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Core capabilities

THE DEVELOPMENT OF CUSTODY SERVICES IN C&E EUROPE

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Investment in new and emerging markets has always presented risks and costs which are disproportionate to those associated with developed markets in terms of research, asset safety, risk minimisation, account set-up, portfolio and transaction enquiries and fees. Often local market legislation is written with only local concerns in mind, amended without notice, drafted in such a way as to be ambiguous and from time to time, reflects little concern for the end investor and the protection of assets.

Notwithstanding this, there have been a number of recent advancements in the market infrastructure of Central & Eastern Europe which can be viewed as positives in terms of risk management. These include the developments in many local stock exchanges and CSDs, as well as plans for securities lending in the more mature markets of Poland, Hungary and the Czech Republic.

The Central and Eastern European markets, perhaps with the exception of Bulgaria, are reasonably well served in terms of custody providers as major Western groups have taken a progressive position in many of these markets.

Groups like Citibank, ING, ABN AMRO and others have established facilities in the Central and Eastern European markets to support their commercial activities and have leveraged their investment in custody elsewhere into these new markets. Equally, the larger indigenous banks have grown their own capabilities based on local market experience and have hired experienced, well educated staff to support their drive into the foreign investor custody business.

However, most markets in the region are small enough to warrant only a handful of sub-custodians. In future, foreign groups without local or regional capabilities may seek regional alliances, which again will have an effect on the development of the industry, pricing, standards of service and most importantly, asset safety. Recent examples include the purchase of a majority stake in Bank Pekao in Poland by Unicredito and Allianz. In the Czech Republic, CSOB is in discussions with KBL. While in Hungary, we have seen the recent purchase of the custody business of Budapest Bank by Bank Austria Creditanstalt.

This will provide foreign investors with a wider range of potential providers in many markets.

Asset safety and risk minimisation remain a priority for investors and their global custodians and in this connection some of the indigenous banks with relatively small balance sheets and poorer credit ratings than their foreign counterparts will continue to lose out. In troubled markets such as Russia, banks with negative equity positions have obviously caused concern among investors.

One of the challenges for custodians in local markets is to hire and retain knowledgeable staff who can support the demands of foreign custodians and the underlying investors. The consolidation in the banking industry of course reduces this problem to some extent but this is a rather haphazard way of managing staff resources in a growing market.

The great uncertainty is that as these markets develop so too must the securities infrastructure. For example, if the stock exchanges do not transform themselves in the near term, the major local companies, by natural selection, will begin listing on foreign exchanges where regulations are solid and liquidity is better and the need for local 'in market' custody may fall away.

Some of the other factors that will influence the development of custody services in local markets will be the role that the CSD plays in the provision of custody and asset servicing activities, liquidity and the relative attractiveness of the market, local accounting practices and transparency of corporate management, and the regulatory environment. To the extent that any of these aspects causes concern at the end investor level or if the global custodian has overt concerns about the ultimate safety of client assets, the market for custodial services will develop more slowly.

Investors are remarkably clear in what they will tolerate and what they will not. As we have seen countless times in the new and emerging markets, investors are quick to vote with their feet. ICFA