

Risk and risk mitigation

“Postcards From The Edge” Lessons Learned On Managing Business In A Down Market

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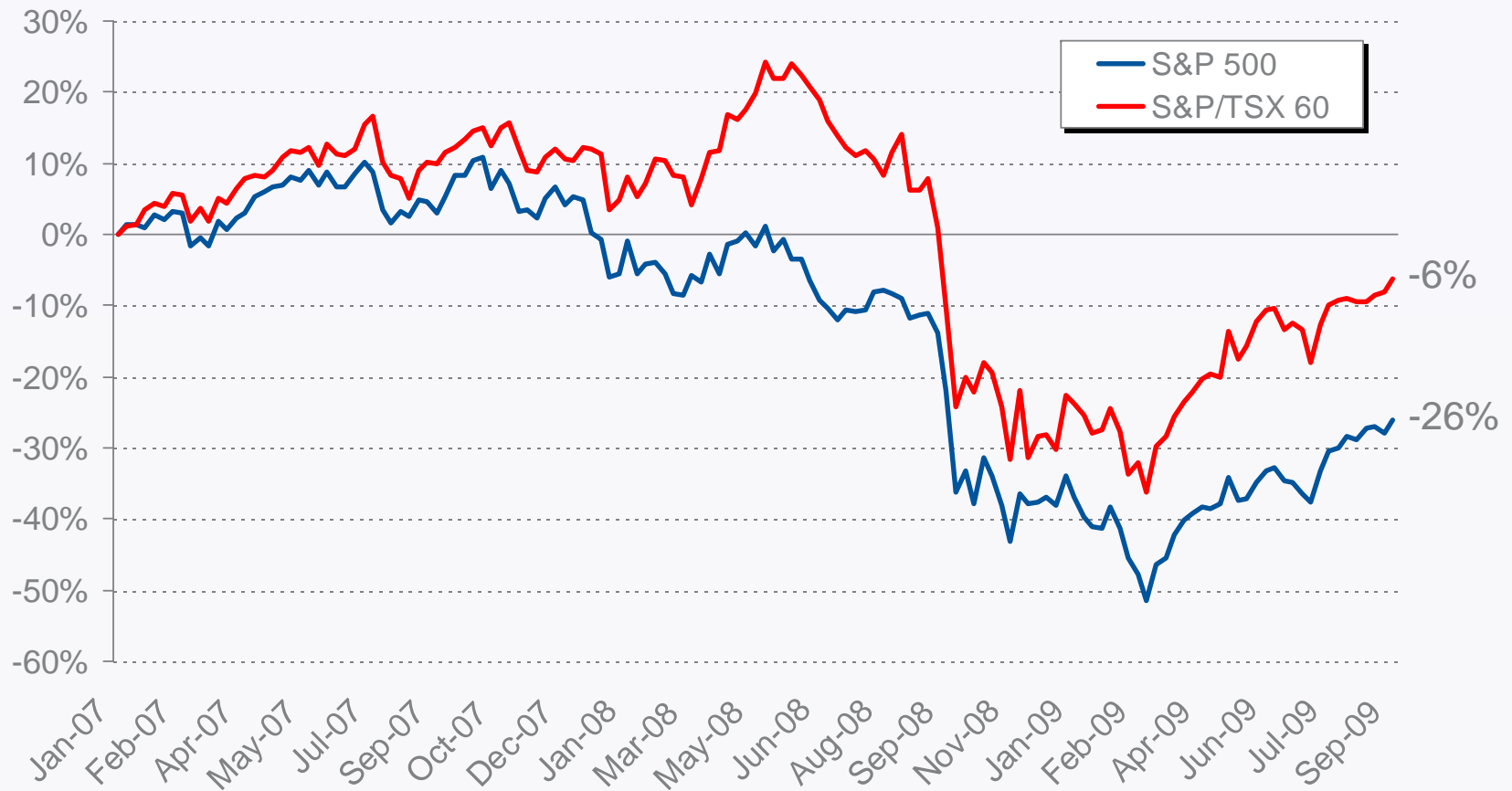


Agenda

- Review the experiences of Operations professionals in navigating the financial crisis
 - Highlight feedback from United States and Canadian market participants
- Identify major themes that emerged from client interviews
- Considerations on how we will move forward



Canadian Markets have not see the losses that the United States has

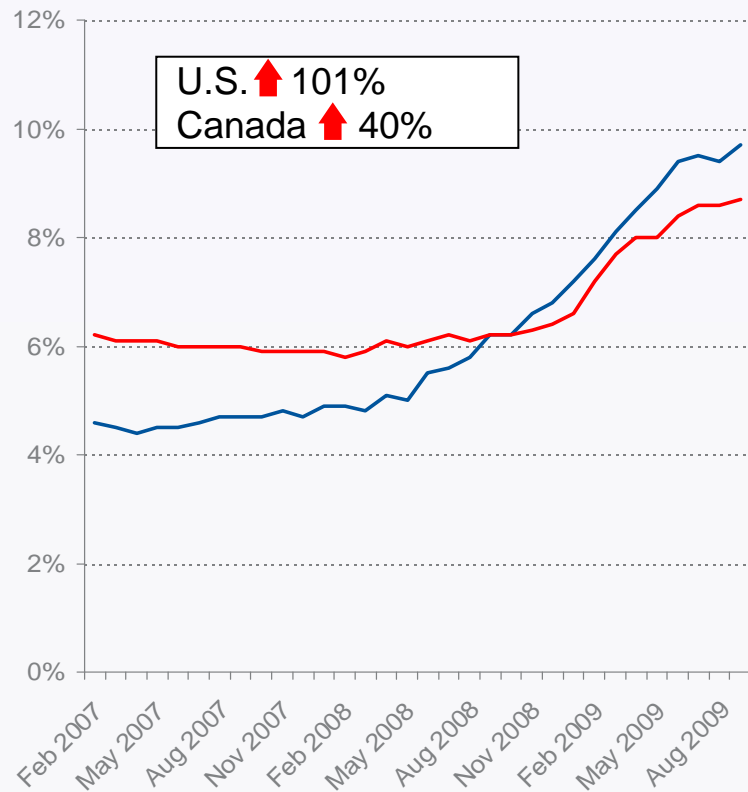


Source; Yahoo! Finance, data through 9/8/09

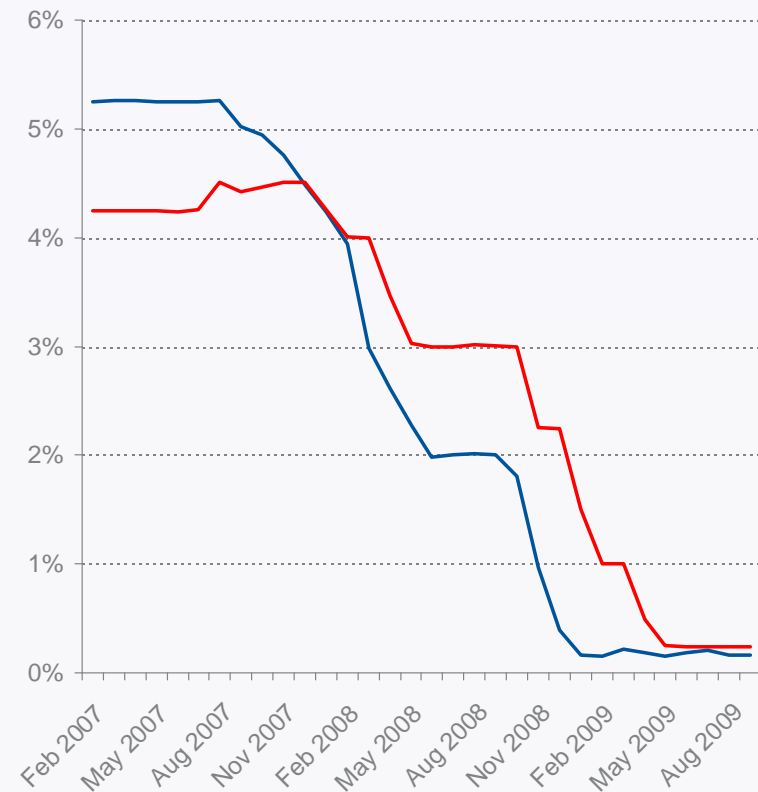


However, economic conditions in Canada have suffered significantly

Unemployment Rate



Benchmark Lending Rate



— Canada

— U.S.

Source: StatCan, BLS, Bank of Canada, U.S. Federal Reserve



No Canadian banks failed and most weathered the crisis well

Top 10 banks in North America (Q4 07 versus Q2-09)

| Q4-2007 | | | Q2-2009 | | | 2007-09 % Chg |
|---------|-------------------------|----------------------------|---------|-------------------------|----------------------------|------------------|
| Rank | Institution | Total Assets (US\$ 000) | Rank | Institution | Total Assets (US\$ 000) | |
| 1 | Citigroup | 2,187,631 | 1 | Bank of America | 2,256,059 | 47% |
| 2 | Bank of America | 1,715,746 | 2 | JPMorgan Chase | 2,026,642 | 39% |
| 3 | JPMorgan Chase | 1,562,147 | 3 | Citigroup Inc. | 1,848,533 | -17% |
| 4 | Wachovia Corp. | 782,896 | 4 | Wells Fargo* | 1,284,176 | 138% |
| 5 | RBC | 627,732 | 5 | Goldman Sachs | 890,137 | n/a |
| 6 | Wells Fargo | 575,442 | 6 | Morgan Stanley | 676,957 | n/a |
| 7 | Toronto Dominion | 441,993 | 7 | RBC | 573,093 | -9% |
| 8 | ScotiaBank | 429,776 | 8 | Toronto Dominion | 501,512 | 13% |
| 9 | Bank of Montreal | 384,044 | 9 | ScotiaBank | 447,424 | 4% |
| 10 | CIBC | 358,223 | 10 | Bank of Montreal | 382,505 | -0.4% |

Note: Wells Fargo increase includes assets of Wachovia which it acquired
 Goldman Sachs and Morgan Stanley became Bank Holding Co's as a result of the crisis
 Source: Company information, FFIEC



Postcards From the Edge...

Six key themes identified:

- Planning & Prioritization
- The Role of Operations
- Relationships
- Risk & Regulation
- The Changing Business Model
- Emerging as a Stronger Industry



Key Themes: Planning & Prioritization

- Continue to invest, but invest smartly
- “Run the firm versus Change the firm”
- Tackle the *low-hanging fruit* with a quick ROI now, defer the longer ROI’s until later
- Don’t forget about the longer term: 3-5yrs
- Find points of connectivity across the franchise, leverage your buying decisions
- Invest strategically to capitalize on competitor’s weaknesses
- In the absence of money and resources, conduct more thorough analysis today.
 - Think about how you’ll spend the money when it comes back

“Monetize your hobbies, or get out”

“Knee-jerk was to hunker down, but as things have relaxed a bit, we’re thinking about opportunity again.”

“Focus on what you do best”

“Focus on talent and leverage people effectively”



Canadian Perspective: Planning & Prioritization



- Firms continue focus on long term strategies
 - Most strategies haven't changed, but analysis & decisions have been revisited, policies have been revisited
 - *"We didn't really change (our focus), but we sure did review."*
 - Some priorities changed in order, but strategic focus remained the same— no increased focus on "low hanging fruit"
- Firms did make tough budget decisions
 - Budget: review, review and review again
 - For quick ROI, *"cut everything"*, then negotiate cost reductions with vendors
- Firms acknowledged "certain may not be that certain"
 - A new reality: things we did yesterday we can not do today
 - To limit risk, stringent client take-on processes and annual risk rating processes must continue
 - Looking even more closely at operational risk
 - Focus on delivering a robust control environment



Key Themes: Role of Operations

- Increased presence in many firms, although already highly regarded in some
- In some firms, Operations is already involved in the sales process
 - Prospects want to know about policies & procedures, pricing practices, issue resolution, etc.
- Heightened concern on fails and any potential risk due to volatility
 - Shorten any outstanding items!
- Seen as stewards of critical data that feeds all downstream systems

“Front Office has increased the “value” of Operations; they care about post-trade because it impacts their ability to sell”

“Business believes that no items should be outstanding”

“We leveraged our past automation efforts and we’re glad we made those investments when we did.”



Canadian Perspective: Role of Operations



- Operations was always important, even more so now
 - Increase efficiency: As execution costs come down, operational costs become a higher portion of overall costs – efficiency gains are beneficial
 - Think about the future: Focus on continuing to build systems/programs to support future growth
 - Drive satisfaction: As returns diminish, operations is an important driver of client satisfaction (ability to give admin items – reporting, websites)
- Firms did not see significant operations personnel losses
 - *“Operations is the last place right now that you would want to let people go”*
 - In some departments, opportunities for cross training
 - Firms are probably more operationally sound now – more effective and efficient
- Firms focus on greater operational due diligence (and clients are demanding this!)
 - Clients are asking *“where is my \$, who controls it, and where does it sit?”*
 - *“Crossing t’s and dotting i’s a little more”* around credit risk assessments
 - Changing counterparties as appropriate



Key Themes: Relationships

- Counterparty risk measurement is a critical capability now
- Firms are carefully scrutinizing all service providers
- Review of contracts and terms surrounding legal protection have taken on new focus
- New outsourcing and/or off-shoring projects are a tough sell right now due to cost and political sensitivity, but extending existing relationships may be feasible
- Firms are analyzing product profitability and considering scrapping unprofitable products
- Brokers are considering selective pricing based on client profitability to deter manual clients

“We’re constantly looking at exposure to partners, but we’re careful about the perception of making any changes [which might move markets]”

“Custodians have cut back as well and managers can’t necessarily fill in the gaps.”

“No change in our vendors, unless they’re related to a bank.”



Canadian Perspective: Relationships



- Counterparties are seeking more transparency around operational efficiencies as margins shrink (efficient firms will be rewarded!)
 - As margins shrink, costs around execution and clearing of a trade will be passed on to the customer
 - Firms will start to look more closely at time to settlement and “*which clients are costing the most money*” – differential pricing is absolute possibility
 - Clients are also asking for statistics on settling and clearing trades.
- Tiered pricing is here and will grow
 - Sell side continues to pressure buy side to become more efficient
 - Tier pricing is here, especially around some instruments, i.e. money markets
 - Custodians starting to differentiate on trade processing charges, and reward those who process electronically
- Folks are leery about “all of the eggs in one basket”
 - Outsourcing interest continues to grow especially around the middle and back office
 - View outsourcing as a way to reduce costs and manage risk



Key Themes: Risk & Regulation

Risk

- Systemic risk moved to the forefront
- All firms have to manage increasing activity levels versus decreasing headcount
- Focus on reducing fails and time to resolution
- Paying more attention to valuations
- Considering risk in all service providers; custodians, counterparties, prime brokers, tech. providers, etc.

Regulation

- Impact of TARP on banks future
- Main Street's perception of Wall Street's compensation model
- Madoff fall-out; good for custodians and hedge fund administrators
- Hedge fund registration and regulation are coming; but to what degree of severity?

“Efficiency has taken a back seat to risk”

“We’re not able to scrutinize breaks as closely, which is creating new risks”

“The impact of TARP restrictions on our business will be enormous”

“Regulation is expensive and time-consuming to comply”



Canadian Perspective: Risk & Regulation



- Firms agree that regulation is necessary
 - Some believe stringent existing Canadian regulations “*made it difficult to get in the US game*”, and as a result protected them
 - However, believe stringent regulations can hinder growth of the industry
 - Need to find balance between new regulation and what it will take to institute and oversee the regulation – at what cost?
 - Like many, believe hedge funds and OTC derivatives are key focus areas
- Firms disagree on whether a systemic risk regulator is necessary
 - Buy and sell side firms agree that a systemic risk regulator is needed in Canada
 - Canadian firms want to compete on an even greater global scale
- Unrealized risk is more important than before
 - Firms are seeing a lot more planning and scrutiny
 - Assessing client exposure and seeking more transparency
 - “*How certain is certain?*”



Key Themes: Changing Business Models

- Brokers' change to bank holding companies
- Boutique-ization of the industry and emergence of 2nd tier brokers
- Coupled with compensation challenges, these will create a shallow bench of talent
 - How will this impact the future of the firm / industry?
- Hedge funds simplifying, closing down risky, complex product lines
- Change in prime brokerage model, however clients' fundamental needs still exist
- Custodians seeking to capitalize on competitors' weaknesses (including prime brokers')

“There will be more consolidation in the industry coming”

“Just the top dogs will win”

‘Boutiques and 2nd tier players are taking on a bigger role’

“Hedge funds won't be abandoned, assets will return – but they'll concentrate with the top players”



Canadian Perspective: Changing Business Models



- Custodian perspective
 - One stop shopping remains highly important – do not predict changes there
 - Industry will continue to consolidate, with many new acquisitions
 - Capital erosions from 2007-on slowed acquisitions, but is expected to rebound
 - Predict 4-5 super custodians in the world
- Buy side perspective
 - “One sizes does not fit all”; sees the big vs. small IM gap growing
 - Sophisticated investors may not want one stop shop, in favor of increased customization and expertise
 - Unsophisticated investors may turn to the one stop shop, if not willing to pay for it
- Sell side perspective
 - See boutique- ization already happening & continuing in the future
 - In the short term:
 - Also predict a period of consolidation and acquisition



Key Themes: Emerging as a Stronger Industry

- Managers “in the trenches” will uncover new solutions to problems
- Managing reputation is critical
- Opportunity to identify the company’s “pianos”
- Future will be less volatile, sophisticated and complex; lends itself to standardization, and automation
- Industry collaboration on best practices
- Attitudes and values of the industry and of individuals have changed... time for insightful thought
- Only way to get people back to industry will be to evaluate the values of the industry, ie, What does “fiduciary” really mean to us?

“Focus on personnel, invest in HR, if you have to cut 20%, keep only the best staff”

“What will emerge will be smaller, but stronger and more competitive”

“Whoever can supply the most information to clients in a timely manner will win”

“You have to think differently, you can’t do the things you used to do”



Canadian Perspective: Emerging a Stronger Industry



- “Greed isn’t a good model”
 - Do not believe the industry is particularly focused on “greed” model overall
 - But some still see pushing products on unsophisticated investors
- Canada has emerged well from this crisis...
 - Believe the market has gained credibility on a global scale
 - Seen as more restrained, having robust systems
- ... But there is still more to do
 - On-going opportunities for firms to show they have good, efficient risk management processes
 - Not only effectively manage risk within own firm, but also manage on behalf of clients
 - Seek opportunities to bring costs down – stay nimble
 - Deferred compensation models
 - Conduct analysis/intricate financial models to determine what happened
 - *“We can’t stop running before the race is done”*



To Learn More

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