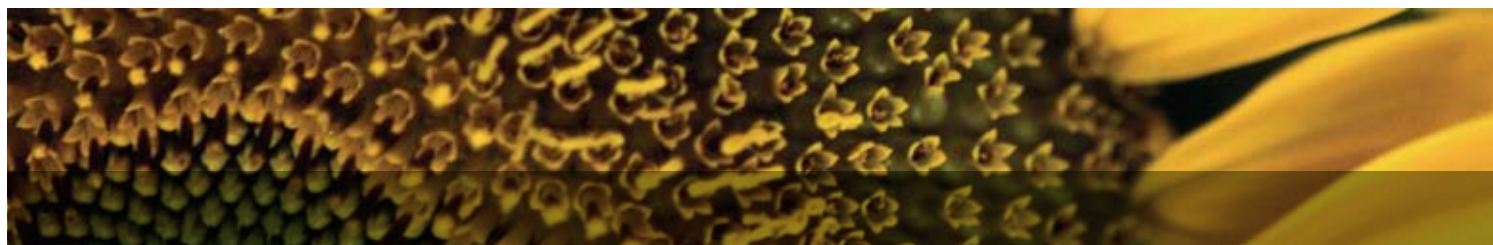


European Pension Funds



BNY MELLON
ASSET SERVICING



Newsletter for Pension Funds

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Welcome



Mark Bewick

Welcome to the first Pensions Newsletter of 2009. This year continues to generate new challenges for the markets in which we invest.

In this issue we have brought together a range of perspectives on the economy, our company and the products and services we offer which may be of both tactical and strategic benefit to your scheme. We are grateful to our clients who have taken the time to offer the benefits of their experience in the areas of corporate governance and investment strategy. We are also pleased to be able to share with you an interview with Bob Kelly our Chairman and Chief Executive Officer. In addition there is an insight into the dawning of a new era in securities lending - topical given Chris Hitchen's remarks at the 2009 Occupational Pensions Defence Union (OPDU) annual conference in London, "Don't abandon your securities lending programmes. Having stock to lend and borrow is crucial for efficient markets." The first quarter of 2009 has shown that a number of our clients are in agreement with this sentiment having re-entered their schemes into The Bank of New York Mellon lending programme.

As we go to print, I am delighted to be able to announce that we have just won six new awards - 'Custodian of the Year' and 'Transition Manager of the Year' from Global Pensions. In addition, we won top rated Awards for Excellence in the following surveys from Global Custodian: 'Global Custody', 'Agent Banks in Major Markets', 'Mutual Fund Administration' and 'Securities Lending'. We are honoured to have received these awards and thank you for the support and confidence you have shown in The Bank of New York Mellon.

Mark Bewick
Editor
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An Interview with Bob Kelly, Chairman and Chief Executive Officer of The Bank of New York Mellon Corporation



Bob Kelly

Strength and stability are today viewed as the most vital attributes that any financial organisation can possess...

Absolutely. A strange thing happened in the last [Q4 2008] earnings season: the market didn't really focus on earnings at U.S. banks. Given the toll that securities write-downs are taking, the question on the minds of investors and analysts was whether banks have enough money. And in our case, the answer is a resounding 'yes'.

Our Tier 1 capital ratio – the ratio of an institution's core equity capital to its total risk-weighted assets – strengthened to 13.3%. 6% is considered well-capitalised. In addition, many institutional investors are focusing more on a company's tangible common equity (TCE) ratio. A percentage of total assets excluding goodwill and after securities write-downs, the TCE ratio is viewed as a more conservative measure, and despite the very difficult environment our TCE ratio has risen to 3.8%.

As it transpired the markets agreed with our positive view. Following our fourth quarter earnings announcement, our stock price went up and all four ratings agencies reaffirmed our debt ratings – which, I should add, are far better than most financial institutions in the U.S. Meanwhile, our credit ratings remain strong. Moody's rates our senior public debt Aa2, the highest rating among U.S. financial institutions and our deposits Aaa, the only US bank with this rating, while our S&P rating was upgraded last year to AA-, the second highest rating among U.S. financial institutions – and we were the only major U.S. financial institution to receive such an upgrade in 2008.

So, when you marry this financial stability to our diversified business model it is clear we are ideally placed to benefit from the flight to strength we are seeing on the part of clients.

The word 'liquidity' is never far from anyone's lips these days...

Indeed, and we are in the fortunate position that we remain highly liquid, as our company is

funded primarily by deposits from our institutional businesses. At the end of 2008, we had over US\$100 billion in cash and short-term investments. Over the last few months of last year we attracted an elevated level of deposits, which illustrates the high level of confidence our clients have in us.

How did you come to be involved in the U.S. Capital Purchase Programme (CPP)?

It is important to note that the business model of The Bank of New York Mellon is very different from a traditional retail or commercial or investment bank. In contrast to most of the large U.S. banks, our business model does not focus on the broad retail market or products such as mortgages, credit cards or auto loans. Nor do we even do typical lending to corporate businesses. Rather, we are a 'bank for banks'.

Given this specialised focus, we were not involved with underwriting sub-prime loans or structuring the complex investments that contributed to the current market turmoil. At the time the CPP was initiated, The Bank of New York Mellon was a profitable, well-capitalised institution – and remains so today. Indeed, we were profitable every quarter last year.

In October 2008, when the Treasury allocated to us US\$3 billion of the US\$350 billion that it has allotted to date, the financial markets were very dangerously in total gridlock and deteriorating rapidly. The global credit markets were essentially frozen and the U.S. financial system was on the edge of a precipice.

We understood that a key goal at the time was to have a range of institutions, including relatively healthy companies like The Bank of New York Mellon, participate in the CPP, removing any stigma that might be associated with accepting Treasury capital and helping reassure the markets of the stability of the financial system. So, we immediately decided to participate. And we believe the capital investments – along with the many other steps that the U.S. Congress, the U.S. Treasury and the

U.S. Federal Reserve took during the height of the financial crisis – have helped the markets to begin to slowly emerge from the extraordinarily precarious position they faced back in October.

What does that involvement in the CPP entail?

The formula is straightforward. In exchange for the US\$3 billion investment, the U.S. government received preferred stock and warrants and The Bank of New York Mellon agreed to pay the government US\$150 million a year in dividends until we repay the US\$3 billion.

Since receiving the investment four months ago, we made our first payment to the government and immediately put the capital to work consistent with the goals of the programme

whose proper functioning is fundamental to the flow of credit for the U.S. economy. By adding liquidity there, we're helping direct lenders generate the funds they need to offer more loans. And, by extension, we're helping to lower the cost of borrowing for consumers and corporations.

What do you think of the idea of removing toxic assets from 'good banks' and transferring them to a newly capitalised 'bad bank', which would hold the troubled securities, identify the bad loans and then pay back investors over time?

I've been a big believer for a long time that the way to end this banking crisis is to get the toxic assets off the balance sheet, and I've been a proponent of creating some kind of 'bad' bank to facilitate that. The Bank of New York Mellon would certainly look

It is important to note that the business model of The Bank of New York Mellon is very different from a traditional retail or commercial or investment bank.

as we understand them, which is to increase lending, restore market confidence and get the U.S. economy moving again.

The US\$3 billion in capital that we received from Treasury has allowed us to do more than we otherwise could have to improve the movement of funds in the financial markets. We've purchased mortgage-backed securities and debentures issued by U.S. government-sponsored agencies to help increase the amount of money available to lend to qualified borrowers in the residential market. We've also purchased the debt securities of other healthy financial institutions, which has helped increase the funds available for them to lend to consumers and businesses. And, we've used some of the capital for interbank lending to other healthy financial institutions to help them increase their liquidity, funding and stability.

These activities are consistent with our business model and are primarily in the secondary markets,

very seriously at participating in such an initiative.

So are we out of the woods yet?

We still have a long way to go to get the credit markets – and the U.S. economy – functioning properly again. Bank capital must be rebuilt, low-quality assets must be sold or written off, sound lending must occur and confidence in our system must be restored.

The Bank of New York Mellon will continue to do all we can to help expand the flow of credit in this extraordinarily difficult environment. We are, and will continue to be, transparent about the use of these funds. We're focused on always retaining the public's trust and we will ensure The Bank of New York Mellon returns the US\$3 billion to the U.S. Treasury and delivers a very good return on that investment. ➤

Responsible Investment in a Credit Constrained World

Ian Burger, Director, Newton Investment Management



Ian Burger

During the past six months, the world has witnessed an unprecedented change in the financial markets. The end of cheap credit in developed economies, for both consumer and company, will have far reaching consequences on future capital expenditure within the corporate world. As a result, fund managers across the world are realigning portfolios and reconsidering the future drivers of growth.

Given recent market conditions, there has been much debate from the corporate governance and socially responsible investment industry, as well as from companies and clients, as to the future role or emphasis of environmental, social and governance (ESG) considerations within the investment debate.

As a result of the inability to access credit, a wave of cost cutting measures and restructuring is occurring within many businesses.

Companies look set to withdraw investment in areas considered less critical to growth or survival. What remains to be seen is whether corporate responsibility will be an area which can be sacrificed. Does this really matter? As a responsible investor, the answer has to be yes and now more than ever.

Companies that continue to identify and manage business risks holistically, such as the risk to reputation of poor ESG management, should ultimately survive and could be the beneficiaries from the economic downturn. We have explored briefly how this may work through a number of responsible investment themes.

Board balance: The right board members, consistently evaluated, are crucial to the long-term success of a company. Shareholders need comfort that their company is being managed in their interests. This can be hindered by the appointment of non-executive directors who are affiliated to the company in some way or non-executive directors that do not possess the necessary skills, knowledge and experience. In addition, the adoption of a well considered

succession planning policy and process is essential to the sustainability of a company. It is necessary for any successful succession planning policy to cover all board positions and those senior positions below the board. The ideal board is one that allows its executive directors to act in an entrepreneurial manner within a closed circle of risk control.

Cost savings: A further reason for ensuring that environmental and social risks are well managed is the financial benefit that can be achieved through cost reduction over the longer term. There can be significant savings made by companies that reduce the amount of raw materials or cut usage of water or energy in commercial operations. A few years ago, when Anglo American, the mining company, announced free anti-retroviral drugs for employees and family members in Sub-Saharan Africa, some investors suggested that it was a misuse of shareholder money. The company has subsequently gone on to demonstrate that the benefits of the scheme have outweighed the costs of replacing staff and having work lost as a result of illness.

Remuneration: A common criticism of companies and their contribution to the severity of the world-wide economic slowdown has been the structure of companies' variable remuneration arrangements. A well managed remuneration structure has many benefits; it will not reward or incentivise unnecessary risk taking, it will align the interests of the recipients with shareholders' long-term interests and it will only remunerate if the company has performed well for the long-term benefit of its shareholders.

Climate change: As a key theme for socially responsible investment, climate change remains a pressing issue for governments. The cost implications for heavy industry in a carbon constrained world are unlikely to abate and companies need to continue to adopt sound environmental policies in this area. Over time, even if economies across the world slow down

or shrink, populations themselves will continue to grow. The UN has forecasted an additional 1.8 billion people across the world by 2030 (from 2005 levels), with 90% of this growth occurring outside the developed world. Demand for goods, services and particularly energy resources will ultimately grow, albeit at a slower pace in the near-term.

Licence to operate: A responsible global company has the ability to gain a competitive edge. For example, global mining companies often have to consider exploration in poor and developing parts of the world and compete with each other for a licence to operate in these areas. A cash strapped government may prefer to grant access to its natural resources to well managed companies that provide community development in addition to the normal tax revenues. At the same time, these areas are often rife with conflict. By ignoring the security and community issues around a company's operations, the risk of attack on facilities and staff increases. This could disrupt business operations, reducing profitability and add additional security costs.

Communication: Managing stakeholder expectations and clearly communicating business strategies and performance is a fundamental role of management in gaining stakeholders' confidence and ultimately their support. Not only is this important in good times, it is arguably more important in more difficult times. From a company's perspective, it also means that its share price will better reflect the company's true value and give a truer picture of its Total Shareholder Return (TSR). This is an incentive for many companies given that TSR is a common feature of performance conditions governing the vesting of share-based incentive awards. Additionally, the company could be in a stronger position should it need to raise additional capital.

Cost of capital: Investors and companies do not, or at least should not, focus resources on corporate governance matters purely to appease

their stakeholders and 'tick the box'. Much is lost if the letter of corporate governance is applied whilst the spirit is ignored. This is true for both the company and the shareholder. Through the adoption and disclosure of good corporate governance practices, companies should be able to benefit from a lower cost of capital. This could be very welcome in the current financial climate.

Increased legislation: Governments will be sensitive to the political considerations of providing finance to companies. They will not wish to be seen to be providing financial support to companies behaving in an irresponsible manner. Those companies considering the wider societal impacts of their operations will be better placed to meet increased government demand and regulation, which could offer a competitive advantage. In addition, those companies with functioning and accountable risk management operations will be best placed to stave off government intervention.

Supply chains: During these economically uncertain times, the survival of company suppliers has a fundamental impact on a company's own survival. Companies that constantly squeeze the margins of their supply chain could put a supplier's economic viability at risk. Ensuring the survival of supply chains, through fair dealings, prompt payments and fair worker conditions, makes sense in ensuring a sustainable source of raw materials, products and services. In addition, the balance of power may shift in favour of suppliers. As the number of suppliers decline, those suppliers that remain may have the ability to be more selective with whom they deal and opt for those customers with considered supply chain policies.

Commitment to responsible investment

Despite the market turmoil, investors should continue to believe that ESG issues remain an important indicator of good company management. The United Nations Principle of Responsible Investment, to which Newton is a signatory, announced that in October 2008 alone,

Responsible Investment in a Credit Constrained World Continued...

investors worth more than US\$1,500 billion of assets had signed up to the six principles that were launched by the UN in 2007.

This demonstration of commitment supports the belief that asset owners and investors are recognising the benefits of responsible investment. Responsible investment has always focused on the risk to business, be it human rights, labour, corporate governance or carbon emissions. Under these challenging economic conditions, the idea of increased risk management is appealing for investors. This is supported by Eurosif's (Europe's social investment forum) findings that at the end of 2007, European assets managed under a SRI strategy had grown to €2.665 trillion. One of the reasons for this is the increase in demand from institutional investors for responsible investment as an indicator of risk management.

Concluding thoughts

The lack of available credit during the economic slow-down will undoubtedly place pressure on some sustainability strategies. For instance, the drop in the oil price may cause some renewable strategies to be put on hold or abandoned altogether. Given what has already been said about the importance of climate change, this could prove to be short-sighted, as governments continue to address climate change and energy sufficiency through future legislation.

It will remain important for investors to hold companies to account. Responsible investment strategies will continue to focus on board structures, the cost benefits gained from companies managing ESG issues effectively and the alignment of executive remuneration with shareholders' interests. This will add substantially to long term shareholder return. ➤

Important information

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"There is now wide agreement in both financial and government institutions that we should act together to shift the market to greater sustainability. The question is how? Today's event suggested that a big part of the solution is going to be ensuring investors have better standards of due diligence around the entities in which we invest, and that should include assessing the environmental, social and corporate governance impacts of our portfolios."

Donald MacDonald,
Chair of the PRI initiative and Trustee of the BT Pension Scheme,
UN meeting to discuss the financial crisis,
November 2008

Why Manage Currency Risk?

John E. Murray, Head of Fund Services FX Sales, The Bank of New York Mellon



John E. Murray

Why manage currency risk?

Hedging currency exposures is a key challenge facing pension plans today. The last several months of market mayhem resulting in unprecedented currency movements has put pressure on pension plan providers and administrators to have a formal strategy and approach to managing their currency exposures.

Cross border investment has long been an accepted practice for improving the return on pension plan assets and diversification of the holdings. Movement in foreign exchange (FX) rates, however, adds an additional risk factor that must be taken into account when managing the Plan's investment portfolio.

Pension plan managers, who previously may not have had concern about currency movements and had always looked to manage assets based on commercial decisions (underlying assets

of the pension plans investments by reducing the risk of losses from adverse movements in FX rates while allowing the plan to benefit from favourable FX movements. A variety of instruments are used in the overlay programme including forward FX contracts, futures and currency options.

The goal of an active currency overlay programme is enhanced returns. In other words, foreign exchange effectively becomes another asset class in the pension fund's portfolio. If the overlay programme is successful, the pension fund's overall return will be enhanced. The drawback of an overlay programme can be the cost. The overlay fees tend to be similar to fees charged by asset managers. In addition, the overlay manager's product mix (options) can at times be more expensive than those used in a passive currency management programme.

The Bank utilises iHedge, an innovative, internally developed application, to manage outsourced hedging programmes. One of the key features of iHedge is the ability to capture information from external sources in support of third party systems

and investment opportunity), would have increasingly seen the risk in currency exposure.

A pension plan's fundamental purpose is to provide retirement benefits to employees of the plan's sponsor. The liabilities of the plan are, therefore, denominated in the currency of the plan.

Approaches to Currency Risk Management

There are two basic approaches to currency risk management, active and passive.

The active approach, often called a "Currency Overlay" programme, has been widely adopted and was designed to improve the performance

The passive approach uses forward FX contracts to reduce or minimise the exposure of the assets of the plan to movements in FX rates. The fees for passive programmes are generally nominal. The cost associated with the hedging is the forward FX points on the contracts plus any "markup" on the underlying FX rates. Generally the markup is only applied to the change in the underlying value of the hedged assets and is relatively small unless there are large movements in the value of the assets.

During recent months, many of these active currency overlay programmes have suffered due to the impact of high market volatility on their option focused strategies.

Why Manage Currency Risk? Continued...

As a result, we believe many plans will be revisiting their longstanding policies for currency hedging.

- Any gains (enhanced returns) through active currency hedging that they may have enjoyed over the last few years during the “bull” market may have been significantly reduced during the recent period
- “Do nothing or do something” i.e. implement a fully hedged passive currency hedging strategy for their underlying currency exposures. Doing nothing, with entire portfolio value exposed to currency gains and losses, in the current environment, is clearly a frightening prospect. Some may consider a more “neutral” stance – 50% hedged and portfolio value is equally impacted by currency gains and losses
- Cost. More efficient (and cheaper) to implement a solution (passive) with their custodian

Over the course of the last six months, The Bank of New York Mellon has seen high levels of interest from pension plans to provide passive currency hedging provision. A passive currency hedge helps to remove the concerns of currency volatility from the Trustees of a pension plan, as it protects the value of the underlying assets

of the fund from currency fluctuation in a fully automated, audited and low cost environment.

At The Bank of New York Mellon, we assist our clients with the design, implementation and administration of hedging programmes. The Bank utilises iHedge, an innovative, internally developed application, to manage outsourced hedging programmes. One of the key features of iHedge is the ability to capture information from external sources in support of third party systems. iHedge is also fully integrated with BNY Mellon Accounting and Custody platforms.

The Bank of New York Mellon has successfully delivered passive currency hedge administration services for its clients for a number of years. We have recently expanded our service capability, and now have a dedicated, centralised team of highly skilled professionals using iHedge. This allows us to deliver hedge administration services to our clients, consistently and accurately.

We believe we are uniquely positioned to service our clients during these challenging and troubled times. 🌐

For further information on iHedge, please visit <http://gm.bankofny.com> and click on the Interactive Tours link. When prompted, enter User Name “interactivetour” and Password “tour2009”.

Securities Lending: Evolution After the Storm

Rob Coxon, Head of International Lending, BNY Mellon Asset Servicing



Rob Coxon

The turbulent market events seen in Q4 2008 – which saw the collapse of Lehman Brothers, the introduction (and, in some cases, subsequent removal) of various short selling restrictions around the globe set against ongoing market volatility and global uncertainty – mean that only now have many pension funds been able to pause and reflect on the state of the markets, and properly assess the impact on their activities.

Not least among those activities is securities lending. Traditionally lending has been viewed by pension funds in particular as a low-risk method of enhancing returns in an ever more competitive environment where every basis point counts. However, recent events have prompted some funds to make adjustments to their programme or even withdraw from lending altogether.

Pension funds' concerns around lending were triggered by a number of factors, not least the short selling restrictions introduced in the UK in September 2008 in a bid to prevent markets going into free-fall after the Lehman bankruptcy precipitated a marked decline in major market indices.

It is now generally acknowledged that these restrictions had no discernable impact on the behaviour of stock prices, declines in which were attributable to many factors including the decision by fund managers to sell securities within their portfolios. However, it was noted by independent analysts that securities prices became more volatile and the cost of financing increased while the bans were in effect. In part, that cost increase has been down to a tightening in the supply of lendable securities as lenders backed away from programmes.

It is worth noting that former SEC Chairman Christopher Cox is on record as identifying the biggest mistake of his tenure as his approval in September 2008 of a three week ban on short selling of financial company stocks – a decision

reputedly made under intense pressure by the US Treasury and Federal Reserve.

Unfortunately, political interference in the operation and regulation of the markets is a theme repeated in the UK – we heard Lord Turner, Chairman of the Financial Services Authority, state in evidence to the Treasury Select Committee in February that the government had exacerbated Britain's banking crisis by pressuring City watchdogs into 'light touch' regulation.

Another concern for lenders was the Lehman bankruptcy and the risk of loss it presented. In most cases, lending agents were able to replace defaulted securities from the available collateral with relative ease, and the general view is that the market actually coped extremely well. Lessons have been learned, however, and this experience has led to a further tightening and review by lending agents of risk controls and management processes.

One thing is very clear, post Lehman, and that is that an increased diversity of collateral profile makes assets more accessible to a greater proportion of our borrowers, assists in the realisation of greater returns for the lending of client assets and is crucial in minimising the market impact of the work out scenarios that result from major defaults in the markets.

Going forward, we expect that pension funds will demand greater transparency from and regular dialogue with, their service providers, with the issue of asset security being at the top of the agenda. In this respect we are well placed, as we have the highest credit rating of any custodian (as at January 2009) and our lack of market exposure has seen a flight of cash and assets onto our books from institutions with greater market and asset exposure. In an environment where pension funds will struggle to accrue real investment returns, securities lending will continue to play an important role in helping them deliver revenue.

Securities Lending: Evolution After the Storm Continued...

During 2008, our lending model was subjected to rigorous stress-testing under extraordinary conditions and performed extremely well, demonstrating its robustness in the face of market adversity. In addressing the collapse of Lehman Brothers and the subsequent repurchase of our clients' missing securities; we demonstrated the transparency of our processes through delivery of client reporting detailing the return of those securities to the correct accounts.

As financial regulators begin to remove restrictions and the securities lending market regains momentum, clients who continue to lend – or who re-enter our programme – will be well-placed to benefit from any potential constriction in supply arising from a shortage of lendable securities.

We possess the flexibility and commitment to deliver a total lending solution that will generate maximum lending revenue on a client's portfolio via our unique business model. That model uses multiple distribution channels for lending within the parameters of a transparent, well-managed and risk-controlled environment. We believe our

'multiple routes-to-market' approach extracts maximum value from our clients' securities held in over 30 markets for fixed income and equities.

Our programme also employs a risk averse, value-added philosophy. We establish and maintain strict guidelines to monitor all aspects of potential risk and conjunction with colleagues in our Global Collateral Management Division we possess a class leading platform for the management and oversight of a diverse range of high quality non-cash collateral instruments. We add value to our clients' portfolios by focusing on extracting the maximum intrinsic value from on-loan securities and lend only to market-leading international and local market participants.

This ability to tailor our lending platform to our client's needs is a tangible demonstration of our flexible business model and customised approach to each lending opportunity – and a key differentiating factor of our service that will assist our pension fund clients in addressing the challenges securities lending faces in 2009 and beyond. ➤

Short Selling Restrictions – did they have the desired effect?

Restrictions on short selling were introduced in the UK on September 19th 2008. The Board of the Financial Services Authority (FSA) agreed to introduce provisions to the Code of Market Conduct to prohibit the active creation or increase of net short positions in publicly quoted financial companies. Hector Sants, chief executive of the FSA said: *"While we still regard short selling as a legitimate investment technique in normal market conditions, the current extreme circumstances have given rise to disorderly markets. As a result, we have taken this decisive action, after careful consideration, to protect the fundamental integrity and quality of markets and to guard against further instability in the financial sector"*.

The restrictions on short selling of financial stocks expired on January 16th, whilst retaining reporting rules surrounding disclosure of positions exceeding 0.25% of a firm's relevant issued share capital. It appears that the short selling ban did not have the desired effect of preventing share price declines and

that the more prudent approach is monitoring short positions more carefully to prevent cases of abuse. This is an approach broadly in line with the market view that securities lending and short selling are not to blame for stock market declines.

Indeed, the London Stock Exchange commissioned an independent analysis of the ban's impact on the 15 affected stocks within the FTSE 100. Liquidity in the restricted stocks fell by about 10% compared with a rise of 50% in trading volumes in the control sample, and transaction costs rose by 150% compared with the control sample.

A separate study by Cass Business School found that volatility of restricted stocks rose significantly more during the ban than volatility of unrestricted stocks.

Although the short-selling ban was meant to support share prices, during the period of the ban the price of Royal Bank of Scotland fell 84%, Lloyds 65% and Barclays 75%.

Dutch Pension Market Focus - Coping with Investment Strategy - Case Study: Stichting Pensioenfonds van de ABN AMRO Bank N.V.

Pierro de Bonth – Senior Relationship Manager, BNY Mellon Asset Servicing



Pierro de Bonth

Introduction

The present circumstances in the financial markets have put the coverage ratio¹ for most Dutch pension funds under pressure. Pension funds saw precipitous declines in their asset valuations as a result of the great market upheaval. The current market environment and the challenges it presents should be a reminder to plan sponsors that a solid risk framework is critical to pension plan management success. This has definitely been applicable to Stichting Pensioenfonds van de ABN AMRO Bank². The pension fund had to deal with both the market crisis and developments relating to the changing situation within ABN AMRO Bank itself. It appears that although the coverage ratio for the pension fund dropped to a level of 107% by the end of 2008, the damage could have been worse, by another 10%, if the plan had not implemented a 'dynamic investment strategy'. In 2008, the pension fund won the NPN award for 'best practice' investment policy for funds with assets over Eur 3 billion. The fund received the award for the innovative decision making process with respect to their strategic investment policy. This article explains in more detail how this decision process works and how it resulted in the pension fund adopting a dynamic investment strategy.

Decision making

To safeguard pension payments in the short and long term, the pension fund has implemented an innovative decision making process for its strategic investment policy. The innovative character will be explained here as well as the process itself.

As the basis for determining the investment policy, three types of criteria, related to all stakeholders in the pension fund, are presented for ten different investment strategies:

A. Criteria related to the coverage ratio: these consist of such criteria as, among others, the average nominal and real coverage ratio after one year and the chance of a nominal

coverage ratio falling below the 105% after one year

- B.** Criteria related to the sponsor: these consist of, among others, the average annual commitment from the sponsor if after one year the nominal coverage ratio is lower than the required nominal coverage ratio. Another criterion for example is the funded status.
- C.** Criteria related to the indexation ambition: these consist of, among others, the chance of fully indexing on the long term based upon the common inflation perception of 2%.

The decision making process on the strategic investment policy to realise the pension fund's goals is repeated on a yearly basis and consists of four steps.

At first, the investment department together with the investment committee prepares the input for an ALM study. The input is approved by the Board of Trustees.

The second step entails, after approval, that the investment department prepares an ALM study in which all type of investment strategies are analysed. These strategies are all combinations of a matching portfolio and a return portfolio which are described in the next section.

As the third step, the results of the study are discussed with the investment committee. They judge whether the selection is a good reflection of the possibilities to achieve various goals, which will be explained below. Also, a judgement is made on the feasibility of actually implementing the strategies. The result of this discussion is a selection of ten strategies to be presented to the Board.

The fourth step is the actual decision making during a strategic workshop that is organised by the investment department to which the Board of the pension fund is invited. The Board is tasked with deciding on the investment strategy to be

Dutch Pension Market Focus Continued...

implemented. However, during this workshop only the results of the strategies in terms of impact on coverage ratio, consequences for the sponsor and indexation ambition are presented. The 10 strategies themselves are not disclosed during the session. This approach ensures that the Board is focused on their goals and is not distracted by the need to review the investment strategies themselves. Any prejudice regarding investment categories or instruments cannot play a role. For 2008 the Board decided on an investment policy with a high expectation of indexation at the least possible risk. This strategy was a dynamic investment strategy.

Dynamic investment strategy

At the end of 2007, the outcome of the decision making process was that the Board decided upon a dynamic investment strategy. The main characteristic of this strategy is that the amount of risk taken in the portfolio is dependent on the coverage ratio. A clear scheme describes for each coverage ratio how much needs to be invested in the matching portfolio and how much in the return portfolio. And the division over these two portfolios is dynamically managed.

The matching portfolio aims to mimic the return development of the liabilities of the pension fund. This means that the matching portfolio is a minimum risk portfolio with the discounted cash flows of the liabilities as the benchmark.

The return portfolio consists of a variety of categories including equities. This portfolio aims to earn a risk premium above the return of the liabilities.

The division of the investments between the two portfolio types depends on the coverage ratio.

With a higher coverage ratio more risk can be taken, which implies a higher allocation to the return portfolio. With a lower coverage ratio less risk will be taken, which implies lower allocation to the return portfolio.

The big difference to a static approach is that the allocation under a dynamic allocation is determined by risk and coverage ratio, and not by a perception of market movements. In addition, the dynamic strategy works both ways; it can add value both in a downward and upward financial market. In alternating markets the dynamic strategy would result in a more reactive approach and will therefore be less feasible to serve the goals of a pension fund investor.

During 2008 this dynamic approach served the fund well, as risks were reduced at an earlier stage and therefore a bigger decline of the coverage ratio has been avoided. However, this has resulted in a defensive mix of investments. In the first quarter of 2009, the Board will hold their annual workshop again.

Conclusion

By focusing on the goals of the fund instead of on the tools, the Board currently has a clear approach towards taking decisions with respect to the strategic investment policy. The outcome of this decision process last year was a dynamic investment strategy. By implementing this, the pension fund has moved away from the more traditional asset allocation approach in which rebalancing occurs towards a strategic investment mix without having a direct link to solvency. ➤

¹The coverage ratio is the relation between the total value of assets of a Pension Fund versus the total value of liabilities.

²Stichting Pensioenfond van de ABN AMRO Bank has total assets under management of around Eur 8 billion and around 80.000 participants of which one third are active and 20% are retired

De Nederlandsche Bank (DNB) Lengthens Recovery Time From Three to Five Years

Henry Aarts, Principal – Risk Management, Buck Consultants

Introduction

In the Netherlands the lower cover (funding) ratios are caused by the combination of the crash of the stock exchange and the lower interest rate. A lower interest rate leads to a higher present value of the pension obligations.

According to Dutch pension law, pension funds are solvent when the cover ratio is higher than 125%. When the cover ratio is between 105% and 125% it is called a 'reserve deficit' and the pension fund has to make a (long term) recovery plan with a recovery time of 15 years.

The DNB has lengthened the recovery time for a 'cover deficit', which arises when the cover ratio is below 105%, from three to five years.

Recovery plans

A pension fund has two important ways to recover from a cover deficit in five years. Firstly, a financial injection by the sponsor and secondly, a restriction of the indexation of both pensions in payment and accrued benefits not yet in payment.

Postponement of the necessary measures means that the younger generation will have to pay towards deficit recovery at the same time that they have to pay the already growing charges arising from an ageing population. In 2030 the people of age 65+ are doubled from 20% to more than 40% of the people with an occupation.

Pension funds with a 'cover deficit' have until 1st April 2009 to make a realistic recovery plan with a maximum recovery time of five years. J. H. Donner, Minister of Social Affairs & Employment, has

indicated that the DNB will investigate annually to gauge whether the pension fund recovery plans are on target.

The trustees of pension funds will be asked to explain what measures they will take when the recovery is insufficient.

Communication

It is very important that the trustees communicate on time and in an understandable way to the participants of the pension scheme about the recovery plan and measures which are prepared and already taken. For actives as well as inactives it must be clear that the pension fund with a 'cover deficit' needs a period with no indexation and what the consequences are for the accrued, and still to accrue, benefits. Of course when the cover ratio exceeds 105% indexation will resume and the threat of a cut off ceases. ☺



The Bank of New York Mellon Financials

At December 31st, 2008

• Total assets	US\$237.5 billion
• Total shareholders' equity	US\$28 billion
• Tier 1 capital ratio	13.3%
• Total capital ratio	17.1%
• Tangible common equity to assets ratio	3.8%
• Market capitalization	US\$32.5 billion

Our Company

• Assets under custody & administration	US\$20.2 trillion
• Assets under management	US\$928 billion

The PPF Levy - Which Way Forward?

Ian Walker, Technical Services Manager, Buck Consultants

Over the last few months, the PPF has issued a number of pronouncements regarding the near, medium and longer-term future of the PPF levy. Together, these confirm the PPF's previously stated intention to minimise short-term fluctuations in the levy whilst moving in the medium term to a basis that reflects the inherent longer-term risk underlying all defined benefit pension schemes, no matter how strong their immediate situation may appear. Its task is clearly not easy, particularly in the current financial and economic environment.

In many ways it is reassuring that the PPF is maintaining a long-term view. The last thing defined benefit schemes and their sponsors need at the moment is a massive increase in the overall levy bill to fund the undeniable spike in short-term risk that is occurring. In terms of immediate cash-flow needs, of course, the PPF is right that it has sufficient assets to meet anticipated outgo for the foreseeable future, barring a doomsday scenario of total economic and financial collapse. Nevertheless, if the number of schemes falling into the PPF increases significantly in the future, leaving fewer and fewer ongoing schemes to fund any shortfall, there will inevitably be problems.

At the moment, the PPF is still adamant that there is no foreseeable scenario in which benefits under the PPF will have to be reduced. For members, this may be the politically expedient

thing to say but one does have doubts. If nothing else, we have always questioned the rationale of providing 100% of the current value of benefits for members over normal pension age when the employer becomes insolvent, but only 90% of benefits, capped at £27,770 a year, for younger members. If an employer goes bust, there is probably little difference between someone just past retirement age and someone approaching it in terms of the impact on their prosperity in retirement. Of itself, this is probably a relatively minor issue but a significant one of principle nonetheless.

More important is the issue of ensuring that expectations are managed appropriately. To suggest that benefits will be sacrosanct implies either a potentially unlimited ability to call upon a diminishing band of defined benefit schemes for support via the levy, or a belief that ultimately the taxpayer will step in to support the fund if need be. To date, the government have been adamant that they will not act as guarantor of last resort. Whether that is politically tenable after the events of the past few months is open to question.

Returning to more concrete matters, let us review the data submission deadlines:

The table summarises the deadlines for the next two levy years (indicative in relation to 2010/11).

Data submission deadlines for the 2009/10 and 2010/11 levy years		
Deadline	For 2009/10 levy	For 2010/11 levy
31st March 2008	Submission of scheme return data, including PPF valuation information Valuation data will be rolled up to 31st March 2008 Employer insolvency score established	
31st March 2009	Certification/recertification of contingent assets	Update scheme data, including PPF valuation information, on Exchange Data to D&B for employer insolvency score
7th April 2009	Certification of deficit reduction contributions Notification of full block transfer	Notification of full and partial block transfers prior to 1st April 2009
30th June 2009	Final certification of full block transfers	Certification of full and partial block transfers prior to 1st April 2009
31st March 2010		Certification/recertification of contingent assets
7th April 2010		Certification of deficit reduction contributions Notification of full block transfers prior to April 2010
30th June 2010		Final certification of full block transfers prior to April 2010

The longer-term future - accounting for long-term risk

The PPF has expressed the view for some time that there is a mismatch between the risks that schemes pose and the levy that is currently charged. The total levy that it looks to collect in any year is based on an assessment of risk over a number of years and the possibility of claims exceeding average levels: what it calls the unexpected risk. In contrast, the current levy formula distributes the risk on the basis of short-term risk only. Whilst the issue was addressed to some extent last year by using 140% rather than 125% of PPF liabilities as the funding level above which no risk-based levy would be payable, this was seen as a rough and ready short-term fix rather than a more scientific and comprehensive long-term solution.

The proposed such solution is to consider a five-year view of employer insolvency rather than just one-year and to take some account of scheme investment strategy risk.

The objectives are:

- Fairer levy bills, both;
 - over time and
 - at any point in time
- Less volatility in bills
- Maintaining simplicity and comprehensibility in the collection process.

To achieve this, the risk-based levy formula would have two elements:


- One will continue to reflect short-term risk but at a lower overall level and using a scheme-specific factor to reflect investment risk over one year

- The other will be a new element reflecting longer-term risk, using the same basic inputs (scheme funding level and employer insolvency risk) but adjusted significantly to reflect investment and employer insolvency risk under adverse circumstances.

The scheme-based component of the levy will be retained, but not necessarily at the same 20% proportion of the total.

Whilst the change would affect the distribution of the levy amongst schemes, of itself it would have no impact on the overall amount to be collected. That will be decided nearer the time.

Conclusion

The way in which existing defined benefit schemes are called upon to support the PPF levy is of vital concern to sponsors and trustees alike. Both parties would be well advised to monitor the development of the proposals for long-term change, as the impact could be to alter the validity of any levy-reduction policy previously considered or put in place. We will be pleased to assist in these deliberations. 

Additional information on The PPF Levy can be found at: www.buckconsultants.com

Please select the Buck UK web site, publications, Buck Issues

Indicative timetable for implementation of longer-term changes	
Consultation open for comments from stakeholders	Nov 2008 - Feb 2009
PPF policy paper published - sets out Board conclusions following consultation	Late Spring 2009
Scheme data deadline for 2011/12	End March 2009
Consultation on draft levy determination published, including final parameters for 2011/12 levy	Autumn 2010
Development of recommendations for formula parameters and caps, with impact analysis	
Final determination for 2011/12 published	Winter 2010

Economic Update

Neil Mellor, Currency Strategist, BNY Mellon Global Markets



Neil Mellor

One of the more interesting developments in the foreign exchange markets in February was the weakening of the JPY – a currency, like the USD, that has attained a reputation as something of a safe haven through the course of the global economic and financial crisis. Indeed, as USD/JPY raced headlong towards the 100 marker from lows of 88.50, the JPY crosses – the ‘traditional’ acid-test of risk appetite in the foreign exchange market – trended higher just as equity markets plumed fresh lows. Moreover, as things stand, there is every reason to believe that the JPY is destined to remain on this track for a while at least.

Japan’s Ministry of Finance flow data are key to understanding the JPY’s path. After all, there has been a close relationship between net cumulative fixed income flows out of Japan and the path of USD/JPY for some time, and it is noticeable that after a lengthy period of fence-sitting, Japanese investors have once more been delving into foreign bond markets. Figures for the week ending February 19th, show that Japanese investors bought JPY 1.23 trillion worth of foreign bonds – a figure only exceeded over the past four years by the JPY 1.36 trillion worth of purchases the previous week. Whilst the magnitude of this total spend is hardly a rarity, consecutive weeks’ purchases of such magnitude most certainly are, and we have to go back to the autumn of 2001 to find comparable figures.

for the economy grow with each economic report published: take, for example, the machine tools orders data for February which posted an 84.4% annual drop or the Q4 GDP data which showed an annualised fall of 12.7% – its largest in 35 years. Worse, with cabinet office estimates of the country’s negative output gap growing to a seven-year high of 4.3% of GDP, it is clear that a fresh era of deflation looms over the beleaguered economy. Perhaps the most startling data, however, were February’s trade figures which showed a 45.7% annual drop in exports – the largest ever recorded. This speaks not only of the collapse in global demand, but its counterpart in the ‘double-whammy’ – the competitiveness-crunching strength of the JPY for much of the past two years (which has seen it trade more than 10% above its Millennium average). With all these developments in mind, therefore, fears abound that the Bank Of Japan may feel obliged to resort to the printing press.

Meanwhile, the political situation in Japan remains poorly attuned to the needs of an economy in crisis. According to the Mainichi Shimbun, Prime Minister Aso’s approval rating has now plunged to 11% – an historic low for the survey – down from 19% previously, with the recent ‘Nakagawa debacle’ clearly not helping the embattled leader. (We note some tongue in cheek commentaries that suggest this is unfair given that the political situation has helped exporters by weakening Japan’s currency!) However, with the JPY’s status

Figures for the week ending February 19th, show that Japanese investors bought JPY 1.23 trillion worth of foreign bonds – a figure only exceeded over the past four years by the JPY 1.36 trillion worth of purchases the previous week.

To understand why Japanese investors are venturing offshore during a period that is traditionally characterised by fiscal year-end repatriation flows and at a time when bond yields globally are collapsing, is to appreciate the clear risks of the JPY remaining firmly on its present track. Fears

as a safe haven now seemingly at an end – at least for the time being – and with questions over the country’s economic (and to a lesser extent, political) future unrequited, then a weak JPY may also be the story for the second quarter, much as it has been for February. ➤

Nonplussed – How About Non Financial Business Reporting?

Frank Curtiss, Head of Corporate Governance, rpm RAILPEN Investments, and chairman of the International Corporate Governance Network (ICGN) Non-financial Business Reporting Committee (NFBR)



Frank Curtiss

The current global crisis has underlined the limitations of conventional financial accounting in informing investors about the risks they face. There is a need for greater transparency, and better information is critical in facilitating well informed decision-making that takes account of risk and other factors. Increasingly shareowners and bondholders across the advanced capital markets are demanding more developed and sophisticated corporate reporting on non-financial issues. The International Corporate Governance Network (ICGN) believes that improving financial reporting is essential but better non-financial business reporting will also help and published its Statement and Guidance on Non-financial Business Reporting in December 2008 to address this in detail.

My NFBR Committee has worked over the last three years on drafting the paper from the investor perspective rather than that of other stakeholders. It has been through several consultation phases and my colleagues and I are very grateful for all comments received from eminent practitioners and other experts which we believe have strengthened the final version.

We believe that it is a ground breaking step for ICGN to say in the paper that it considers it is part of the fiduciary duty of the institutional investors to take into account broader information on risk and wealth creation. It is all about trying to understand the bigger picture over time and how broader non-financial information can help investors to assess risk more effectively and to serve as some kind of lead indicator. It can, and should be, underpinned, where appropriate by Key Performance Indicators (KPIs) and rigorous metrics where they exist. It can be quantitative as well as qualitative.

We set out in our paper seven aspects of better non-financial reporting. Seven is perhaps a lucky number but this is very emphatically not about encouraging the wild proliferation of irrelevant unmanageable data. It is all about encouraging companies to provide sufficient, timely and

credible information with a clear link to the company's strategy. We think that good non financial business reporting should:

1. Be genuinely informative and include forward-looking elements
2. Be material, relevant and timely
3. Describe your strategy, and associated risks and opportunities, and explain the board's role in assessing and overseeing these
4. Make reporting accessible and appropriately integrated with other information
5. Use key performance indicators that are linked to strategy and facilitate comparisons
6. Use objective metrics where they apply, and evidence-based estimates where they do not
7. Undergo independent assurance to give greater credibility

Governance, environmental and social issues are integral to business strategy and long term value creation and quoted companies need to explain how managing non-financial issues increases shareholder value. Long term success in a complex world is increasingly dependent on factors not generally reflected in financial statements and in some cases, until recently, thought to be well outside the sphere of concern for the company and its investors. Climate change is a good example of this.

However, NFBR is not just about social and environmental issues, important subset though it is. It is also about intellectual capital/human capital and intangible assets and other variables that impact on company performance in the longer term. We have a non-exhaustive list of such issues in our paper in the annex on metrics. These include but are not limited to corporate governance, which is of course a central focus for ICGN, and extend to intellectual and human capital, customer goodwill,

Nonplussed – How About Non Financial Business Reporting? Continued...

reputation, human rights, anti-corruption, suppliers and community relations as well as social and environmental issues.

This brings me to a very significant point. The challenge is very much to integrate this with mainstream financial reporting. We want to build on traditional financial accounting which looks backward and is essentially transaction-based. This is not a criticism – that is what it is supposed to be. It is not really designed to capture the more intangible value drivers. The so-called value gap between book cost and market capitalisation suggests a need to go beyond financial accounting.

Traditional accounting measures may mis-value, or entirely miss, intangible “assets” such as brand value, intellectual property, quality of human capital, organisational capital, reputation, environmental and human rights performance, quality of supply chain management etc. While such assets vary across business sectors, in general they represent an increasing share of total assets in the 21st century global economy. This inadequacy is particularly relevant in a knowledge-based economy in which human capital rather than physical capital is the foundation for value creation.

The signs are that the accounting profession is listening and is not opposed to this. After all, the International Accounting Standards Board is looking at what it calls Management Commentary and is treating it as an urgent issue, and we look forward to an exposure draft setting out voluntary guidance in the near future. If adopted, it will be very helpful in encouraging a coherent and consistent global approach.

It is perhaps a statement of the obvious that standardised reporting within and between companies and sectors will assist investor decision-making and comparative analysis. Nor is there any one size that fits all – there will inevitably be different needs for different sectors. For example, reporting

by pharmaceutical companies may include information about the multi-year drug development pipeline whilst retail companies may report on same-store sales.

It is not the ICGN's role to develop metrics for specific sectors. There are many respected initiatives underway across the store and it is not our intention to duplicate this. Our role is to encourage good practice [and we list several highly regarded attempts at guidance and standards in our resources appendix] and to draw attention to areas where current practice could be improved from the investor perspective. We see a potential convening role for the ICGN to advance NFBR and to promote consistency and acceptance and we intend to take this forward over the coming year.

Few companies at the moment adequately explain how managing non-financial issues helps them achieve current and future financial goals. Many jurisdictions in Europe and North America actually require some sort of narrative reporting but sadly much of it is boilerplate and legalistic.

UK firms are getting better at discussing non-financial issues with investors, thanks in part to the Enhanced Business Review reporting requirements under the 2006 Companies Act. Even so, most fail to make the link between their management of non-financial issues and shareholder value. To use the school teacher's old lament it's very much as case of could do better.

Effective reporting is a prize that is not beyond our reach and is well worth grasping. Please do read the paper and encourage companies to read them too and to implement the guidance. Keep reading company reports and encourage improved disclosure and metrics. Praise the good and this could become a virtuous circle in which shareholders and companies, not to mention other stakeholders, all gain. 🍷

Further information on the ICGN, the work of the NFBR and documents referenced in this article can be found at www.icgn.org

Colin's Corner

Congratulations to the winners of the last Colin's Corner Quiz who were Ken Mortimer, BA Pensions; Tim Wilkinson, rpmi and Louis Hazekamp, SFWaterbouw!

This issue provides another topical general knowledge Quiz!

Good luck!

Colin

1. What breed of dog is due to become the White House pet in April?
A. German Shepherd **B. Portuguese Water Dog** **C. Irish Setter**
2. UK interest rates are at an all time low, but who was the Chancellor of the Exchequer when the Minimum Lending Rate reached 17% on 15 November 1979?
A. Geoffrey Howe **B. Nigel Lawson** **C. Denis Healey**
3. 2000 heralded the start of Rugby Union's "Six Nations Championship", but in what year was the "Five Nations" born when France officially joined the competition?
A. 1908 **B. 1909** **C. 1910**
4. Gordon Brown became the 5th British Prime Minister to address the US Congress, who was the first?
A. Winston Churchill **B. Clement Atlee** **C. Margaret Thatcher**
5. NASA has launched the Kepler telescope to search for other planets that could sustain life in the Milky-Way, but what was the nationality of the 17th century astrophysicist it is named after?
A. Austrian **B. Swiss** **C. German**



The Bank of New York Mellon in the News

January

- For the second consecutive year, BNY Mellon Asset Servicing was placed first versus its peers in the Global Custodian magazines 2008 Global Custodian Bank Survey. The bank received the highest number of 'Top-Rated' recognitions and 'Best in Class' awards in the survey league tables.
- BNY Mellon Asset Servicing has launched Islamic Fund Services, an expanded suite of fund administration solutions for European collective investment funds that is designed to meet the specific needs of Shari'ah-compliant portfolios.
- BNY Mellon enhanced its over-the-counter (OTC) derivative services in January by providing automated OTC trade affirmation and confirmation to investment managers and financial institutions in the United States and Europe.
- David Asermely, analytics product manager, won The Spaulding Group's prestigious Peter O. Dietz award for excellence in performance measurement writing for his white paper "Long/Short Portfolio Analytics."

February

- Invesco appointed BNY Mellon Asset Servicing to provide global custody, fund accounting and fund administration services for assets valued over US\$50 billion within a portfolio of 135 funds domiciled in Dublin, Luxembourg and the UK.

- Grail Advisors ETF Trust selected BNY Mellon Asset Servicing to provide comprehensive exchange traded funds (ETF) services for its family of active ETFs. BNY Mellon will supply custody, fund accounting, fund administration, basket calculation, and transfer agency services for Grail Advisor's multi-manager and single-manager strategies.

March

- The 2009 R&M Global Custody Survey ranked BNY Mellon Asset Servicing #1 overall in five categories.
- BNY Mellon Asset Servicing and BHF Asset Servicing GmbH, one of the leading specialists in depotbank and custody business in Germany, have agreed the terms of a new partnership, effective March 1st, 2009. The cooperation will enhance their existing product portfolio, enabling them to continue to offer their respective clients global reach allied with local expertise.
- Global Pensions names BNY Mellon 'Custodian of the Year' and 'Transition Manager of the Year'.
- Global Custodian presents BNY Mellon Asset Servicing with 'Awards for Excellence' in 'the following surveys: 'Global Custody', 'Agent Banks in Major Markets', 'Mutual Fund Administration' and 'Securities Lending'.

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