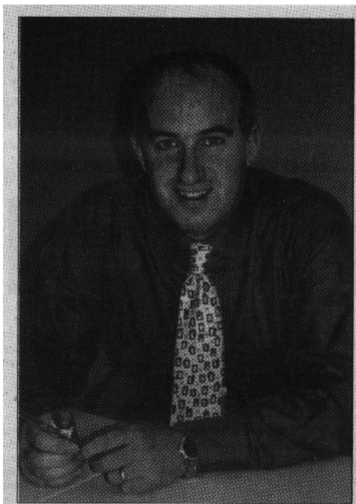
7 - 13 December 1998

FINANCIAL NEWS

Issue 137 £4

Custody has become increasingly expensive and the lack of financial infrastructure is no longer the key issue for providers, writes Caroline Allen

Custodians reassess who should bear settlement risk



'Some CSDs are often thinly capitalised and have little insurance'

Derek Duggan, Thomas Murray

Custody is a growth sector in international investment but it has become an increasingly expensive, complex and exacting business. Quite apart from investment risk, settlement periods have become shorter, transaction volumes more volatile, financing and investment instruments more complex and fiduciary demands have escalated.

The key issue for custody providers in emerging markets is no longer the lack of financial infrastructure, but identifying changing risks in a volatile environment, and pinpointing who exactly is now bearing them. "Global custodians are being pressured to put more emphasis on risk minimisation and sub-custodians are being forced to take on more risk," says Ross Whitehill, director at London-based custody specialist consultants Thomas Murray.

"Clients now want to know exactly what services are offered in terms of income collection, corporate actions or timely provision of information. It is no use any more to say you will pass on such information if it comes your way. The local agent has to be much more proactive in anticipating, acquiring and delivering it."

The Bank of New York operates in 87 markets worldwide and controls its network from regional offices in New York for the Americas, Brussels for Europe, Middle East and Africa and Singapore for Asia. It only uses its own branches for custodial arrangements in the UK and the US.

"In selecting a sub-custodian, we are looking for the highest level of protection for us, which we then pass on to the customer," says BoNy managing director Mark Kerns. "We have focused heavily in the last couple of years on market volatility and operational efficiency through straightforward processing."

The local custodian now acts less as a physical depository and more like an asset servicer, while the number of national and regional central securities depositories (CSDs) in emerging markets is growing (20 more are due to open by 2000). Local stock exchanges, central banks or regulators often back the launch but turn to other local financial institutions to help underwrite costs.

The basic custodial process is little changed with the client (usually a fund manager) first outsourcing to a global custodian who then selects a local agent.

This selection has become a critical factor in the process. Sub-custodians obviously need a solid balance sheet, top credit rating and market standing, but more comprehensive data and automated facilities are now also essential.

The unofficial benchmark for custody standards in emerging markets is still a list of nine points drawn up in 1989 by the Group of 30, the group of leading private sector financial institutions.

The group no longer actively monitors implementation of these standards but specialist consultants, such as London-based Thomas Murray, do.

Thomas Murray's Whitehill also points out that the UK's Securities and Futures Authority had set a deadline of January 31, 1999 for banks to demonstrate due diligence in seven key areas when selecting a sub-custodian. That is now being supervised by the Financial Services Authority.

Most global custodians indemnify themselves through contract or insurance against sub-standard service by their local agent. "There are certain risks no custodian will take on, like investment risk. But clearly it must be a seamless service from the customer's point of view, like dealing with one organisation," says Stephen Appleton at consultants Frank Russell Company.

Previously, the agent tended to be the biggest local bank. But those providers are having to fend off medium-sized foreign operators such as ABN Amro, ING Barings, Creditanstalt or Société Générale, which want to leverage their branch networks. This has had the effect of improving the level of service from local banks.

The cost of servicing a local market is not necessarily the bricks and mortar, nor even the technology; it is the time and commitment needed to acquire local expertise. Even a large branch of a global custodian with perhaps 20 staff cannot match the cover provided by a local bank with 200 staff.

Some global custodians want to be able to tell clients they have the agent with the best understanding of the market – which may or may not be their own branch. Among global providers, Citibank tends to use its own branch network most. Bankers Trust and Northern Trust use their own branches only in the US, the UK and Australia.

'Custodial business has moved from being decidedly back office to firmly middle office'

Stephen Appleton, Frank Russell Company

Consultants like Frank Russell advise investors on custodian choice. "At the top of our must-have list would be an ongoing commitment to the whole business," says Appleton.

"A close second would be the stability and retention of quality staff. In some senses custody is a fairly automated process, but people are still delivering that service. We also like to see renewed investment in technology, which is a part of commitment."

Global custodians will often discuss informally with their competitors the relative merits of local custodians and alarm bells start ringing if less than positive references are offered, says Whitehill.

"Even if you wanted to, it is not always possible to find another sub-custodian and switching can be costly. But reviews, where terms are renegotiated, are being done much more frequently."

Fees are under two-way pressure – clients are demanding more bang for their bucks, while custodians taking on more risk and monitoring duties are seeking to pass those costs back up the chain. But fees are a secondary concern to risk monitoring and management.

Derek Duggan, another director at Thomas Murray, also urges a thorough check on the status of the local central securities depository: who ultimately owns it, the capitalisation and insurance arrangements and loss-sharing provisions. "There has been this view that most CSDs are safe but some are often thinly capitalised and have little insurance."

Global corporate activity through mergers and acquisitions among big players is changing the face of the industry.

Custody clients will be watching to gauge the effect on service levels of the final deal between custody giant Bankers Trust and Deutsche Bank, which has its own large custody division.

"Clients have become a lot more sophisticated and the whole custodial business is a lot more visible. It has moved from being decidedly back office to firmly middle office," says Appleton.