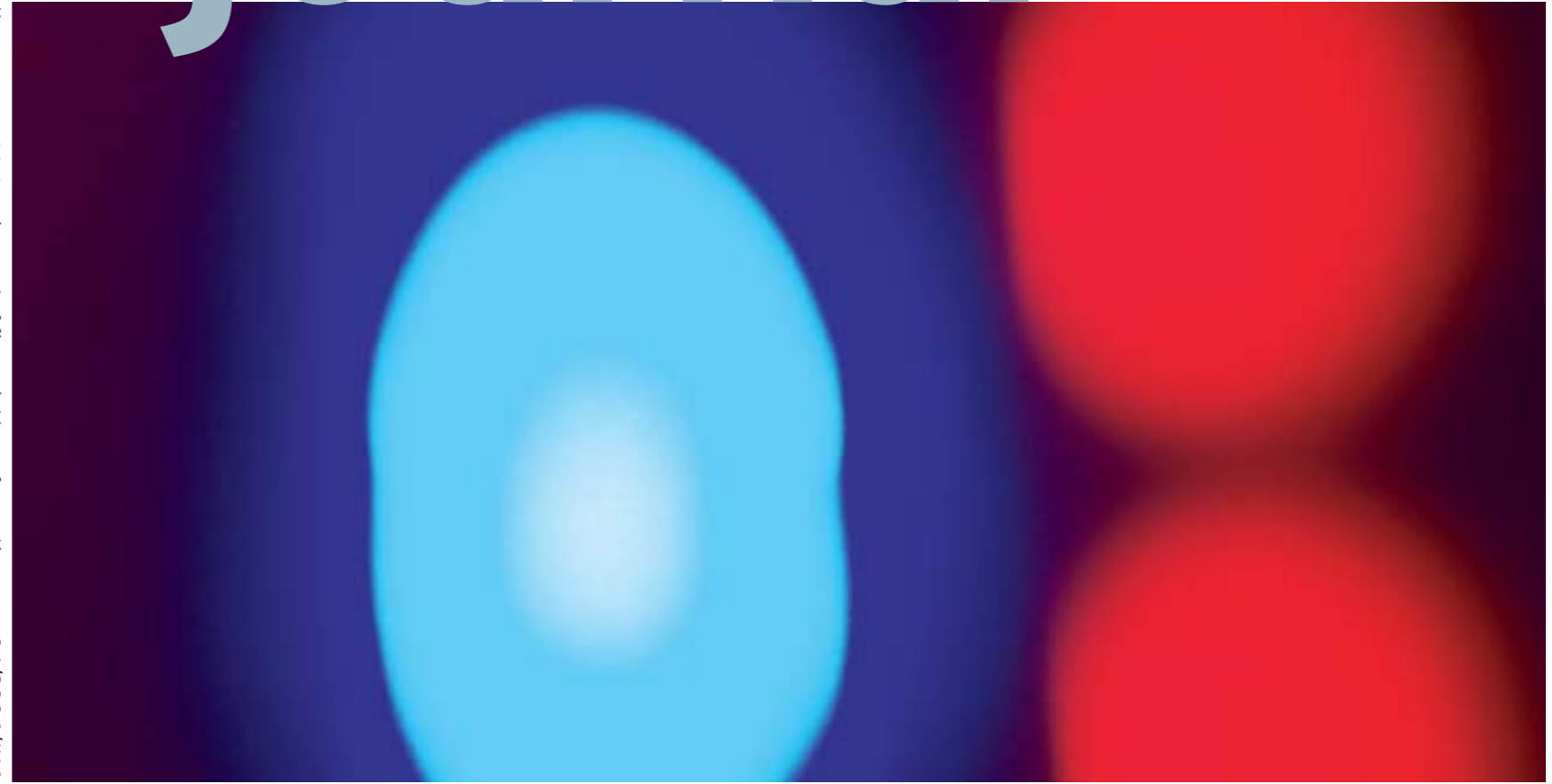


the capco institute journal of financial transformation

# Journal <sup>5</sup>

04/2006/#16

the capco institute journal of financial transformation 04/2006/#16



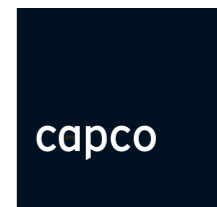
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# How to eat an elephant? Exploring the future of investment fund processing in Europe

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### Abstract

Double digit growth figures, competition, consolidation, and regulatory pressures require the European investment fund industry to enhance operational efficiency and customer service levels. Investment fund distribution process harmonization and automation are critical to reach this goal. Hand in hand with major industry players, The European Fund and Asset Management Association (EFAMA) contributes actively to these efforts through its Fund Processing Standardization Group (FPSG). This article will give you an update on where the industry stands and describe the way forward to achieve a more harmonized market for fund processing in Europe.

## How to eat an elephant? Exploring the future of investment fund processing in Europe

### Current situation in the E.U.

The E.U. Asset Management Expert Group highlighted in its final report, 'Financial services action plan: Progress and prospects', that 'cross-border processing of fund units is a key issue for the European investment management industry.' Today, the European cross-border funds processing landscape is suffering from a high level of fragmentation at both trading and post-trading levels in the transaction value chain, resulting in high operating costs and considerable operational risks.

One needs to recognize, however, that the European investment fund industry does not operate in a single market like the U.S., and is unlikely to find itself in one soon. Europe is a collection of well over 20 different domestic markets, within most of which there still is limited distribution of funds manufactured abroad, and in which the domestic manufacturing, distribution, and processing of funds is dominant. Purely domestic funds still account for 4/5 of the assets under management of the E.U. investment fund industry. Fund administration centers, mainly for the cross-border distribution of funds, such as Luxembourg and Dublin are smaller in size and scale than the combined domestic markets. However, in 2004 and 2005 these domiciliation centers profited from the trend towards open architecture distribution and account now for the majority of new fund flows in Europe.

In this environment, there is clearly no such thing as a pan-European funds execution and processing lifecycle. As a result, the operational problems of the European industry are usually not European per se, but they are mainly driven by domestic distribution and processing requirements. In the current fund markets, the bulk of the volumes continue to be sold by very different distribution structures in domestic markets (with funds sold in the country of issuance) and are largely processed through domestic market infrastructures which are different from one market to the other. In a number of markets these infrastructure players are typically local CSDs and Central Banks offering distinct components of funds transaction services along the processing value chain,

such as settlement, custody, and safekeeping services of fund shares. These markets sometimes have issues with order routing towards the infrastructures.

In a number of markets, however, the funds are not processed through a domestic central market infrastructure and instead through a bilateral spaghetti model linking individual distributors, fund managers, transfer agents, custodians, registrars, as well as market infrastructures. Proprietary fund orders are largely processed in-house through proprietary platforms and procedures which are very different from one intermediary to the other.

Smaller volumes are today executed in fund hub markets with distribution outside the country of issuance and are processed through cross-border market infrastructures. The largest service providers in this space are Fundsettle (Euroclear) and Vestima+ (Clearstream). In general, these markets do not (yet) have a market infrastructure to support the domestic fund industry in the country of distribution. Execution of fund orders and initiation of settlement processes are often manual and different in the large number of domestic markets.

Fragmentation is also reflected by the huge variety of communication standards, channels, and interfaces. For example, we lack common messaging standards and identifiers of funds, fund providers, distributors etc.; we have outdated communication methods; and have to deal with different pricing policies, valuation times, rules for subscription and redemption, payment methods, and custodian frequency/timeliness requirements.

Finally, in terms of regulatory and legal fund clearing and settlement distribution, frameworks, the European landscape is largely fragmented along national lines. To quote a report by PROMETHEE in July 2002, titled, 'Bridging the funds divide': 'As they do not have to develop standardized interfaces to the same common platform, funds have set up a number of administrative parameters in complete disregard of any com-

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mon practice. Two funds chosen at random are likely to have, for instance, different times of valorization in a market day, a different number of decimals for share valuation, different settlement and delivery schedules, different policies regarding how public holidays impact the valuing of funds, and different tariff schedules.'

Clearly, this situation represents a limitation for future development of investment fund management in Europe. It is also widely accepted that without more efficient back-office procedures, the advantages of an internal market for investment funds will be impossible to exploit to the full.

Francis Remacle, member of the Executive Board of SWIFT, used an 'iceberg' as a metaphor for the cost of lack of infrastructure in Europe<sup>1</sup>. The visible part of the iceberg is the €1 billion cost of rekeying those 50% of the present 50 million orders that are processed manually every year; below the surface lie the costs of rectifying errors, reputational risk, and the risk of a non-secure environment. The total cost to the industry, and ultimately the investors, is estimated in the order of €5 to €10 billion.

### A pan-European investment fund market will develop

Of course, as the European single capital and savings markets evolve, a pan-European investment fund market will develop. In a very distant future it may be even serviced by a single centralized investment fund order, clearing, and settlement platform. What the European investment fund industry needs today, however, is a solution that corresponds to its current needs. Going forward, the fund industry in Europe will be facing increasing pressure to change its operating model. This change will be largely driven by the need to service an increasing number of distribution channels and transfer agents.

Third-party fund distribution is still largely underdeveloped today, but expected to increase rapidly when volumes will pick up even more than today. Although integrated distribution models that are based mainly on distribution of in-house funds

will persist throughout the E.U., many fund distributors, especially continental banks, are expected to implement different open architecture models to respond to increasing domestic and cross-border third-party fund distribution requirements. In parallel, higher levels of automation and operational efficiency must be achieved at the level of the market players to cope with higher transaction volumes at reduced cost. Volumes are expected to pick up in the coming years in Europe from currently about 50 million to about 200 million fund transactions in 2007. Fund related message volumes will correspondingly increase from about 500 million per year in 2003 to 1 billion by 2008, according to SWIFT estimates. Processing volumes will not only expand in terms of number of orders, but also increase in terms of reference or static fund data with the expansion of type and number of funds.

Finally, in terms of pension models, an increasing number of defined contribution pension schemes will emerge in Europe as a result of legislative and demographic changes and will change the funds transaction processing requirements. The European Fund and Asset Management Association (EFAMA) has presented the EPPA, the European Personal Pension Account, as a role model for European style defined contribution schemes. Unlike most collective pension products, defined contribution pension plans will require retail transaction, administration, marketing, and investment services and functionality. These new servicing needs may need to be fulfilled by both the market infrastructure players and intermediaries.

### Towards a multi-provider model with a limited number of interconnected players

The threat of regulation may push the idea of a single market infrastructure for (cross-border) fund processing. With regard to the scope of the current E.U. Commissions Communication on Clearing and Settlement<sup>2</sup>, the fund industry maintains that it does not cover the clearing and settlement of fund units and/or fund shares where these are not actually traded on a secondary capital market. Because of the unique characteristics of the investment fund market, which is more like a con-

<sup>1</sup> Remacle, F., 2002, "Manual processing - the iceberg scenario," STP in European Fund Industry conference, London, March

<sup>2</sup> Commission of the European Communities: Communication from the Commission to the Council and the European Parliament: Clearing and Settlement in the European Union - The way forward, April 2004 (COM (2004) 312 final).

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tinuous primary market (investment funds typically offer and redeem their shares to the public continuously and allow investors to exchange from one fund in the fund group to another), the EFAMA believes that the system of clearance and settlement of fund shares should be addressed separately from said E.U. Communication. This is supported by the fact that major CSD providers have established systems for the treatment of cross-border funds which are distinct from their equity clearing and settlement systems.

Leaving regulation aside, the creation of a single capital market in Europe will impact all the players in the transaction processing space across markets and instruments (including funds) and across the value chain (execution, clearing, settlement, ...) and will alter the existing supplier-buyer models.

A key focus of some of the current market infrastructure players is consolidating multiple securities and derivatives markets and instruments under one single roof at respectively the execution, clearing, and settlement/custody levels. Europe, however, not the least because of regulatory constraints on monopolies, will not move easily to a single provider model and will more likely evolve towards a pragmatic multi-provider model with a limited number of interconnected market infrastructures and registrars enabling transactions to flow across the current vertical and horizontal silos and other structures in a more liberalized European landscape. This pragmatic model will most likely also shape the future funds processing model.

In this multi-player model, competition between commercial and user driven market infrastructures will create downward pressure on pricing and margins and drive the commoditization of this business while maintaining the necessary flexibility and agility to meet the evolving needs of the industry.

Local market practices will take several years to harmonize and will continue to fragment the market infrastructures across all instruments, but the overall market will become increasingly liberalized and interoperable. The SWIFT

Consultation on Giovannini Barrier 1<sup>3</sup> outlines a future communication protocol linking mainly clearing and settlement providers, such as custodians and CSDs, over the medium-term. However, such a protocol will impact heavily also on the operating procedures of asset managers and brokers, which are currently considered out of scope. Over time these institutions will be forced to communicate with the clearing and settlement systems as required by the protocol. The end result will be interoperability between all participants in the European securities markets. From this it follows that fund processing players should not just stay on the sidelines of this discussion but should take a deep look at the envisaged protocol too.

Finally, consolidation of transaction volumes with a limited number of market infrastructures and registrars may raise regulatory concerns about systemic and liquidity risks and create the need for alternative liquidity providers. These liquidity concerns may also arise in the processing of funds transactions and may require the funds industry to explore in the future alternative DVP models in the European markets.

### Flexibility as the key success factor for a future European funds processing model

If the future European transaction processing landscape for funds will be one with a more limited number of infrastructure providers and registrars than today (as opposed to one with a single provider), the key success factor for a future European funds processing model will be flexibility. Flexibility should be defined across the following key dimensions: different local market practices, infrastructures, regulatory/legal, and tax regimes; alternative interfaces; and multiple distribution channels.

Flexibility should enable the future European transaction processing landscape for funds to create value through connecting and leveraging existing custody and settlement infrastructures and by providing service components which are not yet provided by domestic platforms, and players. In addition, to meet the expected volume requirements on a pan-

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European level, the future European transaction processing landscape for funds should be sufficiently scalable and enable timely processing of accumulated volumes.

Finally, flexibility can only be realized if the future European transaction processing landscape is an open architecture that connects and integrates easily with existing platforms and players.

### EFAMA acts as a catalyst for change

The lack of commonality in the handling of fund subscriptions and redemptions in Europe – particularly in the case of cross-border flows – exposes market players to inefficiencies. This situation represents a limitation for the future development of investment fund management in Europe.

Progress towards more efficient funds processing procedures requires cooperation among market players and, possibly, but only where necessary, public action. It is generally agreed that this cooperation should focus in the short-term on adopting funds processing standards. Convergence towards industry-wide standards would indeed contribute to overcome national differences in back-office procedures and thereby remove an important barrier to the development of harmonized processing of investment fund transactions in Europe.

EFAMA is well placed to act as a catalyst to promote industry-wide coordination and foster a sensible private sector outcome. An EFAMA initiative in this area, the Fund Processing Standardization Group (FPSG), aims to identify obstacles to efficiency in back-office procedures and outlining possible actions to remove them. The Group is comprised of about 40 expert practitioners representing the European investment funds industry, i.e., fund management companies, custodians, transfer agents, fund processing hubs, and existing standard setting organizations. It has developed a work program with standardization issues and priorities which are dealt with mostly in a working group on fund data and a second working group on fund transaction best practices.

The industry believes foremost that the standardization of operational protocols and increasing the efficiencies of fund processing could bring significant benefits to fund investors across Europe. EFAMA aims to have developed the basis for a flexible E.U.-wide fund processing model and a number of the necessary standards to achieve this aim in the medium-term. EFAMA has approved and subsequently published the first set of FPSG recommendations on the issue of order and settlement as well as a so-called Fund Processing Passport in February 2005.

In the area of fund transactions best practices, the group agreed that order processing messages and standards across Europe can be considered in the context of a generic model of the roles and actors involved. Using a similar methodology, the model will be expanded to reconciliations and commissions processing. The model is based on the analysis of the markets in U.K., Belgium, France, Germany, Italy, Ireland, Luxembourg, and Portugal.

The FPSG has described the key issues to address that have been identified and makes a number of recommendations, which if embraced by the industry will, EFAMA believes, serve to deliver the efficiency improvements that are the industry's goal. At the heart of these is a move to straight-through processing (STP), with firms communicating electronically, using messages constructed to international open market standards (ISO 20022), and that universally recognized unique identifiers (e.g., for funds, the actors involved, etc.) should be used wherever possible. While various domestic message standards exist already, it is generally accepted that convergence with the ISO standards is a necessary goal. EFAMA recommends that this convergence should be progressed as soon as possible and that proprietary standards should be avoided.

In the area of fund data, the basis of fund messaging, such as the ISO 15022/20022 dictionary maintained by SWIFT, has been expanded by 200+ fund transaction terms. More importantly, a European Fund Processing Passport containing all

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details necessary to be able to process a fund order is now available, as well as a European Fund Account Form (containing data points on the end investor in order to be able to process fund transactions in terms of tax, KYC, and AML regulations). Currently there is work being undertaken on an initiative for defining the possible structure of a European fund reference data model based on the various, mostly XML-based, standards, such as DIAMS in France or Funds-XML in Germany.

Since its inception in late 2003, the EFAMA FPSG has become the accepted forum for discussion of fund processing issues in Europe. It interfaces with national initiatives in the area of fund processing. Such groups have been set up by fund trade associations, such as AFG/DIAMS in France, Alfi and the TA Forum in Luxemburg, and IMA/ISITC in the U.K. Additionally, there are now several national market practice groups that focus on the necessary interpretation guidelines for the use of messages. For example, the German SWIFT Securities User Group funds (DESSUG) has developed a complete market practice document for the use of ISO 20022-based fund processing messages, which details the obligations of the various parties and provides, on field level, all the information requirements in fund order messaging in the German market place. EFAMA FPSG representatives are active in the Securities Market Practice Group Funds (SMPG), which works on a global market practice for fund messaging. It started with discussing the content of orders and price reports. Finally, the FPSG works in close cooperation with SWIFT, in particular the joint EFAMA/SWIFT Groups on fund message standardization (ISO 20022/SWIFTNet Funds).

### EFAMA recommendations – order and settlement

The FPSG has described the key issues to be addressed, that have been identified, and made a number of recommendations, which if embraced by the industry will, EFAMA believes, serve to deliver the efficiency improvements that are the industry's goal<sup>4</sup>. At the heart of these is a move to STP, with firms communicating electronically. Automation in the area of order and settlement will serve as the stepping stone for a

debate towards further harmonization of business procedures, such as more uniform cut-off times.

### General recommendations

In order to allow for automation in fund processing, EFAMA issued the following general recommendations. Client-side institutions performing the order placement role should encourage the electronic input of orders and other instructions as early as possible in the instruction chain so as to minimize or, preferably, eliminate the rekeying of data. All electronic messages between client-side and fund-side institutions should be constructed to meet international open-market standards. All actors and, where they exist, account holders should be referenced by way of unique identifiers, using international open-market standards. Where possible, financial institutions should be identified, for the time being, using their BIC/BEI code (ISO 9362 and ISO 8859, respectively). Work is progressing under the auspices of the International Standards Organization (ISO) on an international standard business identifier (IBEI), which in due course should be capable of providing standard identifiers for all client-side and fund-side institutions. When it is introduced, all financial institutions involved in the investment funds market should apply for registration under the standard and utilize the IBEI code that they are allocated in order-related messages and communications. Fund providers should be able to accept and store account numbers or distributor references (where applicable) provided by client-side institutions, in order to allow proper identification of the holding. Uniqueness may be ensured by reference to the BIC/BEI/IBEI code of the distributor associated with the account. In the longer term, the use of IBANs (ISO 13616) or an IBAN-type approach (with codes being issued by the client-side institution) should be considered for the purposes of establishing a unique account holder reference. Fund providers should request ISIN codes for all their funds at the lowest level (i.e., share class) permitted by the ISO 6166 standard and should promote its use as the sole identifier for that asset. Order instructions should include the client-side institution's unique order reference. The fund-side institution will, in turn, provide its own deal reference as part

<sup>4</sup> The efama FPSG recommendations on order and settlement, as well as the efama fund processing prospectus, are available on [www.efama.org](http://www.efama.org) in the standards section.

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of its acknowledgement. All future messages regarding that order should contain both references so that it may be correctly recognized by both parties. Fund management companies should summarize key information relating to their funds in a 'Fund Processing Passport' in order to facilitate their trading. This would include the dealing cut-off time. Where client standing data (address, income/settlement preferences, etc.) is held by the fund-side institution, repetition of that data in messages relating to future transactions should be avoided, unless the data is to be changed, either for a specific transaction (when it should be identified as such) or for all transactions thereafter. Where possible, the fund industry should employ existing open market standards for message construction and reference data. All institutions are encouraged to develop and promote the use of such standards. Where legal or regulatory barriers or constraints to the implementation of these recommendations exist, national associations should aim to work with the relevant government or regulator to remove or alleviate them.

### Account opening and referencing

Where client accounts are maintained by the fund-side institution, identification of the correct holder and holding, whether existing or new, is vital to the correct processing of an order.

At present, no market standard exists for the determination and allocation of completely unique holder references – both the client-side and the fund-side institution will have their own code. There will be situations where the client-side institution does not know the relevant account reference, or where no holding exists at that stage. In such circumstances the intended account will be identified by reference to its registration details. Lack of a standard information set and format for these details can result in the creation of duplicate and incorrectly registered accounts, which in turn can lead to confusion and dealing errors in the future. Where the transaction relates to an existing holding, the account (where relevant) should be identified by way of the client-side institution's reference. Otherwise a standard set of registration

details should be provided. The industry should adopt a standard dataset of mandatory and optional information, to be provided in relation to a new or existing holding for which the client-side institution does not have the holder reference. Where the client-side institution knows the account to be 'new', this should be specified.

### Order placement

Orders are currently placed with the fund-side institution by a variety of means, namely, post, telephone, fax, e-mail, or electronic links. With most of these methods, manual intervention and rekeying is required. As well as being resource intensive, variations in the content of instructions increases the risk of error and has a negative impact on the service levels provided to market counterparties and, ultimately, to end investors. Errors occur due to the misquoting or misinterpretation of client details, fund names, and other transaction details, which are entered or provided manually, perhaps from abbreviated source information. The problem is made worse by the need for investors and their agents to communicate with different fund providers using a variety of communication methods. A further problem area is the variability in valuation points and the associated dealing cut-off times between different funds. This both makes asset reallocation between funds difficult to coordinate and causes confusion for client-side institutions that will need to meet different dealing deadlines depending upon the fund concerned. However, it is suggested that standardizing valuation points and cut-off times would create as many problems as it might solve – they are often set in order to avoid a concentration of activity at one point in the day and in some cases are determined due to the trading hours of the markets in which funds invest. However, client-side institutions should have easy access to information regarding cut-off points, which it is recommended be included within the Fund Processing Passport. Order placement should be carried out electronically, and the fund/class concerned should be identified in the order using the relevant ISIN code supplemented; where a single fund/class is available in different currencies, by the relevant ISO currency code.

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### Order acknowledgement and confirmation

The majority of funds deal on a 'forward' basis – the price of units is calculated at the next valuation point after the fund-side institution accepts the order. This means that confirmation of an order (including the unit price, etc.) will not usually be possible until some time after it is placed. Some, but not all, fund-side institutions undertake to acknowledge orders prior to the relevant valuation point, thus providing an opportunity to confirm that they have been received and correctly understood before the prices are allocated. However, these acknowledgements are often in a form that is proprietary to one party or the other and may not easily facilitate automatic matching by the client-side institution with the original order. In addition, acknowledgement currently may or may not represent acceptance of the order for execution.

Most fund administration systems generate confirmations at the end of the day on which the prices are calculated and allocated, for dispatch the following day. This means that the client-side institution will not receive formal confirmation of the transaction until that following day, or later if it is sent by post. Delays in receiving the confirmation may well delay the settlement process, incurring cost to one or other. Deals should be validated and acknowledged (which would indicate acceptance for execution) or rejected by the fund-side institution as soon as possible after they are received. Acknowledgements and rejections should be provided electronically. Except where complete fulfillment of an order is conditional, under the terms of the fund, upon other orders transacted within the same dealing period, cancellation or amendment of the order should be permitted only by prior agreement between the client-side and fund-side institutions. Only orders that have been executed incorrectly by the fund-side institution should be canceled or amended after the dealing cut-off point, with the fund being compensated as appropriate for any adverse impact that may occur as a result.

Client-side institutions should have mechanisms in place to identify any discrepancies in the acknowledgement and refer them to the relevant fund-side institution as soon as possible

following receipt. Fund-side institutions should issue confirmations electronically. These should be sent no later than overnight following allocation of the relevant unit prices. Where a foreign exchange transaction is executed in connection with the transaction, details should be included within the confirmation message. Client-side institutions should have mechanisms in place to identify any unmatched orders or confirmations and refer them to the relevant fund-side institution on the business day of receipt.

### Settlement

The key issues with settlement are that various settlement media are used (cheque, electronic funds transfer, CSD/ICSD accounting) and that settlement timeframes can vary.

Uncertainty concerning the settlement date is frustrating for both institutional investors and distributors and can have a consequent effect on their ability to settle subsequent purchases on time. As far as is permitted by national legislation or regulation, settlement should occur on a date that is predetermined by reference to the date of the transaction. Settlement for both sales and redemptions should be made electronically between client-side and fund-side institutions or effected via a CSD/ICSD. Payments should be accompanied by the relevant order reference(s).

The FPSG has not as yet addressed the issue of settlement risk in fund processing per se. For example, it is currently exploring the implications of the wish of many banks to settle funds 'like equity' in a CSD system. With respect to this wish some observations may be already made now. Investment funds are mainly primary market instruments, with two differences: Firstly, the issuer (fund promoter) is usually involved in each transaction to buy or sell shares in the fund, and secondly, the securities are not totally fungible because, in an open architecture distribution environment, different rights – linked to specific distribution agreements between fund promoters and distributors – are attached to them. These differences require the business model depending on the market to provide specific functions such as full reporting

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(traceability) of all securities movements between banks and custodians at the level of the fund distributors/investors, trade date accounting (funds' shares/units do not necessarily change ownership on settlement date, but on trade date), multi-level accounting structure (for fiscal and operational reasons), and adequate treatment of decimals.

Furthermore any recommendations or solutions should accommodate, without any preference, the two models for fund processing that coexist de facto in Europe. In the CSD model markets, order routing is currently not offered by most of the CSDs, but performed manually between the banks/investors and the fund promoters. DVP settlement and custody services are provided just as for secondary market bond and equity securities, either because share/units have been dematerialized in the CSD (e.g., France), or through the creation of a global note representing a nominee position in the register. As an example, we refer to the distribution of funds in France and Europe as detailed in a report ordered by the French fund and depository banks associations AFTI & AFG in 2004<sup>5</sup>. The French CSD model is efficient and low cost for settlement and fund custody but has 3 main operational drawbacks, namely, manual order execution, lack of fund operational database, and problem of identification of distributors at both the order and position level (free deliveries are not reported to promoters), creating a very inefficient trailer fees reconciliation process.

Some of these inefficiencies can be solved by integrating an order routing solution to the existing settlement functionality and by reporting free deliveries to promoters.

Additionally, in the Register or Transfer Agent model order routing, cash settlement, and asset servicing are handled directly between the distributors and the transfer agents, acting as depositories for the funds and keeping the shareholder register. Because it allows the necessary identification of distributors'/investors' positions, this model is tailor-made to the specific needs of investment funds, but remains costly and very manual (still a very fragmented market with a lot of

players, and lack of standardization and automation). It, therefore, generates many risks and is considered by some as quite expensive for both the buy and the sell sides, with cash settlement done through the normal banking system, separately from the shares' settlement. The 'core DVP model,' which works on the basis of 'nominee' positions, however, generates a large number of settlement instructions for a single deal, a costly operational set-up for transfer agents, and trailer fees reconciliation issues, and thus additional processing costs for fund promoters.

The EFAMA FPSG will explore these issues in more detail when it is looking at closer harmonization of business practices in Europe.

### Message standards

One of the key issues in implementing standardized electronic communications is which messaging standards should be used. The use of ISO standards is already established within the back-office operations of many client-side institutions and TAs. ISO 20022 already supports many of the messages required for funds processing and this is a developing area. While other standards are currently in use in certain domestic markets, it is generally accepted (and in some cases agreed) that these should converge with the ISO standard. ISO 20022 is recognized as the single European standard for funds messaging going forward and should be the basis for all electronic communications in this area. Convergence of the various existing standards towards ISO 20022 should be implemented as rapidly as possible in order to ensure interoperability. On the flip side, proprietary message standards between client-side and fund-side institutions should be avoided. This will not impair the viability of existing fund platforms, which usually do not only offer messaging but many other services. For example, both Clearstreams' Vestima+ and Euroclears' Fundsettle are early adaptors of the ISO 20022 messaging standards. It is to be expected that order routing systems that have a leading role in national markets, such as EMX in the U.K. or Investro in Germany, will also over time make the necessary interfaces

<sup>5</sup> Eurogroup Study, 'Distribution of Funds in France and Europe,' more information is available from [www.eurogroup.fr](http://www.eurogroup.fr).

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available to the market, which will make it possible for communications on the basis of ISO 20022 standard message formats as well.

### Fund processing passport

Finally, the FPSG proposes the adoption of a single fully harmonized pan-European document – the Fund Processing Passport (FPP) – to summarize, at class level, the essential information on open-end investment funds that should be provided by the fund provider in order to facilitate funds processing. The FPSG strongly believes that the adoption of the FPP as a new standard would increase the efficiency in the fund industry, especially in cross-border situations, by promoting the accessibility of standardized information needed to process trades on investment funds.

It is understood that the FPP will serve a different purpose from the simplified prospectus established by the European fund law, the UCITS Directive. While the purpose of the simplified prospectus is to provide clear information about the essentials the investor should know before investing in a fund, the FPP has been drawn up from the viewpoint of all relevant professional players involved in the operational aspects of investment funds distribution: investor intermediaries, distributors, distribution platforms, and fund management companies and their service providers (transfer agents/registrars, fund accounting agents, trustees, custodians, portfolio managers).

The fact that industry players and not investors would be the FPP users would make it possible to use specialized communication software to minimize the time required to prepare the FPPs and ensure their easy circulation across Europe. As for the FPSG transactions best practices recommendations, EFAMA will seek out the FPP endorsement on a Europe-wide basis. To achieve this goal, EFAMA will disseminate the FPP at national level through its national association members and encourage all players to endorse it, undertake a survey to establish the degree of acceptance, and identify major players who would be prepared to be early users.

In parallel, the FPSG will continue its work on the FPP with a view to agree on general guidelines on the layout of FPP, file format, quality control, etc., to enhance its use at national and European level. Finally, the translation of the FPP content into ISO 20022-based messages will also enable the electronic communication of the FPP and contribute in that way to greater efficiency in the circulation of the key information relating to funds.

### Benefits and incentives

There are a number of benefits and incentives relating to the use of STP generally. Even though some of the following points relate to post-trade processing, it is essential that the end-to-end process (starting with the trade itself) is automated if these benefits and incentives are to be realized fully.

Automation of fund distribution processing is a win-win-win equation for investors and their intermediaries (including distributors), fund companies, and fund service providers. All will reap major benefits from automating their processes based on harmonized best practice principles in three main areas:

- **Profitability** – case studies have demonstrated that operational costs and risks can be reduced substantially by the elimination of miskeying, erroneous data interpretation, delayed or duplicate processing, fraud, and inefficient identification of the sender.
- **Scalability** – STP helps to easily absorb volume growth or efficiently manage volume volatility, and quickly add new counterparties.
- **Service levels** – enhancement of service is demanded by investors, distributors, and fund companies.

Fund companies can strengthen investors' brand loyalty, security, and 'know your customer' processes, while lowering their total expense ratios. To offer best of breed service to the end investors, distributors require better and longer selling windows, efficient processing, improved customer reporting, and efficient commission management. Automation contributes to achieving these goals through improved cut-off times; accurate, prompt, and more frequent reporting; secure

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sender identification and fully secured data transmission; efficient commissions reporting; reduced number of errors; lower costs throughout the whole chain; neutral audit trail of activity between counterparties; and automated price capture and reconciliation.

While the industry has been showing an increasing commitment to automating fund processing, the pace is still slow. A number of players have started to grant or evaluate granting incentives to enhance momentum and ensure markets automate quickly before any major crises arise, which would trigger strong regulatory intervention. It is a welcome move and it is recommended that fund industry players contemplate granting incentives to their clients/counterparties to promote rapid progress. Incentives can be contemplated, for example, in the areas of commissions (better trail or transaction-based commissions when distributor works STP), or lower fees schedule for STP transactions and reporting at service providers (transfer agents, accounting agents, concentrators), or additional services available when STP (e.g., more frequent reporting).

### Next steps

#### Implementation

EFAMA will take a leading role in the adoption of the proposed standards at national level. To support this role effectively, EFAMA will carry out a communication strategy to disseminate the standards in the fund market and encourage industry-wide endorsement by all players involved in fund processing in domestic markets and/or cross-border distribution. A two-tier approach will be implemented to support this process.

**Endorsement** – the first goal of this strategy will be to seek a Europe-wide endorsement of the recommendations. To achieve this goal, EFAMA member associations will seek consensus at national level to endorse the proposed recommendations. FPSG members have also committed themselves to encourage their organizations and their national standardization groups active in the field of funds processing to accept the recommendations. To this end, EFAMA and FPSG mem-

bers are increasing the dialogue with other trade associations and groups servicing asset managers, banks, securities services, and intermediaries, such as APCIMS (U.K.), ISITC Europe, or ISSA. For example, ISSA has issued a questionnaire on the FPSG recommendations to its membership, mostly banks engaged in securities servicing. Their responses provide valuable input for the future development of the recommendations.

**Implementation** – to accelerate implementation by the market place, EFAMA will bring together a number of key players with the objective of convincing them to implement the recommendations, thereby giving other players an incentive to agree on the standards.

A key role will be the active engagement of the 30+ EFAMA corporate members which account for more than 25 percent of asset under management in the European fund markets. Implementation of the recommendations by large parts of the fund side will help to increase acceptance and pick up of the standards by the fund buy-side, i.e., the fund distributors and intermediaries, such as fund platforms. Currently more than 50 European groups active in the fund market are implementing at least the messaging standards recommendations of EFAMA<sup>6</sup>.

The national market practice and early adopters groups in France, Germany, Ireland, Italy, Luxemburg, Spain, Switzerland, and the U.K. play an important role in implementation too. They provide the necessary practitioners forum for discussion of the issues relating to automation and the implementation of the EFAMA recommendations and market practice documents.

Additionally, EFAMA discussed with its members that the national associations could directly implement some of the recommendations. One of the recommendations above urges the sole use of international securities identifiers for funds, i.e., the ISIN and the use of the so-called bank identifier code (BIC) for all financial services firms engaged in fund process-

<sup>6</sup> ISO 20022 early adaptors include: BNP Paribas AM, BP2S, BNP Paribas Fund Services, Banca Intesa, Monte dei Paschi-Siena, Unicredito Italiano, San Paolo IMI, Fidelity, FundSettle, CITCO Bank, AIB/BONY, OKO Bank, Svenska Handelsbanken, DWS, APO AM, eXchanging, HypoVereinsbank, Altrax, FETA, JPMorgan Fleming, Aviva Funds, Bank of New York, Banque de Luxembourg, Citibank, Vestima+,

CACEIS, CSAM Fund Services, EFA, Franklin Templeton, JPMorgan Bank, Pictet Funds, Schroder IM, State Street, ACM, All Funds Bank, Banco Popular, Bancoval, Capital Markets, Eurosafei, AIG Private Bank, Swissquote, BGI, Fidelity Investments, Axa Rosenberg, IFDS, Jupiter AM, Merrill Lynch IM, Skandia, BBH (Source: SWIFT).

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ing. National associations could organize the central application process for BICs on behalf of all of their members. SWIFT which serves as the ISO appointed registrar organization for BICs accepts collective applications (basically a spread sheet with the names of the associations' members). The German fund and asset management association BVI has successfully applied for and obtained within three months BICs for all 80+ German fund management companies (Kapitalanlagegesellschaften) in 2004. On the ISIN, the national association could clearly agree with the national numbering agency that all funds units or shares get ISINs instead of (or at least in addition to) the national identification code. FPSG may develop guidance for the recommendations to be implemented with the help of the national associations.

An annual review of the progress achieved towards endorsement and implementation was undertaken in the fall of 2005. For this review to function effectively, EFAMA conducted in May to September 2005 a survey to establish the degree of acceptance of the recommendations and identify the barriers or constraints to the implementation of these recommendations. On the basis of the results of the Review, the FPSG will revisit, enhance, and add to the proposed recommendations, probably in early 2006.

### **Future developments**

STP does not end with the settlement of an order. Full STP extends into post-trade activities, such as commissions processing and client-side reconciliations etc., as well as the handling of transfer of title and income processing. In the immediate future, the FPSG intends to consider reconciliations and then commissions. ISO 20022 messages for the purposes of providing reconciliation data to client-side institutions are already under development. The role of the FPSG, therefore, will largely be to encourage their implementation in due course and, where necessary, make recommendations with regard to the service levels (response times, etc.) that should surround their use. The area of commissions processing is a complex one and, although the required messages are scheduled for implementation under the ISO 20022 standard by

the end of 2006, work has yet to commence in earnest in this area. The FPSG will assist in that work, providing an advance platform for discussion of the issues and identification of the business requirements. In due course, its role is likely to become one of promoting their use.

In the longer term, the FPSG proposes to consider other key areas, where a lack of harmonization is considered to present a barrier or constraint to the efficient processing of funds-related activities. Two areas identified at this stage are transfer of title to fund units between one person or entity and another, and the processing of income entitlements.

Finally, with this flurry of industry lead initiatives, is there a role for the regulator, especially the E.U. Commission? The E.U. Commission Green Paper on the enhancement of the E.U. framework for investment funds (COM (2005) 314 final) of 12 July 2005, asks this two-part question (p. 9): 'Question 12: Do you think that on-going industry driven standardization will deliver fruit within a reasonable time frame? Is there any need for public sector involvement?'

The on-going industry driven standardization will deliver fruit within a reasonable, i.e., over a medium-term, time frame. A substantive number of EFAMA's corporate members and members of members are expected to endorse (in the short-term) and implement (in the short- to medium-term) the EFAMA FPSG recommendations on order and settlement, including the use of ISO 20022 messaging systems. With widespread endorsement, the fund side will make a clear signal to other market participants needed in fund processing, especially distributors, that the industry is moving to a more harmonized system of fund processing. This will make their investment decision easier, and more standardization and automation of fund processing will be the end result.

This crucial first phase of concentrating on enabling automation and messaging is in overlap with a longer term 'Phase 2,' in which the industry will discuss, decide, and implement recommendations on what is needed in terms of harmonization

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of market practices and individual business procedures to enable existing players to be really efficient. This will include work on harmonization of business documentation, for example, standardized (bands of) cut-off times and distribution agreements, timing of price reports, and client reporting. In addition, they will include changes in industry workflows, such as introduction of 'position keeping agent' in CSD countries, definition of common minimum 'TA process' steps, and procedures for both CSD and TA driven markets, and standardization of fund settlement practices (delivery versus payment and free of payment issues, settlement periods for sales and redemptions) to name a few open issues. The need for a single utility provider in (cross-border) fund processing, with all the issues surrounding monopoly providers, may be avoided if 'Phases 1 and 2' of implementation of EFAMA recommendations are already able to create an efficient and harmonized fund processing environment between the existing players.

As such, there is currently no need for public sector involvement other than the E.U. lending its support for industry lead efforts in the area of fund processing in a similar way as it supports such efforts in the area of clearing and settlement of traditional securities, e.g., fostering the discussion and implementation of the Giovannini reports on clearing and settlement in the EU<sup>7</sup>.

In the end, the big elephant 'European fund processing' will be cut to pieces and eaten bite by bite.

<sup>7</sup> The Giovannini Group: Cross-Border Clearing and Settlement Arrangements In the European Union, November 2001, and The Giovannini Group: Second Report on Cross-Border Clearing and Settlement Arrangements, April 2003.