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All for One and One for All
Expanding Horizons
A Return to Innovation
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While uncertainty remains the keystone of daily discussions on capital, regulations, and resources, financial institutions must embrace innovation to take advantage of opportunities arising from globalisation, urbanisation and digitisation.

Crisis can be a powerful catalyst for transformational change. As witnessed over the last several years, the crisis has magnified constraints on capital, on talent, and on resources; it has fostered deeper regulatory focus and reform, and highlighted the need for even greater operating efficiencies.

“As some of the most dominant institutions in society, financial firms and corporations need to be at the forefront of this change and embrace innovation in a rapidly changing business environment,” he says.

Evolving Globalisation

Social, political and economic forces are being compressed into an increasingly connected global economy that is more and more complex. There are millions of individuals in growth markets who are rising to the middle class and will require increasingly sophisticated and convenient banking services. The global workforce has developed shifting migratory patterns that require access to both relevant local and seamless cross-border banking services. New growth in export and import markets is spurring multinational operations that require unique international banking support. “At Citi, we move over $3 trillion on behalf of our clients in 135 currencies, facilitating more than five million transactions each day, with connections to over 200 clearing systems globally,” says Vanni d’Archirafi.

“Meanwhile, as individuals increasingly move to become citizens of the world as a result of travel, education, communication and investment, we must all take on a new sense of responsibility to the broader enterprise that encompasses our communities and our utilisation of the finite resources that we have at our disposal.” Citi is committed to responsible finance which integrates social, environmental, and financial responsibility into its global operations.
The bank leverages its global network to support the underserved with socially inclusive programmes such as crossborder remittances and mobile applications that service the unbanked population, and partnerships with export and agency finance players that deliver capital to support the development of enterprises in growth markets.

Initiatives to address global climate change include investments, financing and activities that support the commercialisation and growth of alternative energy and clean technology in markets around the world; helping craft industry standards addressing carbon risks in the financing of electric power plants; and a framework to manage and assess the financing of large infrastructure projects to ensure sound environmental and social practices.

**Toward Urbanisation**

In addition to an evolution toward global citizenship there is also a migration trend toward urban centres in developed and developing nations. Today more than 50% of the world's population lives in cities—a figure that will grow to 75% in the next 40 years. The trend toward urbanisation has significant impact on citizens, corporations, and governments. The complexity of cities requires integrated yet dynamic solutions to support financial, administrative, and commercial infrastructures, all of which are required to solve the unique challenges cities face apropos efficiency, modernisation, citizen empowerment and access.

Vanni d'Archirafi says: “At Citi, we are working with a number of urban agencies, governments, and enterprise players to address these challenges, helping to provide...
cities with increased access to liquidity by extending risk participations; to pay employees and unbanked workers and deliver social benefits to citizens in multiple currencies; to improve efficiencies through financial process automation and controlled cash flow; to provide digitised solutions for tax collections and transit operations that contribute to making the running of cities and the supply chain ecosystem more efficient, both financially and socially.

The Future is Digital

The trend toward digitisation is pervasive. "Disruptive technology—the burgeoning use of the internet, mobile technology, and social media—has already begun to influence the way people live and work. Digitisation of money and information is one of the most important trends for financial institutions," says Vanni d’Archirafi.

"Citi is among the leaders in digital banking, harnessing the newest technologies to empower our clients to achieve tangible business goals by employing smart, secure, intuitive and relevant methods using any device, anytime, anywhere," he adds.

“We are helping our institutional clients to build competitive, efficient and global businesses by supporting their efforts to start, scale globally and grow their digital businesses and ecommerce efforts. Leveraging digital and online capabilities, we’re delivering paperless information and supply chain flows; creating digital money opportunities in payments, investing, and information content; and integrating internet and mobile delivery channels across consumer and institutional organisations. For example, we’ve recently implemented a mobile collections service for corporations in growth markets, evolving the collection of cash for delivered goods to an e-wallet that helps secure funds and decrease risk.”

Innovation-Minded

As evidenced by the megatrends of globalisation, urbanisation, and digitisation, the pace of change is more rapid than ever before.

“Innovation must be at the heart of everything we do. Through innovation, Citi addresses these trends in a manner that provides real value for our clients, our partners, and our society,” says Vanni d’Archirafi. “We believe in a framework and a process for innovation that centres on co-creation with our clients and partners. Our clients’ challenges are our challenges and we commit to working tirelessly to make innovation relevant and real—creating new paradigms that promote the next leap forward.”

By working together in unprecedented ways, corporates and their supply chains, transaction services banks, export credit agencies, government development agencies and credit insurers will all become meaningful parts of the solution to the problems facing the industry.

Vanni d’Archirafi says: “It is with a sustained commitment to collaboration and investment in innovation that we and our partners will continue to capture growth and thrive.”
Africa’s New Frontiers

Growing investments from BRIC nations and Japan; a steady flow of development aid; and a burgeoning export economy are all contributing to a more established infrastructure across Africa. But firms interested in doing business on the continent have some things to consider in order to be successful.
Investment and Trade Flows on the Rise

Despite long-standing commercial ties with Europe, Africa now conducts half of its total trade with developing economic regions. From 1990 through to 2008, Asia's share of African trade doubled to 28% while Western Europe's portion shrank from 51% to 28%, according to consultancy McKinsey.

“A significant ‘game changer’ in Africa during the past few years is the increase in commercial activity in the region by China,” says Sridhar Srinivasan, Head of Bank Services for Central & Eastern Europe, Middle East, and Africa at Citi Global Transaction Services. During 2008, China's trade with Africa totalled $107 billion and 30% of China's oil supplies now come from the continent.

China’s thirst for commodities such as oil and minerals to drive its economic growth and industrialisation has led to a steady rise in activity in Africa, which has also driven up commodity prices there. But China’s involvement is not limited to commodities—the country will provide $10 billion of low-cost loans during the next three years and has eliminated tariffs on exports from the least developed nations in the continent by 60%. Along with the construction of 100 clean energy projects and debt relief granted to several nations, China’s involvement in Africa is a two-way street, says Srinivasan.

The Chinese government has set up six special economic zones in Africa which act as hubs for Chinese capital investment. The zones are based on the successful experiment with market liberalisation that China began in the mid-1980s, establishing economic zones on its eastern seaboard to attract investment from the Chinese diaspora in Hong Kong and Taiwan. Observers believe these hubs for Chinese investment in Africa may trigger market reforms and stimulate economic growth in Africa as they did in China.

Japan has doubled its development aid to Africa (it now totals $3.4 billion) but is also investing $1.5 billion in an oil pipeline between southern Sudan and Kenya. More Japanese companies are also committed to increasing their investments in Africa during the next couple of years.

According to McKinsey, the largest share of Africa’s infrastructure spending—65%—comes from the continent’s governments, followed by private investors (25%). Funding from non-OECD countries, of which China is the largest, provides 6%, usually in the form of loans to governments. Official development assistance from multilateral agencies provides the remaining 4%.

Infrastructure Development

“Infrastructure is believed to be a key component to develop Africa’s economy,” says Srinivasan. “Infrastructure spending in the continent rose by 17% CAGR during 1998-2008, from $3 billion to $12 billion.”

According to the World Bank report, Africa’s Infrastructure: A Time for Transformation, infrastructure has been responsible for more than half of Africa’s recent improved growth performance and has the potential to contribute even more in the future. There are challenges to overcome, however, including diseconomies of scale in production and high profit margins caused by a lack of competition. The report estimates the cost of addressing Africa’s infrastructure needs is around $93 billion a year, about one-third of which is for maintenance.

Africa is receiving FDI from India and China in particular, not only for the development of its natural resources but also for the building of infrastructure such as roads and airports and for services such as banking.

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Economics of Africa

According to the OECD, total overseas development aid to Africa in 2008 was $44 billion, with the U.S. as the top donor, followed by European Union institutions. Between 2007 and 2008 development aid increased in the region by 7%. Of that aid, 41% is allocated to social programmes, 19% to economic and 7% to production initiatives.

Africa has emerged relatively unscathed from the global downturn, although countries that rely heavily on commodity exports such as oil, did suffer more than those that do not. According to the World Bank, GDP for the sub-Saharan Africa region grew by only 1.1% during 2009, at a lesser pace compared to the years leading up to 2008, but positive still the same. The improved macroeconomic fundamentals meant that the impact of the recession was less pronounced than in other regions and also was less severe than previous external shocks.

From 1998-2008, according to McKinsey, oil and other natural resources accounted for 24% of Africa’s GDP growth. During the period agricultural output was $100 billion, or 15% of African GDP. However, Africa has 25% of the world’s arable land but only 10% of global output. Sixty per cent of the world’s uncultivated arable land is in the region and, according to Srinivasan, further investment and changes to the industry’s structure will “unfold the full potential” of agriculture in Africa. China and India have been attracted to Africa for its mineral wealth and 11 African countries rank in the top ten of sources for at least one major mineral.

While technology is crucial, partnership with institutions that have a local presence also plays an important role in doing business in Africa.

Doing Business on the New Frontier

Africa is the foremost among the so-called frontier markets, which are attracting interest from institutional investors. The MSCI Frontier Markets index showed 7% growth in the first three months of this year, compared with growth of only 0.3% for MSCI’s Emerging Markets index. China’s involvement in Africa has gone a long way to helping to change attitudes toward investment in the continent. Africa is increasingly seen as a place in which to do business, often by firms that do not want to miss out on the opportunities that China is taking. India and Russia, for example, are upping their involvement in the region as they see the value of engaging in business in Africa.

Despite the promise Africa holds, there are still challenges to be overcome, says Srinivasan. “Great progress has been made in many African countries politically, but there are countries that remain fairly unstable and difficult to do business in. There are also currency stability issues for countries that are very dependent on commodities. Overall Africa needs to upgrade its infrastructure, and follow South Africa as the shining light when it comes to this issue.”
This means that companies investing in the region face infrastructure constraints in moving goods and services, clearing them and operating normally—in some countries, for example, companies must run their own generators in order to provide power for their operations. “This all adds to the cost of doing business in the region and multinational companies and financial institutions are looking for the most efficient ways of operating in the region—they want to be able to keep track of what is happening on the ground there, but there is very little technology infrastructure nor are there complex exchange controls in most countries,” says Srinivasan. Many countries also still depend on cash to a large extent, which is another challenge for investors. “I believe the greatest challenge for organisations in Africa is to achieve operational efficiency in a very varied environment,” he says.

Operational efficiency will take on even more significance as investment continues to grow. Srinivasan predicts that trade will continue to flourish in Africa from the BRICs and Japan, leading to larger commercial flows. As the region grows, so too will the domestic and international banking sectors and domestic small and medium enterprises (SMEs). He also expects to see an influx of multinational corporations playing in Africa. More rapid development of the capital markets will be followed by structural developments and the implementation of increasingly internationally recognised regulations. The rapid increase in mobile subscriptions seen in Africa—where numbers grew from 54 million to almost 350 million between 2003 and 2008 will also have industry changing consequences, he says.

Given the varied nature of development and infrastructure within the African continent, organisations that wish to do business there will seek banking partners who can offer efficiencies through standardised interfaces such as electronic banking platforms, says Srinivasan. “These players are looking for a uniform way of connecting with a financial institution throughout Africa and out into the rest of the world,” he says. “Electronic banking platforms are important here because they give users greater visibility and control of their transactions.”

**Partnership Plays a Critical Role**

While technology is crucial, Srinivasan points out that partnership with institutions that have a local presence also plays an important role in doing business in Africa. “Having a local presence in a country greatly helps to improve the intermediation of flows between the source country of the investment and Africa. Citi’s Asia Desk, for example, helps to maximise the flows and opportunities between the two regions. And we’ve partnered with many local institutions to provide a wide distribution network on the ground to our clients—but with the benefit of globally consistent technology. You cannot overemphasise the importance of local knowledge.”

Local involvement is also a plus factor when it comes to trade services and trade finance. Citi has worked with both local export credit agencies in Africa and around the world on financing large infrastructure projects across the region. “These partnerships leverage our relationships in Africa and globally to deliver financing structures around major trade flows,” says Srinivasan.

**From 1998-2008, oil and other natural resources accounted for 24% of Africa's GDP growth.**

**Africa has 25% of the world's arable land but only 10% of global output.**

**Eleven African countries rank in the top ten of sources for at least one major mineral.**
In putting together a draft proposal for SEPA “end date” legislation, the European Commission (EC) has sparked a serious debate about the future of the European payments harmonisation initiative. At the same time, countries outside of the European Union are adopting the concept of a single payments area.
The coming months could be crucial to the success of the Single Euro Payments Area (SEPA), says Ruth Wandhöfer, Head of Payment Strategy and Market Policy, EMEA at Citi Global Transaction Services. “Europe has come so far with SEPA but there is a chance it could be accidentally derailed. Other countries are keen to implement SEPA, why aren’t we in Europe?”

Gerard Hartsink, chairman of the European Payments Council, which developed the SEPA rulebooks, commented in July that the EC’s regulatory approach in the context of migration to SEPA reflected “political pretense rather than a regulatory intervention aimed at making SEPA a reality.” He says if passed into law, the current proposal would “effectively derail the entire SEPA project and deprive bank customers of the benefits associated with the SEPA harmonisation initiative.”

Hartsink argues that the setting of end dates for the compliance of SEPA Credit Transfers (SCTs) and SEPA Direct Debits (SDDs) with the “essential requirements” as envisaged by the EC would fail to establish definitive deadlines for the phasing out of legacy payment systems. It would also result in the abandonment of the original SEPA vision, i.e., creating one domestic euro payments market where there is no differentiation between domestic and cross-border payment transactions. “Instead, the Commission now seems to be content with mandating cross-border reach for euro credit transfers and direct debits based on multiple (old and new) ‘interoperable’ payment schemes,” says Hartsink.

SEPA Migration Beyond the EU

While the EC looks like it is prepared to abandon the idea of moving to the common SEPA schemes and hence leading to the integration of the payments market as a third step of the euro introduction, other countries and regions have liked what they’ve seen. “Some countries have looked at SEPA and recognised that it is a good harmonisation initiative for payments and receivables,” says Wandhöfer. “They realise that basing a payments scheme on the ISO 20022 XML standard is very innovative. For all these reasons, a number of countries are now looking to copy the SEPA concept and sometimes even the rule books themselves.”

Wandhöfer predicts that a number of what she refers to as “global SEPA replicants” will emerge in the next few years as more countries and regions look to modernise and harmonise their payments systems.

African Harmonisation

Among these countries is Egypt, which has been busy reforming its payments systems in order to reduce the country’s reliance on cash, which according to the European Investment Bank, currently accounts for 97% of transactions.

Egypt has decided to introduce a national system for low value retail and commercial payments (a so-called Automated Clearing House or ACH) in order to provide a more efficient alternative to costly non-electronic payment means. In that context Egypt has looked to Europe for inspiration and the domestic credit transfer scheme that is being implemented since mid 2010 is effectively re-using the SEPA Credit Transfer scheme rulebook developed by the EPC. Direct debit functionality is expected to be launched in a second phase.

Other countries within Africa are also looking at developing a SEPA-type payment zone. “Africa is a very vibrant market and there is a great deal of regional economic integration, albeit at a more nascent state of development,” says Wandhöfer.
In May, it was reported that the International Monetary Fund was backing a push for East African Monetary Union. Earlier in 2010 a team from the European Central Bank (ECB) released a report detailing the viability of monetary union in East Africa. It said the implementation of a Common Market Protocol would encourage a wider integration in the form of trade, financial flows and cross-border movements of people and enterprises. But there are other regions in Africa that already have a monetary union or are working on integrating at monetary, economic and political levels.

For example, the West African Monetary Union was established in 1994 between Benin, Burkina Faso, Guinea Bissau, Côte d’Ivoire, Mali, Niger, Senegal and Togo. This union is characterised by the recognition of a common monetary unit, the Franc of the African Financial Community (CFA F), which is issued by the Central Bank of West African States (BCEAO).

In a further example, the West African Monetary Zone (WAMZ), founded in 2000 by Gambia, Ghana, Guinea, Nigeria and Sierra Leone, is also looking to harmonisation of Member State economies and the creation of a stable currency (the ‘Eco’) that could rival the CFS franc of the West African Monetary Union.
Meanwhile, South Africa, Namibia, Lesotho and Swaziland make up the Common Monetary Area (CMA), where currencies are trading on par with the ZAR (South African Rand), which is accepted as legal tender in all countries. From a regional governance perspective the central bank payments oversight committee (CMA CPOC) is currently seeking to implement a CMA low-value cross-border clearing and settlement model and will focus on driving the standards and principles for the cross-border clearing within the CMA region. In that context the ISO 20022 XML SEPA standards are considered as the best option to employ.

Similarly, the South African Development Community is working on a progressive plan of regional integration in the payments and securities space with the ambition to launch a common currency by 2018.

**Middle Eastern Union**

Monetary union is also an ambition in the Middle East, where the first steps have been taken with the establishment of a common central bank in Riyadh. Led by the Gulf Cooperation Council (GCC)—a political and economic union involving the six Arab states of the Persian Gulf—Saudi Arabia, Kuwait, Bahrain and Qatar are participating in the monetary union project. The United Arab Emirates (U.A.E.) and Oman withdrew from the project in 2009 and 2006 respectively, yet remain members of the GCC.

The initial aim of the project was to launch a common currency by the end of 2010; however, the pull-out by the U.A.E. has proved to be a blow. At present, most of the countries in the Middle East peg their currencies to the USD. In moving away from this system the states need to create a common, independent currency and the infrastructure to support it.

The single market logic of the European Union is at the heart of all of these initiatives, says Wandhöfer. “These countries, in working towards a common market are striving to lower the barriers between each other and develop common regulations that cover monetary, economic and, in the long run, also political dimensions. These initiatives are not as far advanced as in Europe but this will not remain the case forever.”

These regions, which are experiencing healthy economic growth, are trying to align country practice and the flow of people and services. In order to make economic growth more stable they need efficient, cross-border payment as well as securities systems to support the exchange of financial flows, says Wandhöfer.

**European Barriers**

Returning the focus to Europe, Wandhöfer fears that some of the efforts made to remove barriers to harmonisation may be stymied by individual member states’ reactions to the financial crisis. “Contrary to the objective of integration and consolidation, in Austria, for example, a new clearing house is being built because the government wants to have better control over the balances of banks,” she says. In a similar vein, some countries’ central banks are encouraging indirect clearing participants to connect directly to (for example) the local high value payment system, in the belief that this would lead to greater stability in times of financial stress. Such an approach however fails to recognise that the reason that not every bank today needs or desires to be a direct participant in such systems reflects key aspects such as the associated costs of maintaining the highest levels of technical resilience and the necessary levels of collateral/liquidity, together with the existence of a competitive market for indirect participancy solutions.

“There are still many questions within Europe about integration of the payments system and how far it will go. Europe launched SEPA but is still not close to fully adopting it. If the practical next steps around the current regulatory initiative to propel SEPA migration are not successful, other regions might effectively end up taking the helm in terms of payments harmonisation rather than the Europeans,” she says.
Middle East
Emerging from the Frontier
International institutional investment is returning to the Middle East and improving economies and plans for privatisation are attracting interest and boosting intra-regional investment but also a demand for unique services from custodians.

A Step Change to Institutional

The predominantly retail-based investment markets of the Middle East are slowly becoming more institutional in nature, a trend that will be accelerated as the markets mature and, ultimately, governments across the region engage in privatisation activity, says Richard Street, Head of Securities and Fund Services, in the Middle East at Citi Global Transaction Services.

Since the financial crisis significant amounts of cash previously invested in the region have been “left on the sidelines,” says Street. He expects to see a resurgence of interest in the markets as institutions see more value in the region. Institutional interest will be driven by a number of factors associated with the maturing of these markets. Improvements in risk management, particularly in Qatar and the United Arab Emirates (U.A.E.), will bring those markets out of frontier status and into emerging status. Furthermore the arrival of more professional investors will catalyse the interest.

“We are seeing signs that Middle East sovereign wealth and pension funds are more willing to engage in portfolio investments,” he says.

Private Equity (PE) funds still play a significant role in the Middle East and much of the PE funds are invested in real estate and infrastructure projects in the Gulf countries as well as in Lebanon, Jordan and countries in North Africa. Street says this investment will ultimately result in an increase in IPO activity in the private sector. Market participants hope that the issuers will choose to list in local markets rather than going to international markets.

The growth in institutional activity will reduce the relevance of retail investors, thus leading to less of the peaks and troughs that characterise retail markets. “Retail trading tends to be very emotive, whereas professional investing tends to reduce the magnitude of overshoots significantly,” says Street.

Investing Wisely

With the exception of Egypt, all Middle East markets are classified as frontier markets. Egypt hosts the well-developed equity and fixed income markets but does not have the largest market—Saudi Arabia, with average daily turnover of $900 million takes the top slot. (Egypt’s average daily turnover is between $80 million and $100 million.)

Street says any firm looking to invest in the region has to take into account the wide diversity of regulations and business models between the countries. Saudi Arabia, for example, imposes restrictions on foreign investors—from beyond the states of the Gulf Cooperation Council (GCC). Exposure to the market for international firms typically comes via swaps arranged via local banks or Saudi-domiciled mutual funds which can invest into the domestic market.

Almost all Middle East markets are based on a beneficial ownership model—in order to invest a firm must have an investor number that is used whenever it buys or sells securities. Local brokers do not take principal positions, executing only on behalf of their investor clients and in their number and name.
A Return to International Investment

International institutional interest in the Middle East waned during the financial crisis and is returning patchily. Hussein El Sherbiny, Managing Partner at Pharos Holding, a Cairo-based, comprehensive financial services provider established in 2006, says the crisis made it more difficult for firms like his to attract the business of international firms. “The larger institutional firms prefer to deal with their counterparts rather than going directly to local firms,” he says. “But we service institutional investor clients based in London, some in the U.S. and regional customers in the Gulf Cooperation Council (GCC) states. These, as well as domestic institutions, represent about 75-80% of our securities business, the balance spread between high net worth and retail customers.”

The impact of the financial crisis on markets was mixed, says El Sherbiny. “During the past year, countries like the U.A.E., which had structural problems, suffered more. The U.A.E. had a large percentage of international investors and when they pulled out, so too did local investors who traditionally follow the international trends. Saudi Arabia, on the other hand, didn’t suffer this trend quite as much because international investors don’t have direct access to the markets—they have to go through funds or local institutions.” Qatar managed to retain a good percentage of international inflows because it is a rich country with a small population and high growth rates.

In Egypt, around 7% of daily turnover in the markets is from GCC portfolio investors. A few years ago, says El Sherbiny, Gulf investment, particularly in the real estate sector, was the major contribution to the country’s foreign direct investment levels.

El Sherbiny expects volatility in markets will continue in 2010 but by the second half of 2011 the picture should improve domestically, regionally and possibly globally. Egypt’s GDP, for example, in the fiscal year to June 2010 grew by 5.3% and the government is forecasting 5.8% growth for the current fiscal year. The deficit is 9% of GDP, a figure that is “not extremely high,” he adds. “There are no dramatic signals in Egypt that there will be a fundamental problem going forward except inflation which has picked up recently as a result of growing domestic demand and the increase in some commodity prices.”
Service as a Key to Success

Asked what the key to success is in the Middle East region, El Sherbiny cites quality of service and delivery across multiple markets, particularly on the brokering side of the market. “Asset management is quite challenging because in order to grow, you need to establish a strong foothold domestically to offer products regionally.”

Good quality research is also important and should be able to differentiate a company. “We also believe that having a balance of clients—institutional, individual, international, GCC and domestic—helps us in downturns and also when times are good.”

The shrinking margins in all areas of business mean that services must be cost effective. “There is consistently downward pressure on what customers are willing to pay for services in terms of fees and commissions,” he says. “Because of the high competition in the region there is pressure to reduce commissions in order to get more business. With interest rates quite high in Egypt and clients requiring delivery versus payment, financing facilities can cut into what we earn. This complicates life and we, in turn, require greater flexibility in the services and product offerings from our service providers,” notes El Sherbiny.

While the concept of custody is fairly well recognised in Egypt (Citi has been a domestic provider of custody services in the country since 1995), it is just emerging as a concept in other countries, says Street. “Historically domestic investors in the Middle East don’t tend to use custodians. The understanding of what a custodian does and the associated value is evolving. With the maturing of the markets and the professionalising of the regional asset management industry, the employment of a custodian is being viewed as ‘best market practice’ by the industry and investors alike,” he says.

“We are learning about the markets all of the time and we continue to adapt our offerings to meet local needs and to make it cost effective for domestic players to use custodians.”

As a service provider, Citi has to consider each type of client it services rather than providing a generic model across all markets. “We think about the type of client we are servicing—for example an agency broker will require different services from an investment bank acting as a principal. We also look at how we service asset managers holistically—outside of the region and within the region—and the differences in services required. Both types of managers will receive a full suite of investor services, including treasury and FX on Sundays, and local cut-off times,” he says. Before Citi developed these capabilities, investors in London and the U.S. had significant treasury issues. “The important thing is to think about what a customer is doing and meet their requirements, rather than saying ‘we are a custodian, here is what we offer’.”

Commitment

“Citi’s ambition is to provide a top quality and cost effective service in every market across the region. We have a balance at the moment between local and international investors. A return of intra-regional investment, driven by the arrival of more institutional investors including regional public sector funds, will play a critical part in the maturing of the Middle East markets,” says Street.

One of the important considerations for investor services providers is commitment to the region, says Street. “It is important to make sure that the services we provide in different markets work in different markets—we don't want to open and close our offerings in these markets because they are not performing well. When appropriate we partner with key financial institutions in particular countries to get a better feel for the markets and provide a more sustainable offering.”
Significant changes are taking place across Central and Eastern Europe as emerging economies seek to attract international investment. In Turkey, Hungary and Russia, changes to the clearing and settlement infrastructure have established more efficient, developed market structures.

However, in Central and Eastern Europe, a number of moves are being made to bring more stability to the markets, improve risk and, therefore, increase their attractiveness to international investors.

**Russian Convergence**

Among the more ambitious movers is Russia, whose President Dmitry Medvedev, is backing a project to establish Russia as a global financial centre. The Russian government believes the country’s proximity to Europe and Asia and its position as the dominant economy within the CIS and CEE regions, will underpin this ambition.

The Russian government has formed a strategy to develop sophisticated financial markets, with a single trading and post-trading infrastructure, transparency and a wide variety of financial instruments.

The first steps of this strategy came earlier this year with the introduction of regulations covering insider information and market manipulation, clearing, and settlement. The clearing and settlement regulations, which include the creation of a Central Securities Depository (CSD), aim to harmonise the post-trading infrastructure, making it more transparent and efficient while reducing the cost to market participants.
“Many foreign institutions believe that Russia is a difficult market in which to trade, particularly because of its post-trade infrastructure,” says Alexei Fedotov, Head of Securities and Fund Services in Russia at Citi Global Transaction Services. “But I believe that many of these perceptions are illusions, particularly if you compare Russia with the other BRIC countries.”

For example, he says, access to the market is relatively easy, particularly compared with China where approvals for international institutions are limited. “Foreign institutions that want to operate in Russia need only open a custody and cash account, which has become much easier than in the early 1990s. Also, the markets are now much better regulated.”

The difficulties, says Fedotov, arise from the market’s post-trading infrastructure. The Russian post-trade environment remains very complex and securities can be settled in different locations. There are two “de facto” CSDs in Russia—the National Depository Centre and Depository Clearing Company—as well as many share registrars, which are left over from the mass privatisation that took place in the early 1990s.

“For an international firm, understanding the best option for optimising cash flows and settlement is not easy.”

Citi has been working closely with key regulators and working groups to ensure that the best CSD model is created for the Russian market while also meeting the requirements for international institutions. The Federal law on a Central Securities Depository will be key to harmonising settlement in Russia, says Fedotov. “The Russian market does not have an official mandatory CSD appointed by law. The two ‘de facto’ depositories have tried hard to persuade investors to stop using registrars because they are expensive but they have not had huge success in this.” The number of registrars has declined since the early 1990s when there were 500 to 48 today.

In the absence of a CSD, market participants have developed “work around” solutions, says Fedotov, but the introduction of a single mandatory CSD will improve the situation and result in greater savings and increased efficiency for investors.

“Many custodians operating in Russia have created ‘bridges’ with the ‘de facto’ depositories to minimise the cost and time of settlement compared with registrars. It is important to note that all local brokers in the market use ‘de facto’ depositories, but some foreign investors are still convinced that the depositories are not for them. This is particularly the case with U.S. institutions.” In light of that, the gap between foreign investors and brokers remains in place.
It should be mentioned, however, that “de facto” depositories implemented audit procedures, robust operational systems, insurance and other capabilities and risk mitigating measures to attract international investors but failed to convince all of them, says Fedotov. “This is why the law on a CSD will be such a big move for foreign investors and could be a real breakthrough in the plans to create a global financial centre in Russia.”

There is a growing concern, that in accordance with the conceptual CSD model developed by the Russian government, the law may not mandate the use of a CSD. “It is critical that CSDs will be recognised in law as the absolute, unavoidable place to which all investors and other market participants come for the settlement, custody and safekeeping of assets.” This of course is not a solution that the registrars are keen to support and they have the backing of many politicians.

Without the single mandated CSD, says Fedotov, Russia may fail to convince international investors of its suitability as a market destination and its goal to become a financial centre. “More than 70% of our clients already use the de facto CSDs, and constructive dialogue is taking place between custodial banks and regulators to foster market improvement. We will continue to work with the authorities including Federal Service for Financial Markets (FSFM) and Central Bank of Russia (CBR) to convince them and other players in the market that the CSD must be obligatory and centralised.

At the same time, we shall continue encouraging the foreign investors to use the ‘de facto’ depositories rather than the registrars, which they still think are safer in terms of compensation because of their closeness to the issuers.” These market improvements, combined with GDP growth of 5% in 2010 and further stabilisation of the economy, are strong contributors to Russia’s attractiveness for foreign investors in the near future, explains Fedotov.

**Deriving Turkey**

Improvements in how derivatives are cleared in Turkey were made in January 2010, with the launch of ‘Give Up,’ a programme initiated by the infrastructure institutions with a view to easing the risk burden on foreign investors.

In Turkey, the pre-margining rule imposes a local counterparty risk on the executing/clearing broker for foreign intermediaries and investors that require foreign firms to keep buffer amounts of collateral at their executing broker to ensure enough coverage for intraday trading and possible margin calls. As a result, they were required to carry out credit risk assessments and assign credit lines to local brokers, meaning that most foreign investors worked with just a few, and in many cases, with only one local broker, thus concentrating counterparty risk. The pre-margining rules also resulted in high margins and capped volumes for the foreign institutional investors, and increased systemic risk for the market for exchange traded derivatives.

Gunsel Topbas, Securities Country Manager in Turkey at Citi Global Transaction Services, says as a result of these problems, the Turkish derivatives exchange, TurkDex (which was launched in February 2005) worked with clearing house Takasbank to develop Give Up, which allows position transfers from executing brokers to third parties that could take up the positions. “TurkDex saw Give Up as an opportunity to expand market participation and increase the trading volumes,” he says. “The implementation of Give Up enabled custodian banks to participate as third-party derivatives clearing agents. And we were excited to work closely on the development of this programme. Citi clients can now trade on TurkDex using multiple brokers and transfer their positions to Citi, who do the margin requirements,” says Topbas.
Since the launch of Give Up, Citi has been providing third-party derivatives clearing services to its clients. “Third-party clearing delivers greater operational efficiency for our clients, enabling them to work with multiple brokers while using Citi as the central agent to do the clearing. This means there is only one margin call for outstanding positions, which will improve our clients’ ability to mark to market.”

Using third-party clearing services for exchange traded derivatives, decreases the need of collateral for foreign investors. While brokerage houses fund intraday trading collaterals, third-party clearing agents handle margin calls. Thus, foreign investors keep only minimally required collateral to carry futures positions. Since Turkey is a pre-margined market, funding capabilities also help investors for timely trading, explains Topbas.

Topbas expects that the introduction of Give Up and third-party clearing services will further boost international institutional participation in Turkey’s derivatives market. Already more than half of the positions are held by foreign institutional investors and a recent no action letter from the CFTC in the U.S. for ISE30 contracts will allow U.S. investors to buy and sell TurkDex futures.

**Hungarian Centricity**

Hungary’s accession to the European Union in May 2004 has driven a number of improvements in its financial markets to bring practices into line with other EU member states. In October 2009, the Hungarian CSD, Keler, changed its stock exchange settlement process, separating the clearing and settlement mechanisms, as advised by the European Central Bank.

Peter Csiszer, Securities Country Manager in Hungary for Citi Global Transaction Services, says the move was a pioneering one in the Central and Eastern Europe region.

The first phase of the move involved the separation of the Central Counterparty (CCP) from the CSD with the establishment of Keler CCP at the start of 2009. The technical functionality of the stock exchange’s clearing and settlement was separated in October of that year.

Prior to unbundling, clearing members received one specific net amount that was settled. This was sufficient, says Csiszer, until remote membership was allowed on the Budapest exchange, which was made possible following accession. “Once remote exchange membership was allowed, there was a need for broker dealers to use clearing agents locally who could give connectivity to the CCP,” he says.

“Based on the change of the infrastructure, we were able to adjust our processes to distinguish clearing agent and settlement agent services and can now provide full scale, sophisticated General Clearing Member Services to multiple remote members of the Budapest Stock Exchange,” explains Csiszer. Citi introduced settlement and margin processing on the accounts of the non-clearing member clients (remote brokers), as opposed to the previous process, where netted settlement and margining took place on the level of Citi as a General Clearing Member.

“It is very important for broker dealers wanting to trade remotely on the Budapest exchange that their General Clearing Member can deliver services in line with the standards of developed countries in Europe,” says Csiszer. “Citi worked as an advisor to Keler on the development of the stock exchange clearing and settlement process and was one of the first agent banks to offer sophisticated clearing services to broker dealers in Hungary.”

**Emerging Europe**

The emerging market space is highly competitive, with many countries seeking to lure international investment. While China and India have attracted the greatest interest, the countries in Central and Eastern Europe have steadily growing economies and are implementing market changes designed to create a more favourable environment for investment.
Trust lost as a result of the financial crisis has touched more than just the consumer market. Acknowledging the ways in which the banking system needs to responsibly perform its key functions, while keeping clients at the heart of everything it does, will be essential to rebuilding trust amongst counterparties and clients.
Trust not only underpins the economic system, says Naveed Sultan, Head of Global Transaction Services for Europe, Middle East and Africa (EMEA) at Citi, but also the social system. In the lead-up to the economic crisis some companies in certain sectors, including financial services, undermined their social contract with customers, shareholders, regulators and tax payers, he says. But the repercussions of the break in this social contract are much broader—a lack of trust and deterioration in reputation of all financial institutions by myriad stakeholders has resulted.

Trust Barometers

In March 2009, a McKinsey Quarterly Survey showed 85% of senior executives around the world said public trust in business had deteriorated. Moreover, 72% felt that the public’s commitment to free markets had also declined. The 2009 Edelman Trust Barometer indicated that 62% of respondents across 20 countries felt that people trusted corporations “less now than they did a year ago.”

Edelman followed up its annual Trust Barometer in February 2010 with an inaugural Financial Services U.S. Trust Barometer, which showed that 93% of those surveyed believed problems still existed in the financial services industry and must be addressed—63% felt financial institutions needed more regulation.

Those surveyed said quality of communications and customer service were as important in influencing trust as price and performance. Edelman said financial services companies must realise that transparency via frequent communication and high quality customer products and services are “as essential to creating and maintaining investor trust as superior returns and five-star ratings.”

Factors in Restoration

While the financial crisis played a significant role in this deterioration of trust, Sultan suggests other factors were also at play. “There have been underlying shifts in the financial services and business environment for some time,” he says. “The huge advance in technology and its associated impact on channels such as the media; the increasing significance of NGOs and third parties—all are contributing to far greater scrutiny of companies and at a much faster pace. Reputations that have been built over years can be lost overnight.”

The financial services industry has a significant task ahead of it to restore trust with its stakeholders—customers, shareholders, regulators, tax payers and society at large—domestically, regionally and globally.

Legislation could restore the stability of banking, but the financial services industry must do much more to restore trust. “Legislation may help to stabilise the banking system, but it will not repair the public perception of the institutions themselves,” he says. “Banks cannot rely on regulatory reforms to regain trust among counterparties and corporate clients. We, as an industry, must look introspectively—acknowledging our mistakes and leading by example in order to rebuild trust.”

The first step should be to recognise financial services institutions’ responsibility to society, he says. Banks play an important role in helping customers to save, invest, spend, borrow and protect their money with trust and confidence. “We also help institutional clients by providing a core suite of financial services. Acknowledging the ways in which the banking system can responsibly provide these key functions, while keeping our clients at the heart of everything we do, will be essential to rebuilding trust among counterparties and clients,” says Sultan.
In addition to this, banks must lead by example and “walk the walk.” Core to this are the individuals, the philosophy and the infrastructure that shape each bank. Banks must retain and promote employees who operate with a deep sense of personal and professional integrity, accountability and personal humility. “This must be true at all levels of the bank, with all employees,” he says.

Second, banks must establish a philosophy that focuses on the highest ethical standards, embraces diversity, and supports the desire to work for a higher sense of purpose beyond monetary compensation. Finally, says Sultan, the banks’ infrastructure must support a transparent and consistent operating model, offering a foundation which prevents excess.

“How, then, can banks “walk the walk?” Sultan cites supply chain financing, once an activity that was seen solely as a source of funding for small and medium enterprises or companies in distress. But with the credit crunch having had a dramatic impact on corporates and their supply chains, supply chain financing is now regarded as a crucial activity.

Among these actions, he says, is to facilitate economic growth so a bank’s customers—be they consumers, corporates, public sector entities or other financial institutions—can achieve personal and business objectives. Banks will earn back the trust they lost as a result of the financial crisis through responsible actions and evolving the business model, says Sultan.

Challenges Ahead

But there are challenges—the scars of the financial crisis run deep and many businesses and consumers have been hit hard by the ensuing economic downturn. The economic recovery is also patchy—the U.S.-based Institute for Supply Management published a survey in early August that indicated new orders in the U.S. manufacturing sector were slowing markedly and inventories were starting to rise more rapidly than companies intended.
Additionally, second quarter GDP figures for the U.S. economy revised annualised U.S. growth down from 2.4% to 1.6%, indicating the economic recovery is slower than anticipated.

This economic uncertainty has been coupled with regulatory uncertainty as financial institutions face the full impact of a raft of regulatory moves including the Dodd-Frank Wall Street Reform and Consumer Protection Act in the U.S., the revised capital requirements of Basel III, and myriad directives coming out of the European Union including the Securities Law Directive, Alternative Investment Fund Managers Directive and European Markets Infrastructure Regulation.

What these regulations will likely drive, however, are an increased focus from banks on innovation based on solutions, technology and value creation—both for clients and the industry as a whole.

“In this uncertain environment, financial services institutions must focus on addressing their clients’ needs and helping them to navigate this uncertainty. This is a top priority,” says Sultan.

Re-Building Blocks

Corporate social responsibility is also a factor that requires more attention in these uncertain times. “Now more than ever banks need to practise responsible finance and by that I mean activities that are in the interests of our shareholders, clients, colleagues and the communities that we serve.”

How, then, can banks “walk the walk?” Sultan cites supply chain financing, once an activity that was seen solely as a source of funding for small and medium enterprises or companies in distress. But with the credit crunch having had a dramatic impact on corporates and their supply chains, supply chain financing is now regarded as a crucial activity. Most large multinational corporations rely on hundreds of smaller suppliers—companies that have found it difficult to access credit. If one of these players in the supply chain fails, it could hit the multinational’s bottom line. Supply chain stability is becoming a strategic consideration for corporates and also an important element in ensuring economic recovery.

“Corporate treasurers now see supply chain finance as a way to enable treasurers to maximise their working capital and to mitigate risk by easing their suppliers’ financial constraints,” says Sultan. “Such solutions can act as key contributors to economic recovery and stability.”

Financial institutions also have a role to play at the consumer level, providing financial education to broaden understanding of finance. This is an area recognized by U.S. President Barack Obama, who proclaimed April 2010 as National Financial Literacy Month. He said: “Our nation's future prosperity depends on the financial security of all Americans. This month, let us each take time to improve our own financial knowledge and share that knowledge with our children. Together, we can prevent another crisis and rebuild our economy on a stronger, more balanced foundation.”

To support these efforts, Citi has invested $167 million in consumer financial education over the past six years. And we play our part within Global Transaction Services too. For example, over 2,000 of our employees give their time to 49 countries to Junior Achievement Young Enterprise schemes (Europe’s largest provider of entrepreneurship education programmes), of which our CEO, Francesco Vanni d’Archirafi is Chairman.

Winning organisations, says Sultan, will put the client first, invest in employees and adapt to change by leveraging technology. Performance and success will be measured by a financial institution’s relevance to society and to the wider economic environment.
Liquidity Risk Management

New Challenges at Hand

The financial crisis has created heightened awareness of liquidity risk on the part of regulators, financial institution and corporate treasury practitioners alike. The resulting changes in guidance, policy and practise will alter financial services industry operating models and impact relationships between banks and their clients.
The financial crisis highlighted the critical importance of liquidity risk management for both corporates and financial institutions. As asset values dropped, the lack of liquidity and access to funding, in combination with wide asset/liability mismatches, precipitated the failure of key financial institutions and presaged the broader financial crisis.

“A hard lesson learned, but financial and non-financial enterprises alike recognised that effective liquidity risk management is critical to continued operations and must be addressed through comprehensive processes, policies and programmes,” says Elyse Weiner, Head of Global Liquidity and Investments at Citi Global Transaction Services.

Regulators came to a similar conclusion, and there is broad agreement across regulatory bodies and industry groups that more stringent liquidity management guidelines and frameworks are required to safeguard financial stability, although consensus on absolute targets and requirements remains subject to further refinement, she says. New legislation, amendments and policy statements are proceeding at a rapid pace in the U.S. and Europe, driving change across the financial services industry even before final rules are adopted. “Corporate treasurers, many of whom reacted to the crisis by establishing more comprehensive liquidity management practices, should be mindful that the shifting regulatory environment may also affect the provision of global banking services as financial institutions evolve their policies and practices,” notes Weiner.

**Changing Regulation and Implications**

A swathe of new regulations, guidelines, and proposals are underway, with widespread implications for banks and their clients.

The Basel Committee on Banking Supervision, in its role as arbiter of global banking standards, has recently achieved consensus on recommendations for both capital and liquidity, to be presented for endorsement at the G20 meeting in November. “The committee’s International Framework for Liquidity Risk Management and Supervision is a step forward in filling some of the regulatory gaps that preceded the crisis,” says Weiner. The proposed liquidity requirements, measured in the form of coverage ratios, will apply varying run-off and liquidity factors to funding sources and assets for assessment of bank balance sheet liquidity and ability to withstand a given stress scenario. The timeframe for implementation has been extended as quantitative impact analysis proceeds, but a clear preference for depository and relationship oriented funding is evident. According to Weiner, this approach will in turn create a value hierarchy that will ultimately impact price and revenue models. As currently constructed, it will also create a structural funding gap that will need to be filled, thus raising costs.

Although broad and uniform adoption of measures at the national level will span years, banks are starting to reassess business valuations and provision of certain services in anticipation of increased regulatory oversight. Weiner notes that, for transaction services such as cash management and custody, the value of deposits derived from transaction flows is deeply embedded in pricing and margin assumptions. The downstream impacts of the new valuation hierarchy may be pronounced, depressing margins, with limited opportunity for offset through price adjustments. “Faced with this prospect, banks without significant scale and resources may be required to refocus on alternative core areas of strength,” she says.

In the U.S., the Securities and Exchange Commission (SEC) has made numerous amendments to its “Rule 2a-7”, which governs U.S. money market funds, even as the European Commission works towards a common definition and tighter controls. The amendments to 2a-7 raise money funds’ liquidity requirements, impose further portfolio limits based on credit quality, tighten maturity limits, and require added portfolio reporting. While these changes are intended to make money funds more resilient to short-term market risks, there is likely to be ongoing impact to the yields available to investors. Along with the higher capital and liquidity requirements, the tighter credit quality requirements may also affect cost of funding for lower-rated corporate and institutional issuers, as money fund complexes were a major outlet for these securities.
The U.S. Dodd-Frank Wall Street Reform and Consumer Protection Act will also have far-reaching impacts on banks and their customers, although many provisions still require extensive rulemaking by various regulatory authorities. The act expands regulatory oversight and imposes additional capital and liquidity standards on U.S. banks. It imposes restrictions and controls on certain bank activities, most notably the prohibition on proprietary trading, mandatory clearing requirements for OTC derivatives, and higher capital requirements for uncleared trades. It also extends the powers of the Federal Deposit Insurance Corporation (FDIC) and broadens the insurance assessment base as a function of worldwide net assets. Beginning mid-year 2011, banks will be permitted to pay interest on U.S. business demand deposit accounts (previously prohibited), while the FDIC will provide unlimited insurance on non-interest bearing demand accounts for a period of two years. These changes are expected to drive realignment and re-engineering of bank funding options and the offer of new deposit products for corporate and institutional clients.

While there are still many unanswered questions, it is clear that operating restrictions, higher capital and liquidity standards and increased insurance assessments will raise the cost basis for financial institutions, while constraining revenue generation. Some may elect, or be required, to divest or discontinue certain types of business, driving industry consolidation. Weiner points out that “Corporate and institutional clients are already asking their banking providers some serious questions about continued commitment to the business”.

Liquidity Risk Management Practises

Weiner explains that, when it comes to liquidity risk management, there is growing convergence between financial institutions and corporates in the objectives and means employed to improve performance. Treasurers of corporates and financial institutions alike are seeking to improve visibility across their operating networks, move towards greater centralisation of activities, and implement more robust stress testing and liquidity contingency plans.

“Within this risk management framework, the objective is to gauge potential risk, project and strategically address funding needs, and ensure continued operation within acceptable risk tolerance limits. This requires close collaboration between treasury and business units to understand the nature of the positions, ongoing business strategies and balance sheet requirements. It also requires adequate systems and infrastructure to ensure full visibility and control of positions throughout the network,” she says.

Now is the time for bank providers and their clients to evaluate the nature and potential impact of the changes on their respective businesses, with the common goal of improving efficiency and decreasing risk.
Corporate treasury management has gravitated towards an objective couched in terminology familiar to institutional treasuries, i.e. effective liquidity risk management rests on the ability to align internal sources and uses of funds to meet the ongoing funding needs of the enterprise, while reducing dependency on costly, and at times inaccessible, external funding sources. “Many corporates have invested in technologies and infrastructure to improve their cash forecasting processes as bedrock to liquidity planning. They have implemented platforms able to deliver real-time visibility on global positions as well as provide early warning on ‘surprises’, should these occur. To exercise greater control, and guard against hidden risk-taking by subsidiaries, global treasury operations and management are becoming increasingly centralised. Finally, where possible, they are extending and implementing global cash concentration and pooling structures to facilitate access to worldwide cash and take advantage of internal offsets,” says Weiner.

“Financial institutions can take a leaf out of this book and better link strategic and operational execution,” she notes. As they strategically position the balance sheet to mitigate liquidity risk, taking advantage of historically low interest rates to extend maturities and bolster structural funding, they should also be looking to enhance operational liquidity management processes. Faced with higher costs and declining margins, efficient management of nostros and clearing practises is an imperative, she explains.

**Facing the Future**

While the finer points of the various regulatory initiatives are yet to be fleshed out, liquidity risk management is front and center with regulators as well as treasury practitioners. There is little doubt that the resulting economic and regulatory landscape will have an impact on the interaction between corporate and institutional clients and their banking providers, just as it will have an immeasurable impact on internal treasury management practises. The provision of various banking services may undergo consolidation and retrenchment as returns and profit dynamics shift and the ability to scale operations becomes increasingly important. However, this evolution can be viewed in a positive light.

“The ‘new normal’ for banks will be more client and relationship centric, with less focus on volatile proprietary and risk transference businesses. To offset increased cost, banks will need to drive towards higher levels of balance sheet and operating efficiency, deepening client relationships across a wider range of products. In addition, as banks streamline and improve their operating infrastructure, they will continue to innovate, providing clients with improved tools to achieve their financial and business goals. All within a safer and more transparent banking environment,” she says.

The financial crisis, in heightening awareness of liquidity risk, has generated increased focus on this discipline from regulators and treasury practitioners. The resulting changes in regulation and operating processes will affect financial services industry operating models, drive consolidation and influence the interaction between banks and their clients. Even as clients seek diversification to address operating and counterparty risk concerns, they will also need to consider which providers have the scale to control costs and the resources to continue to invest in innovative products and services to meet the requirements of an increasingly global and complex operating environment. Banks, on their part, may need to reassess core competencies and their willingness to support a limited share of business at diminishing return. As Weiner says, “Now is the time for bank providers and their clients to evaluate the nature and potential impact of the changes on their respective businesses, with the common goal of improving efficiency and decreasing risk”. ■
Role of Issuer Services in Securitisation

Often overlooked, the role of issuer services in underpinning the capital markets was highlighted during the credit crisis. “The roles played are a fundamental part of the infrastructure of capital markets world-wide,” says Andrew Gelb, Head of Securities and Fund Services in EMEA at Citi Global Transaction Services. “As the credit crisis unfolded these roles often came to the fore, playing a key part in the continuity of capital markets processes.”

In the early days of the securitisation industry, agents managed, monitored and provided investor reporting for deals, often brought by first-time issuers, in a predominantly manual fashion. In order to make the deals run smoothly, agents had to work closely with servicers to collate every piece of data relating to the underlying cash flows, crunch the numbers and manually enter the results into a report which is sent out to investors. The development of technology to allow aggregated cash collections, segregated data and cash management and reporting began a process that, when added to repeat issuers coming to market and generally accepted servicing standards, created investor comfort and commoditised the business of securitised debt.

At the same time, rating agencies were creating structured finance servicing and management ratings that continued to increase comfort levels and reliance on transaction and counterparty ratings, says Andrew Mulley, Head of Issuer Services in EMEA at Citi Global Transaction Services. A mounting frequency of issuance by the same names bred a further sense of comfort among investors.

Issuer services are at the starting point of a security and at the forefront of monitoring their health. During the crisis, issuer services facilitated access to capital markets, ensured bond and equity holders were paid on time, represented note-holder interests and provided independent asset performance and cash flow calculations.”
Each issued security, says Mulley, has an agent that is responsible for facilitating the underlying payments flows from respective issuers or assets to meet principal, interest and other payment obligations and, as sometimes required, acts as a trustee for the holders, representing their interests.

The issuer services infrastructure currently supports a market of US$25.6 trillion in outstanding debt issuance. As a result, on any given business day significant amounts of funds are flowing through the infrastructure and, either directly or via international and domestic central securities depositories, are paid on to investors.

At times of transaction stress or default, market participants focus on two main questions: “Where is the money and how robust is my transaction?”

“Take the example of international securities, although the majority of payments flow straight-through, some do not for a number of reasons; incorrect payment instructions and delays with correspondent bank processing, being the
main ones. It is vital to distinguish between these process exceptions and a real payment default event—the inability to do this can have significant consequences, signalling that an issuer is in trouble, when it may not be, and creating market disruption,” says Gelb.

The trustee’s role changes when a security or structure comes under pressure from an event such as payment default, bankruptcy, reorganisation, merger or acquisition. In such events the trustee must understand the nature and status of the situation with regards to the interests of the bond holders, says Mulley. “It may be appropriate for the trustee to convene a bond holder meeting to ensure that the trustee acts in accordance with the instructions of the holders and within the transaction structure. The complexity and speed of defaults is a test for trustees, who must balance the need for quick action with fiduciary care and clear legal analysis.”

Securitisation Market Growth

Investors are slowly returning to the asset-backed and mortgage-backed securities markets. According to figures released by Thomson Reuters in July, securitisations globally experienced double-digit percentage growth during the first half of 2010. New issuance of asset-backed and mortgage-backed securities reached $255.7 billion and $93.1 billion respectively.

In September, Royal Bank of Scotland launched a £4.7 billion ($7.23 billion) issue of mortgage-backed securities (MBS) in its first such deal since the financial crisis began. In the Middle East, Emirates NBD Bank and Citi issued a $280m asset-backed security (ABS) secured by a revolving portfolio of auto loans granted to private and commercial clients in the United Arab Emirates. Citi has executed the past two securitisations in the region, the other an AED 4 billion ($1 billion) real estate-backed sukuk for Sorouh in 2008.
Investors are slowly returning to the asset-backed and mortgage-backed securities markets... In September, Royal Bank of Scotland launched a £4.7 billion ($7.23 billion) issue of mortgage-backed securities (MBS) in its first such deal since the financial crisis began.

**Standardisation and Transparency**

Against this background of market growth, financial regulators on both sides of the Atlantic are seeking to improve transparency in the market with new disclosure guidelines, moves that are keeping issuer services providers busy. The European Central Bank (ECB), the U.S. Securities & Exchange Commission (SEC) and the Bank of England (BOE) are all consulting on new rules that would require the provision of loan-by-loan level disclosure of collateral performance and other data to be delivered in a uniform manner over the life of a transaction. The SEC revisions to Regulation AB would revise filing deadlines for ABS offerings to provide investors with more time to consider transaction-specific information, including information about the pool assets. There is also a proposal to require that prospectuses for public offerings of ABS and ongoing Exchange Act reports contain specified asset-level information about each of the assets in the pool. The Bank of England wants to go further by obliging issuers to make loan documentation, cash flow models and deal terms publicly available and impose on investors increased internal due diligence and surveillance systems.

Central bankers have a particular interest in improving transparency in this marketplace, says Mulley. “In the past year, central banks have accepted as collateral bank-arranged ABS and MBS worth billions of U.S. dollars and euros via their special liquidity schemes and discount window facilities. However, there is also an increasing acceptance that the provision and dissemination of more granular information is necessary to lift investor confidence in ABS and MBS and restore liquidity in the securitisation markets.”

Coupled with the continued demand for yield, the conditions are right for investor appetite for ABS and MBS to pick up over the second half of 2010, says Mulley. He says a harmonised approach between central banks and regulators will build a common platform on which the industry can move forward. “By working together, the industry and regulators can promote greater stability and improve efficiency through common frameworks and technologies,” says Mulley. “Regulators should seek industry harmonisation and minimise duplication while issuer service providers should drive the ongoing success and continuity of any ABS or MBS transaction.

The development of such a common industry platform has not been welcomed by all participants, says Mulley. “Frequent issuers that use securitisation, such as building societies and banks across Europe and some non-bank financial institutions, have expressed concern about whether they will have to contribute to the cost of developing a Europe-wide ABS and MBS portal. This uncertainty could create delays and confusion in getting deals to market. At the moment there is some nervousness among frequent issuers in this area.”

According to Gelb, as the levels of comfort are questioned by market participants and regulators, issuer services providers are even more relevant, providing critical services that support transparency, independence and key performance data for investors in support of the ongoing success and continuity of any ABS or MBS transaction. As with any capital markets instrument, issuer services are a key link between issuers and investors, helping to underpin the capital markets.
Decision Making in Uncertain Times

With a ‘new normal’ in the financial services world, bankers have to change tack to improve the quality of decisions.
The profound changes brought about by the financial crisis require a new approach to how decisions are made throughout financial services organizations, says Munir S. Nanji, Head of Bank Services in Asia Pacific at Citi Global Transaction Services. The current unpredictability of the global economy, the raft of regulations being imposed on the industry, the increased use of technology and social media, and the restructure of many financial institutions are a far cry from the glory days of growth and globalisation.

“The way bankers made decisions in the past needs to be changed,” he says. “The upheaval in the financial industry has caused people to review their decision making processes. Old biases built up in the days of growth and globalisation need to be abandoned. The attitude among many senior executives that they are always right and should push through their views is no longer applicable in the ‘new normal’.”

There is ample room, says Nanji, for other judgements when it comes to decision making. By assembling everyone's insights, rather than just their conclusions, discussions can focus on the biases and assumptions that lead to these opinions. An added bonus, he says, is that people start to recognise their own biases.

New Alternatives

One of the main obstacles to overcome in restructuring decision making is the tendency for people to want to do certain things in their own way. This can be tackled by taking a more comprehensive approach to decision making—looking at the pros and cons of a decision in order to come to more balanced conclusions. Such an approach brings a greater element of objectivity to decision making.

Nanji says as banks seek to return to growth and build for the future, decision makers must be less conservative than in the past. Loss aversion plays a very big role in decision making, particularly during the past year, he adds. “Many people fear making a wrong decision because of both internal and external approbation. Very often, decision makers will wait for others—be they colleagues or other institutions—to make a move. But this is not the way to return to growth.”

Now is the time for senior management to “take some bets,” he says, but only through more holistic, consultative processes. This doesn't mean, however, adherence to ‘group think’—which has advantages but also disadvantages. “Group think led to people becoming more driven in their decisions by particular individuals or groups. These people were able to influence decision making and created biases in the way decisions were made.”

Senior executives need to recognise that changing opinions, based upon the strength of the arguments around the table, is an advantage, says Nanji. “It's great to see a leader concede that a decision is difficult and may have to be retested. It's also great to see a leader who will echo the little voice in the back of the room that expresses a different point of view—and thereby change the complexion of the discussion.”

The voice in the back of the room is important, he says. Organisations need internal critics who have the confidence to give feedback. “These critics need to be groomed early on, which requires a certain comfort with confrontation. It is a skill that has to be developed,” he says.
There is also value in having someone play a ‘devil’s advocate’ role, bringing conflict into the decision making process in order to ensure that all of the pros and cons of a decision have been examined. This will be challenging in the current economic environment where many people don’t want to appear to be negative or don’t want to overrule the views of their senior managers. “This is one reason why consultants are successful—they can comment on decisions freely and provide much needed objectivity because they are not looking for promotion or fear for their jobs,” says Nanji.

New Ideas vs. Deep Experience

Social biases—often interpreted as corporate politics—play a role in decision making as well. Nanji describes these as “deep-rooted human tendencies” because even when nothing is at stake, people tend to conform to the dominant views of the group to which they belong (the dominant view is often that of the senior executive). “Social biases also are likely to prevail in discussions where everyone in the room knows the views of the ultimate decision maker and assumes that the leader is unlikely to change his or her mind,” he says.

Changing one’s mind is very difficult for senior managers who may find it a challenge to accept opinions from younger colleagues, for example. Managers need to develop strategies for working with different age groups within an organisation—the more experience a manager has, the better he or she should be at drawing on the different experiences of colleagues.

Closing the Gap

The decisions made by disparate groups that led to the sub-prime mortgage crisis in the U.S., and eventually into the economic downturn, displayed what Nanji calls irrational behaviour. The decisions were made far away from the
The person taking the loan is the closest to the asset bubble, but a bank sold him the mortgage, which was financed by another bank, a ratings agency valued that asset, the risk was sold to another organisation and so on. This chain of events was rooted in the fact that each person making a decision was removed from the actual impact of that decision.

Collaborative Processes

The changes to decision making should not be limited to internal decisions, says Nanji. The increased focus of regulators on the financial services industry mean that banks must find a way to collaborate with regulators. This could require more collaboration with other financial institutions: “Banks compete with each other but they also must realise that in taking certain decisions a collaborative approach is necessary, particularly when it comes to regulation. This is even more so the case now, when most financial institutions face a high level of resentment from consumers. In this scenario we should recognise that working together on some areas will be helpful. Other industries, such as high-tech, do this quite well, particularly with regard to their supply chains.”

To use a judicial analogy, says Nanji, we cannot trust the judges or the jurors to be infallible; they are, after all, human. “But as citizens, we can expect verdicts to be rendered by juries and trials to follow the rules of due process. It is through teamwork, and the process that organises it, that we seek a high-quality outcome.”

He believes financial services organisations are getting better at decision making, with responsibility for decisions being devolved from corporate headquarters. “We are seeing more generationally and culturally diverse managers moving into key positions who may have a different perspective on decision making processes that can take the organisation further in the future.”

A more consultative approach to decisions, involving all parts of an organisation would better recalibrate a decision to where the likely impacts will be. “The financial markets tended to put a distance between themselves and the real world. As we mature and seek a return to growth, we must realise that we have to get back to basics and not focus solely on the monetary impact of decisions.” He argues that if organisations had worked in an holistic manner across all levels, gaining input from a wide variety of people, the sub-prime crisis may have been avoided. “Overconfidence in one’s decision making powers generally results in irrational behaviour such as we saw during the sub-prime crisis. This needs to be recognised and a new way of decision making must be adopted.”
Central banks globally are transforming from guardians of their domestic financial systems to architects of a coordinated global recovery. Commercial banks can assist central banks by providing operational and infrastructural support.
Called upon to play an even more critical role in financial systems, central banks are looking to commercial banking partners to provide operational and infrastructure support as they take on a strengthened role as defenders of the financial system.

The creation of the €440 billion ($545 billion) European Financial Stability Facility (EFSF) special purpose vehicle for troubled Eurozone members in June 2010 highlights the critical importance of governments and central banks in their new role as defenders of the financial system.

While not directly involved in the set up of the facility, central banks have been an important driving force behind its formation, says Filippo Sabatini, Global Head of Public Sector at Citi Global Transaction Services.

“There has been a coordinated effort by European governments—with the help of central banks—to continue to support the economy during the crises we have seen in Greece and elsewhere,” he says. “Central banks will continue to play a key role in driving efforts to stabilise the financial markets, stabilise liquidity flows and support the economy.”

From Guardian to Architect

This role as guardian of the financial system has evolved as central banks—traditionally tasked with setting monetary policy, maintaining the stability of a country’s financial system and acting as sovereign banker—are now playing an instrumental role in rebuilding the global economy.

At the height of the financial crisis, central banks in the world’s major economies coordinated funding windows, pumping massive amounts of liquidity into the financial system in order to alleviate the credit squeeze. They also played a key, if background, role in the handling of toxic assets, via state-guaranteed institutions that take the risk of asset write-downs out of commercial banks’ books.

While the focus in the early days of the financial crisis was on financial institutions and corporations, rescue efforts are now being aimed at the country level as concerns increase over sovereign debt in a number of Eurozone countries. The EFSF will issue debt instruments backed by national guarantees from the euro area member states to ensure the best possible credit quality and rating for the instruments. A number of measures have been adopted, including a 120% guarantee of each member-state’s pro rata share for each individual bond issue and the constitution of a cash reserve when loans are made to provide an additional cash buffer for the operation of the facility.

The EFSF, which will run for three years, is the main part of a €750 billion aid package that EU finance ministers devised to fight the sovereign debt crisis. The European Commission is providing €60 billion while the International Monetary Fund will provide €250 billion, and the balance will be raised through the capital markets.

But preventing a sovereign debt crisis is not the only example of how central banks can help to defend the financial system. Sabatini cites the Central Bank of Haiti, with which Citi recently hosted a one-day conference focused on how to modernise and improve the functioning of the Caribbean island’s financial system. The event was convened to aid Haiti’s rehabilitation after the devastating earthquake of January 2010, to assist with the challenge of managing the flow of international aid.
to help the availability of credit to get businesses back on their feet and the application of new technology to create greater transparency, efficiency and control of the nation’s public finances.

The Haitian government is planning to create credit guarantee funds with its central bank to facilitate access to credit. The Central Bank is optimistic about Haiti’s ability to rebuild and “bounce back” but is concerned about inflationary pressures from large amounts of foreign aid entering the country, and fears that the banking system could collapse under the pressure of debtor losses.

Operations and Infrastructure

On a global level, governments are under severe pressure to reduce deficits and are seeking ways to be more efficient. This includes efficiency in deploying financial resources. “Governments want to reduce spending and control flows and central banks or ministries of finance are supporting financial innovation to develop instruments to do this more efficiently,” says Sabatini.

The new role for central banks has operational implications. “The bank bailouts, government stimulus packages and rescue funds have focused attention on the operational and infrastructure aspects of the financial system,” says Sabatini. “Central banks and their commercial banking partners are playing a critical role in providing a reliable financial infrastructure for the global economy as it recovers.”

In Haiti, for example, money is moved physically from one bank to the other. Citi is looking to help the country develop operational efficiency in the banking system as the country is reconstructed, Sabatini explains. “We are looking at how to contribute to the efforts being made to ensure that the money and capital inflows to Haiti are effectively deployed in the interests of the people. A new system to efficiently distribute benefits and other remittances into the financial markets is very much a priority.”
In a separate move, the concept of “charity aggregators”, which will serve as the linchpin of all non-governmental agencies in Haiti, is beginning to take shape. Such aggregators will focus on exploring mobile payment opportunities and microfinance initiatives so that payments and donations are disbursed in the most efficient way.

Innovation and Efficiency

Elsewhere in the world, operating under constrained circumstances with limited resources, central banks have looked to implement innovative solutions in order to improve efficiencies, the value of which can be redeployed to stimulus programmes.

Sabatini believes that as the world economy slowly emerges from recession, there will continue to be pressure on central banks and financial regulators to transform the financial system to deliver more efficiency to all participants. “Central banks do not directly sponsor all of the moves that are being made—for example, the development of prepaid cards for the distribution of social benefits—but in certain countries they have to regulate or support the development of new financial instruments,” he says.

In the case of the EFSF, says Sabatini, the European Investment Bank will execute the transactions made on the fund and manage all of the underlying aspects such as agency roles and collateralisation of the assets being taken by the borrowing governments. “There will be a significant debt capital market component to this facility and this will have implications for the middle and back offices of the underlying special purpose vehicle, be it the issuer or operator, as well as government borrowers—who will be the recipients of funding,” says Sabatini. In meeting its fiduciary responsibilities for disbursing payments and acting as collateral agent, the EFSF will be supported by the European Investment Bank, which has confirmed its willingness to provide treasury management services and administrative facilities.

This is where commercial bank partners come into the picture, says Sabatini, as they can ensure reliability and competence in handling the operational aspects of such flows. “Central banks and finance ministries are the crossroads of wider public sector efficiency,” he says. “But they need partners to help them to deliver that efficiency.” Highly qualified commercial banks can provide a range of operational services from cash and securities settlement, liquidity management through to securities lending.

Action and Regeneration

For example, Citi Global Transaction Services is working with various governments and central banks worldwide to advise on best practices in the creation of Shared Service Centres (SSCs), which will provide standardisation, greater controls and better cost management for finance activities.

Australia’s central bank, the Reserve Bank of Australia (RBA), established a SSC in conjunction with Citi that provides banking services for more than 90 federal government agencies. The system makes pension payments to 56,000 Australian citizens in more than 100 countries. The platform enables RBA to offer flexible payment options to the non-resident pensioners and to reduce the costs of delivering payments overseas, including FX and local clearing costs.

In the U.K., Citi helped to establish the Government Banking Service, which was launched in 2008. As part of HM Revenue and Customs, the service provides treasury management and banking transaction services to central government departments and wider public sector bodies, using structures and tools to increase efficiency and emulate best practice in the private sector. Users include HM Revenue and Customs, National Savings and Investments, executive agencies, non-departmental public bodies and NHS organisations.

“The impact of the financial crisis highlighted the role central banks play in limiting the risks in the financial system,” says Sabatini. “The world is changing and governments and central banks need to take rapid action to support the regeneration of the private and public sectors. While the economic landscape has changed, the need for central banks to improve operational efficiency and work with commercial bank partners has not.”
Global securities and banking businesses are facing three significant forces for change post-crisis: competition, regulation, technology.

Broker dealers, sub-custodians and universal banks continue to experience significant change in their business. Businesses are being rebuilt following the financial crisis; regulations are being formulated that touch on every aspect of the securities industry; and technology advances are transforming trading strategies.

“At the infrastructure level, powerful market forces have led to increasing competition in trading venues, the growing importance of CCPs that serve those venues and increased focus on risk,” says Tom Isaac, Global Head Client Sales Management for Intermediaries at Citi Global Transaction Services.

Isaac categorises these forces into three areas:

• Post-credit crunch effects, such as the scarcity of liquidity and a push for anonymity, new players entering the scene, pressure on cost and risk, and the sovereign debt crisis—all leading to the need to rebuild businesses;

• Regulation aimed at integration in Europe, best execution, transparency and risk reduction; and

• Technology, which is making high frequency trading and low latency a possibility.
Post-credit Crunch Effects

The sovereign debt crisis is the most pressing issue in the aftermath of the credit crunch and Isaac believes this could be a catalyst for further change.

The reaction to the crisis has been swift and far-reaching. A €440 billion ($545 billion) European Financial Stability Facility (EFSF) special purpose vehicle for troubled Eurozone members was established by national governments. In May, the German financial regulator announced a ban on naked short selling (the practice of selling shares without owning them, borrowing them, or ensuring that they can be borrowed in the future). The ban, which will run until 31 March 2011, covers sovereign bonds issued by Eurozone countries, credit default swaps (CDS) on those bonds, and the shares of ten of Germany’s biggest financial institutions including Deutsche Bank and Commerzbank.

"As a result of the credit crisis, we are seeing some firms, particularly in the sub-custody arena, resizing their businesses and focusing on core activities," says Isaac. “Some firms are exiting businesses in which they don’t have an advantage and others are being forced by regulators to sell assets.”

Rebuilding the capital basis of banks demands more sophisticated collateral and liquidity processes, says Isaac. Financial institutions in the U.K. and Europe have been “reasonably successful” in rebuilding capital but Isaac believes some European banks “still have a little way to go.” Rebuilding capital is a long-term process but it can be seriously impacted by short-term factors such as liquidity. “If there is a hint of concern about any financial institution, liquidity becomes a big problem because people will move money away from that institution. Financial institutions must be able to effectively monitor and use their collateral to avoid liquidity problems.”

When rebuilding, the business revenues also have to be taken into account and there are a number of places where revenue is being squeezed. “The Payment Services Directive, for example, reduces the potential revenue for intra-Europe payments in the euro. At the same time the complexity of the equity trading market in Europe, which has fragmented to many different execution venues, has diminished the profitability of some equities business,” says Isaac.

While revenues are diminishing, clients expect their institutions to provide regional or global access. This presents a difficult set of strategic and tactical issues, says Isaac.

Burgeoning Regulation

On both sides of the Atlantic, regulation is having a significant impact on securities businesses. The Dodd-Frank Act in the U.S., which through one hefty document, provides rules governing every aspect of the financial markets, and a raft of regulations in Europe covering different areas are forces for change.

Regulation is also driving change in emerging markets. In Russia, for example, a law to create a single CSD is currently going through the State Duma. In India and Egypt, short-selling has been introduced.

But the major regulatory changes are taking place in Europe, driven initially by the drive to create a single, harmonised financial market and more recently by the financial crisis.

These regulations could transform the sub-custody business. The Alternative Investment Fund Managers’ Directive (AIFMD), for example, proposes that custodians will be made liable for “any loss of assets” except for force majeure (burden of proof by custodian). This proposal could lead to increased pricing from sub-custodians to reflect the increased liability they will carry. As Isaac points out, this will increase concentration risk as some custodians, unable to take on this extra burden, will exit the business.
Target2 Securities, which will settle euro and perhaps some other currencies in central bank money, will also impact custodians. With settlement commoditised, CSDs will look to substitute revenues by moving up the value chain and offering asset services. As a result there will be more competition in the sub-custody space.

Transformational Technology

Isaac identifies four technology trends that have the potential to transform businesses: smart order routers (SORs), algorithmic trading, multilateral trading facilities and dark pools.

"SORs are now showing examples of generating in excess of 100 million orders on MTFs in one day," he says. “High frequency traders account for nearly 65% of global trading volumes, and Europe is anticipated to reach 70% of trading volumes in DMA and algo by 2012.”

The impact of these technologies includes a shifting of the balance of market share from traditional players to new entrants, who thanks to technology, have found it easier to enter the markets.

Technology is enabling brokers to expand traditional benchmark strategies to incorporate dynamic, real-time variables, customisation and low latency infrastructure. On the buy-side, the adoption of electronic trading in Europe has been significantly more rapid than that of U.S. traders. Sub-custodians are increasingly required to provide real-time intra-day alerts on risk/credit exposures or volatile movements.

Future-proofing Business Models

“Our clients face an enormous set of challenges in developing business models that give them economies of scale but that are flexible enough for them to change direction as market conditions or changing regulations dictate,” says Isaac.

Citi’s open architecture approach, which enables clients to choose specific services, rather than being locked into bundled packages, is well suited to such an environment. “Our clients are looking to maximise their business models so they can have operational processes that reduce costs while enabling them to generate revenues. This may be through the entry into new markets or via new product lines.”

The securities markets remain very dynamic—in Europe, execution platforms are merging and new ones emerging; and interoperability between CCPs may be on hold at the moment, but in the meantime CCPs are competing strongly to win flows, says Isaac.

Getting the skills, and scale, to ensure continued success in the securities industry requires partnership, says Isaac. “Citi is global, committed and has the open architecture that does not tie clients into long-term costs.”
“Once we get the ‘go’ decision, all everyone wants to know is ‘when?’”

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Citi never sleeps®
Clearing the OTC Decks
Changes in the OTC derivatives world will significantly impact the back offices of buy-side firms as centralised clearing, standards, and transparency become the norm.

Among the key issues to arise from the financial crisis were the shortcomings in the OTC derivatives markets. A lack of transparency across many aspects of the markets contributed to high levels of uncertainty once the crisis began.

This lack of understanding was exacerbated by the sheer scale of the OTC derivatives market. According to the Bank for International Settlements, the total notional amounts of outstanding OTC derivatives were $615 trillion by the end of December 2009. This dwarfs other markets such as global bonds ($35 trillion) or indeed global equity market capitalisation, which is currently about $47 trillion.

The combination of shortcomings and size of market has led to a flurry of government and regulatory activity—and the problems with OTC derivatives have been discussed at the very highest levels in those organisations around the world. Rajen Shah, Head of Collateral Management at Citi Global Transaction Services, says changes are now afoot that will have a significant impact on market participants, particularly on the buy-side.

Central Focus

“A key change will be the introduction of central clearing of the majority of OTC derivatives by the end of 2012,” he says. “In addition to that, the introduction of a trade information warehouse will increase transparency across all OTC derivatives.”

These two moves are important, says Shah, because during the financial crisis regulators had no clear view of the levels of risk in the OTC derivatives market. Because OTC derivatives transactions are conducted bilaterally, rather than through an exchange, there was no central point at which regulators could examine the transactions. “Before the crisis, firms were creating derivatives that, had the regulators known about them, would not have been allowed or would have required much more capital to be associated with them,” says Shah.

Another big issue for the markets, says Shah, is the lack of standards. Because OTC derivatives contracts are transacted bilaterally, the two parties to the transaction interpret them in their own way, often leading to disputes that can run for many weeks. “Getting two parties to fully agree to all the terms of the trade can prove difficult. While in dispute, firms could not get to the bottom of their exposure to determine how much collateral they needed to cover it.” If a party fails during the dispute, the other party to the transaction will not be fully collateralised.

“Collateral can create a false sense of security, particularly if it is not managed properly,” says Shah. “Taking collateral to mitigate counterparty risk creates other risks—such as operational risk. During the crisis it became apparent that people thought they had optimised collateral but it was not up to the required strength or quality.”
Many firms on the buy-side were running collateral management programmes on spreadsheets staffed by operational teams that were not fully dedicated to the process and had little derivatives experience. “During the crisis, some organisations were doing margin calculations only once a month, or even relying on their counterparties for the information required to calculate the margin call. These are not the best way to manage collateral.”

**Broad Impact**

These scenarios led to the changes now being proposed in the market. These changes have the backing of the G20 leaders, who in September last year agreed that standardised OTC derivatives contracts should be traded on exchanges or electronic trading platforms and cleared through CCPs by the end of 2012. They also agreed that contracts should be recorded in trade repositories.

The changes will have an impact on buy-side firms, says Shah, who are significant users of OTC derivatives especially in hedging their liability-driven investment strategies. The collapse of Lehman Brothers highlighted the problems of the co-mingling of client and proprietary assets. Administrators spent considerable time differentiating OTC derivatives collateral from the primary assets of the collapsed bank, which acted as prime broker to a number of hedge funds. The reforms should build greater confidence across the financial markets in OTC derivatives. In addition, counterparty risk and systemic risk protection will be improved, along with transparency and standardisation.

Central clearing will mean once a trade is done, both parties will have to go to the CCP to novate the trade. The CCP will guarantee both sides of the trade, taking collateral associated with each counterparty, but will also be capable of pulling in collateral from all of its members.
A trade information warehouse will improve transparency, enabling regulators to go to a central point in order to examine the types of trades taking place in the market and to police firms to ensure trades are not too risky.

These advantages need to be weighed against some other factors, including the likelihood that costs will rise due to initial margin, mandatory use of high grade collateral (cash) and a greater reporting burden. Shah says there is some concern that costs could be disproportionate to the level of risk. The mandatory use of cash as collateral will be a burden to buy-side firms, which generally don’t keep stocks of cash. “Some firms feel they may have to post more collateral than in the past, which would mean cash that is used elsewhere will be committed to OTC derivatives. Pension funds in particular are used to investing all of their contributions into securities and will be reluctant to post some of that cash as collateral.”

Other questions remain about the number of CCPs that will be available to clear OTC derivatives. They are likely to have different processes, presenting buy-side firms with a more complex model than they have today. Moreover, how the CCPs will be governed and where responsibilities lie are yet to be addressed by regulators. Finally, not all OTC derivatives contracts will be centrally cleared—further clarity is needed on what is, and isn’t, a ‘standard’ derivative.

Build, Buy, or Borrow

Shah says the cost of setting up a strong, well controlled collateral management infrastructure and operation in a bilateral environment has been documented by the International Swaps and Derivatives Association as between $1 million to $2 million. The dual clearing model that will be required following the regulatory changes being proposed will clearly be more complex and require further investment, he says.

“From a platform perspective there are many vendors offering credible collateral management platforms and they are preparing to make the investments required to support the dual clearing model of the future. But I think that maintaining an experienced operations team is more difficult than implementing the required system, especially when the scale of operation is relatively small,” he says.

These issues will force buy-side firms to consider what is core and non-core to their business. An alternative option is to outsource the collateral management process to a services provider that has scale and can future-proof against any new CCPs entering the market or new regulatory requirements that are introduced.

“It is important to have experienced, knowledgeable staff when dealing with derivatives and collateral management,” says Shah. “For an outsourcing service provider this is a core activity and they will have staff in abundance to deal with this area, unlike buy-side firms.”

An outsourcing provider can also structure a trade so that it holds the client’s securities as collateral while providing the required cash as collateral to the CCP. The client therefore does not have to liquidate its assets to provide the cash directly to the CCP.

Shah says the OTC derivatives market reforms have been received positively by buy-side firms. “Firms can see that these changes will help to significantly protect market participants against counterparty and systemic risk. They can see the value of transparency that will be delivered by the use of CCPs and by greater standardisation. All of these moves will create greater confidence in continuing to use derivatives as hedging instruments.”
The new regulatory environment is already having a negative impact on credit lines, and banks are working hard to restore balance sheets while staying competitive in the global trade market. The current regulatory environment combined with the move to the updated Basel II proposals have the potential to wreak “significant and fundamental change” on the global trade business.
Credit tightening, changes in accounting regulations and the stringent capital reserve requirements of Basel II have created a more challenging trade environment, but a collaborative approach among industry players and agencies will benefit the industry as a whole.

“Regulators are trying to tighten capital requirements across the board—on all products in the banking industry as a whole,” says John Ahearn, Global Head of Trade, Citi Global Transaction Services. “Trade has been caught up in this new environment although it performed well during the crisis.”

According to the International Chamber of Commerce’s (ICCs) recent global survey, Rethinking Trade Finance, the level of losses experienced in traditional trade products were the same or lower than losses for general banking facilities. Despite this, financial credit lines had decreased in 2009, due to higher lending costs and risk premiums resulting from rising liquidity pressures, scarcity of capital, increased capital requirements and heightened risk aversion to trade finance providers and banks for counterparty and country risks.

Demand for trade finance is high, says the ICC, but access to affordable trade finance is constrained. “The costs remain substantially higher than they were pre-crisis, raising the problem of affordability for exporters. Around 30% of respondents indicated that there had been an increase in fees for commercial letters of credit, standbys and guarantees in 2009,” says the report.

Impact on Instruments

Among the trade instruments to come under the regulators’ microscope are letters of credit (LCs). As off-balance sheet instruments, such transactions are attracting more stringent treatment, with regulators proposing more regulation and added capital charges. “In general, regulators are looking at off-balance sheet instruments in a negative light. However, LCs do not perform in the same way as other off-balance sheet instruments such as SIVS (structured instruments vehicles) and should not be subject to the same capital allocations. The problem is that large parts of the global trade business comprise of off-balance sheet items, but these items are not used for leverage. Looking at all off-balance sheet products in the same way is like trying to paint a Rembrandt with a roller brush,” says Ahearn. Another area of global trade to be affected by the changed regulatory environment is securitisation. Here, says Ahearn, problems were caused by collateralised debt obligations and mortgage securitisation products while plain vanilla receivables portfolios, as used in trade, are important drivers of commerce. “Unfortunately the broad brush approach has decimated the entire securitisation market.”

Ahearn supports regulators’ moves to prevent a repeat of the crisis of 2008, but he believes that a more granular understanding of the impact of regulation is needed. “The remedies that regulators are trying to drive into the banking sector are good because they are an attempt to avoid another crisis. But just because certain products went bad doesn doesn’t mean the whole of the banking industry is corrupt. A more fundamental understanding of the products is needed.”

Against this background the revised Basel II looms large. “Compared to Basel I, Basel II has a more comprehensive approach to calculating risk capital,” says Ahearn. “Institutions are beginning to understand the amount of capital they will have to place against the trade business—it will be extraordinary.”

Basel, the Sequel

Basel I standardised risk weighting through simplistic categorisation of obligor (corporate versus bank) and product type (banker’s acceptance versus commercial LCs). A minimum ratio of required tier 1 capital to risk-weighted assets (RWAs) was required and RWAs were assigned only for credit risk.
Under Basel II, however, several methods for calculating RWA are available for each of the three risk types it covers: market, credit and operational. With market risk, standards have been improved to model default. For credit risk, a formula based calculation that uses an institution’s internal risk parameters associated with each facility, such as probability of default and loss given default, is implemented. With operational risk, a new internal simulation model incorporates estimates of the frequency and severity of operational losses.

RWA under Basel II is aligned with the actual economic risk and a bank’s internal measurement of economic capital. Ahearn envisages three likely scenarios under Basel II and the new regulatory environment. “The cost for trade finance will become more expensive, which is bad for economic growth. Second, the cost of capital will force many banks to decide about the lines of business they want to remain in. Will tier 2 and 3 banks consider trade as a core product? We may well see further consolidation of trade into the major banks, which won’t necessarily be a good thing,” he says. “Finally, there needs to be a much greater understanding of the economic impact of all of these regulations on each line of business in the banking world.”

A Look Forward

At present there is little understanding of the real impact Basel II will have on the transactions banks undertake with agencies in the global trade market. “We are in the great world of the unknown and it will cause us all to take a different look at the banking industry and trade in particular,” says Ahearn.

He suggests that capacity will continue to go out of the trade markets as capital tightens. Requiring banks to put additional capital against certain lines of business will result in scarce and expensive capital. Banks will have to choose what a core business is and what is not and allocate capital accordingly. “I believe banks will pay capital into markets where they have core strengths and take it out of a lot of markets that they see as secondary,” he says.

As that capacity comes out of the market, the ability for trade to drive economic engines will slow down. This could have a domino effect in cross-border trade, says Ahearn, and is the reason banks should monitor and manage regulatory changes closely.
“Citi has spent a lot of time examining what regulation and Basel II will mean for our business. We have scale in global trade, so is there a way we can fill the void that will be created by others as they leave certain markets?”

Citi is developing a multi-bank structure to address the potential capital constraints that allow for the distribution of trade assets. It has been designed to address accounting complexities of the new Financial Accounting standards Board (FASB) rules (FASB 166 and 167) and to ensure non-consolidation. This will also create a platform for banks to benefit from a joint programme where they can attain efficient capital relief as well as a diversified pool of assets.

The Agency Role

Agencies play a critical role in providing funding and credit capacity, particularly during the financial crisis. Through a series of global trade programmes, export credit agencies (ECAs) and multilateral agencies (MLAs) are partnering with banks to address the growing concerns over decreased liquidity in trade markets. Among these initiatives is Citi’s $1.25 billion joint funding arrangement with the IFC through the Global Trade Liquidity Programme. The programme is designed to facilitate the extension of funded trade credits in the emerging markets, and is a risk/revenue sharing agreement for emerging market stimulus.

Ahearn says the definition of emerging markets may well change in the current environment. "Many ECAs' mandates are to support emerging economies, but much of the stress today is being felt in OECD (Organisation for Economic Co-operation and Development) countries, where ECAs cannot help. I think there will have to be a rethink of the concept of where economic activity needs to be helped by ECA involvement—is it in China that has vast dollar reserves or in economies such as Greece, Ireland and Portugal?" he asks.

Other efforts in the agency arena include the U.S. EXIM put option of June 2009, where the U.S. agency and its bank partners agreed to a put option to be available for all U.S. EXIM guarantee loans closed in 2009. Supplier finance programmes supported by ECAs also offer competitive pricing for companies while potentially limiting the amount of capital required to hold on a bank’s balance sheet.

“In the current environment, banks and ECAs need to work together in order to ensure that economies continue to be driven by global trade,” Ahearn says. “Getting money into sectors such as SMEs (small and medium-sized enterprises) will be critical to ensuring the economic recovery continues.”

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GETTING MONEY INTO SECTORS SUCH AS SMEs (SMALL AND MEDIUM-SIZED ENTERPRISES) WILL BE CRITICAL TO ENSURING THE ECONOMIC RECOVERY CONTINUES.

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The intense regulatory focus on the financial services industry is forcing financial institutions to rethink business models. In order to survive and remain relevant in the new regulatory landscape, financial institutions must fully engage with regulators and market infrastructures.
Last year at Sibos, Citi Global Transaction Services published *Perpetual Evolution, The Development of Europe’s Trading, Clearing and Settlement Landscape*, which tracked the evolution of Europe’s financial industry during the past five years. In the year since publication many more regulatory initiatives have emerged and flesh is being put on the bones of regulators’ plans for the financial services industry. It is timely therefore, that Citi has published *Perpetual Evolution II: Innovation in the New Regulatory Environment*.

The whitepaper documents the transformation that a raft of regulations and other initiatives will have on the trading, clearing and settlement landscape. It covers the key pieces of legislation and regulatory-led initiatives facing Europe today:

- The European Market Infrastructure Regulation
- Target2 Securities
- The Securities Law Directive
- The MiFID Review
- The Alternative Investment Fund Managers Directive

Citi sought the views of senior representatives from market infrastructures, broker dealers and agent banks. Our clients provided their insights into these initiatives, including their fears and hopes for the new regulatory landscape. Patrick Pearson, Head of Unit, Banking & Financing Conglomerates, DG Internal Market & Services, European Commission, gives a detailed insight into regulators’ views on clearing while Jean-Michel Godeffroy, Director General, Payment Systems and Market Infrastructure, European Central Bank and Chairman of the T2S Programme Board gives an update of the status of T2S.

The whitepaper highlights the fact that regulation can open up opportunities for innovation—as evidenced by the success of the alternative trading venues that appeared after the introduction of MiFID. It is vital, therefore, that the industry embraces regulation and makes its voice heard in the corridors of power in Brussels and elsewhere in the world.

The following edited extract from the whitepaper focuses on what industry participants can do to ensure their voices are heard during the regulatory process and that regulations are fair and do not stifle innovation.

**The Aftermath of the Crisis**

In the aftermath of the financial crisis it became clear that self-regulation of the financial industry would be a thing of the past. In London in March 2010, EU Internal Market Commissioner Michel Barnier announced that “self regulation has failed.” Such a statement suggests policy makers will fill regulatory gaps, where they perceive risks exist.

Reports and recommendations have been issued by a wide range of groups including the European Commission, the U.S. Treasury, the G30, the G20, the Committee of European Securities Regulators (CESR) and myriad national market regulators.

These recommendations—devised to ensure there will be no repeat of the events of late 2008—are now being put into effect through a tsunami of regulatory initiatives. In the U.S. the comprehensive Dodd-Frank Act touches on almost every aspect of the financial services industry. Europe has taken an alternative approach, tackling specific areas of the industry through different legislative proposals, some of which overlap.
The fragmentation of trading and clearing venues set in train by MiFID, the introduction of central clearing for OTC derivatives, the commoditisation of settlement that will come with T2S, have raised many issues for market participants. Who will survive and remain relevant in the new trading, clearing and settlement landscape? Just as incumbent stock exchanges were exposed to the full force of competition with MiFID, T2S promises to repeat the experience for CSDs, ICSDs and agent banks, which will compete directly with each other.

The influence of regulators in the new landscape cannot be overlooked—nor can the influence of politicians on regulators. The engagement between industry participants and regulators during the past year has been unprecedented. Meetings with market participants have allowed regulators to benefit from their insights in formulating an approach to the issues being examined. Issuers, users, buy-side and sell-side firms have been consulted directly and through consultative drafts issued by CESR. Significant numbers of responses have been received by the European Commission.

Financial services institutions must work more closely with regulators to ensure that risks are managed, contained and quantified without the danger of innovation being stifled. One observer notes: “It is critical that there is a good exchange of ideas between regulators and the regulated to ensure there are viable regulations that the business can live with and that properly share risk out between the players.”

By becoming involved in the regulatory process, at an early stage, financial institutions can help regulators to formulate approaches to the problems raised by the financial crisis, as well as to European financial market integration. Many market participants operate on a global scale; they are well versed in the issues involved in cross-border business and have insights as to how various problems can be overcome.
Uniformity is a linchpin in the success of regulation of the financial sector. In a global business like the financial sector some players will go to where the cost and regulatory burden is the lowest. For that reason, regulators are making significant efforts to ensure regulatory commitments to financial services reform are implemented in a coherent way.

There are a variety of ways financial institutions can become involved in the regulatory process. Representation on working groups and direct submissions to consultative papers is one route, as is the third-party route, where agent banks such as Citi represent their clients’ views. Some firms believe that agent banks can differentiate themselves by playing an active role in the regulatory process, providing them with a voice at the very heart of the process.

The most effective legislation is that which is developed in cooperation between market players and regulators. As an institution, Citi continues to work with regulators in developing legislation that works for all market players. Financial market participants should all become involved in the regulatory process from the start, in order to ensure their views—and more importantly those of their clients—are taken into account.

Organisations that are willing to invest time, money and brain power on the issues that face the industry will have a better chance than others of emerging unscathed—but not unchanged—from these turbulent times.

The months and years ahead will test the commitment to the business of all players. Organisations that are willing to invest time, money and brain power on the issues that face the industry will have a better chance than others of emerging unscathed—but not unchanged—from these turbulent times.

“Financial institutions have a choice—to stand up and be counted or to sit back and react to change,” says Satvinder Singh, Head of Direct Custody and Clearing in EMEA at Citi Global Transaction Services. “I urge market participants to put their views on the table—only through forums and working groups can we get a coherent, industry-wide approach to the issues the industry faces.”

Organisations that are willing to invest time, money and brain power on the issues that face the industry will have a better chance than others of emerging unscathed—but not unchanged—from these turbulent times.
The Rise of the Renminbi

As trade with China continues to grow, corporations and financial institutions require a range of payments services to negotiate a complex environment.
The payments market in China has fundamentally altered following regulatory changes allowing trade settlement in Renminbi (RMB). A pilot programme to allow RMB cross-border settlement began in July 2009 and has been extended to 20 provinces and cities.

- Shanghai • Beijing • Tianjin • Chongqing
- Guangdong • Liaoning • Jiangsu • Zhejiang
- Fujian • Shandong • Sichuan • Guangxi
- Hubei • Inner • Mongolia • Hainan • Yunnan,
- Jilin • Heilongjiang • Tibet • Xinjiang

“The RMB pilot is part of the internationalisation of China that has flourished in the past decade,” says Emma Loftus, Global Head of Financial Institution Payments at Citi Global Transaction Services. “As China has become a manufacturing power, it has built up a capital surplus, the inflationary pressure and FX risk of which escalated during the financial crisis because so much of the trade transactions in China were denominated in USD. Now, the Chinese government is taking steps to reduce the pressure and imbalance of payments.”

A Global Currency Emerges

RMB internationalisation is a relatively recent development—the idea of a pilot programme was first raised at a state council conference in December 2008 and the rules of the programme were issued by regulators in July 2009.

Before the pilot scheme was launched, the RMB was not permitted for cross-border transfer. No RMB conversion was allowed in the offshore market and no cross-border financing took place in the currency. The pilot scheme now makes it feasible for companies to invoice in RMB for cross-border trade of goods and services, enabling settlement for a wide range of activities such as generic payments and receivables, letters of credit, import and export collection and letters of guarantee. Additionally, with local regulator’s approval, companies can make payments in RMB for dividends, investments, and other capital account transfers.

“The significant growth of trade to and from China, and the government’s desire to trade more in its local currency has created a need with many of our customers to transact business in China in RMB,” says Loftus. “As more transactions are invoiced in RMB and there is greater opportunity to trade RMB offshore, there is a need for corporate and financial institution clients to be able to settle in RMB. One of the perceptions in the market is that all financial institutions can offer RMB services, but in reality there are only a handful of banks that can support it.”

Implications of Internationalisation

There are different options for corporations and financial institutions that wish to become involved in RMB payments, covering different levels of participation in the RMB clearing infrastructure.

Those that want to participate directly in the RMB clearing but do not have a presence in China can open a RMB settlement account (nosto) with a domestic clearing bank in China, an overseas RMB clearing bank in Hong Kong, or an overseas RMB clearing bank in Macau. This correspondent banking model is open to all overseas financial institutions.

The advantages of this approach include the ability to offer RMB account services and RMB trade services via the nostro account. Users can settle their customers’ RMB funds transfer requirements directly. Financial Institutions can also offer a full set of RMB related products to their corporate clients.
Other benefits include cash management solutions that allow users to take advantage of possibly higher returns from RMB deposited in the nostro account, making better use of idle funds. By leveraging the RMB nostro account, in the near future, users can participate in the RMB investment market as the People’s Bank of China has launched a new pilot scheme which allows qualified foreign investors to access China’s onshore RMB interbank bond market. However, RMB clearing in China is still restricted to corporations and banks located in the 20 provinces and cities covered by the scheme.

On the FX front, when one conducts clearing through an onshore Chinese bank, RMB conversion in the offshore market is now permitted but subject to an FX limit provided by the appointed clearing agent. Short-term cross-border financing of up to 30 days is also now permitted for overseas Financial Institutions. RMB clearing via banks in Hong Kong are not subject to the FX limit for trade or qualified transactions. In addition, banks in Hong Kong are able to offer FX conversion for non-trade or general purpose transactions but subject to RMB interbank liquidity.

Another option is to outsource RMB payments to an agent bank. This provides the full capability of a RMB clearing services but without the high investments required to connect to China’s clearing system, CNAPS. This option is open to financial institutions with both a RMB license and CNAPS membership but that prefer to outsource their infrastructure. “By outsourcing payments to a bank that can support the infrastructure for RMB, the financial institution doesn’t have to set up the infrastructure to process payments itself. The outsource provider, Citi for example, works in the background, processing and settling on behalf of the bank. This arrangement is invisible to their clients.”

“As more transactions are invoiced in RMB and there is greater opportunity to trade RMB offshore, there is a need for corporate and financial institution clients to be able to settle in RMB.”
Maintaining a USD Focus

It is still early days for RMB clearing in China, says Loftus, and the majority of trade business is still transacted in USD. While some have seen the internationalisation of RMB as a threat to the USD, Loftus believes that USD settlement will continue for some time and likens the situation to that which followed the introduction of the euro. “From Citi’s point of view, our clients are very interested in how to get payments into and out of China. If they are not ready to transact in RMB, then we will continue to make sure their USD transactions get done.”

The focus of Citi’s services in China is to ensure that payments are not only easy but also have a high degree of certainty attached to them. Citi operates throughout the U.S. Fed settlement day, allowing USD payments to be made to coincide with early morning in Asia. The immediate settlement in USD of banks in Asia is an important service, she says. “We offer a range of USD solutions designed to facilitate payments into China, providing access to additional liquidity during Asia morning hours, and access to local USD clearing channels that facilitate intra-Asia payments.”

“We recently improved our capabilities to be able to clear through the local Hong Kong clearing system, CHATS. This means that banks in China can settle via Hong Kong in USD, rather than settling via CHIPS. This is providing another way of reaching banks in China rather than transacting through correspondent bank accounts in the U.S.”

Loftus says financial institution and corporate clients are asking whether they should open RMB accounts now. “We say yes—although the pilot scheme and the transaction volumes are still modest, we do expect that given the Chinese government focus on creating the RMB as a global currency, growth will come over time. It certainly won’t hurt clients to open a RMB account now.”

By partnering with a bank that has a strong presence in China—and in Asia—clients can establish effective payments processes in the region. “Payments destined to Asia can often be delayed due to the challenging, complex and multi-tiered banking system,” says Loftus. “Local knowledge of the banking environment is required for expedited payments into Asia, especially China and India. Financial institutions and corporations should look for a banking partner that can offer local presence and expertise in this complex environment.”

Alan Lin, Head of China for Citi Global Transaction Services notes, “Citi in China has been executing different types of cross-border RMB transactions for its Chinese and Multinational customers, including trade settlement, service trade settlement (such as service fee and loyalty fee), and dividend payments, among others.”

In July 2010, the Hong Kong Monetary Authority and the People’s Bank of China signed the Supplementary Memorandum of Co-operation to promote Hong Kong as an international RMB offshore centre. As a result, there will no longer be restrictions on RMB funds flow within Hong Kong and with other countries except for China. The relaxation of restrictions against corporations and financial institutions opens up many new opportunities especially in RMB clearing business and RMB denominated investment products such as bonds, insurance policies and structured products, paving the way for Hong Kong to become the financial hub for RMB offshore activities.
Today’s payments market presents banks with a new set of challenges as well as opportunities, says Diane S. Reyes, Global Head of Payments at Citi Global Transaction Services. “In order to compete in the new marketplace, banks must be at the forefront of innovation, prioritise investments in infrastructure and be nimble in an increasingly complex environment.”

Payments are moving along a continuum from paper-based instruments such as cash and cheques, to electronic means such as funds transfers/ACH, to the future including mobile, virtual and e-money instruments. As this shift occurs, banks are facing new, non-traditional competitors from the worlds of retail, technology and telecoms as well as money service bureaus that have long played a dominant role in the remittance space. The increasing number of players in the payments market, along with rising costs is placing pressure on prices and margins.

“Financial institutions need to partner with each other and with players in other industries in order to develop innovative solutions to capture the next generation payment methods. By collaborating with other banks, with technology companies and with mobile operators, we can bring together a wider range of experiences and expertise and deliver greater value for end users,” says Reyes.
There are challenges and opportunities in the new payments landscape. Reyes says that there are a number of pressures on payments revenues for financial institutions. At the same time, greater investment in technology is required as electronic payments become more complex and regulatory scrutiny continues to increase. As payments become more efficient, interest income declines. For those banks that want to compete by being first to the market with emerging payment types, a greater focus on innovation is also required.

The opportunities include a role in helping clients to make the transition from cheque to electronic payments. New flows, particularly from the unbanked market, can also be captured with the introduction of prepaid instruments. This is particularly relevant in emerging markets.

In order to succeed in the new payments market, financial institutions must take a collaborative approach, delivering real value to end-users that are becoming increasingly sophisticated in their payments activities.

**The Case for Mobile**

Mobile payments are among the fastest-growing areas in the new payments market. In June, market analysts Gartner Research forecast that the number of mobile payment users would reach nearly 109 million people by the end of 2010, representing around 2.1 per cent of all mobile users and having grown by 54.5 per cent from 2009.

*Market Insight: The Outlook on Mobile Payment*, found strong growth in Asia, Eastern Europe, Middle East and Africa for mobile payments. Adoption of mobile payments in North America and Western Europe was lower due to the greater range of choice of payment instruments, Gartner said. The Asia Pacific has the most mobile payment users, exceeding 62.8 million people. EMEA has 27.1 million users and North America 3.5 million.
In April, technology company Sybase presented a report on the business case for mobile banking. It cited three main areas advantages: mobile banking alerts, emergency bill pay and customer acquisition and loyalty. As consumers move more of their lives to mobile phones, the report said, those banks that make the leap to mobile services in concert with consumer demand will create a sustainable competitive advantage.

Quick SMS messages that alert customers of basic information such as account balance, said Sybase, can reduce banks’ operational expenses and also build customer loyalty. SMS messages that alert customers of upcoming payment deadlines for credit card and utility bills are also proving to be a source of new revenue for banks. Sybase added that mobile payments reduced churn, strengthened brand, improved customer loyalty and added a new marketing channel for banks.

Around 2 billion mobile applications have been downloaded to date. More than 850 million mobile payment transactions were made in 2009 and the estimated volume of global mobile payments for 2010 is $48 billion.

Strong demand for mobile payments in developing markets is driven by the unbanked and under-banked populations that do not have ready access to the banking infrastructure or to a PC.

The use of mobile phones continues to evolve as people use the devices for more and more activities. “People continue to change the forms of money they use over time and that process of change is becoming faster and faster,” says Tomasz Smilowicz, Global Head of Mobile Solutions at Citi Global Transaction Services. “Around 2 billion mobile applications have been downloaded to date. More than 850 million mobile payment transactions were made in 2009 and the estimated volume of global mobile payments for 2010 is $48 billion.”

Globally, mobile commerce is increasingly becoming a part of people’s daily activities. Mobile loyalty programmes, authorisation and reporting, mobile minute top-ups, mobile transit payments and mobile bill presentment alerts are all commonplace, he adds.
Integrating the Paradigm

“Banks need to understand and leverage emerging consumer behaviour to create bundled offerings like mobile top-up or consumer-directed payments in order to respond to our clients’ changing priorities,” says Reyes. “We need to offer innovative solutions for all our clients’ domestic and cross-border payment needs along the entire paper to electronic payments spectrum from traditional check disbursements to virtual payments.”

However this may not be easy for all banks. A recent Citi survey, says Reyes, found that pressure on financial institutions to comply with regulations or meet mandated requirements has led to banks exhausting their efforts in back-office technicalities, rather than pursuing opportunities that exist in the payments space. Fifty per cent of respondents said their top technology spend for 2010 would go on managing core capabilities, while only 10 per cent said they would prioritise new innovations.

In entering into partnerships, says Reyes, banks need to identify strong partners that are operationally stable, with the scale and the means to invest; systemically important, e.g., critical to the overall financial system and able to offer long-term commitment; infused with capital and therefore able to grow.

By partnering, financial institutions can reclaim the innovation agenda and lead it, capturing new flows, redefining the value chain and driving efficiencies.

Reyes says neither financial institutions nor mobile operators or technology companies can “go it alone” when it comes to developing solutions for mobile payments. “Financial institutions know the payments space and we can do secure payments, offer scale and compliance with global regulatory requirements on anti-money laundering etc,” she says. “Partnering will also drive reductions in cost as no one is reinventing the wheel. Everyone involved in mobile payments needs to take a closer look at their strengths in order to understand where they can compete and where they should collaborate.”
Increasing trade flows between Spain and Asia led the Spanish Confederation of Savings Banks (Confederacion Española del Cajas de Ahorros—CECA) to partner with Citi for a private label letters of credit (LC) processing programme. The programme has delivered cost savings, improved Spanish savings banks’ image and led to the winning of new business for their corporate clients.

CECA is the national association of 45 Spanish savings banks. Also a credit institution in its own right, it provides its savings banks members with competitive products and services, both technical and financial.

**Streaming New Services**

“For our member banks, around 85% of their foreign trade inputs come from Asia,” says Idoya Aramendi, Head of International Business Development at CECA. “We decided we needed a solution that would give us a presence in Asia to better serve our clients.”

With the help of Citi, CECA set up a 100% owned subsidiary, CEA TSL, based in Hong Kong. The company issues and processes letters of credit in its own name while Citi provides the processing services to CECA and other members of the group who participate in the programme. CEA TSL’s services are available in 20 countries in the region.

Prior to this arrangement, CECA’s member banks had to open LCs with each beneficiary bank across the region. “There was a high cost attached to this, particularly with regard to the communication tools that were needed. Now we have a centralised hub into which our members can send LCs. Our processes have been standardised and our members no longer have to worry about the differences in processing and treatment of LCs between each country in the region and each beneficiary bank.”

**Increasing Control**

Another advantage of outsourcing LC processing to Citi, says Aramendi, is that counterparty risk has been lowered. “In traditional LC processing schemes, a bank will take a position and will be exposed to the risk that the beneficiary bank might fail. In the new scheme such a risk is mitigated because Citi is our counterparty.”
Under the new arrangement, instructions to open import LCs are sent to CEA TSL. The documentation for these LCs are sent by the local banks to Citi for review. Citi then images these documents, placing them on a web-based system and also reviews them. “By scanning the documents and putting them into the system, we can easily gain control and view what is happening with the trade LCs at any time,” says Aramendi.

Citi reviews the documents based on the parameters set by CECA and its member banks. This is an important step because the documents do not have to be sent back to Spain for review, thus cutting out delays due to the time difference between Europe and Asia.

“The review process is based on continuous communication with Citi. If documents are compliant with our standards, they are accepted and if not Citi will follow up locally. We can then contact our member banks and inform them of discrepancies and check whether it is OK to go ahead with processing.”

Extending the Paradigm

Aramendi describes the partnership with Citi as “like having our own foreign department. Citi understands what we want and the programme is enhanced with a customer service department that is based in our time zone and has Spanish-speaking staff. Citi has put its expertise and knowledge in the trade business at our disposal.”

Citi acts as process agent on behalf of each bank and checks documents and collects fees on their behalf. Fees collected are shared with the Spanish savings banks.

Citi takes the risk of document checking and offers agreed turnaround times, thereby speeding this phase of processing. Group and individual savings banks have real-time access to reports and document images via CitiDirect® BE, Citi’s web-based banking platform.

There were a number of reasons to choose Citi as a partner. The bank and association already had a broad banking relationship, which was very positive, says Aramendi.

“The partnership with Citi has improved our image towards our member banks but more importantly has improved the image of our member banks with their clients.”

“We needed to set up a dedicated company to act for the LC business in the region. This is where Citi’s expertise really helped as they drew on local knowledge, putting us in contact with accountancy firms, ensuring that we registered the company properly and updating us on fiscal issues,” she says. “The impression we had was that other service providers were not prepared to offer this level of support.”

Another benefit of going to Citi was its flexibility—each of the member banks have different requirements, CECA acting as entry point for them. “Citi had to be aware of all of the specifications of each of our members. It needed a technology infrastructure to support all of the capabilities our members required.”

The commitment of senior management was also a factor that swung the contract Citi’s way. “Citi has a very strong trade team of experts who are very much backed up by senior management. We felt that Citi had the commitment to go forward and not only win the mandate but provide us with the tools we needed. Other service providers wanted to win the mandate but we were not convinced they had the commitment of the top management level.”

CECA highly values the scheme as it delivers reduction in processing costs for banks in the group and guarantees processing turnaround times and documentary indemnity offered by Citi.

“The partnership with Citi has improved our image towards our member banks but more importantly has improved the image of our member banks with their clients. It is definitely an advantage to tell clients that you have an international department based in Asia that has local expertise and experience.”

Spanish savings banks have not only gained additional clients as a result of the scheme but have also gained efficiencies, allowing them to grow their trade activities in Asia without having to invest in human or technology resources themselves.
A Return to Innovation

As the global banking industry emerges from the crisis throughout 2010 and as banks take stock of new market opportunities, new business models, and new technologies, innovation has returned to the industry agenda.

During the height of the financial crisis in late 2008 and most of 2009 it was difficult for banks to think, let alone talk, about innovation. Many banks were focused on the more basic elements of survival including sources of funding, quality of assets and counterparty risk, and ensuring that their corporate clients and their supply chains had access to credit and liquidity. Innovation was often seen as a luxury to be addressed at a later date, if at all.

However, outside the world of banking, meaningful innovation continued to move ahead at a "good clip", says Gary Greenwald, Chief Innovation Officer, Citi Global Transaction Services. “Think of the number of new iPhone or Blackberry applications. During the darkest hours of the financial crisis, there was some comfort in knowing that I could hold my mobile device to the car radio and use an application to find out the album and artist whose tune was on the air. Clearly, someone was focused on the next new thing.”

As banks have emerged from the crisis in 2010, innovation is increasingly on the active agenda, says Greenwald. As banks take stock of new market opportunities, new technologies and new business models, it is becoming clear that innovation is a key component.
Three Key Issues

Greenwald identifies three key technology issues financial institutions are focusing on: innovation as a process, innovation and Web 2.0 technologies, and innovation as it relates to evolving business models.

“The first issue refers to how we innovate as banks,” he says. “The conventional wisdom is of great ideas emerging from drawing on napkins at a business lunch. Now there is something to be said for scribbling on table linens; I am as big a fan as anyone of getting together with a few smart people to brainstorm on a topic, but innovation at its best is a broad set of processes and disciplines. Maybe there is the need for some ‘art’ to go with the ‘science’, but really it is no different than any other process we follow in business,” says Greenwald.

Innovation is ultimately about doing two things really well, he says. At the front-end, a business needs a way to generate many good ideas, and these ideas can come from different places within the organisation. Clients, employees and academic and business partners are a terrific source of ideas, says Greenwald. “A number of companies, typically technology firms, have disciplined processes for distributed innovation. Independent developers, working with the open programming interfaces typical of new so-called cloud computing, can be a distributed and scalable source of innovation. The world is moving too fast for any one company to think it can solely maintain the needed pace of innovation.”

Citi’s Research, Development and Innovation Lab (RDiL) reflects this process. Clients can visit the lab for a discussion on a particular problem or challenge they have. Sometimes academic and business partners will also be included in these discussions. Using rapid prototyping and other techniques Citi can quickly scope and iterate on possible solutions to the problem at hand, whether this is an analytic technique, a workflow optimisation, or a creative combination of existing processing capabilities. The idea, says Greenwald, is to solve a specific problem for a specific client, but do so in a way that is more broadly extendable to other clients.

Not Just a Great Idea

The second element in innovation is disciplined execution. “Great ideas without commercialisation are, well, just great ideas. The many ideas coming out of an innovation process need to be filtered to a more manageable few and it is these few that need to be funded and incubated to achieve commercial success,” says Greenwald, describing the process as a portfolio management approach to innovation. In this approach senior managers serve as a “venture board”, providing the needed governance and oversight.

When it comes to Web 2.0 technologies, Greenwald says the technology has made it increasingly easier to collaborate with others to share ideas, information and trends. “As we live our individual lives, we increasingly make use of social platforms such as Facebook, we send or receive concise nuggets of information by using Twitter, and we video chat with our family while travelling.”

There seems, however, to be a large divide between the worlds we live in as individuals and those in which we live as professionals, he says. “While many of us use all the tools just mentioned in our personal life, more likely than not at work we’re focused on cleaning out the large file attachments from our email inboxes that have overloaded the storage quota, or searching for information across disparate corporate intranet locations.”

Video conferencing is available, but often by reservation only, in a special room, he says and many companies block access to social networking and media sites because of concerns about information security, network bandwidth, and perhaps employee productivity.

Greenwald calls the “great chasm” between how people operate as individuals and as professionals the “2.0 divide”. For him, it seems obvious that collaborative and networking technologies can and “keeping pace with technological innovation requires continuous investment” should have profound implications on how financial institutions innovate in a business context.
Bridging the Divide

But this divide is being bridged, albeit slowly. The social networking site LinkedIn, for example, operates a number of discussion forums on topics of treasury management, while the theBenche.com is a collaborative community on trade and supply chain issues. “At Citi, we are increasingly using video media for client workshop discussions, getting several people in a virtual conference room to discuss a particular topic. We also use video media for knowledge dissemination and have begun using ‘jam sessions’ to open up more collaborative real-time idea generation,” says Greenwald.

It is now a matter of adapting the consumer-focused tools to work within and across enterprises, with appropriate accommodations for the needs of a business-to-business model, he says. “The early days of instant messaging followed this model, where the initial consumer technologies such as AIM led to the evolution of corporate equivalents. Given the large potential to transform innovation and other business processes, the same will be true of the broad new set of Web 2.0 tools. This is a matter of when, not if,” says Greenwald.

His third topic relates to the implications for banks of the increasingly fast pace of change. Given this rapid change, he argues that every aspect of banks’ business models should be looked at in the context of how quickly the world in which the bank operates is evolving. “Clearly regulatory changes are on everyone’s radar screens as governments around the globe seek to find ways to avoid repeating the recent financial crisis,” he says.

Beyond that, keeping pace with technology innovation requires continuous investment to evaluate new technologies and, when such a technology does provide potential benefit, requires even more investment to bring the associated capabilities to market. Banks need to be looking at a variety of build, buy and rent models for gaining access to these new technologies, Greenwald says.

A growing trend is private label (or white label) offerings by banks with the scale necessary to make the substantial investments required in developing new technologies. This private label approach adds a new dimension to the historic correspondent banking model, says Greenwald. A similar trend is the growing popularity of software-as-a-service offerings, pioneered by companies such as salesforce.com. In these models a third party manages the software and infrastructure on behalf of many companies, enabling the bank to benefit from new applications in a variable cost model.

Banks also need to be mindful of fast-moving changes in the competitive landscape, as new entrants, unencumbered by legacy technology, look to cherry pick certain aspects of banks’ customer bases. This has been increasingly true in the payments business, where a large variety of players including banks, mobile network operators, and internet companies are looking at how their competencies and assets can be used to reinvent the world of payments, says Greenwald. “Trying to understand and influence this evolution is a healthy and important exercise for banks. New alliances, partnerships, and business models will be the result.”

*[Originally published in The Banker, July 2010]*
“I can help my clients with Baht in Bolivia, Euros in Uruguay and Renminbi in Rome.”

Citi's payment services: global solutions for greater efficiencies and risk mitigation.

New markets mean new currencies. That's why Citi's proprietary network delivers payment services in 135 currencies across 190 countries and territories on a consistent global platform. Our global reach and on-the-ground expertise create the cross-border capabilities that help you and your clients achieve efficiencies and mitigate risk. In both new and familiar markets, you and your clients can gain a competitive edge with Citi. Find out more about our global network and award-winning solutions at transactionservices.citi.com.
“My clients have never been to South Africa, but my trade network makes sure their business is there every day.”

Citi’s trade services: on-the-ground expertise, access and experience in local and global markets.

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