ISSA RM Europe 2005 Summary

Peter Gnepf
ISSA Secretariat

1. Opening Remarks

Stephen Lomas, acting as host and Chairman of the Day, welcomed around 65 delegates comprised of ISSA members and guests. 24 countries were represented. A special welcome was extended to the participants from Iceland, Romania and Serbia and Montenegro who attended an ISSA event for the first time. Budapest was chosen as the venue to pay tribute to the enlargement of the European Union by ten additional countries. Accordingly, the agenda of this year's meeting had a distinct Central and Eastern European flavour.

2. ISSA Information Items

The full text and the slides used in Josef Landolt's presentation are available separately. Main points included:

- A general update on ISSA activities during the last twelve months, focussing on ISSA's involvement with the G30 process and giving an assessment of that process. Progress has been slower than generally anticipated, but there have been positive developments in the area of G30 recommendation 2, 3 and 8. Of special note is a discussion paper for a streamlined withholding tax model, prepared by tax specialists of JPMorgan. ISSA endorses the model although some amendments will be necessary. *All ISSA members and interested parties are invited to review the proposal and submit comments to the ISSA Secretariat or to its authors directly*. The paper is available from the ISSA website or through the secretariat. The tax model has meanwhile been brought to the attention of the European Securities Forum, the British Bankers Association and the EU Fiscal Compliance Experts' Group (FISCO). Those expert groups are in the process of formulating their comments.
- ISSA's involvement with cross-border mutual funds processing (see separate section).
- ISSA's active participation in the General Assembly of the Americas' CSD Association (ACSDA) in March, in lieu of conducting its own regional meeting in the Americas. Through the joint venture with ACSDA, ISSA can reach 24 markets on the American continent, well beyond its own membership in the region.
- Looking forward, ISSA's participation in the CSD8 conference in New York at the end of April, and the ISSA Asia-Pacific Regional Meeting in Seoul in October, in cooperation with KSD.

3. Cross-Border Mutual Funds Processing

On April 20, 2005 ISSA held a roundtable meeting in London which was attended by around 20 representatives from the mutual funds industry, custodians, trade associations and infrastructure providers. The meeting was an outgrowth of the 2004 ISSA symposium where members had recommended that ISSA offer its services to promote more rapid progress in the area of mutual funds processing. As funds transaction volumes rise, so do the processing risks, the inefficiencies and the exception handling. This is perhaps less so for European funds, but most certainly for offshore and non-standardised fund products. The need to bring funds processing more in line with the settlement standards established in the equity market, is a big concern for the custodians. It is however an area neglected by most current industry initiatives.

Neil Henderson who had hosted and chaired the London meeting, Urs Stähli and Stephen Lomas summarised the discussions' contents and findings. Key points included:

The European funds landscape is still very diverse and fragmented. Markets are still largely domestic. There is neither a pan-European market place for funds, nor a "best" business model. Accordingly, problems differ by market. Vested interests abound. Every stakeholder is potentially part of the problem, but could also be part of the solution. Markets where an open funds architecture prevails, have less efficient processing flows than others. The same applies to cross-border trades as opposed to trades

©International Securities Services Association

confined to a domestic environment. The Swiss banks seem to process considerably more cross-border volumes than most others, hence they are more faced with cross-border processing inefficiencies. It will however take many more years for a single and liquid pan-European funds market to evolve.

There is a need for standardisation and for a common communication standard. The cost of building, owning and maintaining multiple links to infrastructure operators such as Vestima, FundSettle, SWIFT is high and is constantly rising. However, the industry would be well advised to question the validity of a business model, before it is "cemented" with new standards.

Continental Europe is supportive of ISO 20022 for funds transactions. Coexistence of ISO 15022 and ISO 20022 will be unavoidable and is acceptable, as long as the functionalities serviced are different. The funds industry should be able to conduct all business in ISO 20022 format, even though custodians would have to support both ISO standards. In the UK, EMX is the dominant messaging standard, interoperability with ISO 20022 will not materialise any time soon.

A common processing platform would be desirable. One "echosystem" within which the custodians, the correspondent banks, the transfer agents and the distributors transacted their business in a standardised manner, would be a vast improvement. However, it is difficult to get a critical mass of early adopters. If a group of significant market players endorsed a certain standard, platform or model, others would follow quickly and the cost of switching would be less of an issue.

Four key infrastructure providers (SWIFT, EMX, Clearstream/Vestima and Euroclear/FundSettle) had been invited to join the discussion at a later stage in the meeting. They gave their assessments of the key challenges in funds processing and how they saw the way forward.

There was a clear preference to not endorse any specific business model but to leave a range of options to evolve. Market forces would gravitate towards the most efficient set-up over time.

The roundtable meeting concluded that the dialogue among all stakeholder should continue. The leadership role in Europe is with EFAMA. ISSA is considered a viable partner to facilitate and drive progress, due to the fact that its membership mirrors the whole processing chain. ISSA should intensify contacts to the specialist groups in the funds industry. The conclusions and next steps for ISSA include the following:

- ISSA should reach out to other relevant industry bodies (EFAMA, IMA...) and continue the dialogue. Additional experts are needed to tackle specific questions in a targeted manner.
- ISSA should seek ways to add value to existing initiatives, rather than create a competing forum.
- ISSA should consider an official endorsement of ISO 20022 for funds transactions.
- The categories of hedge funds and complex/exotic funds must be covered as well.
- A small ISSA working group should look at open issues, set priorities and draft a road map for the next 12 months. First concrete achievements must be available by the 13th ISSA Symposium.

A short discussion generally confirmed the roundtable observations and yielded two additional points:

The new EU member countries are currently reforming, or setting up, their pension systems. Institutional investing will become much more important within the near future. Those markets will adopt efficient infrastructures quickly as they can work in a "green field" environment. Since many financial institutions are already owned by, or affiliated with Western European firms, the transfer of knowledge will occur very quickly.

One vote emphasised the need to act swiftly and decisively. The observation that market convergence will take many more years, must not prevent action. ISSA is well positioned to promote the adoption of guiding principles and small but concrete steps, such as for instance:

- to the extent possible, use the same infrastructures to process equities and fund units
- institute DVP settlement
- promote a book-entry environment and use of CSDs to settle funds transactions.

During the meeting, several ISSA members volunteered to participate in a working group. A useful approach will be discussed within the executive board soon after the meeting and will be communicated as soon as possible.

4. Structural Changes in the Region

Hungary

The Budapest stock and commodities exchanges re-opened in the early 1990s. Initially, traders and owners of the exchanges were identical, no non-trading owners existed. In 2003, the exchanges restructured and became companies limited by shares. As a consequence, many exchange members sold their stakes. Ownership became separated from membership. Private investor groups formed and acquired large stakes in both exchanges. Currently, an Austro-Hungarian consortium controls a majority stake of 68.8%, the remainder being held by the Central Bank. A merger of the two exchanges is planned; permission by the EU authorities has been granted. The consortium is prepared to take full control if and when the Central Bank decides to sell its stake.

Keler was established in 1993, as the common clearing and settlement house for all exchange traded products. 25% of its share capital was held by the stock exchange and the commodities exchange, respectively, with the remaining 50% held by the Hungarian Central Bank. The Central Bank had always intended to sell its stake in Keler to private investors following Hungary's accession to the European Union. At this moment, a decision to sell has not been made. The eventual transformation of the Hungarian market infrastructure to a vertical silo is likely. An internal restructuring is taking place within Keler: The risk free safekeeping (CSD) function is being isolated from the potentially risk-carrying central counterparty (CCP) function. Keler's status as "specialised financial institution" will be transferred to the entity carrying out the CCP function.

Poland

The Polish financial market has recently seen extraordinary growth rates in terms of capitalisation, turnover, IPO activity and dual listings. Growth projections continue to be very optimistic.

The privatisation of the Warsaw Stock Exchange is pending and planned to be completed by the end of 2005. Completion is however uncertain, due to upcoming parliamentary elections in September.

In November 2004, MTS Poland was launched as a new trading platform for government securities (Treasury Bonds and Treasury Bills). Both the WSE and MTS Poland are open to foreign remote memberships. Little activity however has materialised to date on either platform from foreign members.

Due to the rise of dual listings and the possibility of remote members to deal on both exchange platforms, establishing new CSD links has become a priority for KDPW. A number of links to foreign CSDs and ICSDs are operational, they are based on SWIFT ISO 15022 messages.

In parallel, foreign currency settlement capabilities have been enhanced. For EUR settlements, an interface to the National Bank of Poland is operational. The National Bank of Poland is the first central bank among the ten new EU members with access to TARGET (facilitated through the Italian central bank). Significant enhancements to the CSD's risk management system are under way.

Challenges ahead include the implementation of a DVP link with one European CSD which raises a wealth of legal and practical issues to be solved, process automation in the area of corporate actions, standardisation of proprietary communication channels, the separation of CSD and CCP functionality, and the possible privatisation of KDPW. KDPW is in discussions with its users on whether the CSD should adopt the status of a limited banking services facility. This would facilitate the processing of cross-border DVP transactions and enable a more efficient distribution of corporate action entitlements; it is however not intended to engage in commercial banking business.

Romania

A new capital market law came into force in Romania in July 2004, which transforms the relevant EU capital market directives into national law. As a consequence, the Romanian market infrastructure is undergoing profound changes: Today, the Bucharest Stock Exchange - a not for profit institution - is an integrated entity providing trading, clearing, settlement and registrar services. The new law mandates transformation of the exchange into a joint stock company which will be completed in the latter part of 2005, and the externalisation of all post-trade functions. On the other hand, the country's three trading platforms (Bucharest Stock Exchange, RASDAQ Electronic Market, Sibiu Derivatives Exchange) will be combined into one integrated market for all financial instruments. The new exchange plans to become a majority shareholder of the cash market CSD and of the derivatives clearing house once those entities are operational on a stand-alone basis.

***

In the light of the recently aborted takeover offer for the London Stock Exchange by Deutsche Börse, a brief floor discussion centred around the issue of privatising the central market infrastructures and how that would change the identity of a market's infrastructure service providers. Some statements:

- Ownership by the State Treasury or Central Bank may provide stability and might be more supportive of pursuing a long term strategy. On the other hand, there is a political risk in being state owned: the fate of a company may be tightly linked to that of the current government, even to particular persons in the incumbent administration.
- In Western Europe, all infrastructure components nowadays are privately owned. However, there are numerous approaches to running a market infrastructure: for profit, not-for profit, "for a little profit" - meaning that substantial parts of any profit is refunded back to the users in the form of rebates. Governance structures vary considerably. User-owned and user-governed structures seem most appropriate for a central market infrastructure. Are the decision makers really interested in a stable and efficient central service provider, or are they trying to protect their vested interests by "shaping" decisions? The optimal model for any given market must be selected with the utmost care and should not be subject to frequent changes.
- The privatisation process creates uncertainty for the local market participants. Many are concerned that they will be pushed aside by foreign market entrants. Several of the new EU member stock exchanges heavily depend on the trading volumes generated by a small number of blue chip companies. It is important for the local market community that those key issuers remain listed locally. For as long as trading is done locally, clearing and settlement will also occur locally. If those heavy-volume issues move to a foreign listing place, the entire domestic market infrastructure is at risk.

5. European Union Enlargement

Under this heading, a key market player each from the "old" and the "new" EU member countries was invited to give an assessment on how they perceive the addition of ten countries (and more to come) to the European Union in terms of economic opportunities and challenges.

Elzbieta Pustola, KDPW, described the massive "double" challenge most of the accession countries had to master to adjust their legal, fiscal/tax and political environments within record time, given that they not only joined the EU, but NATO as well. One year membership is a short time for a firm assessment. However, using a wide range of economic, social, financial and technology indicators, Elzbieta Pustola demonstrated that the new members rank very favourably within the group of the 25 member countries, exceeding the western European members in many aspects. On close examination, positive trends will benefit the entire Union in the long run, while perceived "threats" are not significant enough to have a negative impact on the Union.

Michael Straka, Deutsche Bank Asset Management/DWS shared the assessment that the new members' economies offer more opportunities than threats. Using the example of Russia, he described how a leading institutional investor made the strategic decision to enter a new market, and how the decision was executed.

6. Entering the Euro Zone - Redenomination of Securities

Preparatory work leading up to the transition of the securities markets to the Euro environment extended over a three year period. Pierre Willems reviewed the process as BNP Paribas Securities Services had experienced and managed it, having gone through the Euro conversion in five "first wave" markets and Greece later on. To the benefit of the new EU members, Pierre Willems shared valuable lessons learned, milestones to be observed, critical success factors and useful hints for project managers who will have to face Euro conversion in their market in the coming years. Please refer to the self-explanatory slide presentation for details.