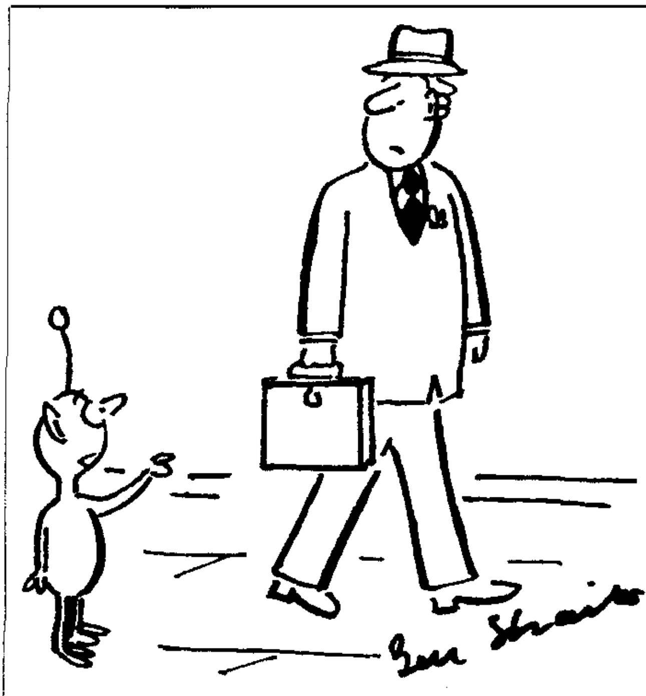
THE BANKER

Stand by for the crunch

The world club of global custodians looks like being squeezed in the future as growing competition and the entrance of US heavyweights sorts out the men from the boys

Not all of the growing number of global custodians are expected to share in the future spoils. Trading in cross-border equities (the measure of the market) jumped from $73 billion in 1979 to $1,528 billion in 1989; but the annual compound growth of 32% does not mean unlimited rewards. Many see a crunch looming for the 50 or more players in the market.

In recent years banks have rushed into the traditionally unglamorous business of international securities settlement, safe-keeping and reporting, attracted by good fees in a relatively low equity industry with good potential. But as US operations have spread, the extra competition has forced down margins by around 30% over the past 18 months. With recession and lower trading volumes in many markets, observers are questioning the long-term commitment of some players.



"Take me to your global custodians"

Says Citibank investor services head John Morris: "To stay ahead in this business you need to spend on systems. Strategic commitment to spending will test the resolve of players over the next two years." US commitment has been heavy: banks have spent tens of millions on in-house information technology (IT), according to Simon Thomas and Michael Beacham of KPMG Peat Marwick McLintock in their recent book *Global Custody*. They claim Chase Manhattan Bank has spent $100 million (including $40 million in the UK), and Bankers Trust, Citibank and Morgan Stanley some $50 million each. Specialist US global custody trust banks, like State Street Bank & Trust and Northern Trust, have done likewise.

But is this the only way forward? In the UK the traditional merchant banking houses, which were investing abroad long before US players got interested, saw what they called "safe-keeping" as an integral part of investment. US banks, however, have marketed what is now called global custody as a separate product and have launched a worldwide crusade for a market share.

Nowadays, the battle is fierce as custodians, big and small, parade before investment managers extolling their virtues. Players like Citibank and Barclays, which have worldwide branch networks, stress the advantages of network consistency, in-house systems and "synergy". Those without global branches, like State Street or Morgan Stanley, stress things like the role of sub-custodians. Says Nicholas Didier, president of Morgan Stanley Bank, Luxembourg: "Our global custody strategy is to select the best player on the block in each particular market."

continued...

THE BANKER

Others claim niches. HongkongBank pushes its regional custodian expertise in East Asia, Lloyds Bank's David Watson targets middle-market funds. Almost every institution claims its strategy, technology and results are superior and provides a mass of hype to try to prove it. Given the market's range, especially in lesser-developed countries, and the various types of fund managers, all custodians may be right to some degree. But there is still a lot of grey areas.

Many of the inherent risks, as well as issues like performance, pricing and technology, are being fudged. Competition and the momentum of the global equities market are creating a Big Bang mentality. Many want to jump on the bandwagon but few are willing to assess the dangers ahead.

Fund managers in London — still the centre for global custody — question whether the new breed of custodian is worried enough about performance. They add that custody is best left under the control of fund managers: there are hidden charges, and it costs more to deal with outside custodians than dealing with it themselves.

These hidden charges include foreign-exchange handling costs. Outside custodians will take a wider spread on a transaction because it is to their advantage; they are not so concerned with the overall cost or performance. But fund managers sink or swim on performance; for them rates are crucial. And the idea that the large custodian bank can use its size to provide better foreign-exchange rates is not necessarily true.

At a recent IBC conference on global custody in Amsterdam, Roger Urwin of UK consultant R. Watson & Sons said that in most situations the extra cost of using a dedicated global custodian cannot be justified. His remarks, however, applied to UK pension funds. Urwin said the same was not true for US pension funds, where the role of third-party custodian has developed differently and has far more credibility. Such differences in approach have made it difficult for US players to penetrate Europe as quickly as they expected. Observers say many US firms did not understand the depth of institutional relationships in the UK and continental Europe.

The battle is fierce as custodians, big and small, extol their virtues to investment managers

Another important issue for the future is regulation. Unlike in banking and other cross-border activities, there is no regulatory body which monitors the flow of global monies through international securities. As Thomas and Beacham write: "Most custody business is seen to be off-balance-sheet and has traditionally been of little concern to the regulatory authorities. However, country, market, settlement and credit exposure risks exist, and with the continuing development of emerging markets it is only a matter of time before there is a serious problem and potentially large loss."

Thomas — serious problem looms

The Group of 30 has made several recommendations but the above risks have been ignored by central banks and regulators. Without recognition of the risks in custody — and appropriate capitalisation of them — the entire system could go horribly awry. The dangers are heightened by poorly capitalised institutions getting in the business and the fact that few banks, especially some US ones, would want to be forced to raise capital for so-called custody risk. For most, the Basel capital-adequacy ratios are tough enough.