

# What lies ahead\*

A perspective on the future of the Luxembourg  
Securities Services Infrastructure

June 2009



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# Foreword

The European securities industry is, more than ever, facing a major transformation driven by market needs for more transparency, control and cost reduction of front and back office services. This drive is reinforced by the expected profound changes to the industry triggered by Target 2 Securities (T2S). The Luxembourg financial centre – which is perceived as a key international securities back office platform – needs to consider these fundamental trends and define its model of the future whose aim should be to attract and retain the securities platforms of global financial institutions in Luxembourg.

A strategic review has been undertaken by PricewaterhouseCoopers (PwC) with the objective to evaluate the situation and identify opportunities and conditions to position Luxembourg in the global financial marketplace through an efficient Securities Services Infrastructure.

In order to support this strategic review, a Securities Services Infrastructure working group has been set up with the participation of major players of Luxembourg's financial marketplace, representing a significant share of the funds transactions in Luxembourg.

The present white paper aims to sum up the voice of the market as of June 2009. It highlights the major business trends, the impacts for Luxembourg and the business expectations of the local actors. It also proposes next steps for a revised Securities Services Infrastructure in Luxembourg.

# Executive summary

Important changes are currently taking place in the European securities business arena, driven by regulation (UCITS IV), European integration (ESES, Link Up Markets, T2S) and country initiatives (e.g. French new model combining CSD and “TA light” services). All these changes are in the context of the competitiveness of the European economies (a.o. the Lisbon Agenda) and should result in an increased efficiency of the financial system and consequently in a drastic costs reduction for investors.

Back office service providers will face a general pressure on costs and will need to adapt their business model and organisation in order to stay competitive. As the largest provider of funds-related services in Europe, the Luxembourg financial marketplace is not escaping to this urgent need. Several large Luxembourg players recognise the threats of business delocalisation to other, more price competitive financial centres, which are or have already evolved to new, innovative infrastructures.

While discussions are currently held around the set up of a national Central Securities Depository (CSD) in Luxembourg, which is regarded as important for the market, key stakeholders believe that a wider reflection should be carried out to respond to the issues triggered by the changing international financial landscape.

To meet current challenges, Luxembourg needs to do more than just align with other European domestic markets. Based on its uniqueness in addressing the international cross-border market, our market place can innovate and develop a world class infrastructure in order to be positioned as the prime location for the trade, post trade and administration of securities and more particularly UCI products. This infrastructure must be price-competitive, and needs above all to provide a high level of value added services.

To be effective, market players believe that such an infrastructure should be built in accordance with the following key characteristics:

1. The sustainability of the platform should be ensured through a user-governed model.
2. The distinctiveness of the Luxembourg Transfer Agent (TA) model (cross-border oriented, dealing with complex structures, highly flexible, open architecture) should be maintained and contribute to the new infrastructure.
3. Major efficiency gains can be expected from the standardisation and the commoditisation of transaction processes.
4. The scope of the Luxembourg platform should be international, in terms of both markets (European but also global clients outside Europe) and openness to other infrastructures (open architecture).
5. Current controlled technology is seen as a strong enabler to build the required pieces of the infrastructure in a cost efficient and phased approach.

As a next step, the Luxembourg financial industry needs described in this document should quickly be transformed into detailed, specific user requirements in the context of a transparent business case. These requirements will then be addressed through either existing or to be developed infrastructure. The goal is to provide quickly Luxembourg with a user driven model. Time to market is critical to avoid falling behind neighboring countries and put at risk both business results and employment. To achieve this, we need a sense of unity and common interest with a strong commitment from different key stakeholders to conduct a “projet de place”, sponsored by one neutral organisation so as to ensure project efficiency and quickly bring practical results.

This is a unique opportunity for the Luxembourg financial market place to demonstrate its strengths and expertise and be positioned in the near future as the global centre of excellence for securities, funds administration and custody services.

# Context: New landscape for the European securities business

There are major transformations in the European securities business landscape. The European Commission is setting up a framework to ensure the development of a single securities market for new issues, trading and post trade of securities. The integration of European financial markets aims to provide a common level playing field for the establishment of requirements for the issuance of securities and the reduction of transaction costs between European countries. Today, the post trading cost per domestic transaction in the EU is eight times more expensive compared to the US. In Europe, the cost of a cross-border transaction is two to six times more expensive than a domestic transaction. In the context of this evolution, one can expect a global pressure to reduce middle and back office costs as well as more consolidation in the securities services and custody bank business.

We highlight below the main drivers of the European securities business industry.

## 1. New European post trading landscape

What is today a collection of fragmented European domestic trade and post trading models will soon become an integrated cross-border model.

In Europe, national Central Securities Depositories (CSDs) manage the clearing, settlement and asset servicing of domestic securities. These securities are usually eligible within the CSD under book entry form. Most or the entire security deposit is held within the CSD and allocated through the participants' securities accounts. Domestic transactions are cleared and settled via the local CSD, usually versus payment, i.e. using the participants' cash accounts within the CSD.

Several projects and ongoing realisations are integrating local CSDs under one common platform (Euroclear ESES) or linking them together (Clearstream's Link Up Markets). The Target 2 Securities (T2S) project, supported by the European Central Bank, also aims to set up a global hub for the European CSDs to facilitate clearing and settlement services throughout Europe. This CSD integration means lower cost for cross-border transactions and higher market liquidity for investors. We may also envisage that the post trading and asset servicing services in Europe will be managed by two or three main groups including Clearstream and Euroclear. T2S will serve as the common global hub between European CSDs for the clearing and settlement of securities.

Today, Luxembourg has no direct link with this new European framework. This is an important issue for a financial centre which positions itself as the leader in the administration of cross-border products.

## 2. Regulatory challenges

One of the consequences of UCITS IV is that it will allow more flexibility in the choice of the fund administration location, hence representing an opportunity as well as a real threat for Luxembourg in the case where the marketplace fails to adapt to the new fund distribution pricing and infrastructure.

It is also expected that EU authorities will put more focus on and facilitate the development of new infrastructures in order to achieve, not only cost reductions in cross-border transactions, but also to improve risk management of post trading transactions (OTC market, use of central counterparty to guarantee trades).

## 3. Issuer CSDs: the new listing venues in Europe?<sup>1</sup>

In the context of the future T2S, CSDs will probably propose a new range of added values services on top of the traditional clearing and settlement activities. Among these services, we anticipate a greater focus on services to the securities issuers. CSDs will try to attract more issuers with services such as the support in the management of corporate actions and events (e.g. proxy voting and AGM), securities lending, collateral management, calculation of fees, tax assistance, distribution and marketing of financial instruments data and reporting services. As a consequence, issuers and fund promoters could be influenced by the CSD services offered when choosing a listing venue. In the future, CSDs may benefit from the same market recognition as stock exchanges do today, hence positioning themselves as listing venues with dedicated issuers' services (e.g. management of corporate actions, hold of shareholders' register, link with tax authorities).

1 The "issuer CSD" acts as the central depository for all national securities (securities which have been issued in the country of the CSD) and to which other CSDs have to address in case they want to move those specific securities. The process is performed by keeping a book-entry on all securities accounts of its participants. The "investor CSD" holds an account within the issuer CSD system so as to move securities for which it does not act as a central depository.

# Impacts for the existing Luxembourg investment management industry

The trends described in the previous section represent opportunities but also important potential threats for the Luxembourg financial marketplace.

In the current financial crisis, it appears that the competition between countries will be intensified to attract and retain securities business. While Luxembourg can rely on its long term expertise on UCI products, this will fall short of retaining business locally versus other financial marketplaces proposing a more efficient and less costly fund distribution infrastructure. The cost related to the current operating model is perceived as one of the major threats for the industry by local TAs (source: PwC's TA Survey 2007). This position will be exacerbated by a clear pressure on transaction costs in the future, which also means pressure on the costs related to the securities administration. In the future, one can expect transaction costs to drop under EUR 1, coming from a current average of EUR 9 for an average STP transaction today in Luxembourg (source: PwC's TA Survey 2007).

Moreover, Luxembourg's current TA model is also challenged by new initiatives from neighbouring countries. By the end of 2009, France will propose a unique combination of CSD and TA activities for domestic and foreign funds – including Luxembourg UCITS funds – and Germany is starting to promote a new secondary market distribution for funds (via Deutsche Börse) – also including Luxembourg UCITS funds.

These new distribution models and the new UCITS IV framework can potentially capture part of the current Luxembourg fund administration business and processes. We already observe trends that international financial institutions active in securities services consider the delocalisation of their back office business in one single place. Given the future T2S landscape, this would most likely be in these banks' own country, i.e. outside of Luxembourg. Unless clear actions are taken by our marketplace, this may have direct social impacts and loss of revenues for Luxembourg's key financial actors: custody banks, fund administration and other back office activities. The risk of Luxembourg evolving towards a sole securities and products domiciliation centre without added value business services and products does exist.

# What the market is looking for

## 1. Market needs

Custody and fund administration businesses have been major strengths of Luxembourg's financial marketplace over the past twenty years, both for UCI and debt securities. These strengths contributed to the international dimension of Luxembourg, which is regarded today as a major financial marketplace, particularly for investment funds. Faced with current trends, more and more market players are wondering how to make Luxembourg's current securities administration evolve into a stronger, more enhanced model, which would be able to compete with tomorrow's challenges.

In the context of the Securities Services Infrastructure working group and interviews with key stakeholders of the Luxembourg fund industry, several views on the most critical market needs have been addressed:

1. The set up of a national CSD in Luxembourg and the launch of T2S in 2013 will alter the local financial landscape by integrating Luxembourg into a supranational, domestic-like market composed of European CSDs. In other words, Luxembourg will be competing with other T2S countries not only on administration and custody as it is already the case today, but also on collection of transactions.
2. The interest of the Luxembourg financial marketplace as a whole should prevail when finding solutions.
3. Time to market is essential: a change needs to take place now. Other countries such as France, Switzerland and Germany are already implementing new models, overall competition is increasing.
4. Setting up a new model must be a starting point to providing additional distribution support services. Luxembourg should not just align itself with what is proposed elsewhere, but take this opportunity to differentiate through new, value added services.
5. Luxembourg's ambition should be to cater for funds from several jurisdictions, hence being able to later service the needs of distributors originating from emerging countries.
6. Luxembourg will leverage its unique knowhow and expertise in servicing international cross-border distribution schemes compared to other European countries which have a tradition of serving their domestic market only.
7. High integration of processes is needed: connectivity mainly around front office but also back office processes will be key to attracting distributors and enabling the cost reductions required to align with the global trends.
8. The types of funds to be included in a model could be UCITs funds or other types of UCIs such as closed-ended funds and hedge funds.
9. International groups (representing the majority of banks in Luxembourg) tend to set up pools of expertise on specific subjects, managed from a specific territory. Luxembourg must be well positioned in order to meet the requirements needed to successfully manage these activities.

The general trend is that Luxembourg's financial marketplace needs to come up with a solution that goes beyond the set up of a national CSD, which is mostly seen as a need in the context of T2S. The opportunity of having a national CSD in Luxembourg is currently being addressed by the Luxembourg Central Bank.

The presence of a national CSD for Luxembourg is important and even mandatory in the framework of the T2S project. Nevertheless, setting up a CSD will not instantaneously solve all issues triggered by an evolving international financial landscape.

Indeed, it would simply put Luxembourg on the same level as other European countries. To meet current challenges, we believe that a deeper change should be initiated. Based on its existing cross-border expertise, we are convinced that Luxembourg has a unique opportunity and more assets than other European countries to innovate and develop a world class infrastructure, which will enable the Grand Duchy to be positioned as the prime location for the trade and post trade of UCI products.

Stakeholders also see a threat in proposing to investment funds key market players – who are strong contributors of the financial activity in Luxembourg – a sole model to settle their transactions. Indeed, a unique imposed platform may not be used extensively due to different market practices (TA landscape, presence of two ICSDs), hence leading to a situation where Luxembourg is behind the neighbouring competition in terms of new distinctive services and cost attractiveness. Should Luxembourg fall short of setting up an attractive and distinctive fund infrastructure, it would put the one of the main characteristics of the marketplace, innovation and international serving culture driven by an exceptional variety of clients and competition among specialised global players at risk. The right balance resides in setting up an efficient and price competitive model based on the commoditisation of less value added processes together with an open architecture to other infrastructures.

The objective should be to propose a model that focuses on the following key aspects:

1. Competitive price of transactions and reduced settlement risk: there will most probably be a levelling of transaction costs throughout Europe. It is important that Luxembourg is aligned and stays competitive with other financial centres.
2. High quality of services: this is where Luxembourg needs to differentiate itself from other financial marketplaces in Europe, building on its strengths inherited through years of cross-border fund administration excellence.
3. Maintain a high level of innovation, investment and competitiveness in an evolving global market by allowing all players (TAs, fund hubs, distribution support services, banks) to develop their offering while using the advantages brought by the infrastructure.

## 2. Envisioned model

Stakeholders believe that the CSD and the fund infrastructure issues should be handled separately. Indeed, the main need of the market today is to rely on an efficient and distinctive solution aimed at ensuring the future of the fund business in Luxembourg, all CSD matters left aside. This means ensuring that what is proposed by the market in Luxembourg addresses the needs from distributors.

The following fund infrastructure characteristics have been mentioned as being important:

1. **User-governed:** market players do not want to be dependent on a single operator (private or not) for the essential parts of the infrastructure and wish that the sustainability of the platform be ensured through a user-governed model.
2. **Building on the strength of the existing TA functions:** Luxembourg TAs are distinctive in Europe and are essential in the current cross-border distribution model. The interviewees wish, in their majority, that the distinctness of Luxembourg through its TA model be maintained in the new infrastructure.
3. **Facilitation and standardisation of order routing via a common standard:** major efficiency gains can be expected from the standardisation of the order routing flows. Preference is towards a market-driven response rather than a regulatory one.
4. **International ambitions:** the objective of the Luxembourg platform should clearly be to service fund subscriptions and redemptions from European clients as well as global clients outside Europe (Asia, Middle East and Latin America).
5. **New open and scalable architecture:** current technology is seen as a strong enabler to build the required pieces of the infrastructure in a cost efficient and phased approach. The model should also tend to be as much open to different solutions and other CSD as recommended by the Markets in Financial Instruments Directive (MiFID).

Most stakeholders also insist on the necessity to start from the user requirements, and that the choice of the platform should be made in light of these requirements rather than starting de facto from an existing infrastructure. The analysis of the requirements has not been done thoroughly to date and needs to encompass the whole value chain (from distributors to service providers).

Features of the model can be further stated according to two main categories:

- Back office: central processing of transactions.
- Middle and front office: routing of orders by distributors.

### 3. Back office needs

Due to the undeniable trend towards a decrease of transaction costs, back offices in major financial centres need to adapt, and Luxembourg is no exception. An effort must be made to achieve cost reductions thanks to the centralisation of some back office processes (i.e. clearing and settlement, cash settlement) into a common infrastructure.

This re-organisation of services allows the concentration of liquidity in one place, hence providing an opportunity to enhance or develop value added services such as:

- Collateral management services, that include the process used to control the correspondence between the market value of the collateral and the required value of the collateral. The service will generally also include generation and processing of collateral movements.
- Securities lending and borrowing services to facilitate the temporary transfer of securities from a securities lender to a securities borrower, thereby increasing settlement efficiency. The service is generally performed on a collateralised basis.
- Valuation and fees calculation (specifically for the funds activity).
- Management of corporate actions.
- Treasury management.

### 4. Middle and front office needs

In order to be competitive, any model needs a maximum amount of transactions to be captured. The architecture proposed at entry door level needs to be as open as possible, giving the fewest possible amount of constraints to distributors to route transactions. In other words, the targeted infrastructure should rely on a strong order routing hub capable of capturing a major portion of the international demand, either by plugging in various existing sources of order execution systems and by setting a single format to comply with. Two types of dynamics can be considered:

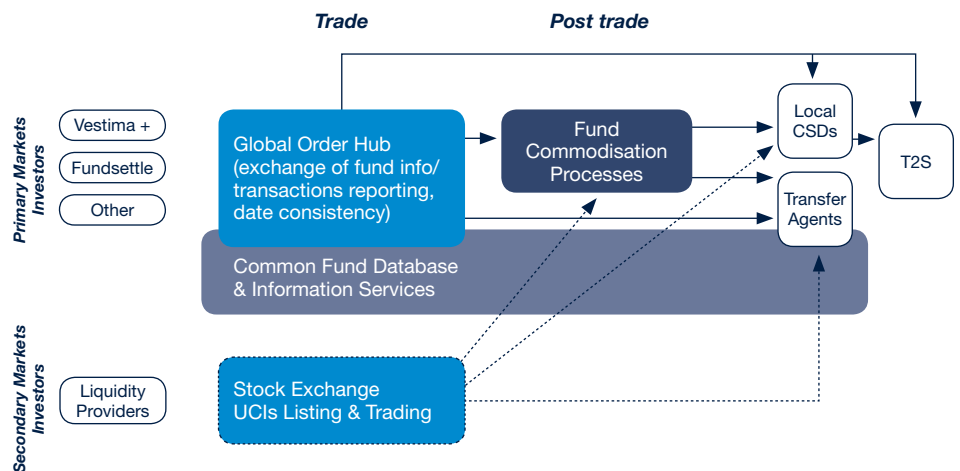
- Orders originating from Europe: Banks remain the dominant network of distribution... They rely on their own systems to initiate orders. Giving easy access to these distributors without the need for them to change their current model is essential, particularly in the current market conditions. If transaction costs can be sufficiently decreased, distributors will face pressure from promoters to use the cheapest route for transactions.
- Orders originating from non European countries (Asia and Latin America), involving a need for extended features such as management of time zones and languages, web-based platforms, etc.

# What to aim for

The high level market needs described in this document need to be detailed in the form of user requirements and business case, highlighting the key elements needed by the new Securities Services Infrastructure over 5 main dimensions:

- **Strategy:** getting the vision right about what's in it for whom, and keeping this vision up-to-date all along the implementation phase.
- **Operations:** getting the functional aspects right.
- **Technology:** relying on modern, scalable, adapted technology to support the infrastructure.
- **Financials:** what are the investments needed, what are the expected benefits?
- **Governance:** who will do what?

The business case should be carried out to also address the contribution, benefits and role of each of the stakeholders of the infrastructure. The main characteristics of the model needs can be built around the following key building blocks:



1. The **Global Order Hub**, is the main entry door to the Securities Services Infrastructure. It does not aim at replacing existing order routing solutions but rather channel their transactions directly to the fund infrastructure. Based on the common fund database, the hub can enhance the consistency and the quality of the orders received and acts as the main reporting platform to provide order solutions with transactional reports and settlement cycle information. The hub complements rather than competes with existing solutions such as Fundsettle, Vestima+, Allfunds Bank, etc. In summary, it handles the following tasks:
  - Unique entry door to the infrastructure;
  - Central point to manage terms of orders acceptance, rejection, processing times and settlement date;
  - Exchange of fund information (Fund Processing Passport - FPP, Simplified prospectus, Key Information Document - KID) and order transactions reporting from/to distributors and TAs;
  - Account registration submission;
  - Open infrastructure to TAs, CSDs and T2S.
  
2. **Post-trade services** in the form of “Fund commoditisation processes”. The “commoditisation” of processes is key to achieve better transactions efficiency as well as cost reductions. Services which could be rendered are:
  - Facilitate the settlement and the cash netting of the transactions;
  - Other post-trading services to be determined in accordance with TA services.
  
3. The **Common funds database**, is the single database where all fund data are shared. This central database provides Fund Information Services, which cover the communication and storage of non-transactional information.  
In summary, it will provide collection and dissemination services for:
  - Daily prices, periodic information (e.g. dividends), savings directive, G-Tax;
  - Prospectuses and financial reports, new fund registration;
  - Fund performance, portfolio (European Fund classification), Fund processing passport (FPP), Key Information Distribution;
  - Consistency of information.

4. The **Transfer Agent services** remain important in order to maintain the flexibility and the management of transactions for more complex products. These services also constitute, among others, one of the key differentiating factors of the Luxembourg model.

In summary, TA services may continue to include:

- Transaction input & processing;
- Calculation of dividends;
- Computation of transaction fees;
- Computation of trailer fees;
- AML/KYC.

We believe such a solution could be set up in Luxembourg if a handful of key players decide to get together so as to concentrate a critical mass of transactions, allowing for cost reduction. Such an approach is seen as more flexible and allows for a scalable implementation. Indeed, services are divided into different blocks leading to flexibility at the implementation level. Adapting this model to the Luxembourg landscape would make it distinctive by its flexibility and efficiency.

The following table sums up the strengths and weaknesses of such a model:

Strengths	Weaknesses
<ul style="list-style-type: none"> <li>• Benefit from a fresh, ex novo solution adapted to market needs</li> <li>• User-owned, user-governed service provider focused on economies of scale rather than profits</li> <li>• Flexibility and scalability in the implementation, with the ability to provide a “quick wins” approach</li> <li>• Fit of the model with Luxembourg’s TA environment</li> <li>• Stronger operational risk management</li> </ul>	<ul style="list-style-type: none"> <li>• Competition with other German or French CSDs will remain</li> <li>• Is this model strong enough to prevent a delocalisation of asset administration and servicing outside Luxembourg?</li> <li>• Potential high IT costs</li> <li>• Governance</li> </ul>

# Recommendations and way forward

## 1. Recommendations

Solutions currently put in place in other countries (mainly France, Germany, Ireland, United Kingdom) will provide securities settlement at competitive prices and support a pan-European distribution scheme above their traditional domestic model.

These solutions may provide as many alternatives to the current Luxembourg model, which largely focuses on cross-border transactions. International groups will most probably use the most efficient solution regardless of where it is located. The time to market dimension is therefore important for Luxembourg in order to define a Securities Services Infrastructure which is not only competitive but also distinctive from other European countries.

We believe that the CSD infrastructure needs to be implemented under the sponsorship of the Banque Centrale de Luxembourg in order to put Luxembourg on the T2S map. However, this long-term approach (2013) should be complemented by an immediate, genuine market driven response in order to propose a world class Securities Services Infrastructure for the industry.

## 2. Way forward

Next steps would require the gathering of a handful of key industry players and experts who can contribute to a more detailed formalisation of the Luxembourg business needs as addressed in this white paper.

The output of this review should enable an objective assessment of the market infrastructure, which can ideally support the best fit for the Luxembourg marketplace's success.

In any case, the following key elements need to be considered today:

- Time to market is very important for Luxembourg in order to agree on business development of a common infrastructure.
- A “projet de place” should ideally support an active development of the fund infrastructure. The “projet de place” should involve the strong participation of different key stakeholders.

This “projet de place” should be coordinated via one neutral organisation in order to ensure project efficiency and quickly bring practical results. It is indeed crucial to rapidly show progress and achievements so as to demonstrate the credibility of the initiative.

This is a unique opportunity for our financial marketplace to demonstrate its strengths and expertise and be positioned in the near future as the global center of excellence for securities administration, investment management and custody services.

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the 1990s, the number of people in the UK who are aged 65 and over has increased from 10.5 million to 13.5 million (1990–2000) (Office for National Statistics 2001).

There is a growing awareness of the need to address the health care needs of the elderly population. The Department of Health (2000) has set out a strategy for the care of the elderly, which includes a commitment to improve the health and well-being of the elderly population. This strategy is based on the following principles:

- To improve the health and well-being of the elderly population.
- To ensure that the elderly population has access to the services and resources they need to live well.
- To ensure that the elderly population is protected from abuse and neglect.

The Department of Health (2000) has also set out a number of key objectives for the care of the elderly, which include:

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