



The purpose of these comments is to bring the "voice of the customer" into the securities services discussion. From a securities services perspective, the "customer" includes asset managers, insurance companies, and individuals; it also includes the banks, broker/dealers, and non-bank financial institutions that provide them with products and market access.

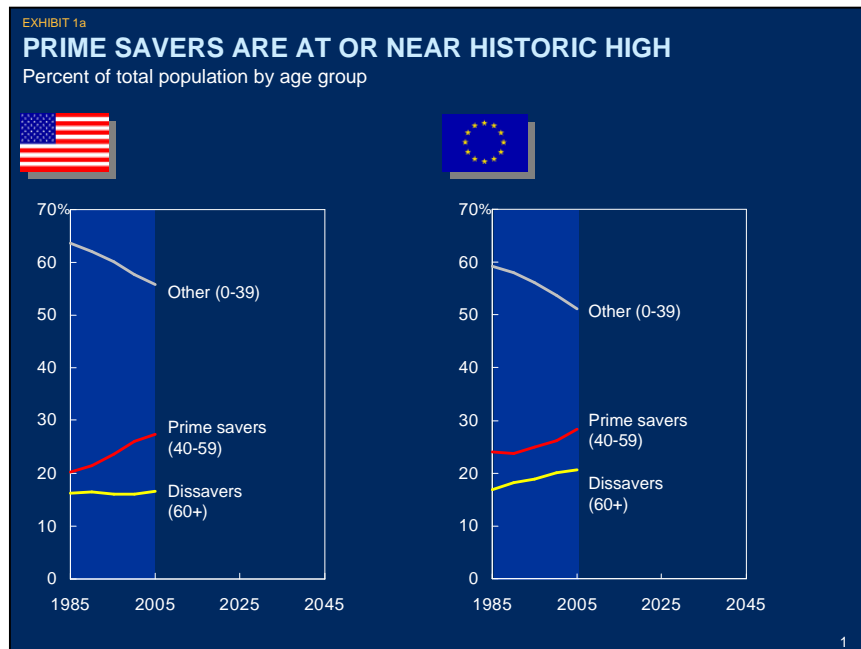
These comments draw on the experience of numerous McKinsey partners and consultants who serve the securities industry. They also reflect a targeted set of interviews with leading asset managers, clearing firms and asset servicers. Finally, they draw on a McKinsey work-in-process primary research effort to develop an updated perspective on the expected global supply of and demand for capital over the next several decades.

These comments follow four themes:

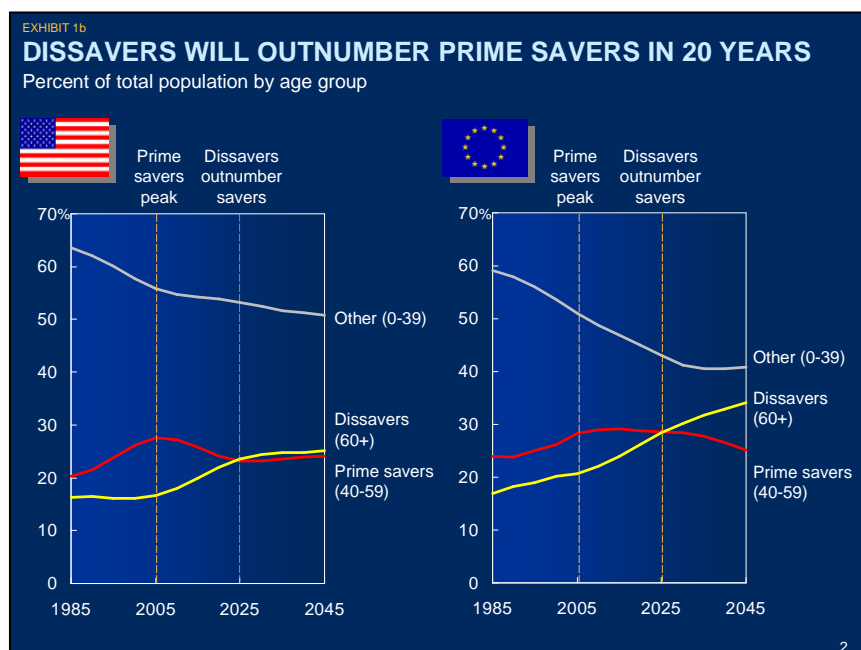
- 1) Demographics: Ageing savers will accumulate surplus capital – the capital they supply will probably exceed what is required to fund global GDP growth.
- 2) Asset reallocation: These investors and their intermediaries will reallocate assets, given pressure on returns (the price of capital). Predictable returns become the trend.
- 3) Customer demands from the securities services industry will change. We are moving more and more towards a world of differentiation, not a world where "one size fits all".
- 4) The most pressing needs extend beyond clearing and settlement – they arise at the beginning and at the end of the securities value chain.

Theme 1: Demographic change will lead to capital surplus

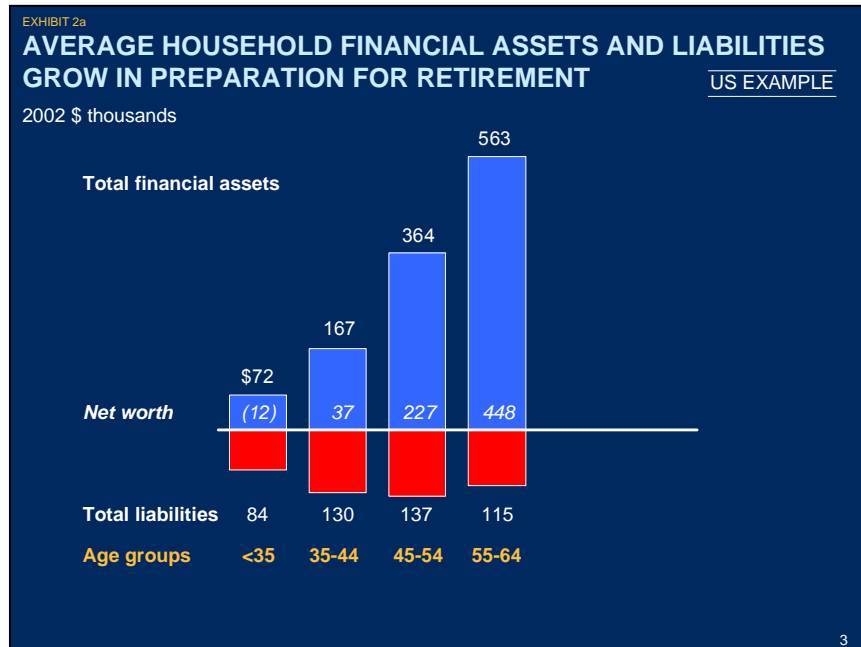
It is of course impossible to predict exactly how demographics, savings behaviour, and economic growth will affect global supply of and demand for capital. That said, there is more evidence for sustained growth in capital supply than for capital demand. We can look forward to a low-return environment for the foreseeable future.



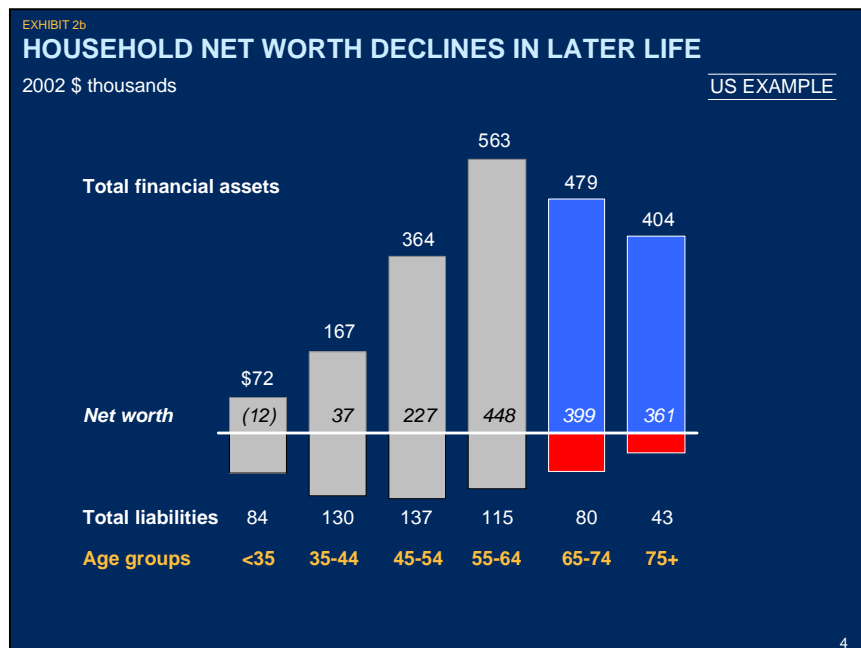
Developed market capital supply will grow steadily with an ageing population and higher savings rates. The developed market population will undergo a major change in the next few decades. This slide shows the percent of the population by age group for the US and Europe over a 60 year period. "Prime savers" (ages 40 to 59) are at or near a 100 year peak.



Looking ahead, this slide illustrates that older "Dis savers" will outnumber "Prime savers" in the US and in Europe; the problem is quite acute in countries like Italy and Japan, where "Dis savers" will outnumber "Prime savers" 2:1. In contrast, India's and China's "Prime savers" continue to grow as a percent of the population.

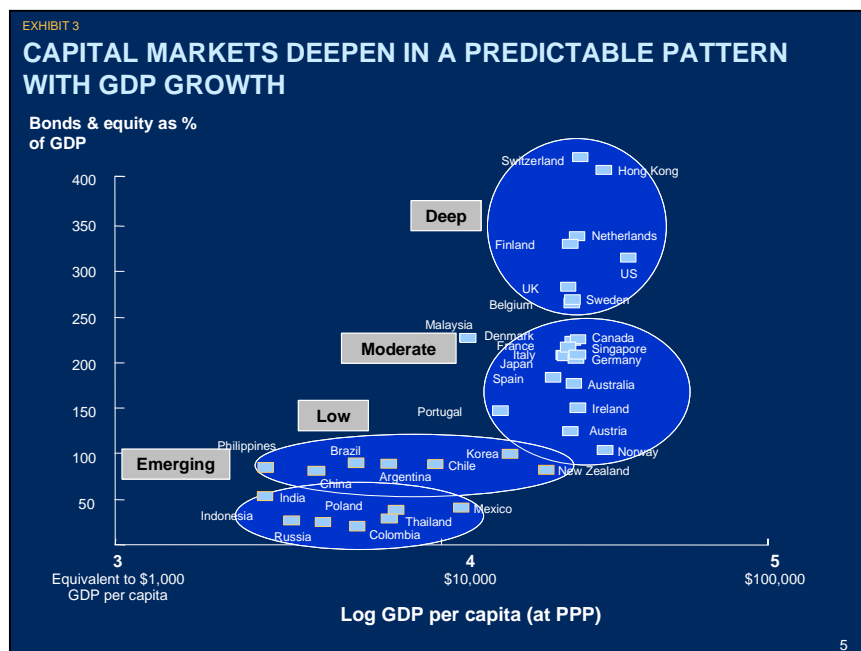


You may ask yourself why you should care about these observations. The reason is that the "Prime savers" accumulate assets through 2015 or 2020 at an extreme growth rate. This slide shows US household financial assets and liabilities by age groups; their average net worth approaches half a million dollars (with residential real estate excluded) per household for "Prime savers" as they approach their retirement age.

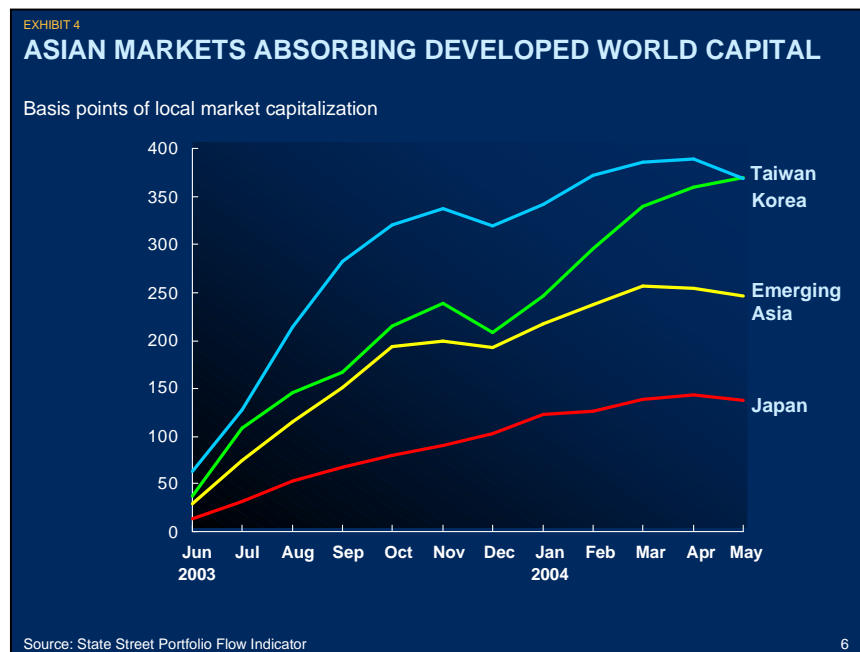


"Dis savers", however, begin to spend their assets. So, if you put the supply and demand trends together, one of two things could be true: The first is that we will see in the next ten to fifteen years, in the developed world, an accumulation of capital looking for yield. Or second, it is possible that over a period of ten to fifteen years, we will see a declining supply of capital as developed market savers begin to spend their money as they approach retirement. Governments and employers are shifting responsibility for the future onto the "average guy". There is, however, an alternative perspective: The people who see this scenario coming, will change their savings patterns, accelerating their savings in earlier years. In other words, the "average guy" is waking up, even in countries with reasonable demographics (e.g., in a 2001 McKinsey survey, 77% of respondents in Korea were concerned about having enough money for retirement).

So overall, over the next ten to fifteen years, it is likely that we will see a large supply of savings capital move into the economy.



The next question is then "What about capital demand?" Let me explain this chart: GDP growth is a very predictable driver of the demand for capital in individual markets. The left axis reflects bonds and equity as a percent of GDP. The right axis is a measure of GDP; we use purchasing power parity and a log scale to group the markets into four relatively enduring groups. We can be confident that emerging markets grow in their per-capita GDP. We will see an increase in the capital need of those economies. So there will be demand from these economies for additional capital.



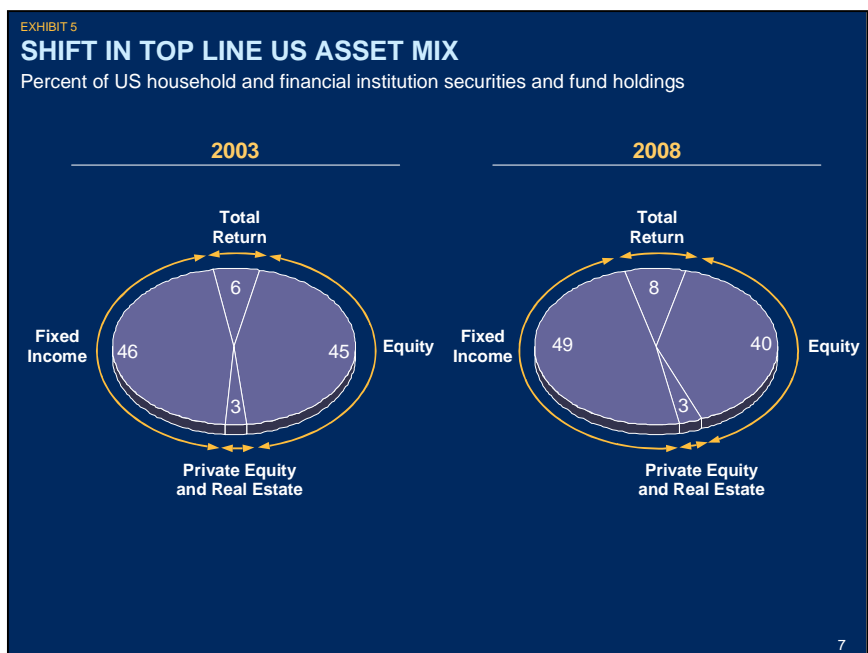
The real question then becomes "Can those markets absorb all the excess capital the developed markets are providing?" This slide shows a selection of Asian Markets and the rate at which they absorb foreign capital, measured in percent of their own market capitalisation. The time surveyed is the past twelve months. The point is that we currently see a continuing shift of developed market capital into Asian markets and into emerging markets in other world regions as well.

But when we consider the supply trends versus the size of those target markets, the conclusion is that the combination of excess capital supply and moderate capital demand will reduce yields. We think that the magic answer "Growth will save us all - all of our savings will produce adequate yield by shifting them towards those new markets" is simply not true. That leads me to the second theme.

Theme 2: Investors and intermediaries will re-allocate assets to capture predictable, adequate return

Excess capital in developed markets will be in a very nervous quest for yield over the next decade. In the past, we saw that different groups of investors pursued very different investment objectives. We now see a growing convergence around a common investment objective which could be described as "risk controlled". Institutional market participants want to be certain that they can meet their current and future liabilities and they are willing to "pay" for this certainty by limiting their upside potential. For example, defined benefit pension funds are lowering their expectations. They used to try to maximise returns, outperform benchmarks and lower funding requirements. Now, they want to lock in adequate returns, minimise volatility, and match liabilities. (In contrast, the "average guy" realises that his asset mix is too conservative. He recognises that deposits and money market funds will not generate adequate yield and is thus more willing to consider securities.) We also see that financial intermediaries are beginning to look more like institutional investors. They are using investment frameworks borrowed from the "buy side" to manage proprietary assets toward target returns on economic capital deployed. Earnings from such investments are growing in importance as income from intermediary agency business (e.g. asset management, trading) declines.

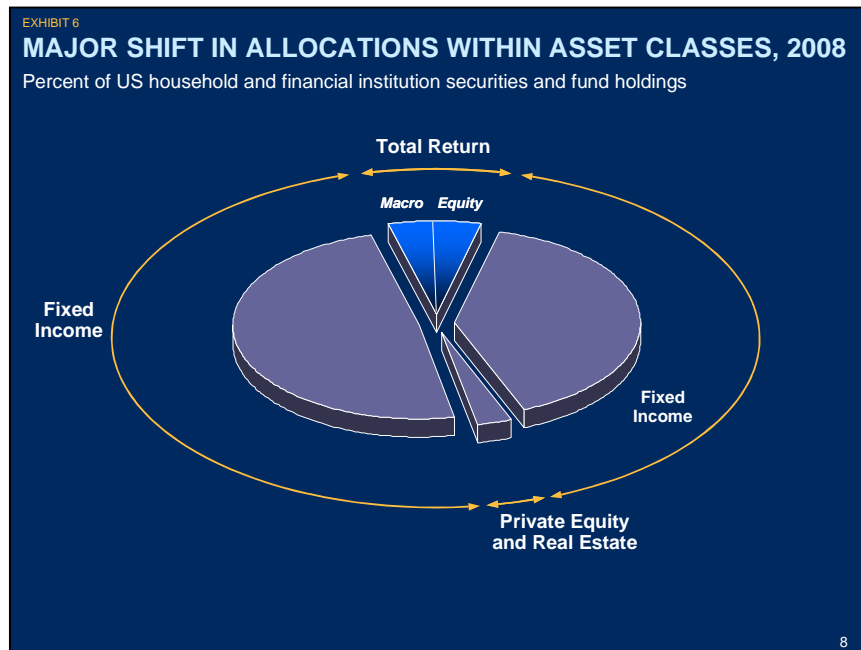
We predict that market participants will change their asset allocations in an effort to meet this new objective.



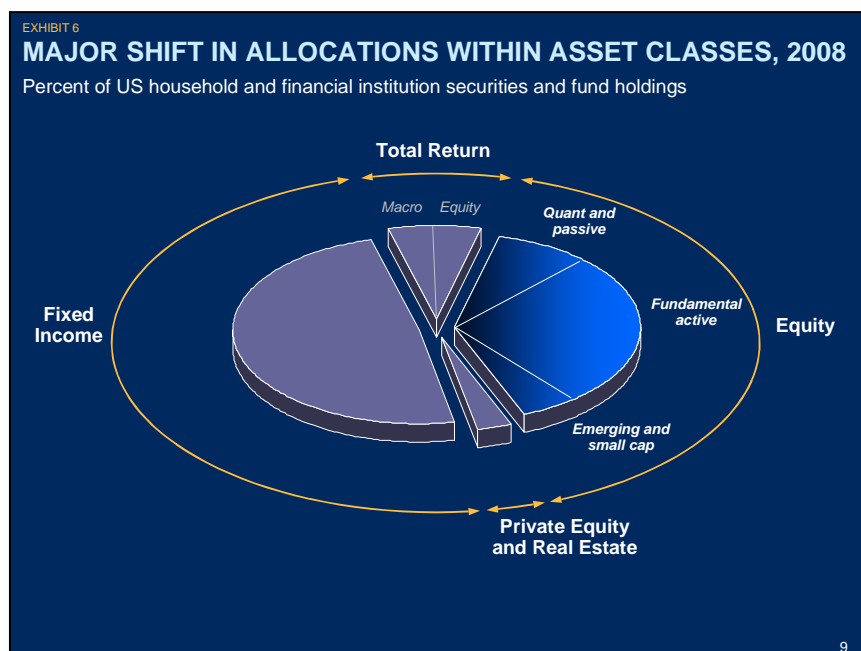
The US offers a striking example of this change, so we'll use it for illustration. Given its well-developed equities and securitisation market, the US is by no means a proxy for the rest of the world. However, most of the investment themes are applicable, despite different stages of development.

For the US, we built a simple model to project securities and fund holdings of households and financial institutions (including intermediaries) by asset class and mandate type through 2008, in order to understand how this quest for yield manifests itself in the asset allocation process.

At the top line, the changes over the next five years are not going to be dramatic. We will see a shift toward fixed income and toward the emphasis of total return. The most important issues, from a securities services perspective, are not changes in the top line asset allocation, but rather in the nature of the investment behaviour that is going on under these top line allocations.



Let's start at the total return point. Our view is that, over the next five years, the total return concept will be one of the few accepted ways for capturing additional value in highly efficient markets. Broker/dealers and banks join hedge funds in using macro total return strategies to profit from fixed income market inefficiencies. On the equity side, electronic trading makes it possible for hedge funds, asset managers and broker/dealers to make trade-offs amongst cash, derivatives and financing products that were not previously possible. We also see a shift to the equity markets where investors have become more realistic about their ability to beat the market.

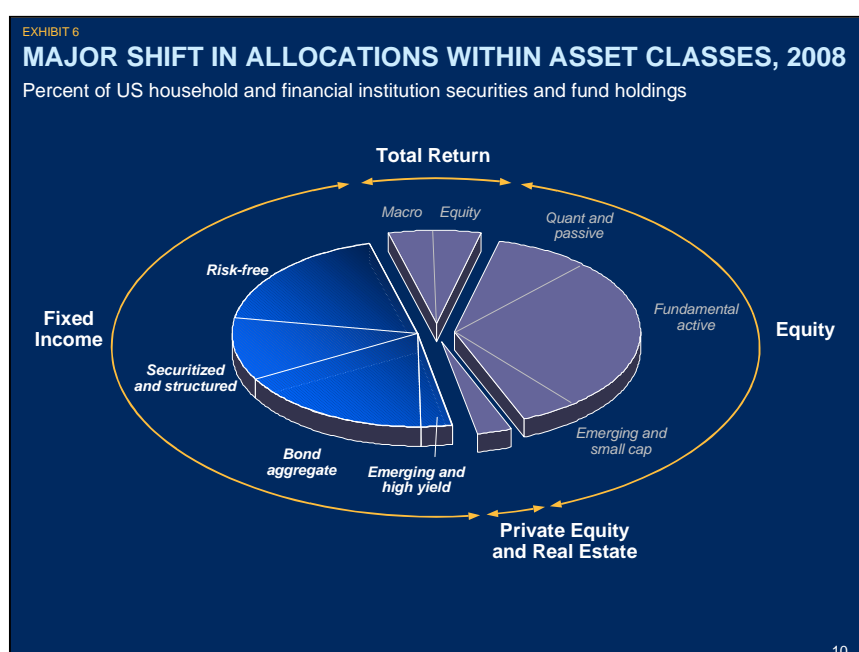


Look at the passive mandate experience that we have seen. Our projection is that quantitative and passive investment strategies, as a percentage of total assets, will be in the range of 10%. Many classes of institutional investors now have as much as a third of their assets in passive, index-tracking accounts.

The interesting thing in this market segment is that we see a blurring of activity between equity total return behaviour and quantitative passive investing. Most of the asset managers who employ passive strategies, are bringing some of the techniques from the equity total return side into their portfolios to create quantitative long strategies with predictable performance in their funds - such as overlay strategies and alternatives to cash instruments.

If you look at the fundamental active side, our vote is that this is going to come under tremendous pressure. Most of the shift into fixed income will come out of this segment. We also think that the definition of success in this sector is going to be changed dramatically. The outperformance promise is no longer what people are focused on. Best execution and low fees matter as much as the performance promise in manager selection. That is an important difference.

Finally, investors are looking for outperformance in places other than in the quantitative arena. They are looking at emerging markets and small caps. So we see greater mandates into lesser developed markets to generate returns that are simply no longer available in the US and in many European countries.

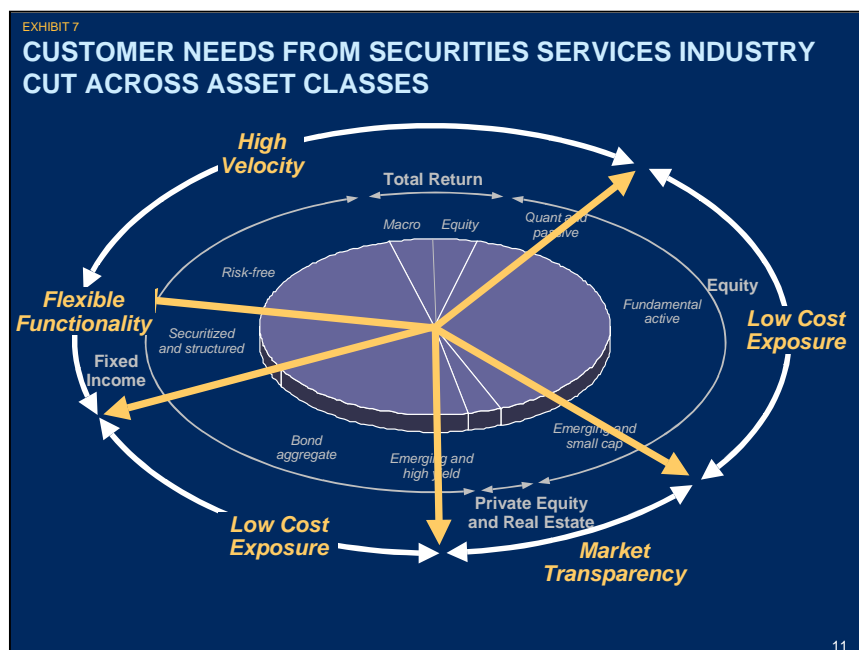


The objective is also changing on the fixed income side and in the asset allocation as well. Our clients are telling us that they increasingly shift to a liability match strategy which they build from risk-free (i.e. government securities, commercial paper) investing up. The broker/dealers, banks and non-bank financial sector companies are emulating that. Risk free positions remain a very important anchor point. As we saw on the equity side, in the risk-free zone the substitution of non-cash products into portfolios that traditionally largely consisted of cash instruments only, is becoming an important part of their position optimisation strategy.

In the US market - and we will also see that more and more in all developed markets over the next ten to fifteen years - the use of securitised and structured products is on the rise. Having established a base with the other two product categories, investors such as banks, insurers, finance companies etc. use very tailored cash flows to match liabilities in a much more intentional way than they have done previously. It is an investor-driven market. The investors are asking broker/dealers to provide all the strange structures that we are now seeing from an asset servicing perspective.

These changes in asset allocation are accelerating trading volumes in liquid products. They are embedding new, complex products in formerly simple portfolios. They are drawing investor attention to relatively exotic and illiquid markets in the quest for yield. Customer needs from the securities services

industry are changing as well. This leads to my third theme, which is differentiated investor needs from the securities services industry.



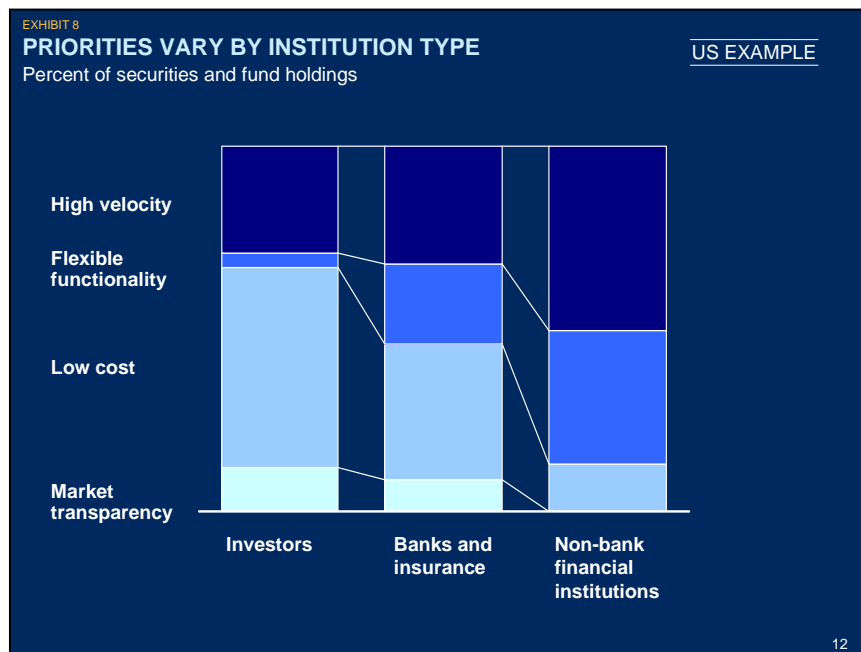
Theme 3: Customer needs from the securities industry

If you look across risk-free investing, macro and equity total return, and much of the quantitative and passive investment management space, the first need is that investors are increasingly demanding speed, and they are looking for infinitely expandable capacity. They want support for straight-through high velocity trading and processing across asset classes. In addition, the definition of "best execution" now includes execution certainty as well as getting the best possible price.

The second need - and that is probably the most difficult one to handle for the asset servicing industry - is what we call "flexible functionality" in the securitised and structured products area. Rapid innovation will not make the nature of these products less complex! If you spend time with the broker/dealers and the fixed income product developers, it is simply amazing what they are contemplating to do. Unfortunately, their consideration for ability to process is quite low. Their goal is "Match with what the investor says he needs" and their definition of flexible functionality is "We need, on an end-to-end basis, the ability to handle the unpredictable!" So, operations departments will see more cash flow structures that are very difficult to manage, or underlying assets whose data are difficult to obtain.

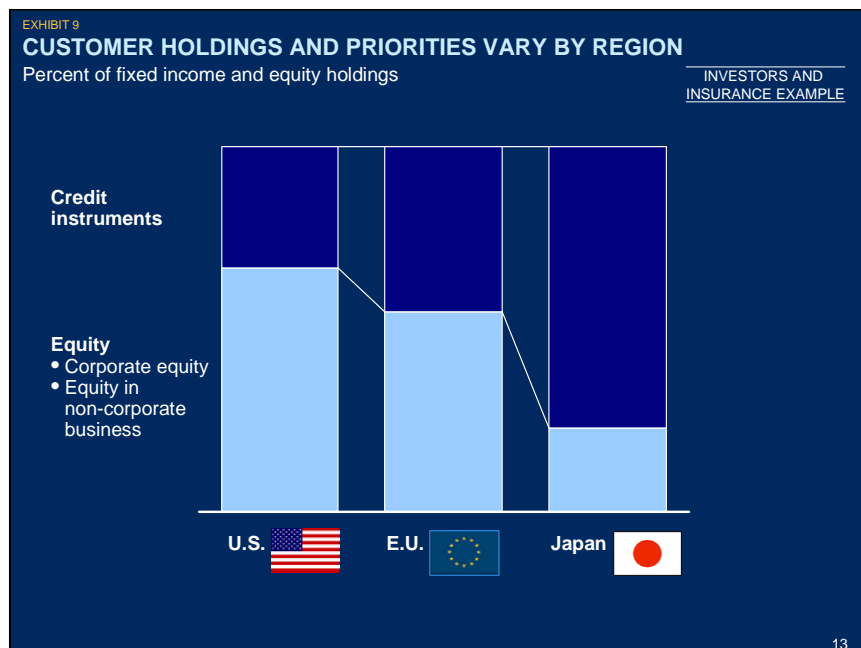
The third need is for low processing cost. Despite the specialised needs just described above, there is still a very large investor segment that is quite comfortable with a "one size fits all" solution. They are just interested in low cost exposure. We should not overlook that group. Their expectations are growing as a result of the economies of scale they perceive the asset servicing industry should now be able to realise through the increased volumes produced by the high-velocity trading patterns.

Finally, there is a growing group of investors in less liquid emerging and small cap equity, private equity and real estate, and emerging and high yield bonds. Their priorities are enhanced market transparency and, in some cases, investor protection. Depending on who your customer is, different products can become your problems in terms of processing capacity.

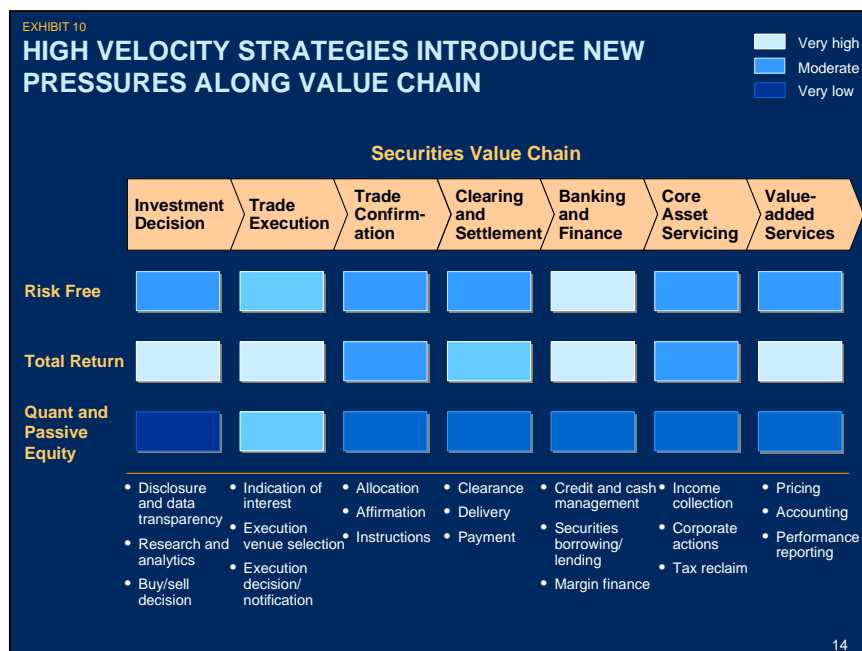


These priorities vary by customer institution type. Investment managers and investment servicers feel an acute need for flexible functionality for structured products and illiquid market transparency. This is evidenced by comments like this one by a top global custodian: "We created a separate accounting system to handle private equity investments for endowments, foundations and pension funds".

Exchanges and clearing institutions feel more pressure to provide capacity for high velocity trading strategies and to deliver low costs in major markets.



Customer holdings and priorities vary by region as well. Thinking about the market in terms of end-to-end customer needs may expand the field in which securities services providers need to operate.



Theme 4: The industry's most pressing needs may extend beyond clearing and settlement

This is the traditional securities transaction value chain, and some input for our discussion groups to help them understand where they could be affected.

I looked at the high velocity trading strategies to understand where they are placing pressure on the value chain.

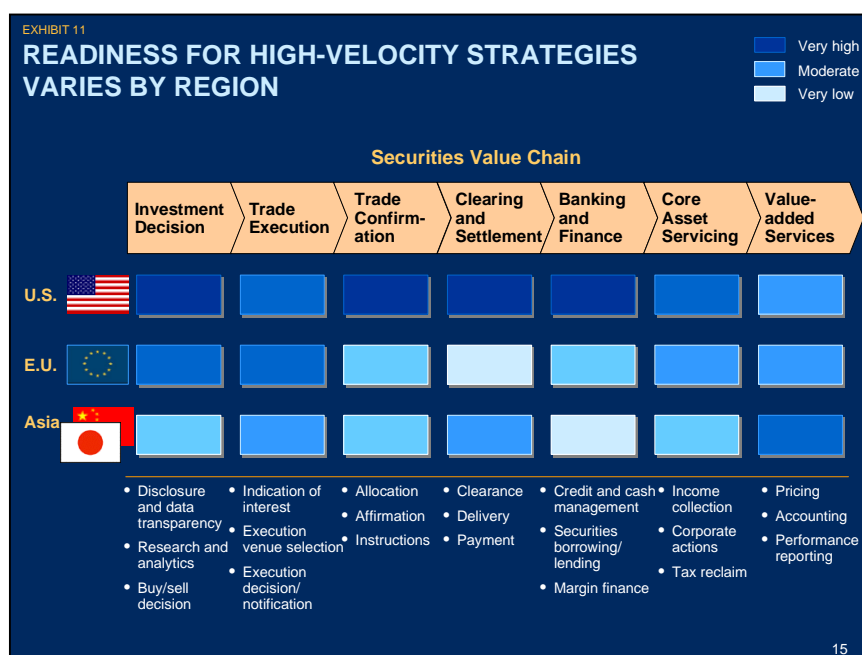
Investment decision: The availability of near-instantaneous data to every investor has exploded. They are using this to arbitrage tiny differences in timing between data vendors. This is a huge problem for broker/dealers who really struggle with how to handle the data management tasks associated with this kind of investing.

Trade execution: The management of electronic trading across venues is extraordinarily complex. You see new players enter the arena all the time (i.e. ATSS, Alternative Trading Systems), and the industry needs to optimise connections between these players to achieve best execution, not only defined in terms of trading cost, but also in terms of certainty of size and time.

Trade confirmation, clearing and settlement, core asset servicing: There is the expectation of infinitely scalable capacity at low cost with zero defects, despite ever-shorter holding periods and trading place proliferation. Clients are increasingly introducing new products to their custodians which the latter do not have the capacity to handle at the speed the clients would like to move.

Banking and finance: There is a strong need for credit and securities finance from a limited number of available lenders. This introduces systemic risk concerns; for instance when there are open positions of several billion dollars between two private sector counterparties. The need is stronger in dealer markets (i.e. the fixed income market) than in order-driven equity markets (i.e. the equity market).

Value-added services: Complex trades and OTC derivatives create valuation, accounting and risk analysis problems.



How ready is the industry for these challenges on a regional basis?

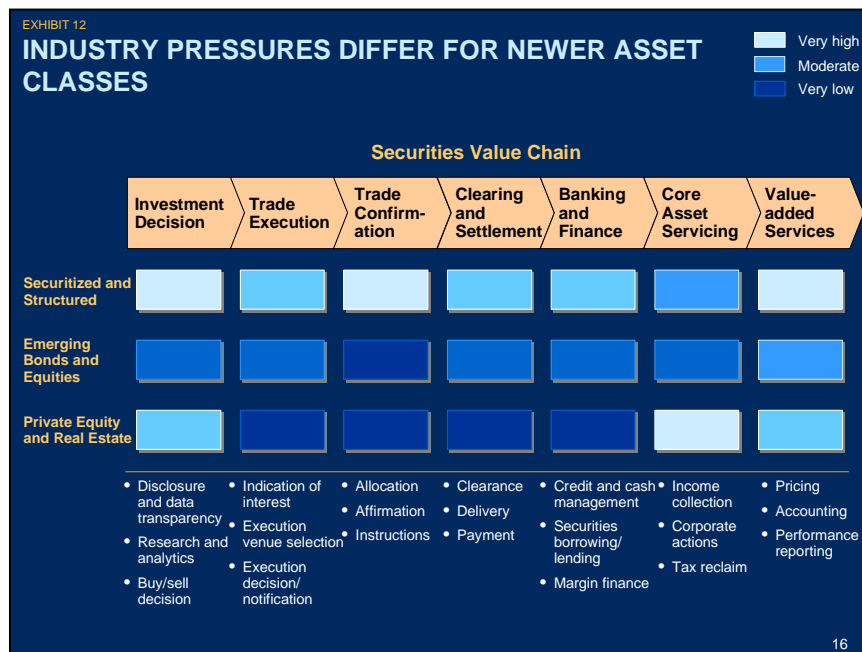
In the US, the core trade confirmation, clearing and settlement, banking and finance processes are reasonably able to deal with the situation. Trade execution is a problem in the US - relatively speaking - because our markets are fragmented. The broker/dealers are challenged not by lack of market data, but by building up capacity to take in and interpret vast quantities of real-time data. In the asset servicing arena, the challenge on custodians is to keep up with non-cash product usage from a pricing, accounting and reporting perspective.

In Europe, the major problem is handling all these challenges in a cross-border context. The need for standardisation and consolidation of the European clearing and settlement environment is well-documented by the Giovannini Group and others.

In most Asian markets, the constraint is the size of the liquidity pools. They would require further expansion to be ready for high velocity, cross-border trading strategies. Many markets tend to have a low float, and extensive family and government ownership limit real transparency despite good exchange data. The infrastructure technology in place is often world-class but there is sometimes no end-to-end STP in place to reap the full benefits from this technology.

Very limited regionalisation takes place. To overstate it a bit, almost every major Asian city has announced plans to become the regional financial centre.

On Asian banking and finance side, investors are generally not expecting to borrow since they know that there is virtually no "short market" activity. They are not concerned if there are no such services available. Asset Servicing (core and value-added) tend to be performed very carefully and precisely, although typically with a lot of manual intervention ("checked and re-checked").



Industry pressures for less liquid asset classes are strongest at the beginning and at the end of the value chain. There is a real struggle to keep up with securitised and structured product innovation. This brings opportunities to bring order to chaos in the OTC markets by launching new services, like for instance DTCC has done in the area of credit derivatives with its DeriveServe product.

Private Equity and real estate products are stuck in a processing "twilight zone". This is an entirely new area for the asset servicing industry, and the custodians still have a long way to go to handle these new products. Let me close with a quote from an emerging markets private equity investor: "We aren't sure how one of our investments performed because we weren't able to find the cash flows".

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