



CUSTODY RELATIONSHIPS A CARTHAGINIAN APPROACH

Sponsored by **vermeg**

A WHITE PAPER FROM B.I.S.S. RESEARCH

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INTRODUCTION

This whitepaper was commissioned by Vermeg, one of Europe's leading software solution providers supplying some of the worlds leading Custodians.

Throughout the years that Vermeg has been servicing its customers, it has noted the changes in Custody Operations and that these changes have had a direct impact on the Custodians relationships with their customers.

The Whitepaper examines the historical development of Custodians which led to the creation of today's custody business and also discusses the future business and technology needs in custody relationship management and servicing.

Custodians can never be accused of not investing in their business. Over the years countless budgets have been spent in building better systems. But it has been specific systems which have sucked in most of the investment for development, tending to be centred on cost and risk reductions or with drivers coming from regulatory requirements. Although these are undoubtedly very important; indeed fundamental, as a service industry the primary emphasis should always be on client services and customer relations.



OPERATIONAL DECLINE

If there is one thing that has stood out during this current financial crisis, it is the need for custody operations to be greatly improved, especially in client services where over decades we have seen a decline, as the volume of transactions continues to increase on a global scale.

Today, investment portfolios are made up of international securities often alongside an array of complex investment and trading strategies and 'over the counter' (OTC) bespoke financial instruments.

The wide use of the web across the worlds securities markets has created a global market place, where institutional and wealthy private investors can invest anywhere in the world, over many new trading venues.

The volume of transactions grows unabated in domestic and international markets and has put huge pressure on the financial processing capabilities of all securities firms, whether large or small from an investing or trading aspect, but it is the Global Custodians that are positioned to take most of the weight.

HANDLING THE PRESSURE

As the international markets buckle under the weight of transactions and the growing complexity of financial products, the financial crisis that first started to bite in 2007/8 was an unwelcome watershed for Global Custodians.

The breakdown of the financial system importantly included the banking credit crisis, which quickly led to a global economic crisis and this led directly to defaults in banking, the private and public sector and eventually the huge government bailouts, of many of the worlds leading banks and all these banks had a custody operation and it is in the custody

area where the industry looks for operational processing excellence and quality of service, which underpins the ability of the market to process efficiently.

For many financial institutions the last two decades have focused too much of their attention and budgets on the mountainous number of new or enhanced regulations that seem to appear all too readily from the regulators.

This has now reached outrageous levels where managers cannot develop systems without first checking what the regulators want. This seems to be a worldwide phenomenon, which following the global financial crisis, shows no sign of abating.

The importance of effective rules and regulations for the market can never be understated but this should not be at the expense of customer services and supporting the client.



HERE COME THE POLITICIANS

Apart from the regulatory burden afflicting global markets there has also been a striking political objective, which has predominantly set the agenda for the securities markets in recent years. For example the European Parliament has caused a significant amount of structural change in Europe, which has put pressure on legacy systems and attacked historical market relationships.

This has been most evident with the break up of the Stock Exchange Cartel into a mixture of new cheaper and faster trading venues and as the markets recover from the financial and economic crisis, changes affecting the markets will continue to be profound and felt worldwide.

Structure changes and the desire to produce more secure, robust and cheaper services for the investor and customer will inevitably be manifested in the need for new or enhanced systems.

The impact of these multiple changes in market structure, in global financial markets, will affect all types of financial services firm, but it is the Custodians who will bare the greatest brunt. Custodians are the engine room of the Securities Industry's Operations and it is imperative for the future success of the industry that they are able and fit for purpose.

This is an exacting position and it will tax both their management skills and of course, systems development budgets. If the Custodians are to keep up-to-date and remain competitive, they will need a long term plan and strategy for change, which enables fast tactical implementation of tested solutions; all this at a time, when a lorry load of regulations are inundating the 'in trays' of their IT Directors. But it is important that Custodians should not take their 'eye off the ball' in supplying quality customer services.

Custodians are instrumental in making the changes inspired from political objectives, successful in the global securities markets and there is no 'timeout' to close one project before embarking on the next, so the Custodians have to be able to multitask to perform everything expected of them. This is putting severe pressure on their management capability as well as their legacy systems.

A VITAL LYNCHPIN

Global Custody is an international business that links market participants by performing operational processes, producing communication and data between trading counterparts and investors. For example the data required to settle transactions is maintained by the Custodian and then communicated to other parties or agents involved in the deal. The eventual payment/receipt details are also maintained by the Custodian to enable final settlement. It is the Custodian that is the vital lynchpin in this process.



A REGULATORY PARTNERSHIP

The Global Custodian is integral in providing an international window into the activity and flow of transactions and assets, which could be used by Regulators and Government Treasuries to monitor trends.

International harmony in regulation has been on the world Governments agenda to find solutions to the financial crisis problems highlighted during the recent hiatus.

The detection of legal or regulatory infringements can never be the sole responsibility of the Regulators and with the Global Custodian there is an opportunity for a perfect partnership to monitor more closely the worlds securities markets, by creating an early warning system through the Global Custodians to potentially detect when a bank is heading into difficulties.

CORE FOCUS

The Custodian is in a pivotal position for implementation of change but despite the huge focus on their operational processing powers, they must always have a core business focus. That core business focus has to be acutely trained on the needs of investors and brokers.

Here's the rub! Whilst the Custodian peddles furiously to maintain operational excellence it is ultimately their ability to service their customers and the investors, which will determine if the markets are performing and at the same time achieving what most politicians will be measured against.

The Custodians are the cornerstone between the wholesale and retail markets and any breakdown will have severe consequences in both.

MiFID

Throughout the history of the global securities markets, relationships and dependences have been created that are not necessarily logical in today's world.

This was highlighted wonderfully in the International Securities Directive and subsequently the Markets in Financial Instruments Directive (MiFID). But often, it is the illogical market structure that proves a barrier to instigating changes, whether from a political or business angle. Market structures are very rarely designed but an evolutionary manifestation.

Rules, systems and processes are created to reflect business relationships and evolving market structure. These can be complicated, perverse, expensive and very difficult to change. Years after MiFID some markets in Europe are still technically illegal because of the difficulties in implementing change.



The investor is often oblivious to the complexities of the market and is certainly not engaged in any market directive for change. All the investor is interested in is a good deal, at an acceptable price, settled on time and without risk.

The Custodian therefore has to ensure a positive investor experience, by being competent and able to operate within the problematic areas of the markets.

THE WEAKEST LINK

It's long been accepted that different business sectors within the securities markets are all heavily interdependent on each other, like a long chain, which is only as strong as its weakest link. Unfortunately in the global securities markets there are an untold number of weak links.

Over decades there have been many committees and groups, formed to identify weaknesses and specify solutions, but each attempt has only managed to slowly inch the industry forward. This track is definitely on the slow train to change.

Even the much lauded Giovanni report published in the nineties and the long list of initiatives that followed, mainly failed to make serious headway, in solving the industry problems, in operations. Indeed, today because of political interference the agenda has changed and the initiatives to effect change are still being designed.

HISTORY LESSONS

Going way back to 1988 and the global 'Group of Thirty', initiative that was spawned by the settlement crisis of 1986/7, the ability of the securities markets to produce industry solutions has been mixed.

Certainly the introduction of SWIFT into the securities markets was a ground breaking move, but in the early days that caused more operational problems than it solved. At the time, SWIFT's network and messages were totally inadequate, unable to achieve the tasks expected.

By the early nineties, ISITC and other groups had been created to specify solutions and this led to the design in 1995 of the ISO15022 message. However, it took many years to implement and only finally saw the light of day in 2003. Now the Industry is looking at embarking on its replacement or evolved message ISO20022, depending on what side of the fence you're sitting.

Another 'Group of Thirty' requirement was to introduce shortened settlement cycles in the world's securities markets. This also produced the need for faster and more accurate trade confirmations and the eventual specification of Electronic Trade Confirmation (ETC). Despite the ETC solutions, the worlds markets still operate on a non standard settlement timeframe; so only a partial success without the complete solution originally specified.



In the late eighties and early nineties there were strong doubts in many market quarters, that the custody business would actually survive, as a number of large consolidations in the custody market had slimmed competition and created huge Global Custodians.

Most of the Custodians were part of large banking conglomerates, which included a 'one stop shop' approach to attract institutional investment.

Banks having assembled capabilities in Fund/Asset Management, Brokerage and Custody in their securities business and with their retail banking outlets, were able to become enormously successful, powerful and in modern terminology were *too big to fail*.

During the course of this period of corporate change, it's doubtful that the investor and customer were not affected; costs certainly went up in real terms and services were patchy at best.

Unfortunately the customer is often a casualty when pressure is exerted on the Custodian. This should serve as a lesson for Custodians today.

AFTER CARTHAGE CAME THE INTERNET

The introduction of the internet in the early nineties really accelerated the international investing business with enormous growth in transaction volume and of course the subsequent payment requirements. With the speed and scale of growth in the international markets huge stress was put on the systems and procedures of the Custodians.

But it should not be forgotten that people working in operations also bore the brunt of the burden as the banks struggled to cope. With international business growing almost exponentially through the nineties and the first decade of the new millennium it is in the engine room of Global Custodians where the battles are being fought and where the war must be won. In IT, was 'it ever thus'!

Today, the securities markets are a global highway for international investment. Institutional and private investors have increasing global portfolios and demand the ability to invest anywhere they can make a profit. These international developments in the markets have been made possible because of the worldwide web, which has created globalisation and the world's population is embracing it on an ever increasing scale.



Globalisation is not new in real terms, with the history books showing that over 2500 years ago Carthage was the most powerful and successful centre for world trade.

Carthage started 'a global trading culture' through its ability to build and house ships safely, sailing the seas to trade wares across the world, building a rich and powerful economic force. In today's global trading environment, the web enables virtual ships to travel anywhere and trade anything.

The Carthaginian success story was only curtailed because of the intervention of Roman aggression; although, today Tunis is building itself a reputation as a centre for financial innovation and excellence.

Each year the growth of online access exceeds the last and with direct communication and online knowledge, comes an increased desire by the consumer and investor. It is the incremental expectation of the consumer/investor, which is putting more pressure on the securities markets and it is the systems and in-house servicing capability of the Domestic and Global Custodian that will determine if the investor experience is good or not.



NO TIMEOUT

One of the main problems in producing solutions in custody operations is to implement whilst the business continues to flourish. It's a bit like being on a treadmill, there's a need to stop and catch your breath now and again, but in custody there is no stepping off.

Most Custodians would agree that their systems need to be upgraded and their architecture reviewed and aligned. These are difficult tasks for any business but for Global Custodians extremely difficult. The result is that systems development solutions are more often tactical than strategic and an ongoing nibbling of the problem occurs, when radical strategic implementations are the order of the day.

With the regulatory framework under continuous evaluation and subject to change, flexible systems are of paramount need for businesses. Modular systems that can be developed tested and implemented fast have to be identified.

It is an unlikely scenario that any solely based in-house developed IT will be as successful as procured technology. The commercial software vendor has a faster development lead time and an ongoing technology upgrade need, which simply moves faster than the best in-house system.

It is the ability to utilise state of the art technology, in modular solutions that holds the key to solving the Custodians problems in systems development.

The Custodians need to develop a skill in systems design architecture, in order to produce a strategic plan for legacy systems replacement, whilst maintaining a competitive edge in the market and most importantly enhancing client servicing and customer relations.

SUMMARY

With the global securities market going through a massive change process that is more revolutionary than evolutionary. The pressure is only going to increase on its ability to service the client and maintain the central efficiency of the markets.

It is the Custodian that is going to tie up the problems of fragmented clearing and settlement structures and allow the continued expansion of global portfolios.

Regulations have been a driver for transformation in the recent past but this has to change. Managers in financial institutions must be allowed the opportunity to manage. Whether its systems developments or changing practices they have to be given the authority and the ultimate responsibility. Management by committee should be consigned to history.

However, the breadth and depth of knowledge at senior management level has been found wanting in recent times and this is a worrying situation when so much needs to be done.

Ongoing training and development of management should be a prime objective for financial institutions. Organisations like the CISI in London and SIFMA in New York are first-rate in providing a central standpoint for raising industry excellence and producing qualifications. These should be made more use of by Custodians and their customers.

The desperate need to replace legacy systems and ensure compliance with changing regulations has to be an ongoing objective. However, firms must always remember that their business starts with the customer and ends with the investor and that's how ultimately their success will be measured.



ABOUT VERMEG

The following information has been provided by the vendor

Vermeg provides a broad range of next generation software solutions for middle and back office operations of asset managers, Custodian banks and financial institutions involved in portfolio management, fund administration and securities processing. Among its clients are major financial institutions in 15 countries.

Since its creation in 1994, Vermeg has maintained recurring growth and profitable activity.

Vermeg's suite of solutions includes OMEGA FA for Fund Administration, MegaLend for Securities Lending & Repo and MegaCustody for Custody & Settlement as well as Megacor.

Megacor is a securities processing system that automates all the tasks of a Corporate Actions back office.

Its functionalities include:

- Corporate Action data capture & cleansing
- automatic multi media client/fund manager notification
- client/fund manager instruction capture and processing
- instruction consolidation (when required) and routing to the related sub-Custodians or CSD's
- automatic entitlement calculation/simulation/confirmation
- comprehensive tax management module
- market claims management

Megacor is fully 15022 compliant and was the first solution to have been awarded the Corporate Action Swift Ready Label. Furthermore, Megacor's design and interface layer simplify its integration with all the back office downstream systems.

Megacor uses a highly flexible, automated workflow – based securities processing engine, allowing users to set up Corporate Action management rules and to handle exceptions through Service Level Agreements which define client notification preferences, standing instructions, actual/contractual settlement requirements, etc.

This flexibility has enabled Vermeg to install MEGACOR in over a dozen countries including 3 sites that each handles over 60 markets.

Megacor technology is built in n-tier J2EE architecture, using Vermeg's in-house Palmyra framework. It offers a thin client interface available through a web browser.

The system is independent from operating systems, RDBMS and hardware. It runs on any J2EE compliant application server (Websphere, Weblogic, Jboss, etc), any RDBMS (DB2, Oracle, etc) and any operating system compatible with this software.

For more information visit: www.vermeg.com

Or Contact: Christian Cure, E.V.P. and Head of Sales

Email address: ccure@vermeg.com

Tel: + 33 1 55 80 24 20



ABOUT THE AUTHOR



Gary Wright, MSI, C.E.O. B.I.S.S. Research has been active in the Securities industry since 1969 and during an impressive career in the City has held senior positions in some of the worlds top financial institutions. He has also been employed within a number of leading suppliers giving him a unique position to appreciate the problems of procurement from both sides. He is the creator of the unique B.I.S.S. Accreditation, which independently benchmarks international systems and services from the buyer's perspective.

An accomplished speaker and commentator on the many changes in the global financial services market place, he is regularly contacted by the media and financial services organisations for his forthright opinions and independent analysis.

His blogs, articles, whitepapers and reports are published world-wide both on the web, in the press and trade journals.

During his career he has been involved in many industry committees covering the many initiatives that have shaped today's securities markets; including setting the CISI Operations Management exam papers, lecturing at Reading University and at the ICMA Montreux event.

He has run a number of industry workshops, training sessions and roundtables and chaired and spoken at many conferences globally on topics related to Financial Services.

ABOUT B.I.S.S. RESEARCH

B.I.S.S. Research is an independent company providing analysis of financial market issues, technology and services of suppliers in the Global financial services industry.

B.I.S.S. Research analysts are all from a business to IT background with a long track record experience and procurement in the financial services market place, which enables them to produce unique and valuable assessments of technology and services and their value to the supplier and the market place. B.I.S.S. Research analysts are available for commission for report writing, articles and speaking engagements including web broadcasts.

B.I.S.S. Research undertakes commissioned research projects for financial institutions and vendors that range from the securities market to the payments industry. Its white papers and thought provoking articles are regularly featured in the media, as well as being published on the B.I.S.S. Research website.

B.I.S.S. Research has created a unique benchmarking methodology to prove the real capability of functionality and service capabilities to buyers in the financial services industry. The B.I.S.S. benchmarking has been operating since its creation by Gary Wright in 2003, which is to be launched on-line shortly.

The B.I.S.S. Accreditation Logo is rapidly growing as mark of confidence for the buyer of software and services, it proves that the vendor has received an independent valuation and thus helps secure the purchase.

The Benchmarking report is an independent source of detailed information and published globally on the B.I.S.S. Research website and marketed through the industry media and analyst channels.

B.I.S.S benchmarking is suitable for suppliers of any financial system or service including; Front Office, Middle Office, Back Office, Corporate Actions, Compliance (including MiFID, SOX, Basel II), XBRL, Market & Reference Data, Risk Management, Treasury, Payment, Banking Services, Custody Services, Broking Services, Stock Exchanges, CSDs, Web Services and Integration.

B.I.S.S. Research is a privately owned company based in the UK, but marketed globally, where it has already large international customer base.

For further information visit www.bissresearch.com

Or contact: Gary Wright

Email: gary.wright@bissresearch.com

Tel: + 44 (0)207 549 3564



