

## **1. Opening Remarks**

The meeting was opened by Mr Yoshinobu Takeuchi, President & CEO of JASDEC, welcoming the participants to Japan. JASDEC acted as the conferences hosting organization. Mr Takeuchi recalled ISSA's long history of involvement with global industry initiatives such as those launched by the Group of Thirty. He emphasized the importance of international cooperation, networking, education and maintaining dialogue amongst all market stakeholders, even though many are competitors on the commercial level. These values are key to ISSA as well as to the regional CSD associations. They were reiterated during the global CSD9 conference in Seoul earlier in the year. JASDEC had played a major role as co-organizer of that event as well.

Josef Landolt, ISSA Chairman, then welcomed 65 ISSA members and select guests to the first ISSA event ever held in Japan. The initiative to hold a meeting in Tokyo was taken in 2006, by Nomura Securities, which is a board member and sponsor firm of ISSA. JASDEC, a long time supportive ISSA member, then took up the idea and offered to host the meeting on behalf of all Japanese members.

The day's agenda was structured into two distinct parts: The morning sessions highlighted market developments in Japan, with a special focus on issues of relevance to foreign market participants. Japan is currently in the final phase of a massive capital market reform, spanning a seven year time period. The time is right to highlight the Japanese market at this crucial project stage.

The afternoon addressed the handling of alternative investment instruments, specifically OTC derivatives. This is a complex market segment and at the same time one that experiences massive growth rates around the world. Following a successful session in the European meeting held in Monaco, the decision was made to carry the discussion into the Asia-Pacific member community as well. The background to that is an increased focus by ISSA on issues posing operational challenges to institutional fund managers, but equally affecting their custodians and the underlying market infrastructures. A newly created ISSA Working Group is currently looking into issues related to the valuation of OTC Derivatives (see below).

## **2. ISSA Information Items**

The full text and slides used in Mr Landolt's presentation are available separately. Main points with regard to ISSA working items include the following:

### **G30 Interoperability Group**

In the 2006 ISSA Symposium, members supported a push to advance G30 Recommendations 1, 2, 3 and 8 which have become known as the "interoperability recommendations". ISSA had offered, and was mandated, to take the role of a facilitator amongst a group of major stakeholders that had indicated a strong interest in working together to advance those recommendations in a concerted fashion. However, in the subsequent months, it became clear that the global players' project resources are fully absorbed by market initiatives having a European focus: Removal of the Giovannini Barriers, the Code of Conduct, TARGET2-Securities, MiFID, the ESCB-CESR Standards, and others. The global G30 Recommendations lag far behind on the priority list. Acknowledging reality, the ISSA board decided in August 2007 to suspend ISSA's involvement as the group facilitator. Continued support will however be given to two G30-related initiatives that are already up and running: First, the withholding tax streamlining model that was designed as a contribution to advance G30 Recommendation 8. The model received broad industry support and has meanwhile found its way into a joint private and public sector working group sponsored by the OECD Centre for Tax Policy and Administration. The second initiative is the removal of Giovannini Barrier 1. This is currently a European project with a due date of 2011. SWIFT has a leading role – mandated by the European Commission – with ISSA having agreed to give support to the extent possible. If successful in Europe, this initiative might be extended to other regions, thus fulfilling G30 Recommendation 2.

### **ISSA Fund Working Group**

The mandate of the Fund Working Group is to make recommendations for an improved processing environment for cross-border mutual funds transactions in Europe. The group met several times in 2006 to define the main obstacles to efficient processing. Those discussions quickly became difficult because the perception of an obstacle varies greatly, depending on the business segment serviced by each stakeholder. What one party sees as an obstacle, is another party's indispensable requirement to properly fulfill its role in the value chain. The group produced an interim report describing ten barriers to be addressed.

The initiative was re-launched in summer 2007. Under the chairmanship of Edouard-François de Lencquesaing, a newly composed working group met for the first time in October and picked up where the previous group had left off. The work areas were prioritized and a project plan for the next months was agreed. Final recommendations will be presented in next year's ISSA Symposium in June.

Parallel to advancing its own work, ISSA maintains its constructive dialogue with the EFAMA Funds Processing Standardisation Group.

### **ISSA OTC Derivatives Working Group**

In the past, ISSA had little involvement with derivatives. However, the use of OTC derivatives shows spectacular growth rates. They pose challenges to asset managers, investors, custodians, broker-dealers, custodians, reference data providers, messaging carriers, and regulators. A dedicated working group led by a core team of experts from JP Morgan, Schroders and Morgan Stanley was formed after the European Regional Meeting in Monaco. The group will look into areas that are fundamental to improve the management of OTC derivatives. These are valuations, trade capture, and confirmations. Final reports on all three aspects are expected to be ready for presentation during the June 2008 ISSA Symposium.

## **3. Key Note Speech: Capital Market Infrastructures Amidst A New World of Global Competition (Atsushi Saito, President & CEO, Tokyo Stock Exchange Group, Inc.)**

### **Introduction**

The Asian economies continue to expand. Overall, the entire global economy has been on a ten year upwards trend, the US economy having been the main engine. The US sub-prime credit crisis brought the trend to a sudden halt, with a massive impact on many of the world's leading investment banks. The sub-prime crisis is a perfect example to demonstrate how closely the world markets are now intertwined: Large amounts of money to finance the sub-prime loans were raised at low interest rates in Japan and in Europe, to exploit interest rate differentials. Now, the US crisis backlashes on the Japanese and European markets.

The same events also show that the extensive securitization of loans has only been possible through the availability and wide use of sophisticated "financial high technology". We cannot shy away from financial innovation. However, in a thoroughly global market environment, the financial industry must give more consideration to provide better safety features. "SOX" was implemented in 2002. Five years later, excessive compliance costs and the density of regulation have raised doubts, even with senior US politicians. There must be different and more effective approaches to achieve more safety in the global financial market.

### **International financial market environment**

Progress in technology (computers, software, telecommunications) enabled and pushed financial globalization. For instance, technology eliminated the need for stock exchanges to have physical trading floors. The cost of trading decreased, and competition between market places for market share and liquidity becomes ever fiercer.

In the European Union, MiFID came into force on 1 November 2007. The directive will increase competition among financial service providers, including the operators of wholesale market infrastructure, in all member states of the EU. The Investment Services Law in Japan uses some aspects borrowed from MiFID as reference.

As the recent cross-border and even transcontinental takeover battles show, the fight for survival for many stock exchanges has begun. The international market environment is much more dynamic than it was ever before.

### **Conclusions for the Tokyo Stock Exchange**

In the long run, three or four exchanges will remain as global leaders. The Tokyo Stock Exchange is determined to be among them. Its strategy is based on the following pillars:

- Stay at the forefront of technology innovation. Start building the next generation of trading technology today.
- Focus on confidence building and transparency leadership. The preferred approach is sensible self-regulation.
- Product and services innovation, for instance by adding Exchange Traded Funds (ETFs) and derivatives to the established product range.
- Attract more foreign listings
- Forge alliances and joint ventures with foreign partners. For instance, the Tokyo and the London stock exchanges just concluded an agreement to jointly launch a new market place for emerging market issuers.
- Enhance accessibility: Similar to the new environment in Europe under MiFID, the Tokyo market intends to make itself more accessible to other trading platforms in Asia.

Cross-border participation and cross-border investing bring with them a number of new challenges that must be addressed adequately, such as:

- The participation of cross-border, remote market players forces market operators to significantly enhance their risk monitoring and risk management capabilities.
- The handling of foreign investments requires close collaboration between the exchanges and the operators of clearing and settlement infrastructures.

## **4. Market Enhancements in Japan**

### **4.1 Completion of Dematerialization by 2009 (Kazuhiro Nishimukai, JASDEC)**

A far-reaching reform of Japan's securities settlement system was launched in 2000. The availability of new technology was a main driver for a complete overhaul of the market environment, including structures and processes. Main goals were to eliminate settlement risk, to lower settlement cost and to improve operational efficiency. The reform is based on three pillars:

1) The introduction of DVP. To that end, JASDEC created a subsidiary, the JASDEC DVP Clearing Corporation (JDCC), to handle DVP for client-side transactions. JDCC commenced operations in May 2004.

2) The introduction of the Pre-Settlement Matching System (PSMS). Implemented in early 2001, PSMS now covers stocks, bonds, futures, options, commercial paper and similar instruments. PSMS electronically connects the trade space to the settlement space and is a key facility to promote STP and increase operational efficiency.

3) Dematerialization. In June 2004, the Law Regarding Streamlining the Settlement of Trades of Stocks and Other Securities was passed, calling for dematerialization to be completed by January 2009.

Under the new system, all stocks of listed companies will be dematerialized on a compulsory basis and managed on the ledger of book-entry transfer accounts created by designated "account management institutions". These will include financial institutions such as securities companies, banks and trust banks. Shareholders' legal title and all associated shareholder rights are recorded in those accounts. The paperless scheme will enable the creation of layered, multi-tiered ownership structures, rather than the simple two-tiered structure distinguishing only between CSD participant accounts and client accounts that exists today. JASDEC will have a closer relationship with the issuers, particularly with regard to handling new issues or redemptions.

The new system will enable JASDEC to offer new and improved services, notably DVP settlement also for newly issued shares, dividend payments made directly to JASDEC participant accounts (for onward distribution to the participants' clients) and more efficient communication of shareholder information between JASDEC and issuers or their transfer agents.

Of particular interest to foreign investors: In the dematerialized environment, JASDEC will be able to collect from its participants on a daily basis data regarding the number of shares held by foreigners. Therefore, JASDEC will be able to disseminate up-to-date foreign ownership ratio information to the public. Foreign investors thus will be able to know earlier if and when a foreign ownership limit is about to be reached.

Transition period: Shareholders whose shares are already in custody with JASDEC, will not need to take any action during the dematerialization process. Shares held physically outside of JASDEC will be subject to mandatory dematerialization, too. In that case, shareholders will need to follow certain procedures to ensure that they retain their shareholder rights and the ability to sell their shares.

With dematerialization completed in 2009, more market-, shareholder-, and issuer-related information will flow electronically through JASDEC. This will yield opportunities to further enhance STP and to offer new value-added information provision services. JASDEC will be enabled to meet its customers' needs even better than today.

#### **4.2 Electronic Proxy Voting (Takeo Nagatani, ICJ, Inc.)**

ICJ stands for "Investor Communications Japan". ICJ, Inc. is a joint venture between the Tokyo Stock Exchange, the Japan Securities Dealers Association and Broadridge Financial Solutions, Inc. with the objective of creating and operating an e-voting platform for institutional investors globally.

According to an international survey conducted by the Asian Corporate Governance Association (ACGA) Japan today ranks lowest among ten Asian markets with regard to proxy voting services.

Using a four-phase illustration (with Phase I describing the current, paper-based environment), Mr Nagatani explained how ICJ's service offering improves the proxy voting process dramatically.

Phase I: In today's environment, paper-based processes and long intermediary chains often make it impossible for foreign investors to make informed decisions and meet the voting deadlines. Indeed, many foreign shareholders do not vote whereas almost 100% of domestic investors do.

Phase II: Overseas investors (= beneficial shareholders) may make use of Broadridge's global platform to vote electronically. Their vote reaches their global or local custodian in Japan electronically, where it is "converted" to the registered shareholder's name. (= the custodian's). From then on, paper processes between custodians, transfer agents and issuers are manual. This phase therefore is a partial solution. It yields improvements to the investors, but not to the other stakeholders.

Phase III: An electronic solution ("Transfer Agent E-voting") was implemented to link the transfer agents to domestic retail investors. It is however not geared towards domestic and foreign institutional share-

holders who may be "registered shareholders" but are not at the same time the beneficial owners. This is a further partial solution.

Phase IV: The ICJ platform closes all gaps. It enables foreign investors (= beneficial owners) to transmit their votes electronically directly into the Transfer Agent E-voting Platform, from where it reaches the issuer in a real-time mode. No detour via their local custodian is required anymore, and no manual handling. The total process time is reduced from many days to just hours. The entire cycle can be completed within less than 24 hours.

The next ACGA survey should therefore propel the Japanese market from a lagging to a leading position.

## **5. Foreign Investor Activity in Japan**

### **5.1 Deregulation and Tax Reform Issues – The Path to a True Global Market (Takashi Kimori, The Bank of Tokyo –Mitsubishi UFJ, Ltd.)**

In the Japanese equity and JGB markets, foreign investors are representing an increasing proportion of trading volume and holding value, now having a larger influence on the market. Market initiatives aiming at the improvement of securities settlement and taxation should better facilitate foreign investor activity and ensure compatibility with global standards. Faster moves in such initiatives are desirable.

A series of slides was shown to illustrate foreign investor activity and underline the growth rates in the Japanese market over the last few years. Against this background, reforms were undertaken (some still ongoing) in four areas:

#### ***A) Recent and Current Achievements***

##### **Securities Settlement System Reform**

The Law Concerning Book-entry Transfer of Corporate and Other Debt Securities went into effect in January 2002. The dematerialization of JGBs was achieved in full in 2003, and the dematerialization of Corporate and Municipal bonds in 2006.

The Law regarding Dematerialization of Stocks went into effect in June 2004. Dematerialization of listed stocks will be achieved in 2009. At that point in time, Bank of Japan will be the ultimate custodian for JGBs, all other dematerialized instruments will be held in JASDEC.

##### **Preferential Taxation on Dividends**

Japanese issuers still have a preference to use profits to build up reserves, rather than to pay out dividends. However, the payout ratio has increased through the past five and a half years (through September 2007) and was up 17% from the previous year.

Preferential withholding tax rates on dividends on listed shares were introduced in 2003 and are in place until the end of March 2009. After that time, both listed and unlisted shares will generally be subject to 20% withholding tax.

A number of double tax treaties with major third countries (USA, UK, France) were revised. Certain foreign institutional investors, such as pension funds, became eligible to enjoy tax exemptions.

##### **Tax Exemption on JGB interest**

Starting 1999, a series of measures were implemented to enable foreign investors to obtain tax exemptions and to benefit from simplified administrative procedures.

##### **Revision of the Company Law**

A modernized Company Law, which replaces part of the Commercial Code, went into effect in May 2006.

**B) Outlook**

Looking into the future, a number of additional initiatives are under consideration or in their early stages. These include:

**Standardizing Communication Messages**

Especially in Europe, SWIFT is the leading and driving message carrier for securities settlement and custody related communication. In Japan, SWIFT today is mainly seen as a tool to support cross-border transactions. The CSDs (both BOJ and JASDEC) use unique message specifications for matching and settlement. An alignment with global standards is intended. JASDEC has signed a Memorandum of Understanding with SWIFT to implement UNIFI-XML (ISO20022).

**Minimizing Settlement Risk**

A shortening of the settlement cycle from T+3 is under consideration. However, the time zone difference between Japan and the US market is a major impediment (close of business on trade date in New York is already T+1 in Tokyo). Improved STP rates throughout all intermediaries to a trade would be a mandatory prerequisite if a shorter settlement cycle really were to reduce settlement risk.

**Expansion of JASDEC's Role**

With the completion of the dematerialization of shares in 2009, JASDEC will have reached a very major milestone of the Securities Clearing and Settlement System Reform. Today, JASDEC does not handle the distribution of dividend and interest income payments, nor tax administration. These may be new fields of activity for JASDEC.

**Streamlined and Electronic Tax Filing**

After a series of measures to create a more attractive tax environment for overseas investors have been implemented (see above), the next steps will focus on the simplification and streamlining of the technical aspects of tax processing, such as electronic filing.

**5.2 Prospects of the Tokyo Market as an International Financial Center:  
Past, Present, and Future (Dr Arito Ono, Mizuho Research Institute Ltd.)**

In a global comparison, the Tokyo market has grown at a slower pace than others. Within the context of a broad reform agenda addressing globalization, the Japanese government is currently discussing the "Plan for enhancing competitiveness of financial and capital markets". A report is scheduled for publication in December 2007.

However, the topic of financial globalization is not new. In the mid 80's, there was an ambition for Tokyo to match London and New York as a leading international financial center. In the mid-90's, a "Big Bang"-style deregulation effort was undertaken, with the objective of making the Tokyo markets "free, fair and global". A third round is now being discussed.

A number of challenges and opportunities lie behind the current debate:

- Globalization of corporate financing on one side, and of investor behavior on the other side
- Rapid product innovation (derivatives, structured products) and a blurring of the distinction between different investment product segments
- Aging Population: Among all advanced economies, the Japanese society is aging at the fastest pace. There is a fear that the overall economic growth may slump, and at the same time hope that the financial industry sector could compensate.
- Economic growth elsewhere in the Asian region provides opportunities for the Tokyo markets to act as a preferred and potent provider of financing.

The key determinants for competitiveness in financial markets include the availability of skilled staff, a liberal, fair and predictable legal/regulatory environment, but also issues like a reliable and efficient urban infrastructure, for instance public transportation.

Dr Ono concluded by offering three possible scenarios for the future of Tokyo as a leading financial market place. Given the current state and competitive position of the Asian region, any of the three could become reality:

- With the third round of capital market reform, Tokyo succeeds to become the region's major international financial center
- A contender (e.g. Singapore, Hong Kong, Shanghai, Beijing) wins the top position; Tokyo remains a large local market
- None of the Asian market places emerges as the region's clear leader

## 6. Alternative Investments

### 6.1 Introduction to the topic

#### "Operational Efficiency Enhances Alpha" (Markus Ruetimann, Schroders)

Alpha: a quantitative technique which measures a stock's or fund's outperformance – risk adjusted - of its benchmark. Alpha is a common measure of assessing a fund manager's performance in excess of a benchmark index or a risk-free investment.

Operational efficiency is at the heart of creating value (Alpha) for the end investors and for all firms filling a role along the intermediary chain.

The hedge fund industry is roughly 60 years old. It experienced massive growth rates in the past few years. Currently, some 9,000 hedge funds are active world-wide. Around 65% of institutional investors place an estimated 5% of their assets in hedge funds. Hedge funds use a variety of investment strategies, some of which use leverage and derivatives to accentuate the impact of market moves. Many seek to reduce market risk specifically by short selling investment instruments, and by using swaps and derivatives. Schroders, for instance, launched 44 new products in 2007. 80% of them have derivatives at their heart.

Those strategies have substantially increased the operational challenges custodians are faced with. They place huge demands on the availability and accuracy of relevant data, on operational expertise across a broad instrument range, and on technology to support the lifecycle of a transaction which can span many years.

To illustrate the operational challenge, Markus Ruetimann briefly explained the main features of a number of exotic and complex yet not uncommon options. Two examples:

- Chooser options (a "compound" option that has an underlying instrument which is itself an option, a strike price, a "chooser" date and an expiration date. At the chooser date, the buyer has the right to choose whether the underlying option is a call or a put option for its remaining lifetime.
- Sports derivatives: after every game, the value of the stock of a particular sports team (if it is a traded company) rises or falls depending on the result of the game. Investors trade these stocks and a number of derivatives using sports events as "underlyings".

Conclusion:

To cope with ever increasing volumes and instrument innovation, the asset servicing industry must find credible ways to **reduce** risks, costs, operational complexity, manual interventions, a multitude of different system applications to process an instrument end-to-end, resource requirements, and time to market to come up with automated solutions. At the same time, it must **increase** processing capacity and effi-

ciency through scalable technology, the definition and promotion of industry standards, and making much more use of shared data services.

The next four speakers presented in greater detail some particular challenges from their perspective.

## **6.2 Broker's view (Andrew Hershon, Morgan Stanley Asia)**

Andrew Hershon walked the audience through an OTC derivative trade life cycle and highlighted the differences to the cash market. In the comparatively "simple" cash market, volume is the main driver of resource requirements. In the OTC derivatives world, trades have extended life cycles, and the maintenance of open positions is much more complex, non-standardized and non-automated. Valuation, collateral issues, contractual issues, corporate actions on the underlying instrument require much more monitoring, product and process know-how, and manual handling. For lack of better alternatives, derivatives often need to be represented in systems they were not designed for.

### **Operations Initiatives**

A number of initiatives are under way or have already brought partial relief, but much remains to be done. Generally, more automation is needed to anticipate and mitigate risk. From Morgan Stanley's point of view, other priority areas for automation include trade capture – "we got to get the data right at the beginning" – and more processing steps linked by straight through processing, to eliminate errors caused by manual replication of data input.

### **Asia Landscape**

Andrew Hershon characterized the Asian derivatives market as follows:

- Massive increase in volumes and complexity. Some products had growth rates of 1,000% over the last twelve months
- Massive increase in the demand for derivatives from the retail client side (much less in Japan than in other countries of the region)
- Extreme shortage of skilled staff
- Lack of system support and system scalability. Most systems currently in place were designed to handle a fraction of today's volumes only.
- Regulatory complexity across the region
- Ample room for vendors to enter the market with solutions bringing substantial relief.

## **6.3 Asset Manager's view (Markus Ruetimann, Schroders)**

The challenge of using derivatives safely efficiently and effectively impacts all parts of a fund management firm. It starts with the making sure that the fund manager has the relevant portfolio and risk metrics positions, to ensuring that Operations and IT provide a timely and accurate service, and ends with the client relationship manager being able to explain why and how derivatives have been used in a client's investment portfolio.

The commercial, operational and technological challenges associated with Liability Driven Investment products, or the "130/30" pattern (put 100% of a given investment amount into an index; sell short an equivalent of 30% of the invested amount in stocks expected to perform worse than the index; use the sales proceeds to buy stocks expected to beat the index) are significant. The key obstacle to managing these products is the integration of system components that can deal with derivatives within conventional fund management systems. The need for scaling up existing operations and personnel skills is large.

To illustrate the dimensions: Schroders currently has some 120,000 open positions in Exchange Traded Derivatives (ETD) and some 1,200 open positions in OTC derivative contracts. OTC transactions at Schroders rose 150% over the last twelve months.

### Industry Inefficiencies

From a fund manager's perspective, there are no efficient, tested and proven operating models. With every OTC contract being custom-based, it is very difficult to standardize the various data components. Firms are all trying to leverage existing systems and processes while avoiding to create dedicated processing environments "just" for derivatives.

Fair and independent valuations of OTC positions are difficult to obtain, but are critical to both investors and regulators.

Ensuring timely mark-to-market requires highly skilled staff who understand the process and the technology to support it.

There are outsourcing opportunities with respect to valuations and collateral management, but this fragments the process, hindering operational efficiency if not making it impossible.

Accounting systems at fund management houses typically do not support complex dealing structures or instruments like derivatives as many of these systems were designed twenty years ago.

Global custodians are all struggling to deliver support for derivatives without creating yet another different platform or operating environment.

There is an ongoing war for talent and substantial resources are spent in each firm to run internal training and education courses on derivatives, to raise the awareness and technical understanding across fund management, operations, sales and marketing.

Schroders intend to centralize all aspects of derivatives post trade processing in one unit while leveraging existing order and transaction life cycle management systems. An internal assessment concluded that there is no appropriately integrated technology solution available yet in the market that could sufficiently cover the entire lifecycle of a derivatives transaction from trade capture to collateral management and close-out. There are still too few industry utilities that can provide solutions to fund managers, brokers, and/or custodians. DTCC is a notable exception with their confirmation service for credit derivatives, Deriv/SERV.

Taking an industry-wide perspective, the key challenges and optimal solutions look as follows:

CHALLENGE	PRIORITY	OPTIMAL SOLUTION
Price capture	Ease of access	Electronic use of broker's pricing model
Trade capture	Low cost	Integral to fund manager's order management system
Compliance	Timeliness	Integral to fund manager's order management system
Confirmations	Scalability, low cost	Electronic interfaces, use of industry standards
Accounting	Integration, low cost	Integral to accounting platform, else outsource
Valuation	Risk reduction	Independent valuation agent, outsource, use of standards
Payment	Scalability, low cost	Integral to accounting platform, else outsource
Collateral mgmt	Risk reduction	Integrated system, incl. workflow tools and reconciliation

## Conclusions

- The industry must find a way of promoting standards in the fields of legal documentation, collateral management, valuations, and data management.
- Industry utilities such as ICSDs, CSDs and global custodians are encouraged to accelerate their endeavors to provide outsourcing solutions which span the entire lifecycle of derivatives, from trade capture to close-out.
- Operational scalability is essential as market volatility and investment risks are likely to further increase the use of derivatives.
- The war for talent to attract skilled operations and IT staff will heat up.
- Above all, the industry must work together to find ways to reduce operational risk in the derivatives arena.

## 6.4 Custodian's view (Matt Brown, Citi)

### Trends

Globalization of the market environment is a general trend for all asset managers. However, without a globally compatible operational framework, the industry cannot continue working effectively and efficiently. Globalization itself cannot succeed without innovation as regards product design, product servicing, and regulation.

Over the last five years, hedge funds have made a transformation from a rarely used, rather distrusted instrument to a core part of almost every portfolio.

Pension funds today contribute roughly a third of all funds placed into alternative investment instruments.

### Challenges to custodians

There are *always* operational and regulatory challenges when entering a new market!

Data management: Do reference and pricing data come from reputable and consistent sources, and are the approaches to create them consistent? The cost for purchasing data to manage derivatives is far higher than for cash instruments.

Technology: There is almost always a time gap between the launch of a new product and systems availability to process it.

Staffing: "Train and Retain" is the buzzword in the derivatives business. Many candidates would like to enter the industry, but few bring along the required skills.

Risk Management: Highly customized service offerings are demanded, which increase cost per transaction.

Education: Both the investors and the industry servicing them tend to lack know-how in the sufficient depth.

Regulation: There are diverging views and inconsistent approaches on the object of regulation: Should it be individual funds, market participants, entire markets?

Growth: Annualized market growth rates are staggering, often 30% or more.

## Implications

- Custodians must be able to move from simple administration to robust accounting and management information reporting
- Operational risk become ever more complex
- Valuation of OTC products (pricing) is complex and new product structures accentuate this even more. More specialized pricing and product knowledge is necessary.
- Evolving fiduciary obligations: If a custodian handles ever more complex products for a client, it incurs a greater fiduciary duty

## Recommendations

Industry standards or industry-wide collaboration is recommended in these areas:

Transparency, with regard to investment policy, valuation (pricing) policy, and responsibility of each party involved. Two out of three hedge funds today do not have a defined valuation policy which their administrators must follow!

Risk Management: Key risk areas include Know Your Customer/Ant-Money Laundering issues; mandate risk, investment manager risk, balance sheet valuation risk, and security/investment instrument valuation risk.

Lastly, the industry must demonstrate commitment to work jointly towards constant enhancement of everyone's operating environment, as regards staff and client education, process automation, core portfolio management and supporting systems support. The valuable work of dedicated industry organizations such as AIMA, IOSCO and others should be supported and leveraged.

## 6.5 SWIFT View (Yuko Ochi, SWIFT Japan)

SWIFT was created to replace the telex and automate the financial industry. SWIFT has a history of more than thirty years laying the groundwork for Straight Through Processing, and has been successful in payments, securities, FX and trade finance

Despite huge improvements the industry has seen in terms of STP, significant risks and costs still exist in the post-trade processing areas. The OTC derivatives market in particular is facing a growing back office logjam. Regulators are increasingly intervening and strongly recommend to pay more attention to back office costs and risks.

There is a paradox in the industry: While investors hedge against market risk – and the use of derivatives is a tool to that end – new operational risks are being created. As OTC derivative volumes have exploded, the processing infrastructures have not been able to scale up sufficiently. Solutions, if any are available at all, tend to be proprietary and of a patchwork nature.

The real challenge SWIFT is facing now goes beyond automating isolated pockets of inefficiencies in the market. It is all about providing true interoperability among market participants globally, across the trade lifecycle and independently of the traded instruments. SWIFT therefore has to have a view on the challenge of making OTC derivative processing more efficient.

### The major industry challenges

The move towards alternative investments such as OTC derivatives is permanent. The most important challenges and inefficiencies include the following:

- Confirmation backlogs, delays and errors: The process is mainly paper or fax based and typically bilateral. Trade capture, the generation, matching and approval of trade confirmations is error-prone and suffers from discrepancies.

- Growth rates of the usage of derivatives are explosive and this is coupled with constant product innovation. The service providers have been unable to cope with volumes, pace and growing complexity. The usage of standardized processes is urgently required here.
- OTC trades are private by essence. Independent, timely and frequent valuations are usually not available. And when they are, they are disseminated in a non standardized fashion to the calculating agent. However, independent valuations are increasingly required which makes it even more mandatory for the quoting party to standardize processes.
- There is no single provider or system able to process all types of derivatives. There is a need for a consolidated infrastructure, or at least a provider of interoperability between these different systems, to avoid the need for a multitude of bilateral relationships.
- Technology and deregulation have provoked an explosive growth of cross-border transactions. While STP is seldom an issue in the domestic market, it clearly becomes one when you deal in ten different markets, having ten different standards, ten sets of regulation, etc. Globalization is inevitable, but the processing issues will globalize as well.

SWIFT attempted to quantify the annual costs of these inefficiencies and arrived at an alarmist amount of 3 billion Euro annually, just for the OTC derivatives market. SWIFT believes that, while not all these costs can be eliminated, more than 50% are attributable to the lack of STP and standardization.

An analysis of the use of existing standards in derivatives processing (listed and OTC products) reveals that there is no industry consistency nor interoperability among market participants: FIX prevails in pre-trade, but not in the post-trade areas. Buy side and Clearing House members and CSDs communicate using ISO standards to some extent. However, most communication between the exchanges and their clearing houses, or between clearing houses and clearing members is in proprietary formats.

### **Solutions**

To deal with the complexity of OTC derivative contracts, more and more participants are beginning to adopt FpML (Financial products Markup Language) which is a standard protocol for complex financial products.

SWIFT has been offering FIN for many years but decided to develop and carry FpML standards for the OTC derivatives area on SWIFTNet. SWIFT worked closely with ISDA and other market groups. SWIFT's FpML Closed User Group, a live service where asset managers submit trade notification messages using FpML on their existing SWIFTNet infrastructures, is a one step forward to link the buy side with custodians by means more efficient than fax.

In 2007, SWIFT entered into a Memorandum of Understanding with ISDA and developed nine FpML messages (six trade notification and three confirmation messages). Based on those, new FpML messages such as Contract created, novated, increased, cancelled, terminated are already used live in the Closed User Group. In 2008, SWIFT will offer value added services in the area of validating interest rate derivatives and credit default swaps. Beyond 2008, further instruments yet have to be prioritized to cover matching between equity swaps, syndicated loans, total return swaps and others. SWIFT user feedback will guide the process.

Other service providers have also been responding to the market inefficiencies already. SWIFT intends to link with them if there is user demand for it. For example, SWIFT is transporting DTCC's services via SWIFTNet for non-US participants so they can reuse their investments in SWIFT infrastructure to connect with DTCC.

### **General Observations**

As a standards body for more than thirty years, SWIFT witnessed the market evolution for various instruments. Patterns tend to repeat themselves: When product demand and volumes are low, processing

can be done manually and the complexity can be solved by adding more back office people. As the demand grows, the risk will increase up to a point where the regulator will intervene. Service providers will then start to look at re-engineering their processes and improve the overall efficiency.

Learning effects will start to play. At one point in time, the demand will justify the need for automation and financial institutions will be able to provide a business case for STP.

But then, and if the demand continues to grow, there will be a need for industry wide collaboration as one single service provider or market player will not be able to increase its efficiency, unless its counterparties move in the same direction.

We are now at a point in time where this collaboration is required.

## **7. Closing Remarks**

Josef Landolt closed the conference firstly by thanking JASDEC and the speakers for their contributions, and secondly by observing that the agenda had obviously managed to capture the audience's interest, evidenced by the questions raised during the day. The meeting demonstrated that ISSA generates value and has a reason to continue. The association's potential as global, cross-industry body has advantages that should be exploited further. But like in the industry initiatives addressed during the day, success depends on the commitment and active participation of the member community. In that sense, all ISSA members are encouraged to stay involved and continue contributing to the success of ISSA.

\*\*\*