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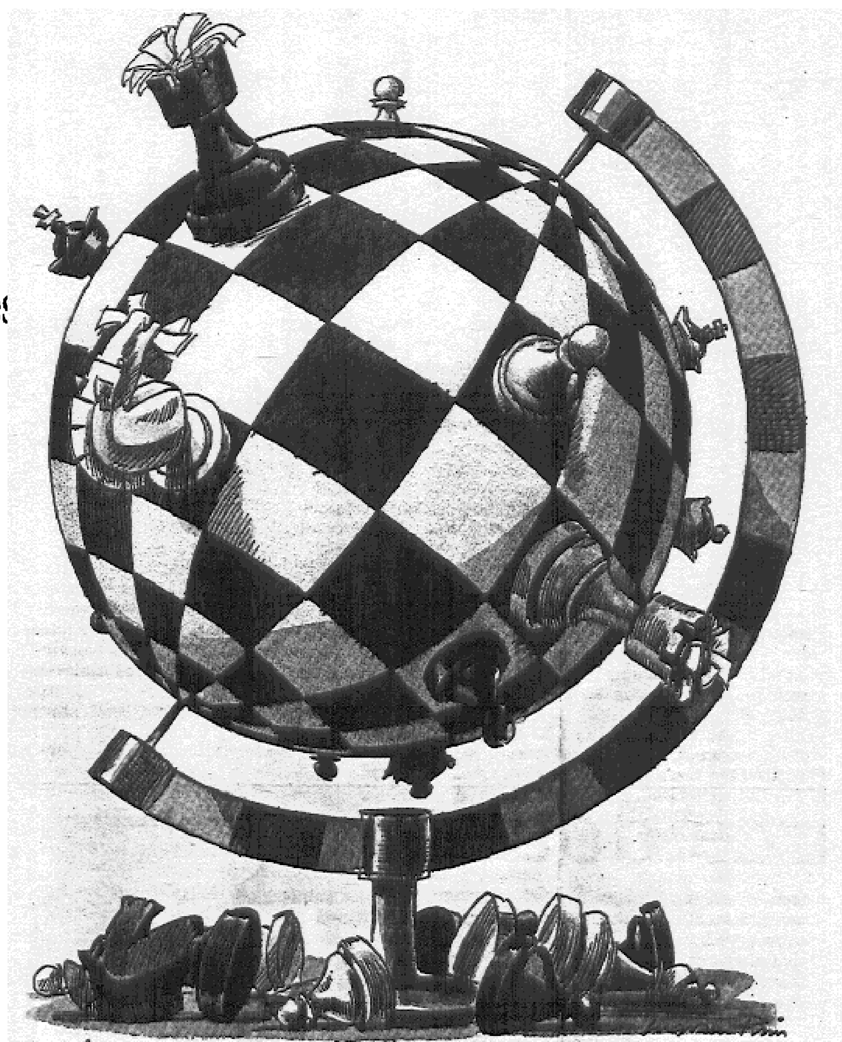
GLOBAL CUSTODY

To stay in the race, global custodians each need to invest up to $200m a year. Some have dropped out, others have merged their operations. John Gapper discusses the latest moves



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The global custody industry is approaching an end-game in its long process of consolidation. Despite seismic shifts such as the recent decision of Barclays and Morgan Stanley to consider merging their operations, the outline of where the industry is heading can already be seen.

At the head of the pack are the large global custodians, which are willing to make the annual investment running into hundreds of millions of dollars to remain dominant.

Names such as State Street, Chase Manhattan, Bank of New York and Citibank appear determined to lead the industry.

Following in their wake are local providers of sub-custodian services and specialised skills which have carved out a distinctive niche. HSBC and Standard Chartered in Asia, and Paribas in France have regional strengths, while consultants such as the WM Company provide specialist services.

Yet, the past year has been as tough as ever on those caught in the middle ground, and obliged to invest heavily to fight for a share of revenues that are ever more tightly squeezed. The exit of J P Morgan last year, and Barclays' recent move, shows how tough many have found it.

"Do you keep on investing $100m or $200m a year to stay in the race? Critical mass has driven this industry, and some people have found it a difficult pill to swallow," says Dick Freehan, Bankers Trust's head of global institutional services in Europe, Middle East and Africa.

"This business can be unforgiving. If you do not keep investing in it, you can quickly fall behind. As soon as one of your competitors stops bringing out new products, it raises questions about their future," says Dan Wywoda, head of global trust and custody for Mellon Trust in Europe.

The shake-out has not only affected global custodians themselves. The largest investment managers in Europe have also started outsourcing custody in an effort to reduce costs. The trend was led in the UK by Prudential Portfolio Managers' outsourcing of its £45bn portfolio earlier this year.

"Some of the bigger organisations are waking up, and saying 'Boy, we have all these people doing things that are not core to our business'," says Mr Wywoda of Mellon Trust, which won the contract to provide custody to Prudential jointly with Midland Bank, the UK subsidiary of HSBC.

Mr Wywoda of Mellon Trust says that although consultants and software houses will play a role in information services, custodians have some key advantages. "If you are handling transactions, it is easy to link that information into accounting and performance measurement," he says.

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Nonetheless, things are not always simple for those who remain in the business. Not only are there risks attached to constant investment – "the cutting edge can be the bleeding edge," says one custodian – but the industry is still awaiting its first catastrophic operational loss.

Despite the Maxwell scandal in Britain, and losses on securities lending in the US, the risks of custody are seen by regulators and others as relatively low compared with activities such as lending. There are no capital requirements for custodian banks related to assets held in custody.

That could change if a custodian makes a crucial mistake in handling a customer's assets at a time of market volatility. Mr Freehan of Bankers Trust recalls one BT manager who, after seeing exactly what custodians did, replied: "This seems to be an insurance business with zero premiums."

Furthermore, the strategy of expansion by acquisition on which most of the larger players are now set carries its own difficulties. Not all customers are happy simply to be handed over. Bank of New York's competitors say that it suffered significant attrition from J P Morgan's customer base.

Ms Bluedorn says that Bank of New York has "had our share of wins and losses" since the J P Morgan acquisition. However, she says that the 18-month process of integrating the two banks' systems and operations has required a great deal of work, and "planning and attention to detail".

These challenges are becoming greater as the global custody industry approaches the culmination of the phase of consolidation over the past years. The most significant challenge for those who have fought their way to the front will be to ensure that the industry remains relevant.

As technology becomes more sophisticated, the danger is that barriers to entry to choicer parts of the business – information and ancillary services in particular – will lower.

For global custodians who have spent their way to a place at the top table, that would be an unwelcome reward.

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Regulators drag their feet

It is unlikely that regulations will be tightened soon because there is a lack of consensus

The fact that the UK is only just getting around to making custody an activity that requires authorisation is a reasonable indication of the importance that has been attached to regulation of global custody. Despite the trillions of dollars of assets involved, regulators have moved slowly.

In part, this is because of the extreme variance in local practice in safeguarding assets held with another party. While it appeared to be mere commonsense in Anglo-Saxon countries for banks to to segregate their clients' assets from their own, the opposite principle holds in Japan.

The result is that global custody still lacks stringent regulatory requirements. The US Securities and Exchange Commission has eased its regulations on custody of cross-border assets held by mutual funds following lobbying from the global custodians most strongly affected.

In August, the technical committee of Iosco, the international grouping of securities regulators, made a series of broad recommendations on ways to protect client assets. However, it emphasised that all regulators had to follow insolvency laws and traditions in casting regulations.

One of Iosco's main recommendations was for all regulatory authorities to recognise the benefits for investor protection and confidence in financial markets of effective mechanisms to protect client assets from the risk of loss, and the insolvency of local investment firms.

However, industry participants doubt whether they have heard the last on the subject from regulators. Indeed, some bankers say that if the inherent risks of custody were better reflected in regulations, it would help to ameliorate some of the cut-throat price competition in the industry.

"In all honesty, the issue has been hugely fudged by regulators," says Dick Freehan, division head of global institutional services in Europe and Asia for Bankers Trust, "A monster trauma has not hit the industry yet, and I think it requires that. I just hope it doesn't happen to us."

The UK approach to regulating custody emerged in the wake of the Robert Maxwell affair with the publication of a Securities and Investments Board consultation paper in August last year. This suggested that custody should be made an authorisable activity, and suggested regulatory standards.

The Treasury is now working on rules for the authorisation of custody companies. In practice, it is unlikely to mark a sea-change in regulation, since virtually all companiespractising custody, apart from some Personal Equity Plan administrators, are already authorised for other activities.

The SIB acted on concerns from bodies, including the Society for Practitioners of Insolvency, that client assets were not sufficiently segregated by law to prevent them being lost if a company collapsed. This concern was inflamed by initial doubts over client cash deposits when Baring collapsed.

These SIB standards are now being transformed into firm regulations by the relevant self-regulatory bodies, the Securities and Futures Authority, and the Investment Management Regulatory Organisation. However, the SIB standards have not turned out to be particularly onerous for the industry.

In particular, the possibility of separating client assets from those of a custodian by placing them in separate nominee companies was not regarded by the SIB as worth the disruption and cost involved. A cost-benefit analysis carried out by the board put the cost of implementation at £100m.

Separately, neither the SIB nor any other regulatory body has made an effort to devise capital adequacy rules for custodians related to the client assets held in custody. The existing UK regulations devised by Imro merely require companies to have capital of up to 13 weeks' expenses.

The principle behind this is that any custodian will have sufficient time to run down the business in an orderly fashion, and transfer custody to another institution, in case of trouble. Regulators argue that it would be impractical to make any form of capital charge in proportion to assets.

"It is inconceivable that any custodian could hold capital that could in any way match assets held in custody. We are talking about firms with billions of dollars in custody," says one official.

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Regulators argue that it is better to insist on firms having adequate systems and controls.

In theory, the lack of capital adequacy requirements is not a problem because custodians act as agents rather than taking on any direct risks from movements in value, or losses, of securities. A similar approach to linking capital to operational expenditure is used for UK fund managers.

However, not all analysts agree with this approach. Simon Thomas,of the consulting firm Thomas Murray, says that the SIB review "walked away from the major issues facing the industry". He argues that the true risks inherent in cross-border custody are far higher than has been recognised.

"There are a large number of risks that are subterranean and have not been recognised at the moment. Regulators and custodians have failed to recognise that banks that issue payment instructions are de facto principals. They cannot maintain agency status if it goes wrong," says Mr Thomas.

Most custodians agree that they would in practice be forced to make up any loss caused by errors. Not only have US courts taken this view in cases of error related to securities lending, but it is a commercial necessity. "If we walked away, we could say goodbye to our reputation," says one.

This implies that – similarly to the case of potential losses affecting unit trusts managed by Morgan Grenfell Asset Management, where the group's parent Deutsche Bank stepped in to make good the loss – any global custodian faces huge potential liability for making operational errors.

Mr Thomas believes these risks are eventually bound to be reflected in capital charges levied on custodians in local markets where the risks are appreciably higher. These risks are currently only reflected in higher charges for custody services in markets with poor settlement systems.

He argues that these capital charges will be passed straight through to investors in higher charges by custodians, implying that investment banks that lack custody operations will suffer. He says this is one important reason for banks with strong balance sheets to specialise in custody.

For the moment, a lack of regulatory consensus among members of Iosco, together with differing local traditions, make it highly unlikely that a concerted push for tighter regulation will emerge rapidly. However, this could change if an equity market crash led to a custodial failure.

Yet the compression of pricing in the industry in the past five years has in effect eliminated any notion of pricing correctly for risk. That could come to be seen as an unfortunate omission by both regulators and custodians themselves if the subterranean risks of custody surface.