

Dialogue

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Neeraj Sahai,
global head of Securities
and Funds Services, Citi

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Securities markets: how far can automation go?

A portrait of Neeraj Sahai, a middle-aged man with short dark hair, wearing a dark suit jacket, a light-colored striped shirt, and a red patterned tie. He is resting his chin on his hand, looking thoughtfully at the camera against a dark background.

Neeraj Sahai is the global head of Securities and Fund Services, Citi, and a member of its Institutional Clients Group and Global Transaction Services Management Committees. He was recently also elected to the board of the Depository Trust & Clearing Corporation (DTCC).

Prior to assuming his current role, Sahai was chief financial officer of Global Transaction Services, overseeing finance, risk, control, treasury and strategy and M&A, among other areas of the business. Sahai has been with Citi for more than 23 years, starting as a management associate in 1984. *Dialogue* spoke to him about the response of securities service providers to changes in the market landscape and the challenging environment in which their clients are now operating.

We know how regulations such as the Markets in Financial Instruments Directive (MiFID) and Regulation National Market System (Reg NMS) have affected traders and exchanges, but it's less obvious how they have affected the post-trade environment. Have the regulations changed the nature of what clients are asking you to do?

MiFID and Reg NMS are having a profound impact on the evolution of market structures, though it will take a few years to properly assess the resulting changes in the marketplace.

Both sets of regulations are heavily focused on best execution, in turn driving electronic connectivity in the securities marketplace and pushing algorithmic trading. These two trends have downstream impacts on the capital expenditures and the technology required to service these capabilities. If we take Reg NMS, for example, broker dealers have to invest substantially in their platforms to deal with new market structure rules and new compliance and surveillance systems, as well as establish connectivity with alternative venues.

Organisations that service these broker dealers have an opportunity to help them deflate those costs. Citi's Lava, for example, has been able to provide full service for these clients as it helps achieve economies of scale.

MiFID has also created the platform for competition among exchanges in Europe and can be seen as the catalyst for the development of the multilateral trading facilities (MTFs). The MTFs, in turn, need central counterparties (CCPs). At Citi, we have expanded our clearance and settlement capabilities to service the CCPs and to give our clients access to them. Citi is acting as agent for EuroCCP by providing settlement in the local central securities depositories (CSDs). It's important to all market participants that settlement follows established practices and takes place in a manner to allow the widest possible participation. We are pleased that EuroCCP and Turquoise share this view and have appointed Citi as their agent to provide the settlement services required in the local CSDs. We also provide clearing services for clients trading on Chi-X and Turquoise, and clearing on EMCF (Fortis' European Multilateral Clearing Facility) and EuroCCP. These developments have been designed to allow our clients to capitalise on the efficiencies presented by these new platforms and facilities.

You mentioned algorithmic trading. Does that in itself provide any particular challenges, given that it results in significantly more trades for the same volume?

Since the mid-1970s when there was deregulation of commissions, volumes in the cash equities market have exploded. With those increased volumes has come the need for great amounts of data. Moreover, connectivity is

required to all the alternative trading venues such as electronic communications networks (ECNs) and MTFs. As a result, trading and execution require investments in technology at various levels, in terms of crossing engines, connectivity, smart routing engines and infrastructures.

There is also a need for new talent. Along with the quants required for algos and the developers for the software, there is a need for network engineers to manage the bandwidth of the infrastructure, as well as client service people to deal directly with the institutional clients.

Besides algorithmic trading, there is also the emergence of new asset classes. The lifecycle of an OTC derivative, for example, is very different from that of a corporate bond. To service these instruments, one requires new processes, new technologies, new kinds of talent and new risk control mechanisms.

We view our platform as an integrated pre- and post-trade platform that provides a seamless and comprehensive service. As an example, to deal with the trends coming out of algorithmic trading, Citi acquired Citi Lava and ATD, now branded as CitiMatch. These have had a substantial impact in the marketplace. Our volumes are regularly 300,000 messages per second. We are seeing increased order flow and reduced average trade size.

Do you see the front, middle and back office becoming less siloed?

The front end of the business is becoming very complex, and the complexity is flowing into the back office. To deal with this complexity – especially where a buy-side firm has to devote increasing resources to the front end of the business – we recognise a need for an integrated supplier for the entire value chain. Citi aims to knit all that functionality together.

We also believe that architecture must be modular and open-ended since clients must be able to choose pieces that work together and mix and match over time as their strategies change. Citi's strategy is to be a full-fledged integrator of best-in-class solutions. That is fundamentally different from the way this industry grew up, as a manufacturer of widgets at lowest cost.

In today's world, it is more a question of economies of scope than economies of scale – and that is a paradigm shift. A client can then pick the best-in-class solution, and at the same time focus on its core competency. For example, as a hedge fund above a certain size tries to expand out of a single prime broker relationship to a multi-prime broker set of relationships, it needs a platform to manage prime brokers and, across that platform, to get the real-time P&L. We provide a platform called OpenPrime, which allows a hedge fund to manage its positions – in one place – across multiple asset classes, strategies and



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prime brokers. We also offer the full spectrum of hedge fund administration services so the information flows seamlessly to the middle and back end. This also allows the client to segregate the assets it uses for leverage from the other assets, which can be ring-fenced with us as a custodian.

What about the general climate produced by the subprime crisis/credit crunch? Obviously that has a direct impact on certain types of business that a bank handles, but less obviously on areas like securities services.

The current financial crisis has an impact at two levels: the product-mix level and the business level. From a product perspective, leveraged credit products are definitely retreating, because there is less credit being provided by investors and banks. The simple products, such as money market funds and exchange-traded funds, are benefiting. This change in product mix obviously calls for a reallocation of resources, at least in the short run.

At a business level, the impact is on the revenue line because structured products are generally higher priced. There's also a flow-through impact: as the equity markets and real estate markets have dropped in value, assets under management (AUMs) have dropped in value and our revenues in this industry are directly correlated to AUMs.

On the plus side, there are still great opportunities to trade assets and to provide custody and clearing in the emerging markets. Another less-known benefit is the battle for talent. With the challenges in the investment banking industry, we're witnessing a move from that part of the financial sector to securities services and buy-side firms. The securities services area is also expanding to cover more of the value chain, so there's both a greater demand for and a larger supply of the requisite skill set.

Over the years there have been several industry initiatives aimed at improving efficiency in securities markets. Have they resulted in any sort of consensus on what should be done in a shared way and what are appropriate areas for competition?

Due to the differences in size, functionality and expertise, there really is no true consensus among players. However, increasing consensus is visible in selected areas such as messaging, trade pre-matching and settlement. Our experience has been that the larger players prefer a do-it-yourself approach while the smaller players are more open to pooled utilities. Ultimately, a critical mass is required for a utility to be successful, and economics is behind that. For a shared utility to be credible, it must be able to demonstrate a great governance model and also exhibit the ability to steer reasonably clear of competitive issues. DTCC and SWIFT are good examples of where that model has been successful.

You mentioned the big players preferring a do-it-yourself approach. One thing that has traditionally distinguished Citi from its peers is the way it organises its agent network, relying more on its own branches and subsidiaries. Does that model still hold?

Our proprietary branch network of 52 markets continues to expand, and is core to our strategy because of the benefits it provides to underlying clients. For intermediaries that comprise broker dealers and global custodians, this model provides them with direct access to information and the added benefit of our ability to work with local regulators to upgrade infrastructures in the emerging markets. For investors, it provides a single window to a globally consistent platform that allows them to better manage their financial positions, information and risk as well as avoid potential reconciliation issues. A result of our proprietary network is a consistent framework and minimum time latency for information. In 52 of the 90 markets we are in, our agent is proprietary, but in terms of market cap, it would probably be well over 90%.

Everyone agrees that end-to-end straight-through processing (STP) would be a good thing, but does everyone agree on where to devote scarce resources to plug existing gaps?

Everyone agrees that a seamless straight-through-processing environment in the pre- and post-trade world is the holy grail of securities processing. In certain areas like trade pre-matching, settlement and clearance, there has been quite substantial progress. In areas of asset servicing, such as proxy voting, voluntary corporate actions and tax reclaim services, progress has been sluggish. If one extends one's horizons to cover the funds arena as well as newer asset classes, the progress has been even slower.

However, work is under way in various forums. In a highly competitive marketplace where there are different players with different objectives and priorities, economics drives convergence. When an asset class matures, and incremental spread and alpha is squeezed out, the players will quickly align their priorities to attain intra-company and inter-company STP, because that's critical to handling large volumes at low cost and acceptable risk.

Is the funds industry a special case? Is it always going to have a large element of manual processing just by virtue of the fact that in many markets there are a lot of small players for whom the economics of automation don't stack up?

Automation in the funds industry is a thorny issue. Fund/SERV in the US provides a higher degree of automation than in Europe. But the US really is a single market, and the largest one for mutual funds. In Europe, the landscape is more complex. There are different languages, different securities frameworks, different investor preferences and different distribution models. Furthermore, European-domiciled funds are distributed in other markets like Japan, Asia and Latin America.

The lack of automation in the funds business has less to do with technology than with the fact that those in the supply chain still make healthy profit margins. So the economics are less compelling. Consensus is required among many more participants, including consumer banks. The industry is less consolidated than a broker-dealer world or a custodian world. Having said that, we have seen a demand for greater automation and have launched a CitiConnect product that allows hedge funds and mutual funds to automate their order routing and the pick-up has been pretty encouraging. I also know that organisations like DTCC and SWIFT are working hard to help automate messaging and order routing in that arena, so there are grounds for optimism.

From your own business perspective, is SWIFT now doing what you would like it to do or are there areas where you would like to see it do more – or less?

SWIFT services are at the core of what we do. As its largest user, we enjoy a very close and strategic relationship with them. Since its inception, SWIFT has driven a lot of operational efficiency in the marketplace. From our perspective, SWIFT is central to the development of this industry.

We would like to see SWIFT expand its messaging standards into new asset classes, extend these standards into emerging markets where there are lower STP rates and finally to remain competitive in terms of price, speed and efficiency with the alternative channels of communication that are emerging. 