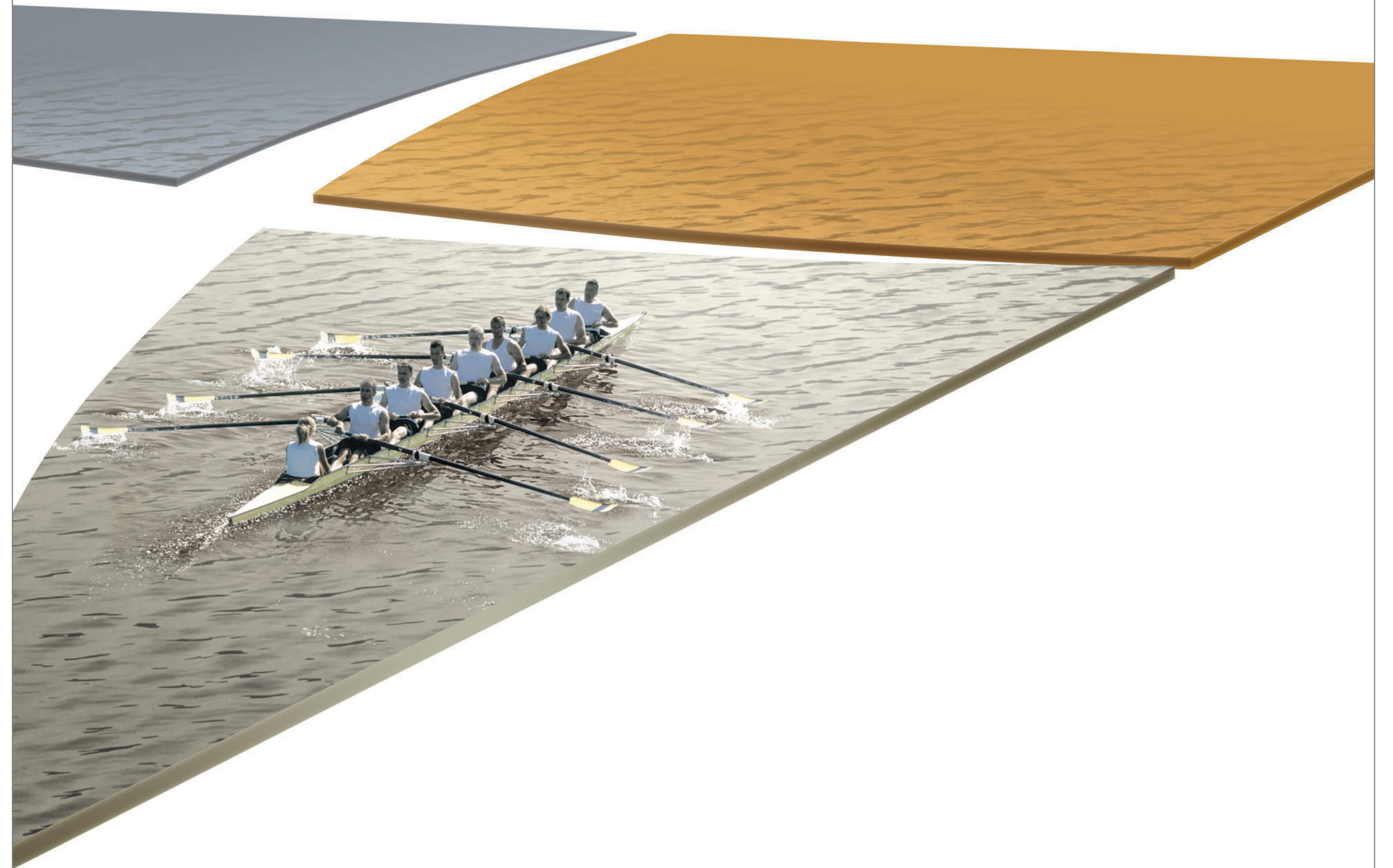

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Custodians confident AIFM will bring clarity

Depositories

The responsibilities are now less onerous than the early draft Brussels directive, writes Baptiste Aboulian

Depositories are breathing a sigh of relief over the alternative investment fund managers (AIFM) directive.

As negotiations draw to a close, the responsibilities of the future hedge fund asset safe-keepers have been watered down compared with early draft proposals.

At the time of going to press, custodians are quite upbeat about the latest version of the directive, which aims to create a secure regime for professional investors in hedge funds.

David Curtin, general counsel for Northern Trust in Europe, says: "There is an improvement on what we've seen in the past where we would have had responsibility on the loss of financial instruments. Now we won't be liable if loss rises beyond reasonable control."

Initial proposals by the European Commission in the wake of the financial crisis stated that depositories would be liable for the loss of AIFM assets "no matter what". After the publication of first drafts, depositories say they went on to lead a rather quiet but apparently productive lobbying exercise in the corridors of Brussels.

According to depositories, unlimited liability would have led to "unintended consequences", including the possibility of increased costs for investors and, most worryingly for regulators, the potential growth of systemic risks in the wake of sector consolidation.

Paul Bodart, executive vice-president at BNY Mellon, says: "There have been a lot of discussions with Brussels. The text is better. Although there is still an obligation of results [where only the outcome counts], we are liable only for things that are under our control. I don't think we will be able to change that for an obligation of means [where intention matters most]: it's non-negotiable."

Also, although finer details of the AIFM directive could still change, custodians are confident the 11-page depository section will bring much-needed clarity to the industry's role and functions.

The legislation, for example, will provide a European definition on safe-keeping, whose loose interpretation recently led to very different legal outcomes in cases of asset loss.

In France, a court ruled that RBC Dexia was liable to return all assets to three hedge funds that had lost assets held by Lehman Brothers, while investors in Luxembourg-based Ucits funds kept by US fraudster Bernard Madoff are still to receive any compensation.

Mr Bodart says: "[AIFM] is a big progress. Previous depository regimes were loose and interpretations were very different. The definition of what a depository must do [under the AIFM regime] is a lot more accurate."

Crucially, the legislation says a sub-custodian will be able to take liability under contract, instead of the custodian.

> 'It goes against how we are structured, and the thinking is unclear'
> **David Curtin, general counsel for Northern Trust**

This, however, will come at the cost of tough due diligence conditions, and only if the custodian "can demonstrate there is an objective reason for the delegation", according to a recent AIFM proposal from the Belgian presidency.

Mr Curtin says: "It goes against how we're structured, and also the thinking is unclear. A lot of things need to be clarified."

Even though depositories will avoid untenable levels of liability under the latest proposals, AIFM is likely to prove lengthy and costly when problems arise. The reverse of the "burden of proof", for example, will mean depositories must prove they have no responsibility in case of lost assets. Before, investors had to prove there had been fault on the custodian side.

Despite these issues, the AIFM directive is still considered as a good deal.

More worrying perhaps is the fact the Commission plans to "reconcile" the hedge fund directive with the Ucits legislation, importing features such as on depositories.

Ugo Bassi, head of unit for asset management at the Commission's DG Internal Market and Services, recently warned that "we'll certainly end up with a [depository] regime stricter in Ucits than in AIFM". This position is shared by the French regulator, AMF, which criticised the Ucits regime for failing to protect retail investors from Bernard Madoff.

Patrice Bergé-Vincent, head of asset management policy at the AMF, recently said: "Institutional investors don't need protection from the regulator but [by doing]... their own due diligence. [However], Ucits are marketed to retail investors who are not capable of understanding custody arrangements. They need rules to protect them."

The Commission is waiting for an agreement over the AIFM directive before starting to draft "clarifications" on Ucits rules. Although it is at an early stage, a few ideas have already emerged.

For example, regulators have explained that the future retail regime will establish the level of liability for each participant.

Whereas contractual discharges will be possible between managers and custodians under AIFM, the overriding rule under Ucits will be that there should be an obligation for a depository to restitute assets to an investor "with very few exemptions". Depositories could expect to have more "constructive explanations" to give to regulators.

Bernard Madoff (left) outside the Manhattan court. The scandal exposed weaknesses in the depository industry Getty

Diverse model helps unit to stay relevant

Profile

Citigroup's global transaction services head says there are three trends vital to the bank, reports Pauline Skypala

The global transaction services unit at Citigroup has its fingers in so many pies it is surprising no one is worried about the concentration of information in one group. It operates in 100 countries and has dealings with financial institutions, companies and the public sector.

But Francesco d'Archirafi, who heads the unit, plays down the bank's influence. He acknowledges the importance of that information, and says his business is about enabling clients to increase visibility, transparency and control so they can improve efficiency, and that comes from real-time information.

But Citi has less than a 5 per cent market share in the countries where it operates. The industry is fragmented, he maintains, and the bank could double its share before data issues became a worry for anyone.

Digitisation and automation of data transmission is one of three trends Mr d'Archirafi identifies as playing right into the hands of transaction services businesses. The other two are globalisation and urbanisation. Citi is a bank for cities, he says. "You will hear a lot about Citi as a preferred partner for city authorities."

The public sector is an area where he seeks to expand. It accounts for about 10 per cent of assets under custody now, and he wants to push that proportion to a third. One example he gives of working with the public sector is that all state pensions paid to Britons living abroad are paid through Citi infrastructure.

Asked if he sees Citi as a dominant player, Mr d'Archirafi rejects the label and says he wants to be "the most relevant provider of services to my clients".

But he goes on to claim the bank is alone among competitors in being strong in all regions; in having a diversified business model, serving financial institutions, companies and the public sector; and in operating across securities services and fund administration, cash management and trading. Competitors are strong in one of the regions, serve one of the client segments or have one of the businesses, he says.

He acknowledges that, post-Lehman, clients are wary of being too exposed to one counterparty, "but we have never been a 100 per cent service provider".

Maybe 80 per cent, but that is OK, he believes, because Citi follows the open architecture model. This means its services are "easy to switch on but even easier to switch off". This is in contrast to some competitors, which make it harder for clients to move.

> The biggest challenge for his business is the pace of change since the financial crisis

The biggest challenge for his business is the pace of change, says Mr d'Archirafi, which has increased since the financial crisis, and will change again due to "regulatory intensity". There is also pressure to maintain Citi's position, which makes him "paranoid" about what it needs to do to "make sure we absorb the volatility, we are not only reactive but proactive on the regulatory intensity, and that we continue to have this great dialogue with our clients so we can identify their pain points and commercialise solutions".

He is concerned about possible unintended consequences of new regulation, pointing to those flowing from Mifid, the European Union's markets in financial instruments directive. One outcome of that has been that profit pools have disappeared very quickly from Europe's trading and post-trading environment, with the result that "everyone is scrambling and talking to everyone else to see if a new business model will emerge that will allow you to maintain your margins".

One positive aspect of more regulation is that it pushes out the marginal players, which is good for Citi, says Mr d'Archirafi.

On the negative side, the fragmentation of the industry means too much time is spent trying to influence proposed new rules, then working out how to deal with them – time and energy that would normally be spent on clients. There is a need for a forum where the industry talks as one to the regulators and politicians, he concludes.

The risk of value at risk

Assessment models

The widely used snapshot picture of overall exposure must be applied correctly, writes Nicholas Pratt

The risk management role was one of the first to be placed in the spotlight following the financial crisis.

It was clear that the various risk models had failed to foresee the market's crash but less clear how this lack of foresight could be corrected. One theory focused on value at risk, the widely used measure for calculating the risk threshold of a portfolio.

Value at risk is designed to work within a stable environment and is best suited to instruments such as equities that display daily changes in risk. But in the pre-crisis period of prolonged stability, Var was often applied to other less suitable or liquid instruments, such as credit, and began to be treated as definitive, forming the basis of portfolio risk management for many firms. Since the crisis the reliance on Var, rather than Var itself, has been called into question.

"Var is still a credible measure but it must be properly used," says Laurent Pasquier, head of investment risk at Axa Investment Managers. "It cannot be used in every circumstance or if it is not well understood. In particular Var is of little use in cases of extreme market behaviour because of the lack of historical data and the limitations in backtesting. Therefore the higher the level of volatility, the lower the level of confidence in the Var figure."

Consequently Var models are being subjected to far greater scrutiny through stress-testing and shock scenarios rather than simple historical analysis.

Simon Bray-Stacey, portfolio risk manager at Aviva Investors says: "The crisis has shown us that history tends not to repeat itself so having a series of well-defined single and multi-factor portfolio stresses gives us a lot of insight into the sensitivities of the portfolio at an individual stress level and gives us some insight into the further tails of the distribution."

The models are subjected to both basic stresses, such as single factor interest rate shifts, and more complex ones – such as bear steepening stresses for fixed income portfolios. "The models are periodically reviewed and whereas the basic models will stay the same, the more complex models will be changed according to market conditions," says Mr Bray-Stacey. Aviva also uses multiple risk models. "This has always been the case with certain portfolios but is now in place across the board."

In terms of the stress scenarios used, it is important to anticipate the worst but also to be reasonable, says Mr Pasquier. "The financial crisis has changed our outlook on global macro factors like interest rate or foreign exchange risk but not so much in terms of specific equity risk. I think we already had the worst of that with Enron and Worldcom back in 2001."

It is important that risk models are able to deal with the sudden spikes in volatility that have appeared in the past two years. Mr Pasquier adds: "Any risk measure, Var included, must be flexible and sensitive enough to know the current level of risk and not just the long-term average because market risk changes fast and this becomes especially important when it comes to backtesting."

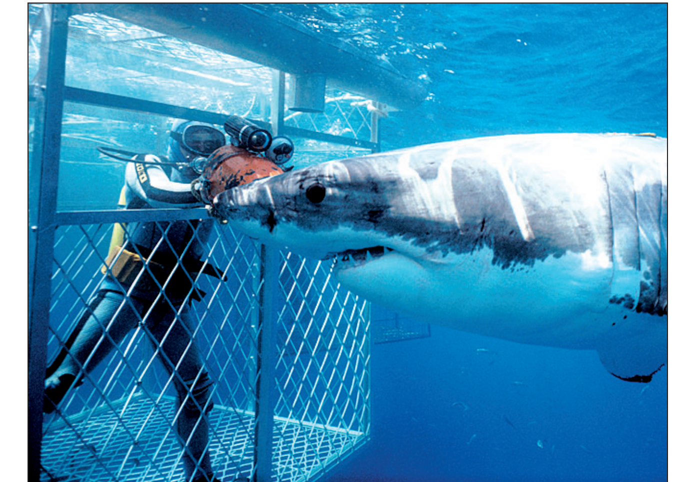
> Since the crisis the reliance on Var, rather than Var itself, has been called into question

It is a similar story in the hedge fund world. "If anything the focus has been to place less reliance on the models," says Matthew Weir, chief risk officer at BlueCrest Capital Management. "All models include flawed assumptions so we run fairly basic models and ensure that we understand the limitations. We then use stress tests to assess where the tail risk lies and try to make sure these are extreme yet plausible."

There has been no real change in methodology since the crisis but more of a focus on the application of existing risk measures. "For example, Var is still a credible measure but as a single tool which shows daily changes in risk rather than a measure of absolute risk," says Mr Weir. "And most people had stress tests before. The change since the crisis has been to focus more on segregation of assets and liquidity – under current conditions and also the change in positions if we were in a crisis."

The asset servicers supplying risk services and systems to fund mangers have also had to make similar changes. "We use a number of Var models from different vendors and backtest our clients' portfolios every day so that we can check the predictive Var against the realised volatility and compare one Var model with another," says Ian Castledine, head of investment risk products at Northern Trust. And although firms now run more models than before, the biggest lesson from the crisis is that models can only go so far.

"The risk framework is not there to change what the risk manager does, quite the opposite," says Mr Pasquier. "It is necessary to have models but also to understand their limitations – common sense and discussion are still very important."



It is important for risk to be assessed correctly Alamy

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Long road to a single European clearing market

Fund clearing

A central fund unit settlement platform still seems some way off, writes **Sophia Grene**

Since 2008, regulators' attention globally has been on clearing and settlement. A huge effort is being made to automate and make more transparent the process of clearing and settling trades of over-the-counter derivatives. In Europe, the long, slow process of making the trading of fund units more automated has been virtually unaffected by the financial crisis.

This is not to say nothing has happened, rather that as the trading system for funds was not implicated in the crisis, there has been no particular focus on making it more transparent or efficient as a result.

However, both the European Commission and a variety of industry bodies had already turned their attention to the question and their efforts continue unabated.

Whereas in the US all fund trades are cleared through a single platform, the National Securities Clearing Corporation – part of the Depositary Trust and Clearing Corporation – they can be cleared in several different ways in Europe. With a couple of dozen markets and low levels of automation, the road to an efficient single clearing market is a rocky one.

The European Fund and Asset Management Association, in collaboration with messaging service Swift, has put a lot of effort into creating a "fund processing passport", a first step towards an efficient cross-border market by standardising the format in which information necessary to trade fund units is available.

Efama has also initiated annual surveys of the level of "straight through processing", the full automation of the order, clearing and settlement process, which is necessary to any attempt to improve market efficiency. Most recently, it found that 69 per cent of trades processed by Luxembourg transfer agents in 2009 were automated, as were more than 80 per cent of Irish trades.

Europe's central securities clearing providers Euroclear and Clearstream have turned their attention to the fund markets, creating fund-specific platforms FundSettle and Vestima+, but so far neither has enough market share to form a single central solution. In the UK, EMXCo offers a country-specific settlement facility, as well as direct communication with the cross-border FundSettle.

This approach – offering easier access to existing systems instead of building a single central one – has been pioneered by UK-based Calastone. This offers to take all necessary information in whatever form is most convenient for the transactor and translate it into whatever form is necessary to communicate with the fund provider.

> A huge effort is being made to automate the process of clearing and settling trades

Although Calastone has been successful in winning clients, partly because its approach requires very little investment in infrastructure or IT, it does not fundamentally alter the problem, according to Paul North, head of product development at Bank of New York Mellon.

"They're very welcome, but they offer more choice," says Mr North. "The more choice there is, the harder it is to force everyone onto the same standard." Without compulsion, which would perhaps come from Brussels, he sees little chance of a single solution developing for Europe.

Calastone has also left unaltered the high cost of transactions in Europe, one aspect of the market that DTCC sees as an opportunity. With its US experience of running a central fund clearing platform, it has a couple of times dipped its toe in the European waters, although so far it has always drawn back.

This time will be different, according to Anne Bergin, head of wealth management services at DTCC. Last year, membership of DTCC's clearing platform (which is member-owned) was opened to non-US providers, while more recently, the ability to settle in euro and sterling has been added. Josée Denis, of BNY Mellon's Luxembourg transfer agency business, welcomes DTCC's enhanced offering but is not hopeful it will transform the market. "I've been using NSCC [DTCC's US platform] and I must admit that for us it's just an additional facility," she says. For new users it requires an investment in IT and has the major drawback that dealing is real-time, but in New York time rather than a European time zone, Ms Denis adds.

The IT investment involved in achieving STP can be a big hurdle for smaller fund providers, since it might even outweigh any benefit from improved transaction efficiency, says Mr North.

Whatever the outcome of the various attempts to standardise European fund settlement and clearing, an idyllic world of 100 per cent STP is unlikely, according to most commentators.

Even if the challenge of bringing together all European markets and creating a standardised fund clearing solution were overcome, the task would not be over. The global success of the Ucits fund brand has been such that significant order flow comes from outside Europe, primarily from Asia and Latin America.

While providers are keen to encourage overseas distributors to improve automation levels, they are also keen to conquer new markets, each of which requires a new effort.

"As long as funds are distributed in other countries throughout the world," says Ms Denis, "I don't see a day, at least not in my lifetime, when there'll be an end to the spaghetti factory."

Each European market has its own way of operating Alamy

ETP growth spurs boost in servicing role

Trends

Exchange traded products have given rise to a new level of market expertise, writes **Chris Flood**

The huge growth in the number and variety of exchange-traded products (ETPs) over the past decade has also led to a big increase in demand for the expertise of asset servicing managers, such as BNY Mellon, State Street and Brown Brothers Harriman.

The number of ETPs has increased to more than 3,000 from just 35 in 1999, according to BlackRock, as new providers enter the market and growing numbers of traditional fund managers expand their product ranges to include ETPs.

This proliferation has encouraged asset servicing providers to develop consultation services for fund managers unfamiliar with the ETP market.

Gavin Nangle, head of business development at State Street in Dublin, says ETP clients are increasingly looking for value-added services. He likens himself to a matchmaker who can intermediate between ETP sponsors and market makers, easing the burden of building relationships due to State Street's extensive worldwide network. Along with providing advice to potential ETP sponsors on market practices, State Street has also seen a growing demand for tax services related to ETPs.

Mr Nangle says US managers, who are used to dealing with a single currency and single tax model, face a daunting shift when trying to move into Europe, where there are multiple regulators and varying tax arrangements.

A key driver of the growth in the European market has been the rapid proliferation of synthetic or swap-based ETPs that use derivatives to track an index rather than investing directly in the constituents of a benchmark.

The number of swap-based ETPs available in Europe has risen from just 27 in 2005 to more than 600. This has required asset servicing managers to expand their involvement in swap pricing.

State Street already has extensive familiarity with alternative managers and the derivative instruments they use, so that expertise was readily transferred into the ETP market, says Mr Nangle.

"State Street runs complex pricing models for OTC products and was able to use that expertise to provide swap pricing in synthetic ETPs."

Shawn McNinch, global head of ETF services for Brown Brothers Harriman, says BBH is seeing "lots of discussions" with potential new entrants that are considering launching passive ETPs and also asking whether active ETPs could fit into their current product offering.

BBH has built a consulting services team that helps potential ETF sponsors develop their ideas from the conceptual phase to market, advising on legal requirements, regulations and tax issues as well as navigating the actual launch process.

It too offers sponsors help with building relationships with exchanges, and market makers.

Mr McNinch says BBH has made substantial investments into its core accounting platform to process swap contracts efficiently, which positions it well to service synthetic ETPs.

The increasing use of synthetic ETPs has led BBH to make substantial investments into its core accounting platform to process swap contracts efficiently and to provide reconciliation services with swap counterparties.

"It is necessary to have a strong infrastructure to support synthetic ETP structures, particularly if multiple swap counterparties are being used in order to reduce counterparty risk," says Mr McNinch.

As ETPs are low-cost products, reducing the costs associated with asset servicing remains a key focus for industry participants that have invested heavily in technology to drive out inefficiencies.

But minimising costs in Europe remains challenging due to variations in clearing and settlement systems and differing regulatory environments that can add to expenses.

Asset service providers also say that because ETPs are traded in both a primary and secondary market, additional levels of information and transparency are required compared with a traditional mutual fund.

Institutions focus on counterparty risk

Margin calls

Management of collateral is now increasingly seen as a buy-side issue, says **Heather Dale**

Counterparty risk has been thrust into the spotlight since the fall of Lehman Brothers, causing the buy-side to ramp up its risk controls, including increasing the frequency of margin calls, changes in types of collateral, and using more counterparties.

Collateral management was mainly a matter for investment banks in the past, but the increasing use of derivatives for hedging or gain by asset managers and investors has made it an issue for the buy-side as well as the sell-side.

Philippe Rozental, head of asset servicing at Société Générale Securities Services, says in responding to margin calls by a counterparty, requiring the delivery of extra cash or bonds, institutions used to rely on the counterparty's evaluation of changing positions.

"Since the crisis, financial institutions want independent valuations of their positions," he says. "So the choice is either to invest in big IT platforms and hire people or to rely on specialist providers."

It is now much more common, according to Mr Rozental, for a specialist provider to monitor the collateral and provide full support to investors on the collateral process. This includes contract negotiations, managing the collateral positions, calculating on a day-to-day basis what are the collateral requirements, dealing with the different counterparts and challenging the margin calls.

Another reason institutions are looking to outsource, according to Staffan Ahlner, managing director of global collateral management at BNY Mellon, is because an increase in the frequency of margin calls means managing those calls becomes resource intensive.

"Prior to the crisis institutions were setting up derivative transactions and only calling the margin once a month. Now we are down to daily calls for collateral," says Mr Ahlner.

Service providers have also noted that the type of collateral now being used is of a higher quality and agreements are regularly being put in place to set out the criteria of how and when collateral is managed.

Simon Lillystone, director of collateral and margin management at Omgeo, which provides tools for parties to agree margin calls primarily on the back of derivatives trading, says the most common type of collateral used in the past was cash.

"Now the buy-side has come on board we are going to see more activity using non-cash collateral," says Mr Lillystone. This means bonds and securities at the moment, but in the future could extend to real estate and letters of credit, for example, which would require more sophisticated systems to value collateral and monitor it.

Paul Wilson, global head of client management and sales for financing and markets products at JPMorgan Worldwide Securities Services, points to an increased use of credit support annexes (CSAs) when managing the collateral between counterparties, as well as more use of customised parameters around the details included in the CSA.

"For example, in a pre-market crisis environment virtually every CSA we supported on behalf of our clients would specify a minimum amount that would move between the two counterparties.

"Virtually all of them today have no minimum amount: whatever the amount of money it is, it gets moved."

Those agreements are also much more specific on the type of collateral that can get moved between counterparties, adds Mr Wilson. "Before the crisis, it might have said any government security and now it might say specifically US Treasuries with maturities of less than five years, or bonds issued by the UK."

Mr Ahlner adds that collateral agreements were in the past set up, but never really used.

"Lehman has increased the buy-side's awareness of counterparty and custody risk. It is not enough for investors to sign a CSA; the collateralisation process has to be actively monitored and managed, which then puts a demand on firms."

JPMorgan's Mr Wilson believes institutions will increasingly have to outsource collateral management because it is becoming more difficult to do inhouse.

"Collateral management is becoming more complex and more time-consuming. If [asset managers] don't have infrastructure in place, buying technology is massively expensive. There is also a huge amount of pending legislation that will potentially change the whole marketplace.

"Therefore [institutions] are going to have to spend more money to keep operations, technology and processes in line with the future regulatory and best practices."

Mr Wilson adds that the biggest changes are coming out of the Dodd-Frank legislation in the US, where a wide variety of derivative transactions will be required to be settled via a clearing house as opposed to bilaterally.

"That is going to change the operating paradigm completely," he says.

"It's certainly going to be a big contributor in reducing risk in the marketplace but can also add a huge level of complexity for an asset manager who has multiple counterparties. Therefore you need to update your technology to deal with all those different scenarios."

Philippe Rozental: 'Financial institutions want independent valuations'

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Managers refocus on making money

New trends

Third parties are taking on ever more work, writes **Nicholas Pratt**

Outsourcing has not always come easily to fund managers, as was the case when several large-scale deals involving the lift-out of back office operations were abandoned five years ago.

But the outsourcing business model has greatly matured since then and fund managers are now embarking on a new wave of outsourcing deals that increasingly involve not just the commoditised processes of the back office but also the client-facing services of the middle office, such as performance measurement and asset valuations.

For the asset-servicing companies, the motivations behind these new services are obvious. "The asset servicers have made huge investments in standard global platforms for back-office outsourcing over the last three to five years and they are now at the stage where they are looking to offer more than simply back-office services," says Gordon Easden, financial services practice leader at Fusion Experience, a UK-based management consultancy company.

For the fund managers, entrusting a third party with anything even remotely client-related is something of a departure but a number of factors have led to this changing attitude.

The tough economic conditions have forced managers to reconsider exactly what processes are important to them. Increasingly this importance is limited to purely front-office roles – for example, stock selection and alpha generation – and not those roles of the middle office, where the processing and production of data is becoming ever more onerous.

"A lot of fund managers are realising that they have more staff in the middle and back office and that's not right," says Susan Ebenston, the head of global fund services at JPMorgan Worldwide Securities Services.

Furthermore, many fund managers are satisfied that outsourcing performance measurement and attribution will not affect their client relationships. "There is a realisation among fund managers that you can outsource the process and the number crunching but keep the investment commentary inhouse," says James Hockley, business director at Investit, a UK-based consultancy. "A lot of the portfolio, accounting and valuation information already resides with the asset servicing firms, so the only question for the fund managers is whether the provider has the right expertise and technology."

> Entrusting a third party with anything client-related is something of a departure

Perhaps the biggest change in this new wave of outsourced services is the underlying demand coming from institutional investors. Whereas the back office lift-out deals of a few years ago created apprehension among investors that the fund manager was relinquishing control over their own operations, these same investors are positively demanding the involvement of third parties when it comes to the valuations of complex or illiquid assets such as over-the-counter derivatives.

The old practice of accepting a counterparty's valuation is no longer acceptable to investors – or to regulators, as recent amendments to the Ucits guidelines have shown.

"Since the recent crisis fund managers are more sensitive about the 'real' values of the complex assets in their portfolio," says Philippe Rozental, head of asset servicing at Société Générale Securities Services.

"They are looking for providers to challenge counterparties' prices and to meet the requirements of different control bodies."

The asset servicers have adopted one of two approaches for delivering valuations – the first is to take clients' positions and then send them to a number of valuations specialists, before aggregating the results and sending them on to the client. The second approach involves the asset manager creating their own pricing model and combining it with raw data in order to calculate an independent valuation from first principle.

Under the second approach asset managers would be able to agree and approve the model and methodology used by the asset servicer. Understandably, given the current focus on transparency, this latter approach is likely to be the preferred option of asset managers, despite the extra costs involved. "These are difficult assets to price and I think you have to be able to create the price and methodology independently and with transparency so that the client can see the working behind it," Ms Ebenston adds.

Developing an inhouse valuations service has become easier in the past 12 months. Initial fears about capacity have subsided as the market has evolved from a handful of specialists to a position where a number of standard models are available for asset servicers to use as the basis for their own calculations. This evolution is just as well, given that demand from institutional investors for independent valuations is set to increase.

Consequently, performance measurement and valuations are likely to go the way of fund accounting and administration – roles that were once performed inhouse but, through a combination of operational efficiency and good governance, are exclusively entrusted to third parties.

"Fund managers used to do their own accounting before they started to outsource it and now it's called fund accounting," says Lou Maiuri, global head of outsourcing at BNY Mellon Asset Servicing.

"I dislike the term 'outsourcing' and I hope that in the future this will all be called middle-office investment services."

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New rules offer the chance of reinvention

Ucits IV directive

The EU regulations offer opportunities for those who move quickly to take advantage, writes **Brian Bollen**

The European Commission's Ucits IV directive should lead to an even more efficient and competitive European Union asset management industry, in theory at least.

The challenge for the asset services industry is to position itself to take maximum advantage of the new opportunities it promises to generate. Much has been written about the directive in recent months. Much more will be written before it comes into effect – member states are required to implement it by July 1 2011. Any asset managers that have not already addressed it are running out of time, warns Sebastien Danloy, global head of sales at Société Générale Securities Services in Paris. The potential for change as a result of Ucits IV is vast.

Asset managers could benefit for at least four reasons. First, the newly simplified procedure to launch a cross-border fund in the EU could remove an entire layer of costs by reducing dependence on consultancy services. Second, in cases where asset managers opt to merge funds across borders, they will need fewer staff to manage those that remain. Third, they will need fewer service providers, capable of providing securities services globally as well as locally. Finally, the new ability to leverage a single management company across Europe will enable asset managers to close down those domestic asset management companies they have traditionally been required to incorporate to comply with local regulatory requirements.

Florence Fontan, in charge of public affairs for BNP Paribas Securities Services, says: "Asset managers will be able to manage funds locally in a less expensive way. It will remove barriers, make the market more efficient, and enhance co-operation between regulators."

Seán Páircéir, partner at Brown Brothers Harriman in Dublin and global head of regulatory strategy, says: "The dominant model is and remains the cross-border distribution of product located in a single domicile into multiple others.

"However, the directive allows for the 'local' branded distribution vehicles to be consolidated from an asset management perspective through the important new recognition of the master passing its Ucits diversification to the feeder. They should benefit from a better product and more choice than is currently possible." He adds: "It also gives a new tool to fund managers trying to build scale." The trick for asset managers is to approach each country bearing in mind investor needs and the characteristics of their own organisations.

Third-party support is needed, says RBC Dexia Investor Services, for a fund manager to better understand the complexities of local markets and to provide detailed local knowledge and expertise.

Paul North, head of product development at BNY Mellon, says: "Only big names with a footprint in multiple markets will be able to support multi-jurisdictional fund mandates."

As managers look to reduce the number of management companies in existence, they will need to consider the location of a centralised management company carefully, taking into account concerns surrounding the tax regime, the regulatory framework, and the availability of qualified personnel.

> Asset managers should approach each country bearing in mind investor needs

What is more, it is clearly better to use the same provider in different locations, says Jean-Michel Loehr of RBC Dexia. "Data integration is important, and data from two different services is unlikely to match, creating reconciliation risk," he says. "If a feeder suffered from an error cascading down from above there could be client and legal implications, and it is not clear who would have to assume liability."

Karen Hamilton, head of fund administration product development at Northern Trust, believes Ireland and Luxembourg will emerge clearly as the two most active jurisdictions. But she does not discount markets with strong investment management, such as France, Germany and the UK. "The low-tax fund domiciles such as Malta may also have some appeal but I expect it will be the more established markets that will dominate because clients will want to align themselves with strong regulatory regimes first and foremost," she says.

Providers that do not fully understand how the industry will need to change to meet client needs will find themselves reconsidering their presence in the new landscape. Ucits IV, says Mr Danloy, will be a step too far for some. Some will argue that the same could be said for some of their service providers. Size could prove a significant advantage, but specialisation could mean there is a sustainable business opportunity for smaller players too.

Successful administrators will be those that form partnerships with their distributors, adds Marty Dobbins, managing director at State Street Bank in Luxembourg. But the necessary tools do not come cheaply, concludes Revel Wood, deputy managing director of Northern Trust Fund Services Luxembourg. "It will be tough for small administrators without economies of scale to cope with the heavy investment needed."

Flags flutter at the Commission's headquarters in the Berlaymont building in Brussels AFP

Newcits present monitoring challenges

Regulated funds

Custodians and fund administrators must maintain their oversight, writes **Brian Bollen**

Hedge fund managers have responded to regulatory uncertainty and investor demand for liquidity and transparency by launching regulated versions of their strategies. In particular, they are using the flexibility offered by Ucits III, the European cross-border fund structure, which allows funds to engage in hedge fund-like investment activities, subject to constraints.

Someone has to ensure that such funds, known in the trade as Newcits, are Ucits-compliant at launch, and then remain so; this is causing custodians and fund administrators to add monitoring to their range of responsibilities.

While the development has been broadly welcomed, there are growing feelings that Newcits could be a threat to investors, alongside the challenges they offer to custodians. If the phrase "mis-selling scandal" were to be linked to Newcits, it could seriously damage the Ucits brand. Europe's work to create a truly harmonised pan-European fund structure with copper-bottomed investor credibility would be hit.

The challenges for custodians and administrators, then, in helping Newcits funds take full advantage of new opportunities without exposing investors to unwanted risk, are more complex than normal.

For institutions that already have a track record in servicing alternative investment funds, there has been little to do in terms of operational change. "You have to make sure that sufficiently regular net asset valuations [NAVs] are being carried out, and that the new funds are complying with their objectives and asset limits under Ucits," says Henry Raschen, HSBC Securities Services' head of regulatory affairs, Europe.

These compliance requirements can quickly begin to seem surreal for those who lack everyday contact with the industry. This is true, for instance, in the field of these NAVs. The trustless atmosphere around even the simplest financial product is such that a single valuation is no longer enough. "This has raised challenges for our clients when it comes to verifying the price of instruments being traded," says Stuart Plane, a director of Cadis, a data management specialist set up to address the problems facing the industry. "A lot of fund managers outsource their NAV calculations but they need to ensure that the price they are being given is correct."

> 'Not many firms are capable of handling... alternative Ucits funds'

The result is that even those that outsource their back office still need to receive data from other sources to cope with the regulatory burden they face. "As a result, we are increasingly seeing custodians and fund administrators as clients, to help them help their fund managers," says Mr Plane. "It's tough to keep up with regulations. To be Ucits III-compliant, you need a high quality middle- and back-office infrastructure delivering multiple inputs of data and processing. The firms that can cope with those demands are the ones that will succeed."

For those custodians and fund administrators that might not be doing enough preparatory legwork, the message is clear. The challenge for them is to manage every element of the trade process, notes Olivier Laurent, director of alternative investments at RBC Dexia. "Not many firms are capable of handling the requirements of alternative Ucits funds. Over time we will see new entrants, especially specialist hedge fund administrators allying OTC derivatives capabilities to their existing offer."

Vigilance is needed to ensure that Newcits are structured and managed appropriately, concludes Ian Headon, senior vice-president, hedge funds product at Northern Trust. "We have had healthy hedge fund and Ucits businesses for many years and have had the plumbing and the know-how to help clients keep compliant.

"There are no magic answers and there is no substitute for the hard graft of governance, control, reconciliations, exposure calculations and valuation processes to ensure there is no confusion about what clients are getting into."