



**OPERATIONAL
PERFORMANCE OF BROKERS
Market Survey
OTC Derivatives Products
2004**

Summary of Findings

Version 1.0

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1. Introduction

1.1 Scope of Study

This document is the report of the Operational Performance of Brokers - Market Survey (OTC Derivatives), 2004 carried out by Z/Yen Limited for a consortium of 8 major Banks.

The study was performed based on individual, predominantly face-to-face interviews using a structured questionnaire, as developed by Z/Yen and the participating Banks. 36 leading Investment Management companies, and/or in some cases, their Outsource Agents (the Clients) were interviewed between 1st August and 30th November, 2004.

The Sponsoring Brokers were as follows:

- ABN AMRO
- CSFB
- Deutsche Bank
- Goldman Sachs
- HSBC Bank plc
- JP Morgan
- Morgan Stanley
- Royal Bank of Scotland

A list of the Clients interviewed can be found in section 5.

1.2 Approach

The approach adopted for this study was to:

- Z/Yen set up and facilitated a series of workshops with the Banks to agree and finalise scope, structure, format and questions;
- The Banks selected the Clients who they wished to be interviewed and introduced Z/Yen to appropriate senior operations personnel;
- Z/Yen performed the interviews and documented responses and additional comments;
- Z/Yen published the findings and presented these to the Banks.

2. Overall Summary of Findings

2.1 Background

36 Clients were interviewed between August and November 2004. Clients interviewed were Investment Managers (20%), many of whom have Pension/Insurers as end-Clients, Corporates (8%), banks (16%), and Hedge Funds (56%). 57% of Clients were based in the UK, 20% were in Europe and 23% in the US.

All Clients interviewed were active participants in at least one of the derivative asset classes covered in the survey and supported a mixture of proprietary trading and hedging activity.

2.2 Key Messages

A number of key messages emerged from the questionnaire, all of which have been recorded in detail in Section 3 of this report. Although the survey covers 3 different asset classes within the derivatives space, it was significant to note that Clients expected similar levels of service irrespective of the asset class.

The large percentage of Hedge Funds amongst the interviewees also meant that the respondents were highly sophisticated and had a detailed knowledge of the Banks/Brokers support models and processes.

Key messages from Clients were as follows:

A. Core Processing

Getting the basics right is very much regarded by Clients as the primary responsibility of the Banks/Brokers. Clients felt very strongly that given the levels of investment that the Banks/Brokers had put into their Derivatives Operations Units there should no excuse for errors and tardy delivery of reports.

Overall the standard was viewed as being both high and steadily improving with nearly all Banks/Brokers achieving the level of competency that was expected for most core processes. There were a couple of notable exceptions to this: Customer Valuation Statements, and Collateral Management, where Clients expressed frustration at the inconsistencies and unacceptable level of errors.

Whether a Bank/Broker performed well in the provision of Customer Valuation Statements and Collateral Management was seen as being a good indicator of the overall competency of the Derivatives Operations Unit. The justification for this was that the accuracy and timeliness of these processes is dependant on upstream processes such as trade capture, confirmation production and the quality of a Bank/Broker's systems and infrastructure.

B. Client Management and Resolution of Issues:

Clients tended not to monitor Banks/Brokers' operational performance as a matter of course but rather approached it on an exception basis. Although some Clients adopted a zero tolerance to errors, most acknowledged that for more complex non flow transactions a small number of issues were inevitable. It was in these situations that they felt the quality of Client Service was a distinguishing factor between Brokers.

A commonly expressed view was that the Client Service Team should be the first point of contact when an issue arose and that Clients expected to be able to call once, notify the CS team member of the issue, and then be given regular updates or confirmation that the issue had been resolved.

Client Relationship Managers should oversee the resolution of issues and be the 1st escalation point but should also be an asset to the Client in terms of rectifying processes which were unnecessarily cumbersome. Some Clients were concerned that Client Relationship Managers tended to be used as a marketing ploy and were not always the effective "rainmaker" that would add value to the core process.

C. Low Level of Outsourcing:

The percentage of Clients that have outsourced some or all of their Operations was low with only 4 Clients stating that they had outsourced any part of their Derivative Operations process. Only 1 further Client indicated that they had any intention to do so in the near future and a number of Clients stated that they would be centralising their process as far as possible to improve control.

This low up-take of outsourcing is in contrast to the trend seen in other product areas such Securities and it may be that this will start to increase over the next 2 - 3 years. Other reasons for such a low percentage may also be to do with the small size, and multi-discipline nature of the Client's Operations Groups.

D. Low STP Rates:

Although this was not a specific topic covered by the survey it was clear from the responses to some of the processing requirement questions that hardly any Clients use auto-matching or have an electronic connection to external parties. Most Clients still expected to receive confirmations and settlement notifications by fax or email. In addition, only 1 or 2 Clients had any plans to do so. Entry or up-front cost was not generally cited as the reason for this, most Clients stating that they lacked information.

A number of Clients mentioned that this might be an area where the Banks/Brokers could provide a lead, with advice or information on what platforms are available.

E. Global Support:

A large number of Clients are active in all 3 major time zones and took the view that these markets are global 24/7.

Clients expected Bank/Brokers to provide a support service in their time zone and did not feel that there was a seamless communication flow between Banks/Brokers processing hubs. Clients did not want to have to wait for the Bank/Brokers local operations units or systems to be available in order to be able to look-up simple requests for information.

2.3 Core Transaction Management (Operations Best Practice)

Clients were asked to apply a weighting to 7 categories of Core Transaction Management (Operational Performance). The results were as follows:

	Interest Rate Derivatives	Credit Derivatives	Equity Derivatives
Confirmation Timing	23%	34%	21%
Confirmation Accuracy	21%	23%	18%
Settlement Performance	16%	11%	18%
Post Settlement Performance	14%	10%	11%
Static Data Management	10%	8%	8%
Collateral Management	6%	7%	11%
Client Valuations	10%	7%	12%

The most important of the Core Transaction Management categories was easily Confirmations with a combined average weighting of 44% for Interest Rate Derivatives, 57% for Credit Derivatives, and 38% for Equity Derivatives.

The high proportion of Hedge Funds amongst the respondents means that the proportion of non-vanilla or exotic transactions will be higher and therefore requires greater levels of scrutiny.

Another two important categories were Collateral Management and Client Valuations. Many clients saw these as inextricably linked since they relied on the broker to provide a valuation statement to back-up any collateral calls/returns.

Some clients also stated that the quality of these processes were very often indicative of how well controlled and professional the Bank/Broker's Derivative Operations process was since they relied on getting all the upstream processes correct.

The other 3 categories were each viewed as being slightly less important with the exception of Equity and Interest Rate Settlement Performance.

2.4 Client Management

For the purposes of this survey, the participating Banks/Brokers have agreed the following terminology:

- **Client Service (CS):** An individual or team who is/are the day-to-day contacts for Operational Issues.
- **Client Relationship Management (CRM):** An individual/team responsible for the overall operational relationship.

Clients were asked to apply a weighting to 5 categories of Client Management. The results were as follows:

	Interest Rate Derivatives	Credit Derivatives	Interest Rate Derivatives
Client Service (CS)	37%	34%	33%
Client Relationship Mgt. (CRM)	23%	31%	23%
Linguistic Skills	11%	12%	12%
Product Knowledge	20%	15%	20%
Regular MIS	9%	8%	13%

Client Service stands out as being the highest weighted of the Client Management categories with similar results for Equity and Credit Derivatives and a slightly higher weighting for Interest Rates which probably reflects relatively higher volumes.

Client Service was also weighted higher than CRM for 2 asset classes, indicating that clients tended to regard day to day service as being more important. The exception was Credit Derivatives where clients saw day to day service and overall CRM as being equally important.

The importance of product knowledge was also seen as important with Clients expecting to be able to talk to an experienced and knowledge person straight away. *"This is what my system says"* was a quotation often mentioned by Clients to illustrate that many Broker operations contacts to not have a deep understanding of the products and market.

Linguistic skills and the provision of regular MIS were not weighted highly and were therefore seen as less important, however French, Spanish, and Italian Clients were more likely to require a local language speaker and local contact person.

2.5 Linkage of Operational Performance to Business

Only a minority of Clients currently perform a regular ranking exercise across all their Brokers. Significantly though, nearly all stated that they would start to monitor the performance of Brokers who did not perform up to a required standard. The close proximity of Operations Groups to the Traders and the high standards demanded by Clients means that operations standards do feature in the "Broker Vote" at more than half of the Clients.

However, the influence that operations performance has on Broker selection is asymmetric with most Clients having a tendency to penalise poor performance without necessarily acknowledging good performance. This was true for all 3 asset classes with the average "Broker Vote" being in the range of 20 - 22%.

Nearly all Clients stated that the Front Office had the most influence over Broker selection with other criteria such as: price, quality of ideas, and credit being considered important.

2.6 Internet Portals

Most Clients are keen for banks to implement client portals or websites. Most Clients did not want Client portals to replace the existing process but viewed it as a useful back-up or a way of reducing the number of queries and therefore speeding up the daily processing. Not surprisingly, the most popular service required would be around confirmations and valuation statements.

Two major concerns however are the overheads generated by having to logon to multiple Client portals (passwords, and other logon details), and the suspicion that Banks/Brokers would use Client portals to shift more responsibility on to the Client.

This overall positive finding was in some contrast to the results of previous studies in the securities markets. However, in 2004 for securities, in marked contrast to 2003 and 2002, there was more "warmth" towards the idea than before.

2.7 Penalisation of Banks/Brokers for Poor Performance

80% of Clients stated that they would penalise Banks/Brokers in some way for poor performance. This was consistent across all 3 asset classes and was most likely to be due to errors with settlements. If there is a control failure in the booking and confirmation process, an error will often not be picked up until the first settlement which is why settlements are so common as the cause of a problem.

Most Clients would look at each situation on a case by case basis, particularly if the trades concerned were non-flow or exotic type trades. Penalising the Bank/Broker was viewed as a last resort or as a means of protecting themselves against operational risk. The length of penalty varied from a few weeks to indefinitely.

2.8 Strategic Direction - Initiatives Planned

As mentioned previously, there was generally a low percentage of Clients who were either currently outsourcing or had plans to do so. In addition, the incidence of pure Straight Through Processing (STP) was also low with most Clients relying on faxes and emails to confirm trades and send and receive data externally.

A clear opportunity exists here for Banks/Brokers to play a lead role in facilitating the wider use of auto-matching, and external connectivity platforms. Some Clients mentioned that workshops and Client groups would be a welcome forum for them to get together and discuss best practice and barriers to improving their STP. Examples of systems in which Clients would be particularly interested include: SWAPSWIRE, Creditex, and DTCC.

2.9 Client Feedback on the Survey

For most Clients, this survey was the first of its type that they had participated in for OTC Derivatives. The fact that Banks/Brokers were now trying to proactively understand Clients needs and ask for feedback was welcomed.

Without exception, all Clients interviewed were extremely keen to contribute and adopted a positive and constructive approach to both the questionnaire and the ranking exercise. The level of detail required and the degree of granularity of data was not seen as being too onerous.

The slow start to the project and the extended time it took to complete the interviews does indicate that in some cases, Banks/Brokers Operations Groups do need to develop closer relationships to their Clients. This was not true of all sponsoring Banks.

2.10 Next Steps

Z/Yen will arrange 1-1 feedback sessions with the each of the sponsoring Banks.

The Clients who participated in the survey, will be sent a summary copy of the report and, if the demand is there, will be invited to attend a workshop/presentation of findings.

This survey can be repeated in 2005, or as a bi-annual process in 2006.

2.11 General Client Comments & Observations.

During the Client interviews, Z/Yen asked Clients if they had any additional input, either on

On Operational Service for OTC Products, Client observations/quotes included:

- *"The standard of service is good, and is steadily getting better. Its all about the size of contrast between the Brokers we use. If a Broker stands out as being far better than the rest then it would impact the amount of business we do with them".*
- *"We see Brokers as providing us with a package of services including Operations, ultimately the business will decide who they conduct business with but will use operational service as a differentiator".*
- *"In order for us to do business with a particular Broker they have to be able to provide a certain standard of operational service. If they fail to meet our requirements, we owe it to our business not to use them".*
- *"Brokers should distinguish between Clients based on the value of business that they do with them. As a Hedge Fund we know that we are an extremely profitable Client but don't feel that this is recognised by the Client Service staff at our Brokers".*
- *"The service that Brokers provide is only as good as the weakest link. It's frustrating to see the variable quality of service within a single Broker across functional process, location, and even over time". It tends to be the quality of the individuals not the structure or culture within a Broker that makes the difference".*

On the Z/Yen survey process, Client observations/quotes included:

- *"This is the first multiple Broker survey that we've participated in, its good to see that they [the Brokers] are being proactive; as long as they take action based on the results".*
- *"We've participated in Z/Yen surveys for other product areas and are pleased that this has now been extended to Derivatives".*
- *"We would love to see a summary of the results and be able to share it with our business colleagues".*
- *"We were surprised and impressed that Z/Yen wanted to do the survey face to face. It has made it a more effective process. We don't even get this level of service from some of the Brokers".*
- *"I can see this as being a useful tool for Brokers to use. It's a shame that there weren't more of the Brokers involved that we use".*

3. List of Participating Clients

All Clients Interviewed

- Goldman Sachs Asset Management International
- CDC IXIS Asset Management
- Robeco Alternative Investments
- BNP Paribas Asset Management
- BlackRock International Ltd..
- GLG Partners LP
- Oak Hill Funds
- European Credit Management Limited
- Dexia Group Brussels
- BlueCrest Capital Management
- Harvard Management Company
- KBC Alternative Investment Management Limited
- Renault Finance S.A.
- CQS Management
- Ferox Fund Limited
- MTR Corporation Limited
- Export Credits Guarantee Department (ECGD)
- Heritage Bank Shares Inc
- Banca Intesa SpA
- Brevan Howard Asset Management
- Cheyenne Capital Management Limited
- Amaranth
- Clinton Group
- Highbridge Capital Management
- Stark Investements
- Banco Bilbao Vizcaya Argentaria, Madrid
- Bank of America N.A., London Branch
- Endeavour Capital Management
- Telefonica S.A.
- ING Belgium
- Tudor Investments
- Northern Rock
- Yorkshire Building Society
- Bayerische Landesbank
- HSBC Asset Management Europe
- Western Asset Management Co.

4. About Z/Yen

Z/Yen is the UK's leading risk/reward management consultancy.

Risk/reward management is the application of risk analysis and return incentives to strategic, systems, human and organizational problems in order to improve performance. Z/Yen believes that the intelligent management of risk is the basis of significant reward. By recognizing, understanding and managing risks, more risks can be assumed and performance increased.

Z/Yen applies risk/reward management in the public, private and not-for-profit sectors, with particular expertise in:

- Financial Services
- Technology
- Not-for-Profit Sector
- Professional Services
- Business Intelligence

Within Financial Services, Z/Yen performs Cost per Trade benchmarking studies, operational performance analysis, best practice surveys, strategic planning (outsourcing, re-engineering, relocation) and other market intelligence. Z/Yen's market scope encompass European Securities, US Securities, Asian Securities, Global Treasury

Z/Yen's work has enabled banks and other financial institutions to:

- Understand whether economies of scale efficiencies have been realized;
- Identify in which products or businesses they are either efficient or inefficient processors;
- Identify where in the trade processing lifecycle they have scope for improvement;
- Identify and quantify "best of breed" and determine efficiency targets;
- Analyse progress and trends on a year-on-year basis;
- Monitor relative performance for management.

For more information on Z/Yen, visit our website www.zyen.com or call Jeremy Smith on +44 (0)20 7562 9562.