ICB the magazine for Global Transactions Services

Evaluating supplier characteristics

A few hundred years ago Machiavelli complained that he lived in an increasingly turbulent world. Buyers of custodial services could be forgiven for feeling that Machiavelli had an easy life.

The upheavals in the custody industry have made the task of finding the right custodian and monitoring its performance, commitment, independence and competitive position increasingly complicated. The task is made more difficult by limitations with existing rankings of custodians and traditional ways of evaluating global custodians and agent bank suppliers.

Conventional analysis and rankings of securities services suppliers tend to concentrate on two particular features: the size of each supplier; and the quality of service. Size is usually measured by the value of assets under custody. Service quality is evaluated using a mix of benchmark data on operational performance and qualitative feedback from a sample of the supplier's clients. But buyers should be aware that there are limitations with these rankings.

First, the rankings are often based on data provided by the suppliers themselves, or by clients selected by the supplier. Figures for the size of assets under custody provided by individual suppliers are open to misrepresentation and manipulation – to such an extent that some large suppliers refuse to provide figures at all. Equally, benchmark data is only as good as the data provided by each supplier, and client feedback is only as representative as the sample selected. The results are interesting and in some cases give valuable insights into suppliers, but they should be treated with care.

Second, rankings of suppliers based on size and quality of service do not address (indeed, do not attempt to address) a number of the key buyer requirements and issues. This includes, for instance, issues relating to a supplier's financial strength, business strategy and commitment, credentials and coverage of services. Although the information may be available on each of these and other key characteristics, it has not yet been pulled together into a consistent framework.

Third, and perhaps most awkward, many different types of supplier operate in the global securities services market. Positioned at one end of the market are the leading global custodians which supply a wide range of banking, custody and investment-related services, with offices in financial centres around the world. At the other end of the market are the Central Securities Depositories (CSDs) which supply a narrow range of services within their own country. Positioned in between are thousands of banks and non-bank suppliers. This diverse group includes, for example, major domestic banks which supply a global custody service for domestic clients investing internationally; asset managers and the ICSDs, such as Euroclear and Cedel.

It is critical that buyers fully understand the impact that different characteristics have on the level and quality of service that they receive. Take the example of a supplier's network strategy.

The quality of a supplier's agent bank network has a direct impact on the ultimate level of service provided to its clients. As a number of global custodians have found, a poorly-performing agent bank network can seriously undermine their own operations and ultimately their client relationships. Furthermore, because securities and cash are handled directly by third party agents (and in turn by their counterparties), a poorly-selected network also brings into question the very safety of client assets.

iCB Magazine's January/February 1996 issue contained some fascinating statistics on global custodians' network management teams, SWIFT links, coverage and likely future expansion. The banks interviewed also provided qualitative feedback on "best practice" monitoring and evaluation procedures. It is particularly interesting to compare the number of markets covered by each bank with the number of network staff.

Table 1: Average number of markets covered by individual network management staff

ABN Amro	11.0
Bank of New York	6.0
Barclays	8.4
Chase	2.1
Citibank	2.1
Lloyds	9.8
MeesPierson	12.3
Midland	15.0
Morgan Stanley	4.3
Northern Trust	9.6
Royal Bank of Scotland	8.0
State Street	3.6

Source: *iCB Magazine*

continued...

Evaluating supplier characteristics

What do these staff actually do (or not do)? (See table 1.)

Statistics, of course, only tell part of the story. The existence of large numbers of network management staff may not be a true indication of the safety and quality of the network they manage. Buyers of custodial services, and especially those using global or regional intermediaries, may also want to consider other issues, such as:

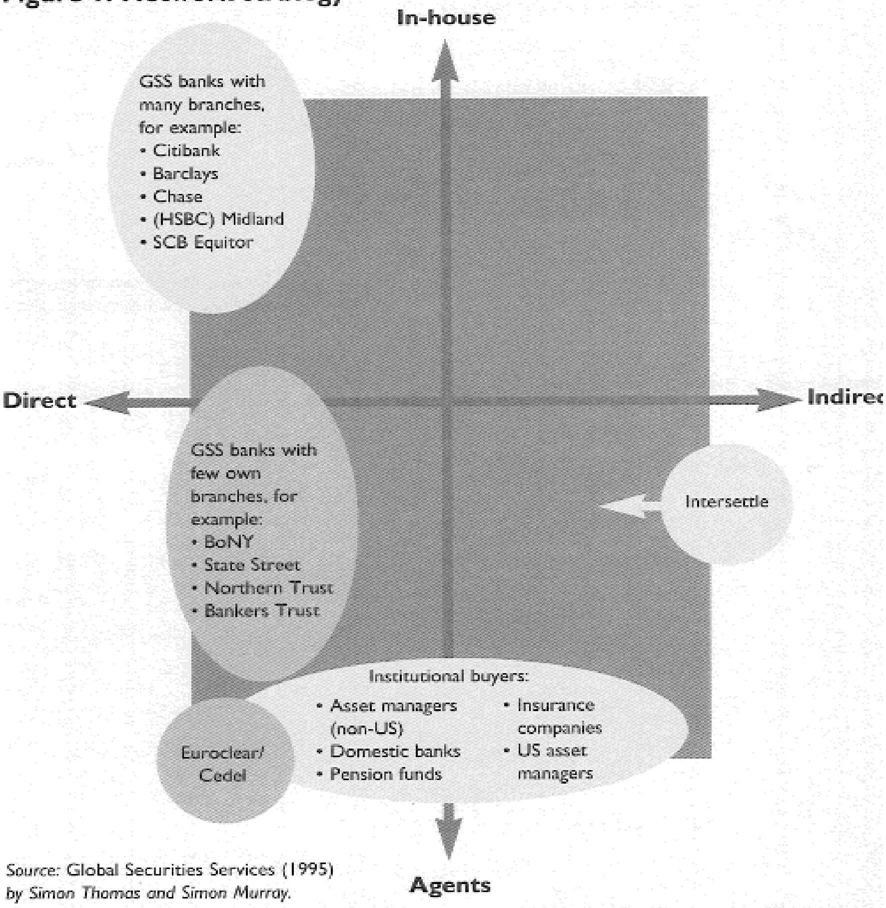
- What advantages and disadvantages does the buyer get from using suppliers with either predominantly in-house networks or predominantly agent networks?
- What advantages and disadvantages does the buyer get from using suppliers which link direct with local markets, rather than using a global or regional intermediary?
- How many agents used by a supplier have specifically been selected for the GSS business (versus the use of existing correspondent banks)?
- Do the suppliers, buyers, regulators and their advisers fully understand the strengths and weaknesses of the CSDs used in each country – assuming a fully operational CSD exists in that country?

Two critical factors in examining these issues are: the development of a supplier's network in foreign countries; and the extent to which suppliers link directly into the local securities clearing, settlement and/or CSD systems, or use a local intermediary to interface with those systems.

Figure 1 represents one way of mapping the positions of different supplier types, according to their network strategies.

The X-axis shows a continuum between direct and indirect network linkages:

Figure 1: Network strategy



Source: Global Securities Services (1995) *by Simon Thomas and Simon Murray.*

Direct

The supplier links directly into the domestic clearing, settlement and/or central securities depository systems, by becoming a participant/member of the system. Sometimes described as the future for the global securities services market, with fully automated links and straight through processing, and the total or partial disintermediation of local agents, Euroclear/Cedel's central role in the international Eurobond market is the pre-eminent example of this phenomenon.

Indirect

The supplier uses a local intermediary (own branch or agent) to interface with local systems. This is the norm in the vast majority of markets outside Eurobonds. For a variety of reasons, the total disintermediation of local agents is currently considered to be unlikely in the foreseeable future.

The Y-axis shows a continuum between in-house and agent bank networks:

In-house

The supplier has a relatively large number of offices (own branches or subsidiaries) in foreign countries. These offices are participant members of local clearing, settlement, and/or CSD systems. Suppliers which fit this model include Citibank (86% own branches), Barclays (39% own branches), and Chase (28% own branches before the merger with Chemical), as well as HSBC and Standard Chartered Equitor Group in the Far East.

Agents only

The supplier has no own branches outside its domestic market. All of its foreign-based business is handled by agents. These agents may or may not be the same as the supplier's correspondent banking agents. Euroclear has no overseas branches, while US globals such as Bankers Trust, Northern Trust, State Street and Bank of New York have fewer than 5% own branches in their global network.

The chart is a useful tool for starting a more informed debate about the pros and cons of alternative network arrangements. But it is only one of a number of key characteristics that buyers need to evaluate to better understand their suppliers. ■