

# the year ahead

Navigating change in the global  
Financial Services Industry in 2012

This publication is part of an ongoing research initiative into the major issues impacting the global Financial Services industry.

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# Contents

|   |           |
|---|-----------|
| 12 trends for 2012 .....  | <b>04</b> |
| Four Corners: A view from around the world .....                              | <b>06</b> |
| 1. Insurance - Solvency II: The countdown to compliance .....                 | <b>11</b> |
| 2. Insurance – Outsourced Managed Services, a growing trend .....             | <b>12</b> |
| 3. Retail Banking – The Opportunities and Challenges of SEPA.....             | <b>14</b> |
| 4. Retail Banking – The move to mobile.....                                   | <b>16</b> |
| 5. Regulatory Briefing - FATCA .....  | <b>18</b> |
| 7. Corporate & Investment Banking – Prime Brokerage: Key Success Factors..... | <b>21</b> |
| 8. Corporate & Investment Banking – OTC Derivatives Reform .....              | <b>22</b> |
| 9. Corporate & Investment Banking – Collateral Management .....               | <b>24</b> |
| Best practices for navigating change in the financial industry in 2012.....   | <b>27</b> |
| 1. Best Practice - Project Portfolio Management .....                         | <b>28</b> |
| 2. Achieving Excellence in Reconciliation and Exception Management .....      | <b>30</b> |
| Investance Capabilities .....   | <b>31</b> |
| Introduction to Investance .....  | <b>32</b> |

the year ahead



For the past 10 years I have sent out my thanks to all of our clients and employees via a letter during the holiday period. However, this year I am delighted to introduce the first edition of "The Year Ahead", a new publication from Investance looking at the major trends, challenges and opportunities facing the financial industry as we head into 2012.



**Franck Dahan**  
CEO

In 2011 Investance celebrated its 10th anniversary with continued growth across all of our segments. As a management consulting firm specializing in serving leading institutions in the Financial Services Industry, we have observed first-hand the challenges our clients have faced and opportunities that lie ahead. Our broad relationships and span of engagements allows us a deep insight into the industry trends across the Investment Banking, Wealth Management, Asset Management, Insurance and Retail Banking sectors. As we stand at the beginning of the New Year, we see the pace and scale of change facing the Financial Services Industry continuing unabated. During the past 3 years the market landscape has changed beyond recognition. Regulatory deadlines are fast approaching, the ongoing sovereign debt crisis is threatening to derail the Eurozone and stifling growth whilst Government-led austerity measures are weighing on consumer confidence. The global Financial Services industry is not immune and 2011 was a difficult year for our clients.

However, being present in all major financial centres around the world we could not miss many positive and exciting developments. As CEO I frequently travel to our offices in New York, London, Hong Kong and Singapore where I get a chance to meet with clients and employees. There are tremendous growth opportunities that will unfurl over the next decade. With economies such as India, China, Brazil and other Emerging Markets forecasting 7-8% growth, financial services firms are looking to gear-up their operations to take full advantage of the new business opportunities.

Investance is committed to its clients and every day we strive to support them to respond to challenges and take advantage of new opportunities. To meet this commitment, we are making an investment in developing our research and advisory capabilities and in "The Year Ahead" our colleagues have brought

together a broad range of research on issues impacting our clients. Specifically we focus on the organizational impacts of operating in a market with shrinking margins, the challenges and opportunities for Investment Banks as they realise the full extent of regulatory reforms and the new frontiers of cash management and mobile banking for retail banks. Our colleagues working with clients in the Insurance industry focus on the impact of the 2013 deadline for implementation of Solvency II as well as examine outsourcing trends for Insurance.

As I frequently tell our clients, employees and prospects, our growth is a testament to our hard work and values. Investance continues to move forward in its mission to become a leading specialist consulting firm focusing on the Financial Services industry. I am happy to report that in the past 18 months we have opened three new offices in Singapore, Amsterdam and most recently in Mumbai, expanded our team to 300 people and established relationships with 10 new institutions. We invested in marketing and branding to better communicate the value we offer our clients and opportunities we offer our employees and candidates.

There is little doubt the next 12 months will remain challenging for the industry but as the new financial landscape becomes clearer, our industry specialists stand ready to assist you to navigate the challenges and find answers based on industry insights and practical solutions that add value.

I hope that you will find "The Year Ahead" useful, if you have any feedback or are interested in speaking to any of Investance experts, please do not hesitate to contact me or any of my colleagues.

Best wishes for a successful 2012.

Franck Dahan  
CEO

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# 12 trends for 2012

2011 is likely to be recorded in the history of the Financial Services markets as another watershed year that significantly reshaped the face of the industry.



**Rashad Kurbanov**  
Head of Advisory

Just 3 years after the credit crisis of 2008, events of the past year put further pressure on the industry still recovering from the deepest contraction since the Great Depression. Increased market volatility and speed of market reactions have put significant pressure on bank CEOs to react almost in real-time to events unfolding in the market.

- Fear of contagion stemming from the Sovereign Debt Crisis in Europe defined the second half of 2011 and drove stock prices to levels last seen during the aftermath of Lehman Brothers collapse.
- Drying global liquidity pushed major banks to consider large scale asset sales and to seek funding from central banks.
- Higher capital requirements mandated by G-20, Basel III and other regulatory initiatives are making usual profit engines such as OTC Derivatives and proprietary trading prohibitively expensive.
- Slowing economic activity and increase regulatory uncertainty has impacted bank earnings across the globe. While 2009 and 2010 saw near record earnings for major financial services firms, 2011 has seen banks reporting reduced earnings everywhere.
- Ongoing complex litigation in the US from investors demanding to be compensated for underwriting errors in the run-up to the credit crisis of 2008.

Entering 2012 the Financial Services industry is facing a host of challenges that will change the way the market operates. But will these evolutions lead to a more sound and stable industry? Investance has identified 12 key trends facing the industry over the next 12 months that market participants need to consider in their strategic plans to identify challenge and turn them into growth opportunities.

- 1. Focus on Capital:** Basel III, the Collins Amendment in Dodd-Frank Act, Solvency II for insurance companies in Europe and other regional regulations will significantly increase the minimum required capital. Adding to the pressure on the capital reserves of financial institutions and the ongoing need to evaluate both new and existing business activity based on balance sheet impact.
- 2. Right-sizing the business:** Many Financial Services firms will continue to review their diverse operations with a goal of identifying core assets, clients and businesses. Anything deemed non-core will be put for sale or closed down to free-up or preserve capital. However, untangling many years of rapid growth through mergers and acquisitions will prove challenging and will require significant investment of resources to accomplish.
- 3. Re-pricing of the risk:** Low real returns on remaining "safe haven" assets will force investors to move up the risk profile to achieve desired returns. While markets will force re-pricing higher of all risk assets, counterparties most suitable to underwrite this risk – hedge funds, insurance companies will be active in the market for the "right assets at the right price".
- 4. Growth of Hedge Funds:** Hedge funds will continue to experience growth and will attract institutional money seeking higher returns. There will be no shortage of talent to support this growth as investment banks downsize their trading operations and shut down proprietary trading units. As a client segment, hedge funds are likely to gain in prominence and all banks must be prepared to support them through service innovation and high quality.
- 5. Stronger emphasis on fee based business:** Financial services industry will renew its focus on fee based businesses to limit their risk taking activities. Wealth Management and Private Banking will become more prominent components of universal banks. To service this market segment, Financial Services industry will focus on product and service innovation.
- 6. Growth in Emerging Markets:** Global investors will continue to clamour to access Emerging Markets to diversify their portfolios and achieve higher returns. Latin America, Middle East, Eastern Europe and Asia-Pacific markets will attract global capital by offering significant growth opportunities. Further, growing middle class and wealth accumulation in the Emerging Markets countries will create a mass pool of new retail investors looking for opportunities to invest their savings. Breadth of Emerging Markets capabilities will become a differentiating factor for the Financial Services industry players.

- 7. Harmonization of regulatory regimes:** The last 3 years have seen a wave regulation of the Financial Services Industry across the globe. Indeed, Dodd-Frank Act in the US, EMIR and MiFID II in Europe, Basel III and other regulations around the world have created a new set of rules under which the industry has to operate. Regulators will try to rationalize the regulatory regime across all markets to avoid regulatory arbitrage and prevent emergence of less regulated locations and markets that will attract higher risk activities. In response, Financial Services firms will need to coordinate regulatory response initiatives across all of their locations to ensure optimal allocation of resources and technology investments.
- 8. Electronification of global trading:** Driven by regulations and market innovation, electronic trading will increase in volume and product scope. In particular, Derivative instruments currently traded in bi-lateral OTC markets will move en-masse onto organized exchanges, resulting in more price transparency and lower spreads. Electronic markets will compete to attract and provide liquidity, drive product innovation and create new revenue streams from providing of real-time data, access and speed.
- 9. Improvement in market infrastructure:** Industry utilities and infrastructure providers will continue to improve and broaden their services and reach. Central Clearing Counterparties for OTC Derivatives, Trade Data Repositories, CSD, exchanges and other service providers will gain prominence in the industry and will offer services that will partly compete with banks.
- 10. Continued consolidation of utilities:** As market infrastructure providers attract new revenues, consolidation between exchanges, clearing houses and other utilities will pick up speed. Economies of scale and the desire to offer broadest possible set of services will drive narrowly focused utilities to seek combinations with other utilities to increase breadth of products and services offered. As a result, we may see emergence of truly global, multi-product integrated exchanges able to provide access to trading and settlement of a wide variety of financial instruments in a seamless fashion.
- 11. Growth of Custodians:** Operational Risk considerations will result in accelerating growth for the custodian banks. The spectacular blow-up of MF Global in 2011, rogue trading scandals of the past 10 years, bankruptcy of Lehman Brothers and resulting issues will force asset managers and hedge funds to seek safety of their assets outside of the Dealer community. Custodian banks will be able to offer them security and better Operational Risk

Management through value added services such as third party collateral management, valuations and other services. Dealers will have to rethink and redesign their existing processes to accommodate third party service providers.

- 12. Cost focus:** Faced with pressure on revenues, the Financial Services industry will redouble its efforts to lower and optimize its costs structure. Several key initiatives, launched in prior years will gain momentum. Outsourcing to lower cost locations of non-key functions, continuous growth of the captive locations, emergence of new low cost locations in Eastern Europe, Latin America will substantially change the composition of the Financial Services industry labour pool. Technology rationalization efforts will attract substantial investment as the industry aims to streamline its internal systems, divest legacy platforms and achieve flexibility to integrate with new utilities and third party service providers. Furthermore, the Financial Services industry will need to carefully evaluate technology vendors who offer an attractive alternative to in-house development across a wide variety of functions.

The crisis of the last 3 years exposed critical weaknesses in the way Financial Markets operate. The resulting market turmoil and radical changes in regulations are laying a foundation for more sound and stable industry. Despite the number of challenges that lay ahead we remain optimistic that the industry will be able to adapt to these changes and return to profitable growth in the near future.

*"When it comes to the future, there are three kinds of people: those who let it happen, those who make it happen and those who wonder what happened."*

**John M. Richardson**

# Four Corners

A view from around the world

## European and French Banking: A New Paradigm



David Robson  
Managing Director, France

Today, the French Financial Services industry is faced with significant challenges and the CEOs of major French banks must consider multiple drivers in defining a new strategic focus. Specifically, we want to highlight 4 trends and provide high level views on where we see the industry evolving in 2012 and beyond:

### 1. Regulatory framework changes and the scarcity of liquidity – reduce balance sheet and right-size the business footprint.

Traditionally, French Corporate and Investment Banks (CIBs) have been much more active in the areas that played well to their strengths. Proprietary trading customized highly complex derivative transactions, Structured Finance and other similar high margin/low volume business made up a large portion of their revenues and profits. They have been among the world leaders in financing activities, especially infrastructure development, air and shipping financing activities. While these engines of profitability fuelled growth, French CIBs invested less in other types of activities that were dependent on large volumes of low margin transactions.

However, the recent economic slowdown, global regulatory drive to reduce the risks associated with OTC Derivatives, push out proprietary trading and increase capital requirements make previously high margin businesses a lot less attractive. Indeed, the volumes of such transactions have gone down, client demand has dried up and margins have shrunk. On the other hand, vanilla OTC Derivatives and high volume agency trading in Equity and Fixed Income markets grew in their importance to Investment Banks.

As a result, French CIBs have to urgently rethink their strategic focus and business mix to ensure survival in the new environment. This urgency is driven by many factors, including the accelerating pace of implementation of new prudential ratios (Basel III and G20 commitment), the scarcity of liquidity and balance sheet pressure from sovereign debt crisis.

Access to liquidity should of particular concern. French CIBs can rely in some extent on their parent entity's retail deposit base, they actively use wholesale lending markets to fund their previous activities. Unfortunately, the last 3 years saw multiple episodes where interbank and wholesale lending markets suddenly withdrew liquidity, leading to potentially severe funding crisis for anyone relying on these sources.

### 2. Evolution of the Universal Banking model and its future – rescale and rebalance business portfolio

Is the "Universal Bank" model dead as a result of market dislocations and regulatory changes? Should Investment Banks continue to be part of the larger banking companies with significant retail operations? Can the benefits be realized and synergies leveraged? These questions are high on the agenda of CEOs of major European banks. Despite the fact that the universal bank model has been criticized recently due to its perceived riskiness and systemic impact on the financial markets, it continues to be useful in financing credit business on which French CIBs rely for a significant portion of their revenues. Being part of the "Universal Bank" allows them to avoid being dependent solely on wholesale lending markets, making financing cheaper and less risky.

Indeed, recent events that led to a dramatic withdrawal of liquidity and dollar funding in the global wholesale markets proved traumatic for French CIBs. However, they had some protection from retail deposit base of their universal bank parents. Had they relied exclusively on wholesale funding markets, they would have ended much earlier in a more complicated situation.

While we see the "Universal Bank" model continuing to operate in Europe, implementation of new prudential rules will require evolution of this model. French banking CEOs will need to focus on re-scaling and rebalance of banking groups' portfolio of activities to lower risks and put themselves in a less vulnerable position to survive future crises.

We believe that in 2012, driven by changes in their operating environments, French CIBs will implement significant reduction of their balance sheet (balance sheet reductions between 50 and 70 billion Euros by end 2013) and scale down their staff.

### 3. Development of the private banking as a new source of growth and security – cross-business coordination is key to success

As discussed above, access to a reliable deposit base is of paramount importance to the future security and continuous operations of the French CIBs. Private Banking activity has now become strategic avenue to increase this deposit base. While traditionally French banks did not actively pursue this business, they now must make it part of their core focus and start competing with Swiss and US private banking institutions.

In particular, French banks must take into account global demographic trends in search for new opportunities in Private Banking. High Net Worth (HNW) client segment continues to grow despite the recent economic upheavals. Globally the number of HNW individuals is rising, in particular in the Asia-Pacific and Emerging Markets regions. HNW individuals are clamouring for new products, services and access to new markets.

French banks can leverage their core strengths to grow in the Private Banking space. To achieve this they must break the barriers between their internal businesses and focus on design and distribution of innovative products to HNW clients. They should actively leverage the investment banking expertise in derivatives to create new ETF-like products and give clients the desired exposure. They should leverage global presence of their corporate banking network to access local markets and use their operational expertise to help clients to meet global tax regulations such as FATCA.

Success in Private Banking is dependent on cross-business coordination. Senior Management focus will be required along the way to ensure the right focus and approach.

### 4. Direct and indirect impacts on the operating model – look for new frontiers.

Market environment changes and the consequent impact on business portfolio will require a significant redesign of banks' operating models. In fact, any initiative intended to move towards an optimised operating model is becoming a top priority project for banks constantly looking to reduce costs.

Various measures have already been taken in order to meet this goal with an increased focus on expense reduction and budget control has resulted in a strong drive and development in Outsourcing and Offshoring activities. Indeed, many leading French banks have significantly ramped up activities in their captive offshore locations. Senior Management is becoming more attuned to optimising the project portfolio to

ensure active management of priorities and resources.

The next frontier is likely to be the mutualisation of specific operational services and functions within and/or across banks. This will continue the trend that saw the emergence of dedicated providers of securities processing services.

Operations must become more focused on driving revenues from services. They should change their mindset and operate as client facing business serving external customers.

## North America: Headwinds and hope



**Elie Cohen**  
Head of Americas

Looking back at 2011 we saw economic uncertainty, increased regulations and political changes as being high on the agenda of the US Financial Services firms and their management. While the start of 2011 brought some hopeful signs of improved economic activity, these proved to be transitory and economy slowed down

considerably during late spring and summer periods. As the world watched, the US Congress came perilously close to default on US Government debt. Only a last minute deal averted a disaster, but uncertainty from the political process remains high. Indeed, the Super-Committee's failure to identify required budget cuts leaves open a key question for the markets and economy – will the US have to go through the same bruising battle to extend the debt ceiling limit at the end of 2012? On the regulatory front, after a long delay regulators published detailed rules clarifying key parts of the Dodd-Frank Act, including the Volcker Rule.

The US economy is in a fragile state and is facing many headwinds. Economic projections for 2012 are divergent with some analysts predicting marginal growth and some predicting a recession. Furthermore, any external shock is bound to result in a broad economic downturn.

Not surprisingly, the US financial services industry is likely to come under increasing pressure in 2012. Three key themes are likely to dominate 2012: regulatory response, balance sheet management and organizational "right-sizing". For the US banks, painfully slow economic recovery, increased regulatory pressure, the European sovereign debt crisis and legal actions by state governments and investors will put pressure on bank earnings, balance sheets and activity levels. The

spectacular failure of MF Global highlighted once again the interconnected nature of the financial markets and speed with which firms caught on the wrong side of the markets can collapse. We are certain that the regulators are going to press all banks to become more transparent and reduce risk on their balance sheets as much as possible. A new round of stress tests mandated by the Federal Reserve will shed additional light on the state of the industry early in 2012. We expect US banks to continue reviewing their operations with the goal of finding the right business opportunities to deploy their somewhat limited capital.

European banks operating in the US are likely to feel even more pressure than their US counterparts. Pressure on their balance sheets from souring European sovereign bonds, dramatically slowing economic activity in their home countries, an increased perception of their counterparty risk and drying liquidity likely to force them to scale down their US operations and focus only on core businesses and client segments.

Two bright spots in the industry in 2011 were Canada and the Emerging Markets in Latin America. Indeed, all major banks are growing their presence in key Latin American markets. Canadian Banks, having survived the credit crisis relatively unscathed, are making key investments in business growth and infrastructure improvements.

## Asia: A region in transition



**Cedric Boisine**  
Head of Asia

Asia as a region is no longer a small player in the Global Financial Industry. Market activity is continuing to grow especially in domestic markets, with firm growth in regional institutions. The importance of generating new revenues and opening up new client bases has become a key objective for most firms and is therefore a continued focus

for investment in the main regional hubs. China remains the main growth engine, however steady growth though in markets such as South Korea and Indonesia is starting to balance the region. However, there are some signs that the economic situation in the US & Europe is beginning to have an effect in Asia (for example South Korea - Asia's fourth largest economy - recently downgraded their 2012 growth forecast from 4.5% to 3.7%). Despite this news, resource rich Indonesia, has seen a rapid recovery from its severe economic woes of the late 1990s, mainly on the back of commodities. High net worth Indonesians are also starting to be noticed in high-end property markets

in the West. A special note should also be made of the Philippines and Malaysia which until recently were almost ignored, however, the investment by major players in BPO operations in particular have made a significant impact and is expected to continue to grow.

## Regulatory Changes

One of the big issues facing Asia is the complex regulatory environments in place across the region. Coupled with this are the very different approaches taken by the regulators themselves; ranging from open and eager for new business to more protective and aggressive in nature. The coming year will not see a radical change to the overall complexity of the region though there are likely to be some material changes in individual markets. The main concerns of regulators in the region are around overall financial strength and ensuring regulated financial firms are adequately controlled, capitalised and in some cases have adequate assets onshore. There are some positive signs coming from Korea around operational requirements but potentially the reverse is true in Indonesia. There are also indicators that some of the established and more open markets in the region, such as Singapore, will be introducing some more restrictive legislation. Having a clear understanding and approach to each market is one of the keys to success in the region.

## China, has the world's second largest economy reached a turning point?

The onward march of China's economy is almost without parallel, massive cities that have sprung up almost overnight and a gargantuan manufacturing capability that results in most products stamped "Made in China", but what about "Consumed in China"?

The near term will be pivotal in determining whether China can continue to grow at very impressive levels or will it fall away once it reaches its manufacturing peak. If China is to overtake the US as the world's largest economy it has to become a more balanced economy which means shifting its capabilities towards the domestic market. 2012 looks like it will be a lean year for China's manufacturing as European and US consumers reduce consumption. This coupled with increased fears over government credit risks and the potential knock-on effect of no longer investing trade surpluses in USD/Euro government bonds. If these investments are not made and more funds are converted to Yuan, the pressures on the currency will only exacerbate the issue by making Chinese exports more expensive overseas.

## India: Knowledge is power, a country on the rise



**Eric Lecoquierre**  
Head of Outsourcing Services

Some commentators are predicting that India will become the world's third largest economy in 2012, overtaking Japan in terms of Gross Domestic Product (GDP). Whilst India's GDP is 9th largest in the world, India is now the fourth-largest in terms of purchasing power parity behind the US, China and Japan. And following

March's devastating earthquake, Japan's economy is widely expected to contract in the next fiscal while India's economy will grow between 7% and 8%.

India is developing into an open-market economy. Economic liberalization has served to accelerate the country's growth, which has averaged more than 7% per year since 1997. Although more than half of the work force is in agriculture, services are the major source of economic growth, accounting for more than half of India's output, with only one-third of its labor force. India has capitalized on its large educated English-speaking population to become a major exporter of information technology services and software workers.

Services exports are likely to expand due to India's comparative advantage in software services. The National Association of Software and Services Companies (NASSCOM), which serve as the chambers of commerce for the Indian IT and BPO companies, had projected software exports in US Dollar terms to grow by 16-18 per cent in 2011-12. However, as the Indian IT industry is inter-twined with the global economy, with the US and Europe constituting the bulk of Indian software exports, some impact from a slowdown in advanced economies can be expected.

## Knowledge Process Outsourcing an Opportunity for financial services

The Indian financial industry underwent rapid transformation post liberalization in the early 90's, resulting in greater inflow of investments. The Indian Banking sector has been successful in maintaining its growth trajectory due to low defaulter ratio, least complicated financial products, regular intervention by central bank and proactive adjustment of monetary policy.

Indian BPO providers are moving up the value chain to offer higher-end services, end-to-end business process outsourcing and domain-specific expertise. This has given rise to a new concept named KPO (Knowledge Process Outsourcing).

In effect, KPO represents the latest step, in a continuous multi-decade process of value creating strategies, with respect to a typical financial institution's back and middle offices.

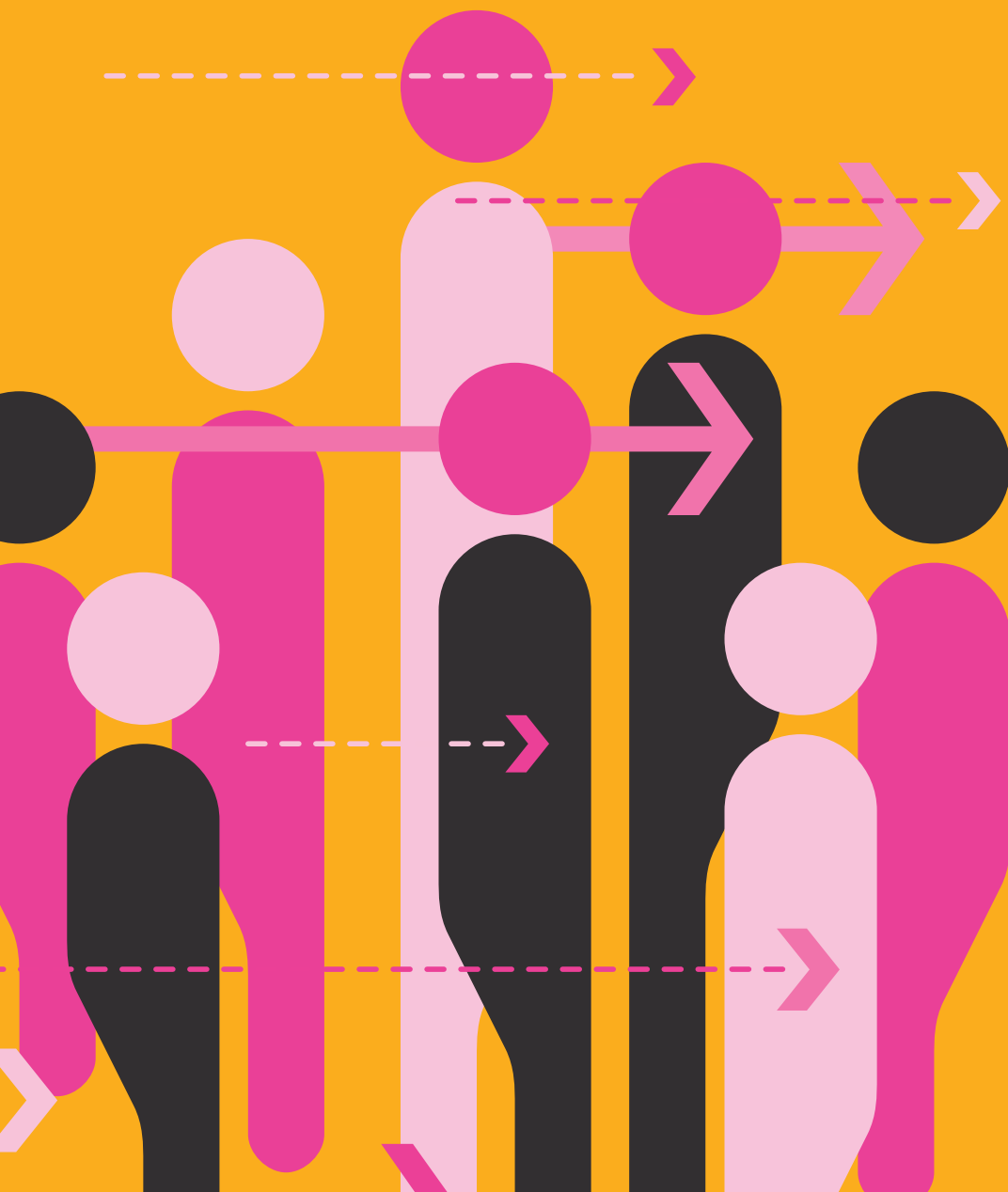
Currently, Financial Services accounts for more than 60 percent of the KPO work performed in India. With the exception of a few firms that had significant headcounts, most Financial KPO service providers had an average of 500 resources or less. The Indian KPO sector employs more than 250,000 KPO professionals for USD 12 billion.

Skill-sets sought by the KPO industry include financial analysis and statistical analysis skills (including actuarial skill-sets). Financial analysis skill-sets in demand in the KPO industry are those of Chartered Financial Analysts (CFAs), Chartered Accountants (CAs) as well as Engineer-MBA and Engineer-CFA combinations. The KPO industry faces a severe skills shortage. This is demonstrated by both churn rates (now about 25 percent per annum) and salary inflation (typically around 30 percent per annum) making retention of people a critical issue. It is particularly acute with KPO providers compared with BPO providers, reflecting the more demanding KPO learning curve.

Overall, there is growing client interest in KPO. However, providers face challenges, which are in some ways similar to those faced by the ITO and BPO industries. However, as Financial Institutions look for yet more ways to reduce their costs, KPO is expected to continue to hold client attention and enjoy a steady growth rate.

# forward thinking for financial services

A selection of knowledge and insights from Investance across  
Insurance, Retail Banking and Corporate & Investment Banking



## 1. Insurance - Solvency II: The countdown to compliance

Whilst most Insurance industry players have acknowledged the need to prepare for implementation of the Solvency II Directive, the deadline for the implementation is likely to be delayed. Today, the deadline is still fixed for 1 January 2013. However, the Omnibus 2 directive proposed by the European Commission (which should be voted in the European Parliament in 2012) is likely to impact the implementation of controls under Solvency II causing them to be effective as of 1 January 2014, thus providing a transitional period of one year.

Preparation for implementation within Insurance companies has progressed but in most cases has only involved small internal project teams, with a majority of players focusing mostly on Pillar 1. Indeed, for the major players the biggest concern was (and still is today) to define an internal model to measure the capital required for their activities; whereas "small" players have focused on quantifying equity requirements in-line with the standard method.

Although the challenge posed by Pillar 1 requirements is probably the most important and most complicated to address, Insurers have been quick to realize that the two remaining pillars should not be neglected; not in small part because the Solvency II regulation (enhanced by the requirements of the 8th Directive) has urged them to take it seriously.

Pillar 1 has been the focus for Finance Departments and the actuarial groups. However, they are not the only stakeholders affected by Solvency II. As focus shifts to Pillar 2, where the emphasis is on risk governance, Risk Management departments must become proactive in defining a comprehensive Risk Management policy and ensuring that all parts of the organization become more attuned to it.

Regulators are looking for Insurers to embed an effective Risk Management system. To achieve this it will be necessary to take advantage of analytics and use statistical models to optimize the amount of capital allocated. Risk Management systems and their outputs must ensure that they correctly identify the level of capital required.

Solvency II is pushing Operational Risk high on the agenda for Insurance companies. If we accept definition of Operational Risk as **"Risk of loss resulting from inadequate or failed due to processes, people and systems, or external events,"** it becomes apparent that all parts of the organization and its Information Systems are key to measurement and control.

### Data quality at the heart of Solvency II compliance

Data acquisition plays a crucial role. Before undertaking any work on the Pillar 3 related reporting, groups tasked with capturing data from contracts and the IT teams that build the data warehouse must define a comprehensive roadmap to ensure data quality. They need to ensure that the data used by many of the statistical models developed as part of Pillar 1 meets completeness, quality, auditability and traceability requirements of data. Furthermore, they must also ensure high levels of integrity of the information communicated to the supervisory authorities and the public.

Having paid attention to the actuarial and computational aspects, Insurance companies are turning their attention the quality of their data. Poor quality data can result in mis-calculation and potentially an increased level of capital required; at the very least unreliable data will generate negative feedback from Regulatory bodies. In order to guarantee the reliability of calculations and related adequacy of capital reserves an in-depth analysis of the data held and a considered and proper investment needs to be made.

In our view, it is essential to ensure that the entire organization commits to a thorough, collective effort towards full Solvency II compliance. Planning work well in advance is key to allow a timely and organized response to any issue that may arise, especially as the deadlines loom.

Every challenge opens new opportunities. Despite the uncertainty surrounding the deadlines for Solvency II, Insurers that make the right investments and look beyond simple compliance will likely reap benefits of a renewed culture of risk management across the enterprise. With the right commitment, they will achieve new levels of operational excellence that will lead to increased profits over time. However, commitment at every level of the organisation is critical to achieving these results.

For more information on how Investance can assist you to deal with regulatory reforms in insurance contact [Nicolas Consigny, nconsigny@investance.com](mailto:nconsigny@investance.com)

## 2. Insurance - Outsourced Managed Services, a growing trend

Against a backdrop of reduced margins, rapidly changing technology, regulatory pressure and increasing global competition Insurance companies are looking for new ways to reduce their operating costs. Whilst many larger insurers have already outsourced some functions such as IT and customer services, we are now seeing many insurance companies using managed services from third parties to manage their core functions, from contract issuance and claims management to accounting management.

### Why outsource the management of insurance contracts?

Today, it seems that the traditional vertical model is becoming obsolete and businesses are at a crossroads in terms of choosing the right operating model to position their businesses for future growth.

Economic instability, globalisation, tighter regulatory control and increases in the size and complexity of insurance firms through consolidation have meant that insurers are being forced to review their operating models to position themselves for future growth.

One of the key question marks for insurance businesses is their willingness — or capacity — to invest in new information systems, - and accept the related maintenance costs - to ensure their compliance to regulatory change.

In response, we are seeing certain insurance brokers deciding to keep the management of some of their functions in-house, and outsource the management of others to reduce costs; however this has invariably resulted in high management costs and required changes to the organization in spite of their small volume.

### The advantages of outsourced management/managed services?

The main benefit that insurance companies can derive from the use of third party managed services clearly lies with cost reduction. However, beyond cost cutting by transferring its fixed costs to a third party, an insurance company has the potential to increase its investment capability and improve productivity.

The advantages of outsourced management, however, are not limited to economies of workforce; it also allows insurance companies to avoid expensive investment in new information systems and related maintenance costs; reduce their administrative overhead and focus on creating and selling new products.

### The impact of Solvency II on outsourced management/ managed services

Solvency II will have a broad-ranging impact on the Insurance industry in 2012 as we get closer to the implementation deadline. However the directive not only impacts insurers, it affects the entire value chain including the providers of outsourced managed services.

The Solvency II directive mentions that “the internal assessment of risk and solvency is instrumental to the sales strategy, and it directly impacts all strategic decision-making”.

The sales strategy is becoming a key component impacting risk management and solvency for insurance companies. In effect, this means that product pricing will in future include risk-related costs.

Insurance brokerage specialists believe that this reform will significantly impact products and distribution networks, for they are key components of the sales strategy and financial management of insurance businesses.

We expect partnerships between insurance companies and outsourced services providers to significantly evolve, as rigorous control of outsourced managed services is made compulsory.

## Challenges and opportunities

Looking forward the challenges that insurance companies face are multiple:

- 1. Increasing operational efficiency through the use of new technologies** — new information and communication technologies (i.e. smart phones, social networks, etc.) are bringing about new challenges to target customers, but also new opportunities in terms of rationalization and industrialization of operational processes
- 2. Reaching out to new customers** — the new communication technologies make it necessary to integrate traditional distribution networks into multi-network distribution models. This results in the increased demand for concise information delivery and therefore training of teams to interact and deliver content to a better-informed audience.
- 3. Launching new products and services while containing costs and improving profitability** — insurance companies have to develop new products and services in response to the major challenges of tomorrow such as increasing longevity and providing products to support people who need long-term care and retirement. Whilst the on-going economic crisis and strong competition have seen margins decrease significantly, forcing companies to look out for new ways to contain costs.

The past few years have seen many insurers outsource a number of their non-core processes to low-cost locations; we are now seeing a move with insurers working with third party managed services providers to outsource core functions.

This option offers a number of benefits to enable insurance companies to increase their market share, reduce overheads and manage operational risk, through:

- Sharing investment in information systems and communication technologies as well as research and development in multi-channel distribution to allow a better industrialization of processes and improved visibility of data
- Increasing organization flexibility by mutualising management teams, and gaining access to a qualified workforce even where there is an internal skills gap in certain activity sectors or geographical areas
- Monitoring management processes and accounts with crystal-clear transparency, backed by clear reporting standards.

As Insurance companies look to optimize their operating models and find new ways of reducing cost, working with reliable, innovative, "Solvency II-compliant" outsourced managed services providers could prove an attractive solution.

For more information on how Investance can help manage costs through our managed services offerings contact **Alexandre Simard**, [asimard@investance.com](mailto:asimard@investance.com)

### 3. Retail Banking - The Opportunities and Challenges of SEPA

The expected impacts of the Single Euro Payments Area (SEPA) project on the banking industry have been widely reported. We expect to see:

- Banks looking to reduce costs and maintain profitability by creating outsourced "payment factories" located in the most attractive countries of the Eurozone from the cost perspective.
- Concentration of European ACHs (Automated Clearing Houses) with the market limited to three or four major pan-European players.

The SEPA project doesn't currently appear to be particularly well received by banking clients. The reasons are numerous and varied depending on the size of clients:

- Small and medium-sized companies and the general public are relatively unaware of the SEPA. There has been little or no media coverage of what it means for businesses and the consumers.
- Mid-size enterprises and major corporations which are not large billers see the SEPA more as a regulatory constraint than an opportunity.
- Large billers, although not thrilled with the SEPA, realize that it might be somewhat promising in the long term provided they make the changes that are required

The banking industry has been slow in defining its strategic approach. There is a gap between intentions and actual activities:

- None of major players currently plan to outsource any of their domestic payments processes
- No European ACH plans to give up its flows to a competitor
- Half a dozen banking players are aiming to become global payment leaders, setting up potentially fierce competition
- No real "value-added service" has yet been presented to attract clients and users

To take advantage of the SEPA driven changes, banks must address several challenges:

#### **Remove obstacles to achieving greater market concentration**

The persistence of domestic payment instruments may constitute a major obstacle to global outsourcing projects since it tends to reduce the number of potential partners for banks with a nation-wide network. Most are also direct competitors which further reduces the desire to partner. On the other hand, it is important to state that most existing ACH belong to the national central banks, which tends to be an obstacle to centralization and pan-European concentration.

#### **Standardize and centralize internal systems**

Computerized payment processing has been around for more than 15 years. However, given the "cross-business" nature of the payment activity (most financial services offered by banks include transactions handled by a payment system at some stage), the number of systems involved in processing of payments is large. Further, the systems portfolio is highly fragmented; in many cases relatively recently developed multi-functional systems are used side-by-side with legacy applications.

#### **Address proprietary data requirements**

End-to-end bank transfer processing requires handling proprietary data which the sending bank needs in order to process the transaction correctly (accounting references, application date and time stamp, etc.). Outsourcing of payments processing is likely to require a specific approach to deal with this requirement, necessitating maintenance of additional data for each bank customer and associated costs. This would limit the service's attractiveness to potential outsourcers and the reduce competitiveness of outsourcing option vs. maintenance of in-house capabilities.

## Longer term strategy

SEPA is inevitable and banks must define their longer term strategy to take advantage of the opportunities offered. Specifically, they must:

### Define core competency areas and be prepared to outsource the rest to lower costs

In the long-term European banks are likely to retain payment processing where they have a strategic position (linked either to the volumes processed for mass payments or the geographic coverage of the network of correspondents), and outsource payment processing on which they are less competitive. Every bank must review their core capabilities, clearly identify outsourcing candidates and engage with potential providers of outsourced services that are not likely to emerge as competitors in the areas that will be retained. National ACHs must be put through the same analysis to ensure that pan-European players can emerge.

### Develop “Additional Optional Services” as a way to build customer loyalty

Payments processing has become a basic service driven by large companies' demand for lower payment transaction costs. It now extends to all payment types for all customer segments, including individuals (payment cards, mobile payments, online bank transfers). Value-added services (“Additional Optional Services” or AOS) can be seen as a major new opportunity coming out of SEPA. The European Commission presents AOS as a way for banks to build customer loyalty and to win new markets through creative payment service offerings. For example, banks focusing on large billers and major corporate clients can define AOS offering incorporating new requirements for:

- Verification of the debtor's BIC/IBAN before the first SEPA Direct Debit (SDD) is sent.
- Dematerialization, storing and management of the mandate.

- Automatic re-presentation of a rejected SDD.
- Factoring of the company's unpaid bills, based on the bank's scoring models.

### Master electronic document management and e-invoicing

Some banks expressed readiness to offer their corporate customers electronic document management services, in particular for invoicing and SDD mandates. However, these types of services have rarely been successful in the past. Electronic document management isn't part of the bank's core business, and most often requires partnerships with specialized providers. As a result several major banks announced that they plan to focus on cash management solely rather than venture into electronic document management. Advancement of e-invoicing (which is still in its early stages although supply and demand are starting to develop) may add impetus for banks to further improve and invest in electronic document management capabilities.

## Conclusion

The European Banking Industry has an opportunity to transform its basic payment services into more efficient and profitable business. The implementation of SEPA will lead to demand for value-added services which will help to guarantee continuity of existing services. Although SEPA instruments don't have all the features available for current domestic instruments, over time they will be developed to incorporate domestic requirements. Once that happens, banks that have defined their strategy and are internally ready will reap benefits of larger market.

For more information on Investance Retail Banking insights and capabilities contact **Michel Hascoët**, [mhascoet@investance.com](mailto:mhascoet@investance.com)

## 4. Retail Banking - The move to mobile

From branch banking to ubiquitous banking: everything, anywhere, anytime

### The rise, fall and rebirth of online banking

The Dot com boom of the mid-90's saw the beginning of a move from a traditional branch-led banking model towards a diversified online model. Ambitious new entrants keen to win market share invested heavily in IT and marketing and enjoyed some initial success. However despite strong initial customer enthusiasm online-only banks such as Egg in the UK and Zebank in France failed as the dot com crisis of 2001 took hold.

In the meantime, well established retail banks enjoying high returns through cheap money and a highly leveraged banking model, limited their Internet presence to simple information sites, preferring to concentrate on increasing the size of their branch networks.

Today, changing consumer behaviour, the volatile economic environment and advances in online and mobile technology are changing the shape of the retail banking industry and we are seeing the following trends amongst our clients:

### How mobile technology is helping banks to switch from a branch driven model to a customer centred one

European retail banks are now at a turning point in terms of business and operating models and looking to adopt a multi-channel approach to deliver services to their customers.

Most banks have launched online and mobile services in the past few years and call centres, ATMs, Internet Banking and Mobile are being used to make the most of customer transactions by cross-selling products and services.

The major players still maintain a large number of high-street branches as they continue to be the main entry point for their customers, but the emphasis has shifted from processing routine transactions to the branches as the dominant channel for sales & advice, complaints & post-sales support.

Banks are moving to a more diversified channel mix to deal with structural issues impacting the industry:

- Rethink their offerings, switching from a production to a distribution focus.
- Economic slowdown means that operational costs are being scrutinised and drastically cutting distribution costs (i.e. branches network related costs) could generate desired bottom line savings
- New revenues will come through delivering value-added services to the customers that can be better priced and lead to cross- and up- selling
- Customers trust and loyalty have diminished whereas their understanding of financial matters increased driven by access to information and the rise of social networking.
- Multi-banking is emerging as a long term customer behavioural trend, partially based on pragmatic analysis of risk (if one bank fails, the other one may not), as well as through looking for good deals (promotional savings rate, low account management fees and other factors)

European retail banks are leveraging new technology and leaving behind their bricks and mortar image and strategy:

- Almost all banks have disposed of transactional corporate sites, allowing their existing customers to manage transactions and handle remotely part of their relationship with their account manager as well as buy new products or services directly
- Some banks have also acquired or launched their own "virtual" subsidiaries (offering access via Internet or Smartphone apps). These services are targeted at a young, wealthy, technology friendly population using aggressive promotions and turning old fashioned banking communication into mass media, multi-channel advertising campaigns
- Specialized financial services such as consumer finance now deliver their services via call centres, Internet and mobiles, whilst aggressively promoting financial services on third party merchant sites
- Banking groups have initiated huge IT and organisational efforts in order to unify core banking systems into credit and servicing 'factories' to achieve economies of scale.

## Challenges and perspectives: how ubiquity is redefining banking

European retail banks are facing a long and challenging journey. Most are now engaged in huge transformation initiatives to rebuild their ROE (back to 15%):

- Management is rethinking the internal organization, promoting and evolving a multichannel transformation plan, breaking down “channel silos” to achieve full and real time integration.
- Significant IT investments are being made for banks to become agile, and the pace of change will require new skills and training. Leadership from the senior managers is critical as internal culture generates resistance from channel managers and employees

Focus is on understanding and anticipating customers' needs and expectations; however, to improve on this front banks need to identify the skills, tools, marketing techniques and approaches they will use. For example:

- A real investment in Customer Relationship Management (CRM) tools is required along with the development of behavioural / predictive scoring and new metrics to reduce time required to process customer requests and target pre-approved financial services to the customers that need them
- Constant monitoring of social networking and comparison sites is key. But more important is being able to successfully link social channels to CRM and to front office banking systems to help generate loyalty among customers
- Understanding the “Generation Y” and “Net Generation” customers who are less predictable but more demanding and require particular attention and follow up
- Increased customer education (access to financial information or training), and control of their account(s) is key to overcoming mistrust and increasing loyalty.

Rolling out such a huge transformation and implementing a multichannel organisation demands management to carefully analyse the size and purpose

of its branch network. In reviewing the role of branch employees, management must keep in mind potential social and political risks related such large-scale reductions in branch network:

- Diversification of branch formats and optimization of FTE per branch may improve efficiency, but reviewing locations may lead to redundancies and the creation of “banking deserts” where no branches are operating
- Switching the focus from handling transactions and operations to sales and advisory service will require new skills and training
- Governments will undoubtedly question these restructuring programmes especially where the public are impacted through branch closures and reductions in services.

Technology has significantly decreased barriers to market entry (as shown by the success of P2P platforms such as Prosper in the US). A fierce battle between banks and Telco operators is expected as banks invest more in mobile-based financial services, and consider offering subscription, and innovative payment solutions, whilst some Telco operators are planning to go head to head with the banks by launching their own financial services products and services.

## Conclusion

Retail banking is being revolutionized by breakthroughs in technology and the faster than ever pace at which people are adopting new communication tools. Rationalization and innovation are necessary as banks face economic slowdown, new regulatory mandates and a more competitive environment. The transformation of old bricks and mortar banks into agile ubiquitous financial service designers and providers has only just begun.

To find out more about Investance Retail Banking insights and capabilities please contact

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## 5. Regulatory Briefing - FATCA

As part of the Hiring Incentives to Restore Employment Act (HIRE) signed into law by President Obama in March, 2010, the U.S. Treasury enacted the Foreign Account Tax Compliance Act (FATCA). The Act requires financial institutions to enhance their due diligence processes and be able to identify US individuals or legal entities that have invested in non-US financial accounts or non-US entities. The Act's objective is to prevent those US individuals or entities from hiding assets and income abroad.

Under the provisions of FATCA, Foreign Financial Institutions (FFIs) and other financial intermediaries will be expected to sign an agreement with the Internal Revenue Service (IRS) and comply with new reporting, disclosure and related requirements. Failure to do so will potentially subject the Institution to US withholding tax of 30 percent on all payments it receives. Similarly, US entities of the FFI are required to enforce the FATCA requirements on their clients. Individual accounts of the FFI, whether U.S. or Non U.S., that fail to provide FATCA required additional documentation to the FFI, would be considered recalcitrant. In this case, the FFI will be required to apply a 30% deduction to any withholdable payments made to those accounts

The FATCA scope extends beyond institutions and high net worth accounts. The rules will affect thousands of clients who will need to be informed that account details might be disclosed to the IRS, raising issues of privacy and account protection potentially stretching across multiple jurisdictions.

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*An FFI should decide to enter into an agreement with the IRS by mid 2013 to ensure sufficient time to become a Participating FFI by January 1, 2014 when some withholding will come into effect*

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### FATCA Key Impact and Considerations

The ability to align all the key stakeholders across the entire organization (Legal, Tax, Operations, Risk, Technology) is paramount to successfully comply with FATCA. Key considerations include:

1. **Timing:** Although, the provisions of FATCA apply to payments made after December 2012, the IRS took under consideration that financial institutions would need more time to implement the required changes. As such, they have outlined a set of transitional rules that do not require any FATCA related withholding until January 2014
2. **Entities:** FATCA will impact any business that has custody, receipt or release of any withholdable payment. Such payments include US sourced fixed and determinable annual or periodic income (FDAP) and proceeds from the sale of assets that generate US sourced interest or dividend income
3. **Front - to - Back Impact:** FATCA will cut across silos and require updates and enhancements to all areas of the Firm's data resources, reporting, compliance and ongoing new account information gathering efforts
4. **Data:** FATCA requirements go much further than current KYC/AML standards and will require firms to identify key gaps in their current customer data quality. Identification of these gaps and impacts to related entities will be crucial in preparing for FATCA compliance
5. **Cost and Mandate:** Although various foreign countries have voiced opposition to FATCA, it is coming and it will require an investment in systems and operational processes. By being proactive in assessing and analyzing the impact of FATCA, firms will ensure a timelier and cost effective FATCA compliance solution.

## Preparing for FATCA

The detailed rules and provisions of this Act are being developed and final regulation is planned for the summer of 2012. The IRS however, has issued preliminary guidance in the form of "Notices" (Notice 2010-60 in August 27, 2010; Notice 2011-34 in April 8, 2011; & Notice 2011-53 in July 25, 2011). Although, these notices do not have any authority, they are a very good indicator of direction the IRS is taking in its implementation of the Act.

### *Summer 2012: Expected final regulations from the IRS and Treasury*

The time for action is now! Detailed systems analysis and process extensions to enable thorough identification and capture of account information for FATCA compliance will take time. Many firms have invested in studying the implications of the Act and are pro-active in planning for enhancements in Operations and Technology.

6. **Entity Analysis:** Detailed analysis and identification of all group entities that will be impacted. This will include implications of FATCA compliance against local regulations and FATCA compliance type. Payments for Insurance products for example may not follow the same rules as FDAP type payments
7. **Functional Approach:** Determination of agreement with IRS or changes to the business model. Communication to internal stakeholders and external notification to clients regarding FATCA information requirements. Review of existing processes and measure of IT system capabilities to identify U.S. accounts or US Entities with greater than \$50,000 (aggregated), and withholding. Analysis of current management reporting needs to adhere to both FATCA and internal audit compliance
8. **Gap Strategy:** After identifying areas needing process enhancements, a strategic roadmap should be created identifying key stakeholders, timeframe, data and IT needs. The opportunity for a firm to go beyond FATCA and implement all around compliance, KYC, AML best practices is large. Future customer data mining capabilities could be greatly enhanced through these process improvements

### *July 1, 2013: FFI Applications become effective*

#### **FATCA Opportunities**

While the onus will be on compliance and reporting, FATCA does represent a strategic opportunity for firms to embark on a holistic review of their current data quality and client communications. By creating and implementing an efficient communication strategy, firms can renew out dated contact information and strengthen relationships.

Improvements to data quality could also provide the opportunity to deliver enhanced management reporting and identify potential operational upgrades.

Technology upgrades to account, calculate, withhold and report represent an enhancement across multiple business units. Proper analysis, requirements definition and testing will be crucial to yield the most cost and data efficient compliance and future flexibility.

### *Jan 1, 2014: FATCA withholding begins (limited to US sourced FDAP on payments to new accounts)*

Communication to clients will be a key element in every firm's FATCA compliance strategy. By taking a hard look at current account and communication processes, firms can take this opportunity to update client information and train internal employees regarding account opening and maintenance.

For more information on how Investance can help your organization create a roadmap towards compliance with the FATCA regulation contact

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## 7. Corporate & Investment Banking - Prime Brokerage: Key Success Factors

With the focus of many institutions to combine their clearing business within the Prime Brokerage infrastructure and to provide best of class technology and service levels, many investment managers are evaluating closely their choice of Prime Broker (PB). We see a strong demand for PBs to meet the demands of their clients by developing enhanced service offerings around:

### Effective Reporting and ODD Support to Funds

We are seeing significantly increased investor pressure for more reliable operations, combined with greater transparency into operational controls, tax risks, remuneration, investment portfolio construction and performance. Furthermore, funds must also demonstrate quality of returns: their accuracy, risk, management, and strategy adherence. This translates to a requirement for far more effective technology and reporting offerings from PBs as well as advice on conducting effective ODD.

### Asset Segregation

The rush to develop an effective asset segregation model post the Lehman default in 2008 saw several PBs utilising a bankruptcy remote structure for unencumbered assets (fully paid for) by using a separate third party custodian. Whilst some clients elected to use this service and segregate excess balances, many clients saw the additional cost and complexity outweighing the risk reduction, and were happy to settle for a PB with a strong capital base.

Recent focus amongst the major primes has been to establish more cost effective segregation structures internally by using a bankruptcy remote separate entity to hold cash balances. This is easier to operationally manage and more cost efficient so attractive to PBs and clients. It is important to note that these mechanisms have only been tested by legal opinion rather than actual default, and whilst they are a key priority for some of the major primes, clients may be more comfortable with having assets segregated at separate custodian. Some institutions will meet this demand by utilising their own custody offerings, whilst others are using third party custodians for both encumbered and unencumbered assets so as to differentiate themselves from competitors.

### Cross Product Offerings

Whilst counterparty risk is a key priority, we are also seeing an industry trend to not only offer cross product

margining to facilitate netting efficiencies across asset classes, but also centralisation of PB products into a one stop shop across listed, fixed income, FX and equity lines. This not only allows for process synergies and system alignment but additionally offers an improved client service offering. Design of optimum platform and service offerings is seen by PBs as a real opportunity to meet client expectations.

### Additional Differentiators

As well as increased reporting and ODD support, cross product margining and client service, combined with effective asset segregation procedures, many PBs are positioning their business ahead of the competition by the additional value they provide to their client base. This is often in the form of offering PB consulting support to investment managers with a variety of services extending far beyond marketing and capital introduction. This includes advising funds on regulation, resourcing and recruitment, systems implementation and operational requirements through all phases of the fund's maturity.

### A Market Opportunity?

Whilst the months following the Lehman default saw some of the major primes reaping the rewards of clients rushing to be onboarded, the environment now is very much one of competition for the core revenue generating clients. Whilst some PBs are looking to build out a niche infrastructure for the high revenue clients, others are looking to grow their business to take on a significant number of new relationships by approaching the smaller client bases.

We are seeing a clear trend that cost effective and secure asset segregation procedures, cross product margining, best of breed technology and additional consulting support will be key for Prime Brokers to stay ahead in an ever competitive landscape.

For more information about how Investance can assist you with developing your Prime Brokerage business please contact **Charles Fisher**, [cfisher@investance.com](mailto:cfisher@investance.com)

## 8. Corporate & Investment Banking - OTC Derivatives Reform

The Financial Services Industry focus for the past 12 months has been on the broad implications of the Dodd-Frank Wall Street Reform and Consumer Protection Act (DFA). Indeed, it seems that many sections of the DFA such as clearing of OTC Derivatives, limits on proprietary trading and a ban on investments in hedge funds – are designed to limit the earning power of the industry.

For global Financial Services institutions, the Dodd-Frank Act is not the only major regulatory change on the horizon with a potentially disruptive impact on their business. They need to incorporate in their strategy the implications of European Commission reforms aimed at building a safer and more competitive European financial market place namely EMIR and MiFID II. Also on the horizon are the higher capital requirements to be imposed under the Basel III accord a Capital Framework for which major G20 Countries must adopt by the end of 2011 and implement between 2013 and 2019. The net result of all current and proposed regulations is that global Financial Services institutions will have a much harder time realizing high return on equity in the foreseeable future.

Under the weight of regulatory scrutiny it is easy to think that opportunities are limited, however there are potential business opportunities emerging from changes in regulation specifically looking at Prime Services and alongside the potential revenues from using Swap Execution Facilities (SEF's) to create competitive advantage. There are 5 steps that all Investment Banks should consider to prepare for the upcoming changes that regulation will bring.

### Do regulatory changes provide a business opportunity?

At this time, the uncertainty surrounding global regulations pose the biggest threat to the lucrative OTC Derivatives market. The longer this uncertainty lasts, the greater the toll on market participants both in terms of revenue opportunity and costs. Furthermore, many market participants outside of the major Dealer community will find it difficult to build and implement a strategy to comply with the new rules.

We think the path forward for the major Dealers is to build a multi-year strategy focused on new opportunities coupled with intelligent investments in technology and operational efficiencies. Specific attention must be paid to identifying the capacity bottlenecks in the OTC Derivatives platform to lower cost, increase capacity and automate Front-to-Back processing.

### Prime Services - future engines of growth?

OTC Dealers will benefit from bundling new and existing services and delivering them to their OTC Derivatives clients through an expanded Prime Services channel. "End-Users" may find it attractive to allow their Prime Service providers to focus on dealing with operational complexities, financing and identifying an efficient way to comply with new rules rather than making large investments in upgrading internal operational support capabilities and IT systems. Indeed, we have already seen this trend taking shape.

### Swap Execution Facilities (SEF's) and E-Trading Platforms - Potential automation of operational complexities?

With the mandate for OTC Derivatives to begin trading on SEF's, an e-trading platform with electronic connections between OTC Derivatives Dealers, clients and CCP's will be of great importance. The challenges of building in house e-trading platforms that link to multiple SEF's are significant. We also see an opportunity for major OTC Derivative Dealers to develop in-house trading platforms to compete with multi-dealer SEF's in order to internalize the flow and derive additional trading revenues.

## 5 steps to prepare for upcoming changes

The time to act is now, even if the proposed regulations to implement DFA are far from completed. As regulatory reform is rolled out across the financial markets, the impact and difficulty for market participants to comply will be felt through higher transaction costs, limited availability of parties willing to enter into customized financial transactions, mandatory reporting requirements and data retention costs. In response to this, organizations should begin by clearly defining the overall business strategy and the operating structures that achieve the best return on capital with the lowest risk exposure.

Leading banks must decide where their future competitive advantages will be and focus on making the right investments to defend and expand their business:

1. Evaluate the OTC derivatives business model – Given the uncertainty in the market, in the short-term our research suggests that the overall volumes and notional value of the OTC Derivatives transactions will continue to decline. Assuming that regulators agree on the rules and they are adopted by July 2012, many of the firms will have to perform a cost-benefit analysis to decide whether they have sufficient volume in OTC Derivatives activity and a viable business model to make investments in a compliance framework. The alternative outcome could potentially be to transfer OTC Derivatives business to another geographic location, exit the business or sell their derivatives franchise to another firm.
2. Invest to achieve operational efficiency - Evaluating, designing and implementing appropriate technology and infrastructure solutions will be critical to meeting the changes mandated by the new rules and market evolution. Given the magnitude of changes anticipated across trade execution under SEF's, pre and post trade reporting to data repositories and CCP's, trades confirmation and settlement under CCP's and price valuation and risk management firms should take advantage of the opportunity to build out the infrastructure in manner that can be commoditized and bundled with existing Prime Services product offerings to clients.
3. Focus on product development – The ability to bundle execution, risk management, collateral management and operational support services

will differentiate leading OTC Derivative Dealers from the rest. This approach may require closer cooperation between Execution and Prime Services businesses, flexible pricing models and active involvement from Operations departments in product development.

4. Evaluate capital and financing implications – Depending on the operating model firms choose, they will have to model the proper capital requirements and daily funding needs to ensure that they can support existing business and withstand future market challenges. Firms may find new business opportunities in lending and managing collateral requirements on behalf of clients or through properly costing out balance sheet usage by client against their required rate of return. However, with cost of capital increasing, OTC Dealers will need to find ways to price Balance Sheet usage and develop pricing models to pass these costs to their clients in a transparent manner.
5. Implement a comprehensive compliance framework - The challenge that many firms face is that their internal compliance resources and systems are not geared to support OTC Derivatives trading. However, with the increase in regulation, potential threat of litigation and focus on the internal controls, compliance will become a key control function and perhaps even a business enabler by providing senior management and the trading desks with greater certainty.

Extract from Investance Point of View. OTC Derivatives Reform: one year later. Creating a roadmap to implement regulatory change.

For more information on Investance experience and insights into OTC Derivatives reforms contact **Rashad Kurbanov, [rkurbanov@investance.com](mailto:rkurbanov@investance.com) or Sanjiv Singh, [ssingh@investance.com](mailto:ssingh@investance.com)**

## 9. Corporate & Investment Banking - Collateral Management

Reforms in the OTC Derivatives markets, in particular the move to Central Clearing of standardized OTC Derivatives, have suddenly cast collateral management into the spotlight.

In the years since 2008, the drive towards transparency and stability of the OTC Derivatives Markets has been reinforced by governments on both sides of the Atlantic – the “Dodd-Frank Act” or DFA in the US, and the European Markets Infrastructure Regulation (EMIR) in the EU. Similar initiatives are taking shape in Asia as well. Clearing through Central Counterparties is a core component of all new regulations and it represents a radical change to the way the current bi-lateral model operates. Essentially to manage counterparty credit risk in future, Central Counterparties (CCPs) will demand collateral to be posted against all cleared derivatives. Initial analysis estimates that the industry will need more than \$2 trillion of high quality assets to be used as collateral. Further, non-cleared OTC Derivatives will also require additional collateral as Dealers aim to lower credit risk and associated capital charges.

The net effect of these regulatory responses has been to change the nature of the counterparty risks on OTC Derivatives from bi-lateral to a centralized model. Regulators clearly view Central Clearing of OTC Derivatives as a core stability mechanism designed to prevent cascading failures that could result from a major dealer default.

CCPs have been empowered to introduce a broad mandate that all OTC Derivatives market participants have to post collateral with CCPs irrespective of their credit rating. The evolution of the OTC Derivatives markets is still a work in progress, however, the demand for collateral is rising fast – as is the demand for service

providers who can manage it effectively and efficiently. Several industry estimates suggest that more than 50% of the total volume of OTC contracts could be centrally cleared by 2013 and that the additional collateral requirements will reach between US\$2 trillion and US\$2.5 trillion. With CCPs requiring cash as collateral for variation margin, and cash or sovereign bonds as collateral for initial margin, most dealers are considering extending credit lines to their clients and providing a collateral transformation service – accepting a broad set of assets from clients and transforming this collateral into assets acceptable to CCPs.

### Challenges of the CCP model

For the users of OTC Derivatives, the move from the bilateral model to more transparent central clearing market will make investment and trading decisions more complex. Indeed, in addition to considering the pure economics of the trade and the credit rating of the counterparty, they will also have to factor margin into their overall transaction decisions and assess risk on the basis of different factors. Users will have to also consider the impact of the choice of CCP on the overall trading decision. This will make the complexities of capturing margin information from multiple CCPs more acute.

## The changing industry landscape for collateral management

In our view, the current trends in the OTC Derivatives markets will enhance the role of collateral management service providers and potentially lead to the creation of an industry collateral and services utilities. Many features of this landscape are already in place, while others are emerging and maturing rapidly.

As the CCP model takes shape, an attractive space in the value chain has emerged for a new breed of collateral management service providers —collateral intermediaries. Three new types of players have moved in to capitalize on this opportunity:

### 1. Collateral Intermediary

In light of potential complexity of collateral management, a new breed of organization is emerging to centralize movement of collateral between various market participants - for example, Euroclear

### 2. Tri-Party Custodians

Having segregated collateral for centrally cleared OTC Derivatives, money managers looking to further reduce risk with their Dealers have begun segregating margin with third party custodians in bankruptcy-protected vehicles for all un-cleared OTC Derivatives. Major custodian banks are developing new services to meet this demand from the buy-side.

### 3. Collateral Messaging Solutions

Operational risks associated with the current processes require urgent attention from all parties. There are escalating discussions about the use of messaging to replace emails. These offerings have not yet gained critical mass in the market, but ultimately they are likely to do so.

As the new market environment takes shape, Dealers have an absolute need to review their collateral management approach and systems, and to define a strategy for how they will continue to offer this service to their clients into the future. The strategy must also address how they will mitigate the potential loss of access to high quality assets, which clients will start safekeeping as collateral held at third party custodians.

Alongside the development of an explicit strategy, Dealers have to find ways to manage major evolutionary changes to the OTC Derivatives market. The pressure to come up with increasing amounts of collateral to support OTC Derivatives trading in a more sophisticated and efficient way is emerging at a time when banking institutions are already struggling to meet higher capital requirements and keep funding costs as low as possible. Indeed, rising capital requirements will be a significant factor, as Basel III and other regulations force Dealers to take greater account of risks and have a sufficient capital buffer in place.

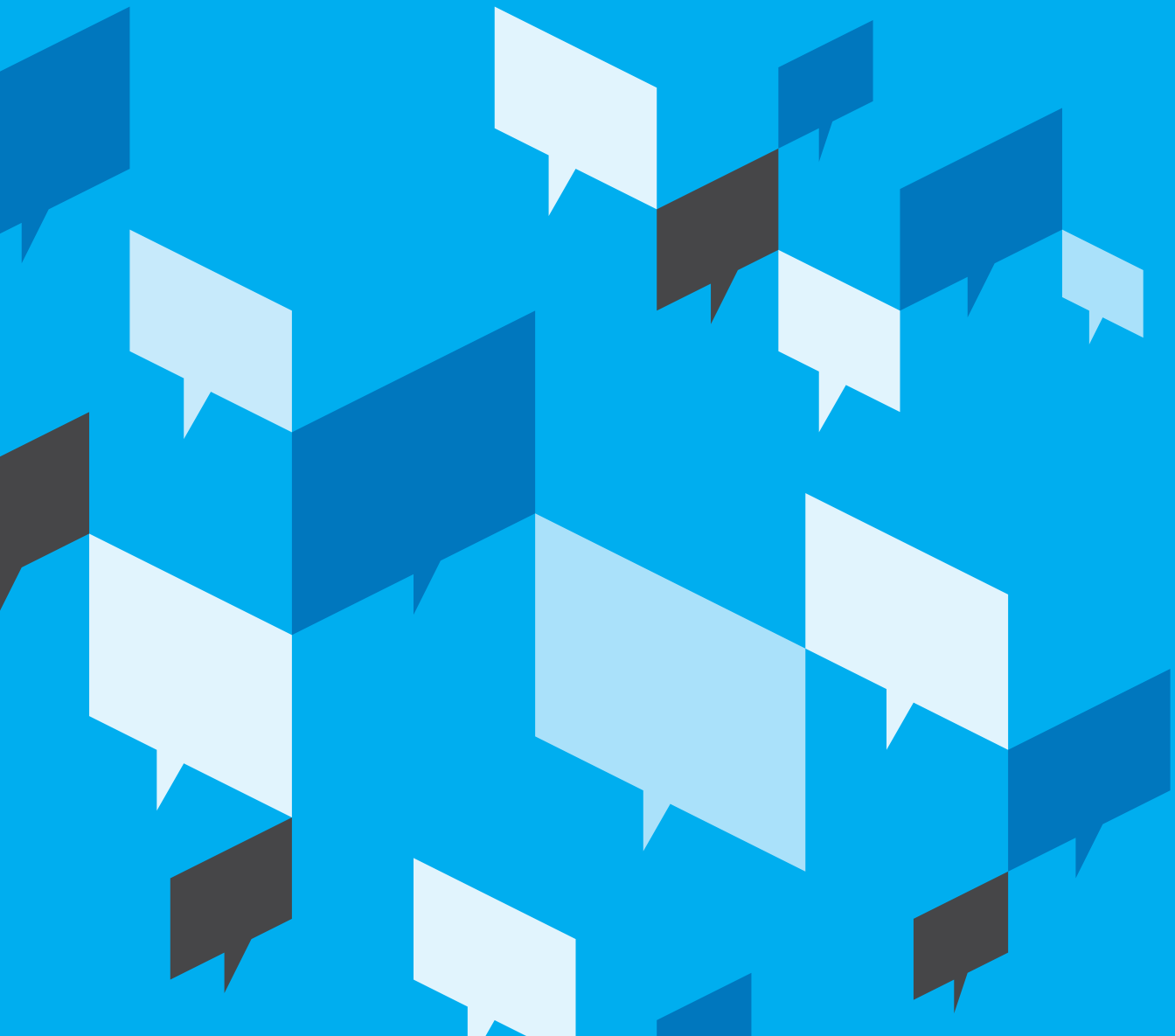
These requirements will cause them to demand higher collateral for all un-cleared OTC Derivatives, placing further pressure on the users of OTC Derivatives. Against this background, any Dealer that fails to develop a clear strategy faces being at a competitive disadvantage to those that have put such a strategy in place. This reflects collateral management's central role as a key enabler of a wide array of products and services, including securities financing and trading risk management. Beyond this benefit, efficient management of collateral also has the effect of freeing up liquidity, thereby enabling banks to offer more services and helping them to comply with the new capital regulations more easily at lower incremental cost.

To realize these benefits, some Dealers are moving towards an approach based on managing collateral across business lines and geographies. This can enable them to gain visibility right across different pools of collateral in all areas of the bank, and to boost efficiency through holistic, coordinated management of the available assets.

For more information on Investance experience and insights into Collateral Management contact

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expertise applied.  
value added.



## Best practices for navigating change in the financial industry in 2012

For 10 years Investance has been supporting leading financial institutions around the world to deliver projects that achieve real business impact. Our consultants have extensive industry experience and have developed best practice methodologies to enable us to deliver complex projects for our clients.

Here we showcase two proven Best Practice solutions we have developed for clients:

### **1. Project portfolio management: Best Value or Who Shouts Loudest?**

More than ever Financial institutions need to evaluate and prioritise the vast number of projects they have running at any one time, quickly and efficiently to identify those that offer the best value. In this article we explain how using a best practice Project Portfolio Management tools and help to manage costs and add value.

### **2. Achieving Excellence in Reconciliation and Exception Management**

Processing transactions in a context of increasing transaction volumes and waves of regulatory pressure continues to represent a major operational and technical challenge for financial institutions. Having delivered over 300 client projects for major financial institutions over 10 years our Transaction Management specialists have the insights to achieve excellence in reconciliations and exception management. Here we explain the key challenges and how to deal with them.

## 1. Best Practice - Project Portfolio Management

### Project portfolio management: Best value or who shouts loudest?

In today's resource constrained operating environment financial services institutions are finding it increasingly difficult to effectively manage the increasing number of projects being undertaken to implement change.

Decisions regarding which projects are prioritised are often decided by who is best at arguing the case or who shouts loudest, not which projects deliver most value. With cost management contributing a significant part to the board agendas, determining which projects are best suited to deliver value is critical.

To help in these decisions organisations are increasingly using Project Portfolio Management (PPM) to address this. PPM refers to a set of tools and processes that assist organisations in better managing change across all the functions that form a core business line e.g. the Markets business. PPM tools and processes are scalable and can also be applied directly to any subgroup of projects e.g. the Cash Equities Project Portfolio.

Typical symptoms of an organisation that is not fully able to management a portfolio of projects include:

1. Governance & Communication: inconsistent control of the execution of multiple unrelated projects: includes inability to communicate or escalate the relevant project characteristics (e.g. plan variance and risk status) to Senior Management in a timely and coherent fashion.
2. Benefits Realisation: inability to accurately and consistently measure the realised benefits of a given project or programme
3. Project Prioritisation: unable to produce consistent project priorities as part of the annual prioritisation process; subsequently the same prioritisation processes inhibit ability to manage changing in-flight priorities
4. Project risk management is focused on too few characteristics resulting in misleading risk ratings
5. Resources are over utilised and unsure of project priorities

The key objectives of the PPM service are as follows:

1. Provide an aggregated view of project & programme data
  - a. Plan variance
  - b. Concentration risk (system release)
  - c. Value (earned value & present value)
  - d. Risks & issues (multi-dimensional)
2. Provide basis upon which data be more effectively correlated
  - a. Dependency management (project, programme, resource or system)
  - b. Plan management (structured planning)
  - c. Decision making (structured process)
  - d. Prioritisation (annual & in-flight processes)
  - e. Resource (relationships between projects)
3. Provide a solid foundation upon which communication processes can be built
  - a. Portfolio governance
  - b. Custom & automated status reporting

## Project Portfolio Management Service Solutions

|   |   |
|---|---|
| <b>Governance &amp; Communication</b>       | <ul style="list-style-type: none"> <li>✓ Structured review of meetings &amp; objectives</li> <li>✓ Define meeting objectives &amp; escalation process</li> <li>✓ Synchronise reporting &amp; controlling processes across business &amp; geographic boundaries</li> </ul>   |
| <b>Reporting &amp; Controlling</b>          | <ul style="list-style-type: none"> <li>✓ Define data repositories &amp; engineer process for consistent collation of all project data</li> <li>✓ Implement a more vigorous data updating process</li> <li>✓ Define &amp; normalize key project reporting templates</li> <li>✓ Automate reporting process</li> </ul>   |
| <b>Milestone &amp; Dependency</b>           | <ul style="list-style-type: none"> <li>✓ Restructure projects into more consistent, hierarchical &amp; relational structures</li> <li>✓ Run working groups with project managers on normalisation of plan structure &amp; key milestones</li> <li>✓ Define &amp; implement tool migration strategies</li> <li>✓ Define approach for aggregating smaller projects into baskets; allowing for aggregate management project information</li> </ul> |
| <b>Prioritisation &amp; Decision Making</b> | <ul style="list-style-type: none"> <li>✓ Define prioritisation tool &amp; process specific to an organisations characteristics &amp; strategy e.g. collating metrics related to project drivers, impact upon stakeholder value, time sensitivity &amp; risk tolerance</li> <li>✓ Build decision making process wrapper to facilitate trade-offs and provide improved retrospective management information</li> </ul>                            |

PPM tools & processes will increase consistency of all management information relating to a project portfolio. Through coupling this increased data quality with the PPM processes and tools project, programme or portfolio status can be reported (1) more accurately, (2) more frequently and (3) to the relevant decision making audience.

In addition to this any project prioritisation decisions will be derived through a consistent and objective set of measures that will facilitate the relative accuracy of priority decisions whilst enabling the increased governance of the actual benefits a project or programme realises.

In addition to this, any project prioritisation decisions will be derived through a consistent and objective set of measures that will facilitate the relative accuracy of priority decisions whilst enabling the increased governance of the actual benefits a project or programme realises.

To find out more about how Investance's Project Portfolio Management solution for financial institutions please contact **David Lewis,** [dlewis@investance.com](mailto:dlewis@investance.com)

## 2. Achieving Excellence in Reconciliation and Exception Management

Processing transactions in a context of increasing transaction volumes and waves of regulatory pressure continues to represent a major operational and technical challenge for financial institutions.

Risk, Finance, and Operations are focused on implementing capabilities and services to ensure better controls and reconciliations processes.

However, while Reconciliation vendors have acquired considerable experience in developing new solutions, the Business and Technology sides of the business have to partner and play an equally crucial role in addressing a new set of challenges bearing with data quality, end to end execution and total cost of ownership.

So, today and in the next 5 years, what will the Controls and Reconciliations challenges be?

How should organizations respond to the new Controls and Reconciliation regulatory constraints and their practical implementation?

How should better Technology be positioned to offer a robust architecture framework and what key components should be offered to support the challenge of an end to end reconciliation process?

Investance believes there are three main challenges Financial Organisations should focus on to strengthen their ability to serve sophisticated, demanding 'control and Reconciliation' processes and consumers.

First, It is unlikely that a single system could on its own generate a comprehensive view that dynamically and systemically reflect exceptions across all business lines, offering the possibility to segregate the control function from Finance and Operations.

However, it is possible to organise knowledge, formalise thought processes and identify technical options for incorporating controls and investigations that are currently separated into a single technical platform.

The strategy, therefore, lies in incorporating validation and investigation processes into a single platform with three objectives:

- (i) to capture and exhaustively manage and centralise all controls, irrespective of the type of exception, and the department to ensure independent controls
- (ii) to dynamically distribute and share resolution processes and propose resolution methods based on operators' experience
- (iii) to display a summary representation of exceptions, and in turn a summary report, irrespective of the department

Second, control operating models have radically evolved; creating more 'Control and Reconciliation' information data pull to be compared, their execution timing to be shortened at a higher frequency

Analysis shows that reconciliation systems have not reached a sufficiently advanced stage of development and that most of the criticism they elicit is usually levelled at data warehousing systems that incorporate data from multiple sources.

To correct these defects, new solutions will need to include innovative techniques that move the concept of centralised data towards the more general concept of artificial intelligence-based systems that can combine different types of knowledge management tools, representations and pre-emptive resolution methods.

Another problem encountered relates to improving the ability to process large volumes of data sourced not only from different systems but from a wide range of geographical regions.

Therefore, few solutions have the resources needed to improve both the hardware and software components in the context of substantial volumes of data, particularly in relation to regulatory requirements on archiving data. The largest databases in financial institutions hold tens of millions or even billions of items of continually updated information.

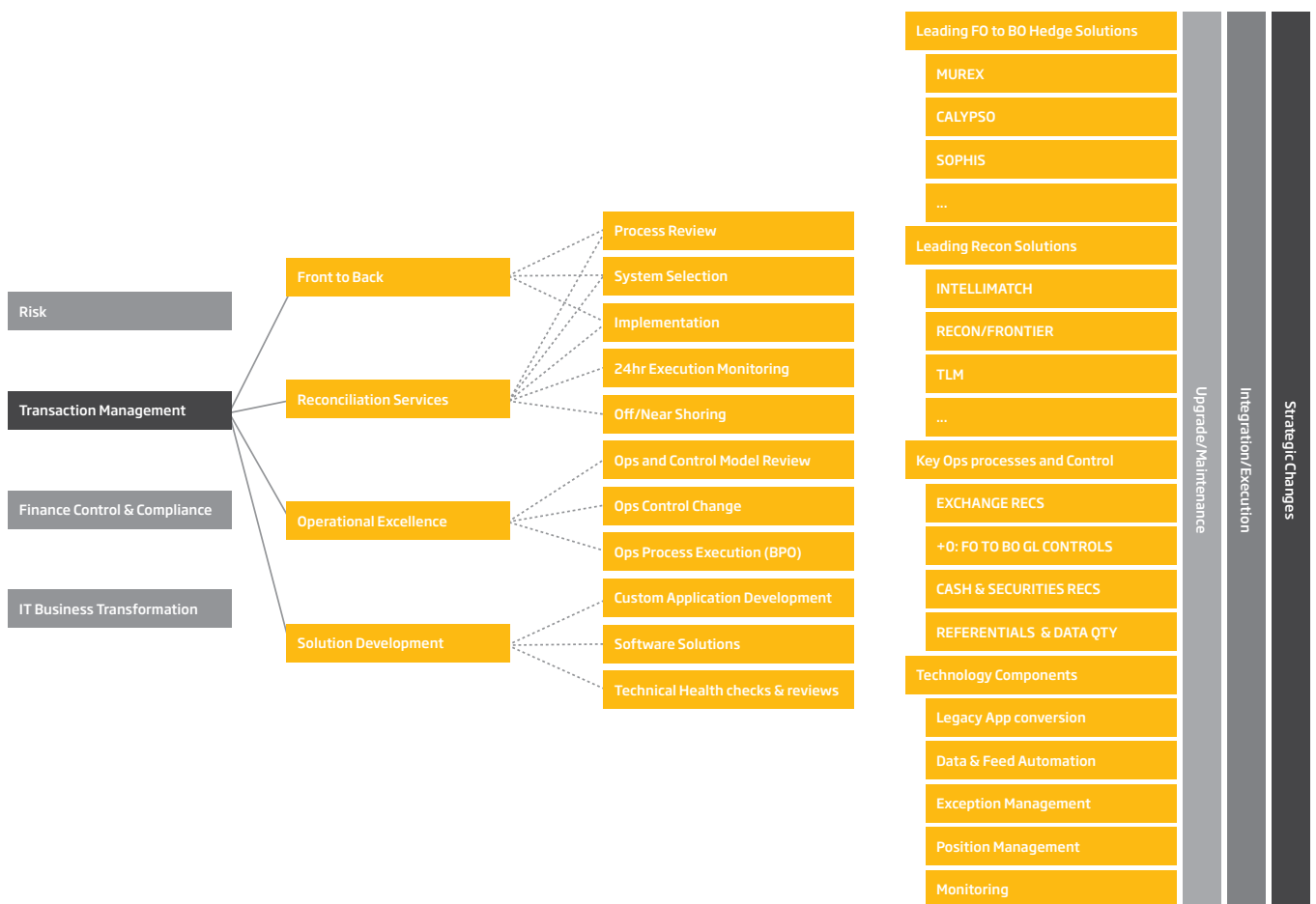
Finally, given the fragmentation of activities performed by financial institutions, exception detection and resolution processes need to take into account many different types of exceptions not limited to processes that are known today. Confidentiality rules, and therefore new types of cross-functional checks, will need to be implemented.

Investance is already acting on these trends and helping financial institution to build reliable end to end Control and Reconciliation, thus sustaining their growth and reducing their operational and financial risk.

## Investance Capabilities

To help our clients to address the challenges facing financial institutions in relation to transaction management Investance has brought together a Global Transaction Management practice focused entirely on the alignment and optimization of the transaction life cycle processes:

- Implementation and upgrades of Front to Back office Systems
- Target Operational Control and processes design, optimization and execution (BPO)
- Reconciliation and Controls system implementation , off/near shoring support of reconciliation systems
- Innovative Package Solutions and custom application development



To find out more about how our Global Transaction Management team can help your organisation contact:

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## Introduction to Investance

Investance is a global management consulting firm dedicated to the financial services industry. Our people have deep expertise in risk management, operations, finance and technology strategy. We blend this expertise with specialist capabilities in advisory, technology and knowledge process outsourcing to maximize value for the world’s leading financial services organisations.

| Industry Vision                                       |                       |                       |                             |                               |
|---|-----------------------|-----------------------|-----------------------------|-------------------------------|
| Knowledge, Insights & Research - Investance Institute |                       |                       |                             |                               |
| Sector Expertise                                      | Our Capabilities      |                       |                             | Specialist Teams              |
| Corporate & Investment Banking                        | Management Consulting | Software & Technology | Custom Outsourcing Services | Risk Management               |
| Investment & Wealth Management                        |                       |                       |                             | Operations                    |
| Retail Banking  |                       |                       |                             | Finance, Control & Compliance |
| Insurance   |                       |                       |                             | IT Strategy & Architecture    |

Every sector of the Financial Services Industry is facing unprecedented change. A fast changing regulatory landscape has forced institutions to rethink their operating models, refocus on clients and look for new ways to manage cost and increase revenues. The collective insights and experience of our people means we can bring team of experts with relevant sector experience, capabilities and specialisms to each and every engagement.

### Investance Institute

The Investance Institute underpins all our activities acting as a think tank to help our clients predict and prepare for change through research, training and business events.

### Sector Expertise

We are organized across four core sectors. Retail Banking, Insurance, Corporate & Investment Banking and Investment & Wealth Management.

### Core capabilities

**Management Consulting** - Strategic Advisory, Business Analysis, Operational Consulting and Change Management.

**Software & Technology** - Technology strategy, bespoke software and own-brand industry specific products for Asset Managers and Investment Banks.

**Custom Outsourcing Services** - Advisory, operating model review and location strategy, including designing, implementing and operating cost effective solutions in nearshore and farshore locations.

### Specialist Teams

To help our clients reorganize, unlock the value from their operating models and address the major challenges we blend our project teams of sector experts with specialists in risk management, finance, control & compliance, operations, technology strategy & architecture.

## An established and growing business



To find out more about how Investance can support you to achieve your business objectives in your region please contact:

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## About Investance

Investance is a global management consulting firm that combines industry expertise in strategy, operations, risk and IT with specialist technology and outsourcing services to add value for the world's leading financial services organisations.

We have more than 300 people supporting Investment Banking, Insurance, Retail Banking and Investment Management organisations around the world to deliver superior business results.

We operate from seven offices strategically located to best serve our clients: London, New York, Hong Kong, Singapore, Mumbai, Amsterdam and Paris.

## Investance Institute

The Investance Institute is the research, training and business events arm of Investance Group. The Institute acts as a think tank to help our clients predict and prepare for change and provides a platform for the dynamic sharing of knowledge through publications, training courses and seminars.

Find out more by visiting:

**[www.investance.com/institute](http://www.investance.com/institute)**



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