THOUGHT LEADERSHIP ROUNDTABLE

THE FUTURE OF INVESTOR SERVICES

ATTENDEES:

Attendees: from left to right

TIM REUCROFT: director, research, Thomas Murray Ltd

TIM KEANEY: co-chief executive officer, The Bank of New York Mellon Asset Servicing

FRANCESCA CARNEVALE: editor, FTSE Global Markets

LUC LECLERCQ: head of IT and operations, Foreign & Colonial

PAUL STILLABOWER: global head of business development, Fund Services, HSBC Securities Services

ERIK GORIS: managing director, Goris & Partners BV

RONALD WUIJSTER: head of strategy & research, APG [via phone]

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PROFITS: EVEN IN CHALLENGING TIMES

TIM KEANEY: The year began with a credit crisis, which quickly escalated into a liquidity crisis. This resulted in a lot of change, largely driven by clients. There has been a fair degree of growth in terms of transaction volumes, a flight to quality and clients have been putting more money into cash and keeping it on the sidelines. The march away from equity markets into non-traditional investments continues to gather pace. It has been particularly interesting to see how investment trends have shifted. From an operational perspective, the bar has been raised. We are clearly in a period of zero tolerance. for a defect environment; especially these days, when everyone is broadcasting net asset values (NAVs), accounting and performance and risk data on a daily basis— indeed throughout the day. In terms of errors, there is nowhere to hide, as many investors and clients are basing important investment decisions on the information we provide them. Financially, we have enjoyed outsized earnings over the last 12 months: in part, because of the impact of the credit crisis; the impact a lack of liquidity has had on foreign exchange volatility; and what has happened in areas such as securities lending. Oddly enough, it has been a rather good environment for making money.

LUC LECLERCQ: Clients are reassessing what is happening in the markets. We see a flight towards different asset classes, compared to say 12 or more months ago. There is higher demand for protection; to secure returns. Therefore, while clients are increasingly interested in a higher level of sophistication, particularly instruments in the derivatives space, they are also more demanding and require better and quicker results in terms of performance or risk measurement. There has been a shift whereby clients no longer have traditional benchmarks as their main objectives. Moreover, they have a variety of requirements .

PAUL STILLABOWER: A key question for securities services businesses is whether we are in a V-shaped downturn with more volatility, and therefore trading revenues, or in a U-shaped downturn, where clients tend to trade less and move to less lucrative instruments. Right now, we continue to see trading activity. We see a lot of activity from hedge funds that are dealing with institutional investors that demand industrial strength administration services. As institutional investors push more money in that direction we see an increase in complexity of investments. It is also visible on the traditional side with UCITs III type vehicles, where there is more use of derivatives and sophisticated instruments. These developments are straining those businesses supporting these trends; either because the activity is happening in full employment markets, or because it is difficult to find people with the skill sets to deal with that increasing complexity. Therefore, the people side has become quite important for our businesses. Asset servicers and asset managers, prime brokers and investment banks are all looking for the same type of talent. Additionally, we still see a lot of interest (driven by macro demographic trends) in Asia and the Middle East, in spite of the market downturn. Because we have such a strong fund administration business and we have people and a bank support network in these markets, we have been growing quite quickly in that space. Again, it has not been without its challenges—given the difficulty finding staff to deal with the growth. Finally, post Bear Stearns, hedge funds specifically have been looking at de-risking their pure prime broker relationships. This has resulted in an opportunity, given the flight to quality, for asset servicing providers that are not prime brokers. Our ability to segregate their assets and not rehypothecate are advantages that hedge funds are starting to look at very seriously.

RONALD WUIJSTER: What has been important for us is that we cannot force a different pace from the long term horizon that our pension fund clients have. And we do mean long term. It does not only refer to the investment horizon, but also the ability to stay in deals and to make a liquid investment. Also, we have tried to become, as others are doing, more absolute return oriented. We have succeeded in that (partially, at least) though we need to go further. We still however, have a large equity exposure risk, which means that we suffer from declines in the equity markets. Consequently, we have tried to diversify our systematic risk a little bit. We have increased our investments in areas where we can earn a liquidity premium, and this in some instances has involved buying distressed risk. Moreover, we are exploring other, alternative risk factors that are of interest for long term investors. Of course, at the same time, the only short term factor that we have to take into account is corporate ratios because of our central bank, which is the regulator of the benchmarks that we manage money for. Up to now though, we still appear to be in safe territory, so we can keep our focus on our longer term investments.

TIM REUCROFT: There has been a major collision between two very interesting trends. The first is that everyone is moving into alpha, away from beta. Beta is so cheap these days. You can buy ETFs and get beta for virtually nothing. Everyone is going for absolute returns. Institutional investors are coming to us and saying: "Our fund managers now are into all sorts of funky products, OTC derivatives, and new asset classes. Our custodians cannot handle them and we are being forced into the prime broker solution and we don't know what we are doing either." There have been a lot of cries for help. That trend then collided with the credit crunch. This was extremely interesting, because there was a credit bubble, where people could not quite price credit correctly. When they found that they could not price it, there was suddenly a massive freeze on liquidity and the central banks' response to that was to pump loads and loads of money into the system. That did nothing to help those people who had sub prime mortgages in the United States. All it did was bail out their own church—the broker/dealers and the investment banks. The result? When you pump loads of money into the system, interest

rates go down. When interest rates go down (and this is where the problem starts), commodity prices go up. What you have done is transfer one asset bubble (the credit bubble) into another asset bubble (which is now the commodities bubble).The trouble is that it is not a temporary bubble; it is a Pandora's Box! Once opened, it will not go away. So what we now have is two crises, where previously we had one. That has also exacerbated the fact that there is a lot of alpha in commodities, so people have been encouraged to chase that because it is a win/win game and it is going up and up.

ERIK GORIS: The last twelve months have put most investment strategies and models to the test. Many institutional investors made significant changes to their investment portfolios in search of alpha, diversifying further into alternative investment classes and increasing their use of derivatives and other complex instruments. These posed new challenges for asset servicing companies. Certain investors, in particular the small to mid-sized pension funds, tried to regain control of their asset management function after the dotcom crisis in the early 2000s. In an environment of increased regulation and financial requirements, they looked for new models to structure their asset management organisation and operations, as well as increase returns. For example, the concept of fiduciary management strongly emerged in the Netherlands and is still growing in importance. However, these models are now being put to the test and they are showing very mixed results. The Holy Grail of fiduciary management embraced by a significant number of pension funds ultimately still depends on the quality of the underlying asset managers—something that people may have forgotten. Additionally, certain legislation by regulators designed to increase focus on sound governance and operations may have had the opposite effect and increased the complexity of pension fund operations. It will be interesting to see how these new models and organisational structures emerge from the current turmoil.

… WE ARE ALL IN THIS TOGETHER, TO GET IT RIGHT

FRANCESCA: Do you think that the change is of a degree that it will redefine the relationship between investment service providers and their clients?

PAUL STILLABOWER: There has to be a sufficient amount of investment, not just in technology, but in people, which I have already noted. I guess one of the factors is that we are all in this together. There is a vested interest in everyone getting this right. It is not just about an ability to process a derivative. It is a market issue and it involves standardisation of products, the paperwork, legal contracts, and there needs to be a change in taking some of the operational risk out of the market. Certainly, asset servicing firms are well placed. We spend a lot of money on technology. It is a very difficult business to get into if you have not already made the investment in the infrastructure. One of the areas we are focusing on is our core

TIM KEANEY, co-chief executive officer, The Bank of New York Mellon Asset Servicing

clients. We are spending a lot of time ensuring that we meet the needs of our existing clients since client retention is a key driver of profitability. Fund administration is a particular product that scales almost imperceptively, and it is extremely sticky; whereas custody tends to be a more commoditised product, and where the profit in the industry is generated. Balancing all that is a challenge. You cannot just give away all of the hard products without any return, and that probably comes to Erik's point, where customers need convincing that the price of processing some of these instruments is, and should be, higher. Moreover, there is a higher risk of error in processing complex instruments. Service providers cannot do these things for free and take all the risk, so there has to be some sort of balancing act. Perhaps re-pricing of risk servicing in the industry is coming.

TIM REUCROFT: In fact, the industry has changed already and gone through a paradigm shift. We cannot go back to how it used to be. Some custodians have systems that are hard coded, so that they cannot hold short positions, because in the traditional world you were never allowed to have short positions. However, that simply does not work anymore. These days you are running extension strategies and involved in stock lending and borrowing, and thereby running short positions. The game has changed completely. If I can pick up on what Paul says on taking operational risk out of the system. This is fascinating because, if you look at the history of regulation, there was an almighty crash in the 1980s and, at the time, regulators said that you had to put capital aside against market risk. People did that and realised they could use exchange rate derivatives and hedge against their market risk. Then the regulators said: "We don't like counterparty risk and we think you should put some capital aside to mitigate it." Then some bright spark came up with credit default swaps, and we know what happened then. Subsequently, it

LUC LECLERCQ, head of IT and operations, Foreign & Colonial

got out of control and there was a glut of operational risk, resulting in a nightmare. What are the regulators saying now? They are saying: "We don't like all the operational risks". Invariably then, some bright spark will figure out a way to transfer operational risk through the system and we will be back to where we were before. In fact, it is the regulator who is driving half the problems we are facing in the first place. Actually, you do need to take operational risk out of the system, but the regulator will put it back in again.

TIM KEANEY: Step back 10 years and 100% of our profit in asset servicing came from custody, whereas today only a modest amount is derived from custody. If I look at the paradigm shift that has taken place, it has demanded a substantial transformation in the knowledge-base of the people in this business. Some of our smartest people can today be found in the new business development and client relationship areas. Why is that? Because they are at the sharp end, dealing with clients who are evolving their investment models. They understand the nature of these changes and can help position our company to ensure we have the right technology and processes at the right time to better support clients' changing needs. This is a knowledge worker business because it is now a front office business. Asset servicing is accorded the same stature in our company as asset management. This year we will spend around 15% of our top line revenue on technology: the equivalent of a drug company's spending on research and development, and that is a statistic that still grabs my attention to this day. About a third of that I would characterise as keeping the lights on and keeping the factory running; another third is spent to address regulatory requirements and other duties I am compelled to carry out. The final third is spent on developing new products and services, which ties back into changing client needs.

RONALD WUIJSTER: Technology, processes and services have become more important for us as well. As an organisation we are moving in the direction of a true multi-client environment for the first time. We did manage smaller pension funds before, but now we are moving towards a more open market environment and we do feel that our processes, technology and IT are playing a crucial role in our service range. We want to be the best pension fund investor in the world and we think that if you look at our investment process and our portfolio construction, the way we manage assets, we are already there or almost there. We also have an innovative approach to investment, which generally needs little additional work. However, our processes and technology need to be flexible and adapt to change, so there is a lot we still have to do in that space. Also our asset service suppliers play a crucial role in this regard. What we do now more than before is partnering. I heard the example earlier of complex products, and I can provide as an example of this in action. Our back office is partnering with a service supplier to deliver a better quality product to the front office. It is not that we want to be the best in everything ourselves, simply that we are taking more of a partnering approach to our growing requirements.

LUC LECLERCQ: Our business depends on a number of service providers. Each of them now faces very different challenges. Firstly, the broker community is facing liquidity constraints and is constantly reviewing counterparty risk, which has an effect on trading and the turnaround of legal documents such as ISDAs. Secondly, data service providers also face difficulties regarding the services they offer. Everyone has seen the problems with asset backed securities prices. Therefore, finding the right data provider is not only difficult, but also it has become (sometimes) very costly. Thirdly, custodians have always faced demand for change, but the speed of execution demanded now is higher than twelve months ago and some are struggling to come up with the right expertise and knowledge required by the market. Fourthly, the software providers are under pressure to keep up with the pace of change. There is not one provider who is capable of giving us a complete solution for most of the asset classes we are active in. Moreover, the speed of software release is becoming much longer and the cost of release is increasing. Bringing all these strands together, we all see that things are becoming much more complicated.

ERIK GORIS: We have noted two issues. One is that most institutional clients that we represent in custody searches do not recognise the intricacy and complexity of the structures that asset service companies have to provide a solution for. So from the client side there often is less appreciation of the processes and issues that are brought up during the selection process and the implementation phase thereafter. This has implications for the pricing of these services, both for core custody services as well as value-added services. Looking at that aspect of the custody business, the front office function has become more important for asset servicing companies. Their job is to

create both awareness with clients as well as establish a working relationship. This is particularly important for the less sophisticated investor. Of course, investors such as APG know what they are looking at. But there is a vast group of institutional investors that is not as familiar with the level of complexity of asset servicing. The other issue is technology spending. Looking at custody searches we performed over the past five years, the group of global custody providers has shrunk immensely. Other than through consolidation in the sector, one of the key factors is the vast amount of technology spending that the leading companies have continuously invested in infrastructure and processes. As a result, the leading global custody providers have widened the gap with the rest of the competition.

DIVERGING DEMANDS

FRANCESCA: Do you get a sense that the market is dividing into the "über funds" with sophisticated requirements and are ahead of the curve, and they are straining at the limits of investor services provision? Then there are small and mid sized funds that are aiming for sophistication and then those funds with more traditional custody requirements? Is it the need to service such a wide spectrum of requirements nowadays that is straining the provision of investor services?

TIM KEANEY: Larger organisations tend to be the ones pushing the envelope in respect of sophistication and complexity. Yes, that is a very fair point and this has been driven in part by the under-funded nature of the pension systems in certain markets, such as the United States and the United Kingdom. That scenario has been pushing investors to diversify their assets in their constant search for alpha. It has been interesting though to see the growing level of sophistication among investors, with alternative fund managers grabbing a larger share of wallet as a result of changing investor trends. So whether it is real estate, private equity, 130/30 funds, venture capital or derivatives from alternative asset managers, they have been hugely innovative. So, on the one hand, yes, you see investors, the owners of the assets, diversifying into higher returning asset classes. On the other side are the fund management communities, which have been very quick to innovate and come up with new products, and which continue to impel asset servicers to expand the boundaries of our own product range. So, to summarise, the larger funds and alternative asset managers in general have been driving product innovation.

PAUL STILLABOWER: That's right. Everyone has their anchor clients—their über clients—who keep the lights on in the business by eating up fixed costs. However, über clients have pricing power and therefore it is generally the middle client segment that tends to be more profitable. As Tim says, in particular product areas you need innovative clients to drive forward your product development. But it is a balancing act, because you cannot do that for every client because of the cost of constantly developing product. Those very small innovators tend over time to be either acquired, partnered, or replicated by competitors. There are few successful strategies that are not quickly replicated by large managers with deep resources, expertise and capital to buy in expertise to do this. So, small innovators might occasionally hit a home run, but on balance stay small, or specialised, and therefore it is uneconomic to just focus on small, innovative clients.

THAT NATIONAL/INTERNATIONAL DYNAMIC

FRANCESCA: Is investor services today a game best played by giants?

PAUL STILLABOWER: It is a game of giants, though it is still changing constantly. There are a handful of providers who can say they are truly global. But in the main it is a national industry—not global. There are national banks who provide these services all over the world. This is the change from a custody industry to a fund administration and middle office services industry, which are very intensive and hard to scale services—whether in Europe, where there are a couple of huge offshore centres, and certainly in Asia and the Middle East, where for the most part you have to be on the ground with local employees. If you look ahead, say ten or 15 years, the Chinese banks will be large players in the industry; much like the Japanese banks were in the 1980s, driven by their massive national stock market. One of the things to consider, and we have seen this in Europe, is that local banks are very hard to dislodge from local customers, because they lend money, they offer distribution and provide other banking services. That strength at the grass roots therefore that you find in Europe, or Middle East or in Asia, means that there are local banks to contend with. It is a challenge for a foreign firm, for example, to provide services for a South Korean fund that in local terms is huge, but in global terms is not: being local in faster growth markets is an important objective for service providers right now.

TIM KEANEY: Paul makes an excellent point. If you take the investible assets around the world, somewhere around $120trn, only about a third are in the United States. And what you see as you travel around the world is that 80% to 85% of the assets stay local. For example, French investors invest primarily in the French mutual fund market and only about 15% to 20% of assets are cross-border. It is those cross-border flows that the global custodians are competing for. As the conditions change for global custodians, the scale model that we have seen emerge in the market will give rise to opportunities for the global players to encroach more and more into the local frame. For our part, BNY Mellon is already local in a number of key markets —the US, the UK, the Netherlands—and we are looking to expand into certain markets with strong growth characteristics, and our ambition to do so is increasing.

PAUL STILLABOWER: And there really is only a handful of banks that can do that.

TIM REUCROFT: The outbound business from a lot of these emerging markets is only just starting. You have QDII which is taking off in China and the sovereign funds setting up in Russia. That money is just starting to move abroad. At the moment the only candidates who can handle that are one or two American and European global custodians. But it will not be long before you see VTB and Sberbank become global custodians, and it won't be long before you see China Construction Bank become a global custodian. They will start to carry a lot of this outbound business. Clearly they will come up against some of the same problems that other global custodians have got in handling all these varied asset classes.

TIM KEANEY: There has been a generational change in the leadership running many of the large financial institutions across Europe. Historically, firms have taken a more localised approach to the asset servicing business, and we now see chief executive officers and their executive boards seeking greater transparency and pulling businesses apart to better understand them. It has been interesting to observe one of the bigger players in Italy exiting a couple of years ago and to see a couple of German players exit for exactly the reasons that you have described, Tim. They are feeling the same pressure as their own asset management businesses and their underlying clients—they are utilising and having to support derivatives and are having to figure out ways to invest in the technology that they require to do that. Everyone is feeling the same pressure, whether you are on a small patch or a big patch.

ERIK GORIS: Clients are looking for this global solution, which means that they are currently looking at a group of global custodians that has become smaller over the past years because of market consolidation and exiting providers. The issue is, however, that because core custody services do not yield as much income as they used to, asset service providers have developed a range of value added services. A lot of our clients, though, are just looking for one point of contact for asset servicing in a global solution and a limited use of value added services. They do not run sophisticated investment portfolios to the extent other investors and asset management firms do. So our clients often, as we phrase it, are offered a Ferrari to do their groceries! It is a state-of-the-art service offfering, but too complex for the client. This is where it becomes difficult since choices for a one-stop global solution are limited, but these service providers actually only thrive on income from value added services.

RONALD WUIJSTER: What we are trying to do, which is related, is to offer a unique and integrated solution to our pension fund clients. So we offer pension fund administration, communication and asset management and that all in one go as an integrated solution to them. We try to have everything in range, but also be innovative in all aspects of this. We try to offer them something unique, so in that sense we are different. Our main focus is on the benefits to clients and our approach is that they should take our full proposition so that there is no cherry picking. It is not the most commercial approach maybe, but it is the approach that we think will work for us.

NEW ROLES, NEW PLAYERS

FRANCESCA: Are large fund management firms assuming some of the work and characteristics of investor services providers, perhaps because there is less choice out in the marketplace?

LUC LECLERCQ: I do think there are less players, but in contrast to five or ten years ago we can change some service providers quite easily, particularly in the custody space. This added flexibility compensates the fact there are less players in the market. We see that the big providers are increasing their service offerings in line with demand of the client/market. However, the increasing customisation of services and the shortening of the lead time to bring a product to market puts the providers under extra strain. This can lead to an increase of costs charged to the clients and will trigger the clients to look for alternatives, such as doing it in-house or looking for an alternative kind of provider. As such, we see that in the derivatives space the traditional providers are 'complemented', or in some cases replaced, by new players such as central clearing parties and clearing houses. Let's not forget that ten or fifteen years ago, the clearing houses themselves were not capable of doing a third of what they do now. So you are right, the number of players are reducing, but there are a number of other players coming along.

TIM REUCROFT: Going back to the question directly, what is happening is fascinating and what we see is that a lot of what are traditional institutional investors are now behaving like traders. They have recruited people in investment banks who trade by nature, and they have put 5% of their portfolio into hedge funds. You buy a hedge fund and you have no idea what is inside it. It could be completely toxic, right? So actually, some say that they don't like doing that, so what they do is begin to replicate what the hedge funds are doing. They hire a trader and he can represent or replicate whatever arbitrage strategy the hedge fund was doing in-house. That has taken them right down the trading end of the spectrum. As a consequence, the custodian, who used to provide back office services for the traditional long-only positions, is having to change, because the trader wants middle office. A lot of the custodians, I would argue, are not in that space. Or have not been in that space and are now scrambling to get there. That is creating all sorts of issues, and there are a lot of acquisitions going on and they have to integrate all sorts of different platforms and it is a bit of a mess. Nobody has succeeded in doing that. There is not a single provider out there who has solved this. I challenge anybody around the table to come up with a name, but you are not allowed to nominate your own bank, who has really solved this problem.

PAUL STILLABOWER: Providing investor services is like building a spaceship! It is complex. It is not something that just comes out of a box on the shelf. It requires investment in complex products: it is the data warehouse; it is the independent pricing engine, corporate actions, trade

matching in the middle office services, etc. It takes time to get new products right. I do think there is an element of fund managers starting some things in-house, and the question is: is that where they intend them to be forever? Probably not. But products have to become replicable and scalable if providers are to make them industrial strength. At the side of all this, of course, is the question of risk management. We have chief executives asking whether there is a $5bn fraud in here somewhere, or is someone mispricing investments or holding illiquid products. So there is an element, of course, of wanting to have some control over new products, and a feeling that providers are not fully ready for some products. It is clear though that providers will spend to develop in products. It is just a question of how quickly you can make the right investment and implement the right technology and get the right people.

LUC LECLERCQ: Custodial activity generates extra income from stock lending and FX and might make the custody business model self-sufficient. If you are moving towards the middle office space, you are moving away from standardisation and are confronted with a high level of sophistication and customisation. On top of this, you are taking more risk. A good example of increased risk is the treasury function in the middle office segment. It would be interesting to learn how you cope with this because, for us being on the receiving side, your business model is not always clear.

TIM KEANEY: Let me zero in on the middle office as an example. If I took my shirt off, you would see the scars on my back from my past dealings in the middle office arena! Back in the day it was the bigger asset managers that outsourced the middle office. Organisations ran into problems in a bear market, there was a profit challenge in the fund management industry and consequently we saw a mushrooming in middle office outsourcing among asset managers. As they tended to be the bigger guys, they had the pricing power and were demanding about just how they wanted their middle office to work. As an industry we were very quick to recognise that this could be a big business opportunity, and so we took out our hammers and our screwdrivers and bent our plumbing to support these clients – but in hindsight maybe we were a little naïve about just how that would work out in reality, given the inherently bespoke nature of many of those mandates. Interestingly, the market that has quietly developed almost unnoticed is the mid and small sized fund manager segment, and they have been very, very open to taking a standardised approach and in recognising the trade-off between costs and customisation. As our industry matures and we get a more scalable model, I am starting to see more and more of the big managers saying: "Look, I don't want to put a large round peg in a square hole. If you can articulate how your middle office works and demonstrate it to me, I am much more willing today to consider a standardised process than I might have been four or five years ago." So watch this space: middle office outsourcing is going to come back on the upswing.

PAUL STILLABOWER, global head of business development, Fund Services, HSBC Securities Services

TIM REUCROFT: There is a lot of convergence going on. I mean, you would not dream of settling Crest transactions bilaterally would you? So you have a utility in the middle there, that makes standardised straight through processing and everything a lot, lot easier. Now what we are seeing is that those utilities are now emerging in the OTC derivatives space. To a certain extent, you can say they were forced upon us by the regulators when the credit default swaps crisis blew up. But those utilities solutions, such as Deriv/SERV and SwapsWire etc, were designed by investment banks and the problem is that the custodians have been slow to join. What you have to do is batter the door down, really get to the table and make sure those utilities are run in your own interests as well as everybody else's. If you can do that and achieve functional convergence, so that exchange trading derivatives, cash markets and OTC derivatives all look pretty much the same, then it becomes much easier for you: same model, but you just plug it in different product lines. Life then becomes a lot easier, particularly if you are running IT. So there are solutions out there.

FRANCESCA: Has the custodian side has been a bit slow off the mark in this regard? Is it the investment banking side of the business that might now set the pace of change?

TIM REUCROFT: Yes, because the investment banks have had to become involved to support their own prime broking operations. We are extremely fortunate that there are no prime brokers in the global custody space, because

ERIK GORIS, managing director, Goris & Partners BV

they mainly pulled out a few years ago. There are one or two that have still got prime brokerage operations and there are one or two that still have custody operations: Citi and JPMorgan spring to mind. They have been threatening to put them together, but never succeeded. I presume they are still working on it. It comes back to my earlier point that there is nobody out there who has been able to combine all these asset classes and products.

TOWARDS UCITS IV

FRANCESCA: I believe that in the last few months the European Commission has said it wants to move ahead with UCITs IV, once it comes into play and you have a true European passport. What impact do you think that will have on the provision of services to the investment industry?
TIM KEANEY: It is good for investors, it is good for the industry. It is going to lower the cost of providing fund administration when you can develop one investment strategy and market it to 11 different markets. Generally, anything that is good for investors is good for asset servicing providers like ourselves. UCITs IV certainly raises the level of sophistication, and that sophistication will only continue to increase – and as it does, institutions will be driven to assess their own core competencies. "Am I going to be a distributor of investment product? Am I going to be a manufacturer of investment product?" One example that sticks with me is Pioneer Asset Management: it closed down $10bn of Italian domiciled funds and transferred them to Luxembourg to sell them back into Italy. In the process it lowered the cost of administration, it improved the after-fee performance of its funds, and it created a tax advantage for the investor. That is a very good example of the power of UCITs. I believe it is terrific and will lead to significant growth in the choices open to investors.
LUC LECLERCQ: What you forgot to say is that you will lower your costs as well!
TIM KEANEY: Yes, that is true, because we clearly have a scale model. I would say that every two or three years it leads to our clients coming back to the table, wanting us to share the benefits of our scale with them through a lower rate card. It is a key element of our business today.
TIM REUCROFT: If you look back, you used to be able to buy indices and buy unit trusts to invest in certain countries and you could buy into the beta of certain markets fairly easily as an individual investor. But nowadays you can buy ETFs and have done. I am looking for the time when hedge funds effectively go on exchange. UCITs IV is essentially going to take us in that direction. With these things people are going to get used to effectively investing in alpha. Now you get beta through an ETF, if you buy into UCITs IV you buy alpha, so then it is only a question of time before that itself goes on to the exchange and then people can buy and sell them. Obviously that will improve the volumes. But what it does for the custody business, I am not quite sure. I have not figured that out yet. But for the end investor it is fantastic as you can choose how much beta or alpha you want. You can do your global asset allocations. It is fantastic.
TIM KEANEY: The other interesting variant on this theme is ETFs. I may be a little off on my timeframe, but as I recall a little over a year ago I hardly noticed any ETFs listed on the London Stock Exchange. The last time I took a peek, the total stood at over 120 or so. Regarding the point you were making earlier Tim, about the separation of alpha and beta, one of the spaces to watch is what is going to happen to ETFs. They are very cost-effective, and I know that in the US the regulators have said they will speed up the approval process for ETFs. There are actively traded ETFs now, commodity ETFs, there are tax-efficient ETFs. So from my perch as a custodian/asset servicer, it will be fascinating to see just how big a global phenomenon ETFs become.
LUC LECLERCQ: What is the impact on your business model? With the introduction of these products, there are a lot of transactions that you will not see going through your books, since they are cleared and settled elsewhere.
PAUL STILLABOWER: ETFs are quite interesting. We support a lot of ETFs in Asia and you are kind of getting three or four bites of the cherry, as service providers. For example, we get fees for transfer agency, for fund administration, for global custody, the sub-custody. As a universal bank, the interesting thing is that there are three more bites of the cherry: there is the asset management fee, the structuring fee and the equity financing fee. As products they are very interesting and certainly we see an opportunity to put, for example, an HSBC brand on an emerging market ETF which would provide a group-wide product benefitting multiple divisions.
LUC LECLERCQ: So that goes outside of your classical view of custodian/asset management provider? The structuring would be done by other parts of your bank's business.

PAUL STILLABOWER: Yes, it is other parts of the organisation, but that is one of the benefits of a universal bank model, or providers that have the multiple components. As well, regarding internalisation where you have different parts of one organisation that require securities services and they are pushing boundaries and you co-develop together, it is one of the exciting elements for a universal bank.

TIM REUCROFT: The old transaction banking model is pretty much broken. The idea of putting cash and custody together worked great for ten or fifteen years, but now it is all changed because you have all these new products and asset classes. One of the things that HSBC, for instance, has been successful at is that they do run a separate network management for exchange traded derivatives. You cannot always go to the traditional custody providers for exchange traded derivatives, because it is a completely different network, with different providers, so you have to run it separately, and you are going to have to run different networks for prime brokers and OTC derivatives and many other asset classes. The transaction banking model is holed and is now sinking underwater, and you have to start looking at these new models.

RISK MANAGEMENT

LUC LECLERCQ: You have to distinguish between risk management and risk measurement. Around the table we all do risk measurement, but few do risk management, which is a front office function. Given the volatile markets, the requests from the fund managers, the sophistication of our clients, the demands from regulators and external advisors, risk measurement becomes more and more important next to risk management.

PAUL STILLABOWER: The very last thing anyone would do today is to go into their board and to say that a new product is risk free. That is probably the fastest ticket out of the boardroom with zero dollars to spend!

ERIK GORIS: Our clients are looking at their custody provider to monitor investment guidelines and restrictions as well as provide risk measurement. The service level required for these services is also becoming more intricate. In terms of risk management, parties are looking to unload these activities either to an asset manager or to the asset service provider. On another level, looking at counterparty risk, investors are increasingly questioning asset service providers about risk management at the service provider itself. Previously clients would look at e.g. financial robustness, management and people. Currently we review all aspects of asset service providers ranging from core processes to disaster back-up procedures, as well as how risk management as a firm is being conducted by service providers.

TIM KEANEY: We are being invited in more frequently by financial institutions that are looking at launching new products. And we are now being brought in earlier in the process, because once a decision is made to alter an investment style or launch a new product, the length of time from formulation of the idea to new product launch is about half of what it was just a few years ago. As a result, and I kind of like this, we have the opportunity to understand early on the scope of the operational and risk implications in supporting that change. When you are our size and you put it in the context of us custodising 9% of General Motors shares, for instance, then if we make a mistake on a corporate action for General Motors, or an income item—and imagine overpaying investors when you custodise and process 9% of General Motors— then that is measured in earnings per share. It is on the front of the Wall Street Journal and the front page of the FT. That harsh reality will drive the industry to the faster adaptation of standards (notably in respect of derivatives) but it will also drive people down into the engine room together to figure out the best ways of launching the product quickly and with the least possible amount of risk.

PAUL STILLABOWER: There are a couple of good examples of change, in the area of risk management, which have always been there, but had kind of been forgotten about. Two examples have come up really over the last two years. One is where the institutional investors are directing a lot of money into alternative investments and they are asking questions about the back office, the administrator, the custodian, the support mechanisms. If they are going to invest $500m into a fund, they want to have some understanding of who is doing the back end processing. Then secondly, specifically out of, or just after Bear Stearns' collapse, you have hedge funds starting to ask about the pooled account model of prime brokers and what happens around rehypothecation of assets, or what happens if another hedge fund goes down the tubes and assets are in a pooled account and get frozen until an administration company sorts out the ownership issue. The threat of not being able to trade for a period of time scares hedge funds. So they are starting to move assets not required as collateral from the prime brokers. Then it is not a big reach to move the financing to say a professional custody bank that will properly segregate their assets. And then, one step further, if the hedge funds don't really require the financing for leverage, or they are funded by institutional investors instead of a prime broker, do they really need to be a prime broker at all?

THE FUTURE?

FRANCESCA: What will be the important influences on your businesses over the next five years, how are you preparing for it and what might the future of investment services be?

PAUL STILLABOWER: The $64m question! At HSBC we are sticking to the roots of the organisation. The securities services business is following the bank footprint. We believe in the universal bank model and we have moved a lot closer to joining up the bank in the last few years, for example, with the investment management business, the global markets division and private banking. In macro terms, we like the long term demographics, which indicate continued faster growth in the investor base in Asia and the Middle East and in parts of Europe. That trend favours HSBC because we have a strong brand (we have a retail and bricks and mortar in those markets) and balance sheet in those markets. We are

investing heavily in the two trends that we talked a lot about today, which centre around the convergence of traditional and alternative managers and the increase in complex investments. We are focused in our spend, on reusing our technology dollars, attracting people that have different talents, that as Tim said are really required in today's business. So it is and will continue to be—in spite of the immediate downturn, which is perhaps starting to look more U-shaped than perhaps we would like—a good long term growth business. We are also investing heavily in the business because it is one of the fastest growing parts of HSBC.

ERIK GORIS: Looking from the investor side again, as was mentioned earlier, there is a need for increased flexibility in supporting alternative investments because clients want to invest in these products and need somebody to service those assets. It becomes important for the industry to provide a sophisticated level of reporting and risk measurement because we see a lot of demand there from our clients. This is also driven by improved supervision and scrutiny regarding pension funds on those issues, on understanding what actually is in their portfolio and the inherent risk level. They are important elements of the service provision that clients will look for and that will be high on the list for selecting and choosing service providers.

TIM KEANEY: From our perspective, we are going to step out from being just a global house and supporting cross-border investors. We want to take our game, our intellectual capital and apply that to local markets where we can help and drive change in a competitive landscape in a selective fashion. One of the big changes I know I am bracing for is when clients start to bind asset servicers to a hook. Fiduciaries and fund managers are going to say: "If you give me a calculation, you will have to put your imprimatur, your guarantee, on that." No get out of jail free card. They will expect us to be comfortable with putting a valuation on their assets because they will be acting on that valuation. It is a game change. It is now all about those companies who put the capital investment, the people and the expertise behind their brand and who are prepared to put a 'Good Housekeeping' seal of approval on valuations of assets that are fluctuating quite rapidly.

LUC LECLERCQ: One of the main drivers to make the industry successful is standardisation, but unfortunately this is lacking. We had some great successes such as Swift but we need more in order to push the industry and technology forward. Transactions could be processed so much easier if clear industry standards would be available and applied. The technology will enable us in the future to track transactions from inception to settlement across providers. This will not only enable us to better understand the status of each event but also reduce potential errors.

FRANCESCA: Tim, obviously the clearing and settlement landscape is undergoing massive change, with DTCC coming into Europe and this ambivalent relationship between Euroclear and Clearstream and now the rise of the new trading venues with their own clearing and settlement arrangements. It is an increasingly fragmented landscape. What are the key issues that have to be addressed for you?

TIM REUCROFT: There was a metaphysical debate a few years ago, asking should we have competition or consolidation in the post trade landscape? The debate was won in favour of consolidation and Europe has set out to do that. I take my hat off to Euroclear (though I do not agree about the way that they went about it). They were open and said they were going to consolidate the CSDs. However, they are also an ICSD—effectively a global custodian—and they used that position to compete with the global custodians in Europe. Quite rightly Citi, BNP Paribas and a few others under the Fair & Clear banner said: "No, that's not right. You have access to CSDs and we don't; you also have direct access to central bank funds via the integrated model which none of the other clearing banks in Europe have either. This cannot be fair." However, Euroclear's justification is that the only way to reduce the cost of cross-border settlement in Europe is by taking out the cost of the agent banks (which is where the majority of the cost is). So, the Euroclear business model is good, but the way they went about is (perhaps) bad. Fair and Clear fought back and whispered in the ear of the ECB saying "Wouldn't it be better if you came up with a pan-European solution called Target 2 Securities (T2S)?" Now I do not think that this is the solution to Euroclear, because T2S will not work. It does not have a financial justification. Central banks are not in the business of clearing and settlement (they do not provide uncollateralised lending, so cannot oil the wheels of settlement); T2S does not deal with the retail model (that is a whole separate argument) and there is no belief that the ECB will deliver what they say they will deliver. The main problem is however, that it effectively puts Europe on hold until 2013, because one of the basics of their financial case is that there are no more changes made by CSDs. We are not going to do any Giovannini work anymore because the ECB says we can't, otherwise it destroys its business case for T2S. So that sets back the agenda for everybody. Now, that might suit some of the custodian banks, because it means that CSDs are no longer in a position to really compete with them, but the problem is if the CSDs see themselves as being nationalised by the ECB. That is essentially what the ECB is doing, taking this money away from the CSDs and the CSDs are saying: "Naturally we want to survive and the only way we can do that is by going up the value chain and taking on the business of the global custodians." Then you are back to where you were before, with everyone objecting to what Euroclear was doing and going up the value chain and competing with the global custodians. And you have just recreated that by threatening all the CSDs in Europe. It is a very scary landscape.

FRANCESCA: Tim, do you find it a lot easier in the US, where you have this rolled up system, compared with Europe where it is very fragmented and where you have the vertical system and the horizontal system or the bank system to deal with?

TIM KEANEY: We like the DTCC model. It is scalable and the people that bring volume to it have a say in its governance. That is one of the things that has to be looked

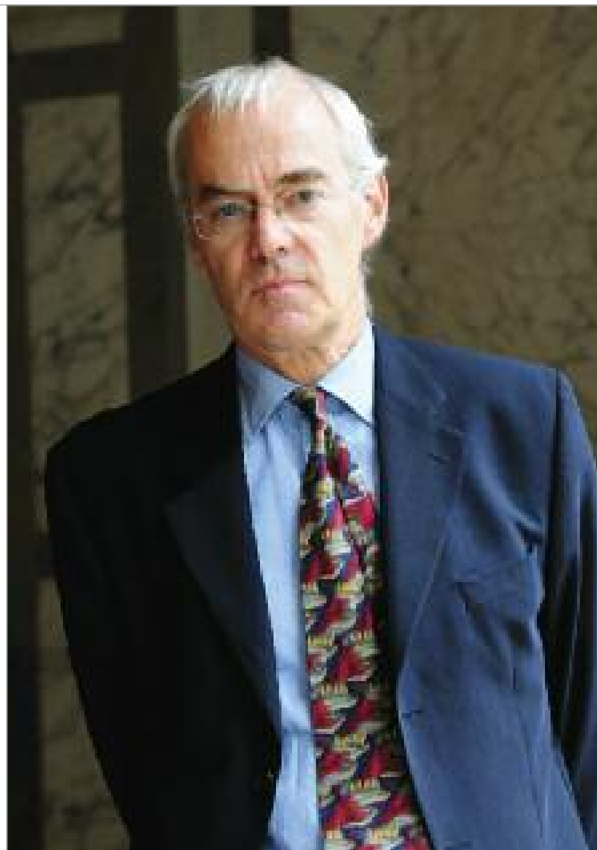
at quite carefully in the European context, and in a few years we will have moved on to talking about the Asia-Pacific infrastructure. So yes, when you look at what T2S is costing, at what Clearstream and Euroclear are spending, it is unsustainable. That is one of the reasons why it costs eight times more to process equity trades in Europe than it does in the US, and that has got to change. I also think that a lot of volume should be pumping through this, but I worry about a for-profit infrastructure. Whether that infrastructure is vertical or horizontal, the industry—and global custodians—need to be more forceful when it comes to driving that change onto the agenda in Europe, where it is a more user-oriented model and where the people that are bringing the volume have a major say in the governance model. So yes, it is calling out for more scale, everyone cannot continue spending hundreds of millions of euros and not expect to see cost efficiencies in respect of equity trades over here. It simply has to change.

PAUL STILLABOWER: The more infrastructure consolidates, the more there is standardisation in the infrastructure, the more comfortable citizens will be to invest more in the market. And that should benefit investors and that therefore benefits us. That eventually will happen, whether that has to be prescribed by government or not, it is inevitable. It is clear that there is enough vested interest in continuing to make money that slows the whole consolidation and standardisation process down, which is why it is something that may have to be prescribed, but certainly trends like UCITs IV and the passport plan in Europe, mean that eventually standardisation will come. It is unfortunate that in the meantime it is so painful to get there. But certainly if you made it easier and more transparent in the processing you would have much more investment, and that would mean a larger and healthier industry.

FRANCESCA: With no immediate resolution in sight, do you see more or less pain?

TIM REUCROFT: It has gotten worse because of the MTFs, because you now have EuroCCP, Citibank is the settlement agent for Turquoise, you have EMCF and Fortis acting as settlement agent for ChiX, so that has confused everybody. You have the PEP market opening up in NASDAQ/OMX, and they are going to use the EMCF solution, you have Burgundy threatening up in the Nordics and they have not yet announced what their post trade solution is going to be. So the whole thing is getting really confused and getting confused at the exchange end, as well as at the settlement end. All the MTFs are taking liquidity off the exchanges; MiFID just missed the target completely. It went for best execution when really it should have gone for price discovery.

TIM KEANEY: Complexity is not just down to infrastructure, it is also a function of the diversity of tax rules within Europe. Look at the tax rules in places such as France. Furthermore, when do you own a stock and when do you not own a stock? Is it trade date or is it settlement date? The exchanges are one aspect of all this, sure, but the regulators also need to sit down and demonstrate a greater sense of urgency when it comes to harmonisation efforts.



TIM REUCROFT, director, research, Thomas Murray Ltd

ERIK GORIS: It is a step too far, maybe even for us, to try to fully understand how this element of the business works, but it is at least important to know the level of knowledge of the provider, for example with respect to tax regimes. This is especially important for pension funds because they are not subject to taxes and look to avoid taxes to any extent. It often remains enormously confusing, however, to explain to clients that e.g., in transferring assets from one custodian to another you can (albeit temporarily) lose the beneficial or legal holding of your asset for tax purposes in some jurisdictions. On the one hand they maybe don't even want to know, but on the other hand they need to acquire more knowledge as it is one of the key selection criteria for core services. It would be nice if on the pan European side there would be a more harmonised solution somewhere.

PAUL STILLABOWER: The crux is that it is not a United States of Europe. It is fragmented and Asia is the same, where there are 14 or 15 meaningful markets. The tax status is complex depending on your domicile, and the products you are investing in. So it is very, very complicated.

LUC LECLERCQ: It seems to me we are consolidating, and by the same token we are propagating. I strongly believe that if transactions cannot be done in the physical world, it will be done in the synthetic world and it will happen more and more. If I go synthetic I can get exactly the same as in the physical world without having to care for some of the inefficiencies of the physical world.

FRANCESCA: Thank you very much for a very interesting discussion.