

How to Select a Global Custodian

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Introduction

There are several alternative methods of selecting a global custodian, each with its own strengths and weaknesses. Over the last ten years, the process of selecting custodians to support large institutions has become increasingly based on the structured search method in the UK and parts of Europe. However, the custodian selection business is still in its infancy compared with the selection of fund managers by investment institutions.

The custody world continues to develop and Thomas Murray is using internet technology to support the selection process, and is working towards formally and publicly rating the service capabilities of custodians.

Alternative Selection Methods

The main methods used by institutions to select a global custodian are:

- Name recognition/custodial asset size
- Recommendation/industrial surveys or word of mouth
- Structured search
- Custodian ratings

Each selection method has its advantages and disadvantages. These are as follows:

Name Recognition/Custodial asset size

Advantages:

- Low cost approach
- 'You can't be fired for buying IBM'
- A large custodian is likely to have existing clients with requirements similar to your own
- Size may mean economies of scale, so competitive fees

Disadvantages:

- No assessment of custodian capabilities, strengths and weaknesses
- No certainty that your particular service requirements can be met
- Difficult to demonstrate objectivity and due diligence

Recommendation/industrial surveys

Advantages:

- Low cost approach
- May be a reflection of real client experience
- Regular surveys may demonstrate trends in custodian performance

Disadvantages:

- Surveys and recommendations may reflect other clients experience whose service requirements differ from your own
- Surveys tend to be perception-based and linked to the quality of and relationship with the customer service representative

- They are unscientific, with random samples of clients and of the people within clients to respond, which have tended to decline in quality due to over-surveying
- There are concerns over the objectivity of surveys, with custodians encouraging their “best” clients to respond
- They can be too general to be of real value
- Different surveys may produce conflicting results
- “Top” custodians may not be willing or able to support your particular requirements

Structured search

Advantages:

- Can compare the offerings of competing suppliers and negotiate
- Develop a better understanding of best market practise
- Develop a better understanding of internal requirements and processes
- Selects provider which best meets client needs
- Credible process, easily explained and objectively based

Disadvantages:

- A structured search requires time and money
- Client must deploy internal resources to work through the process

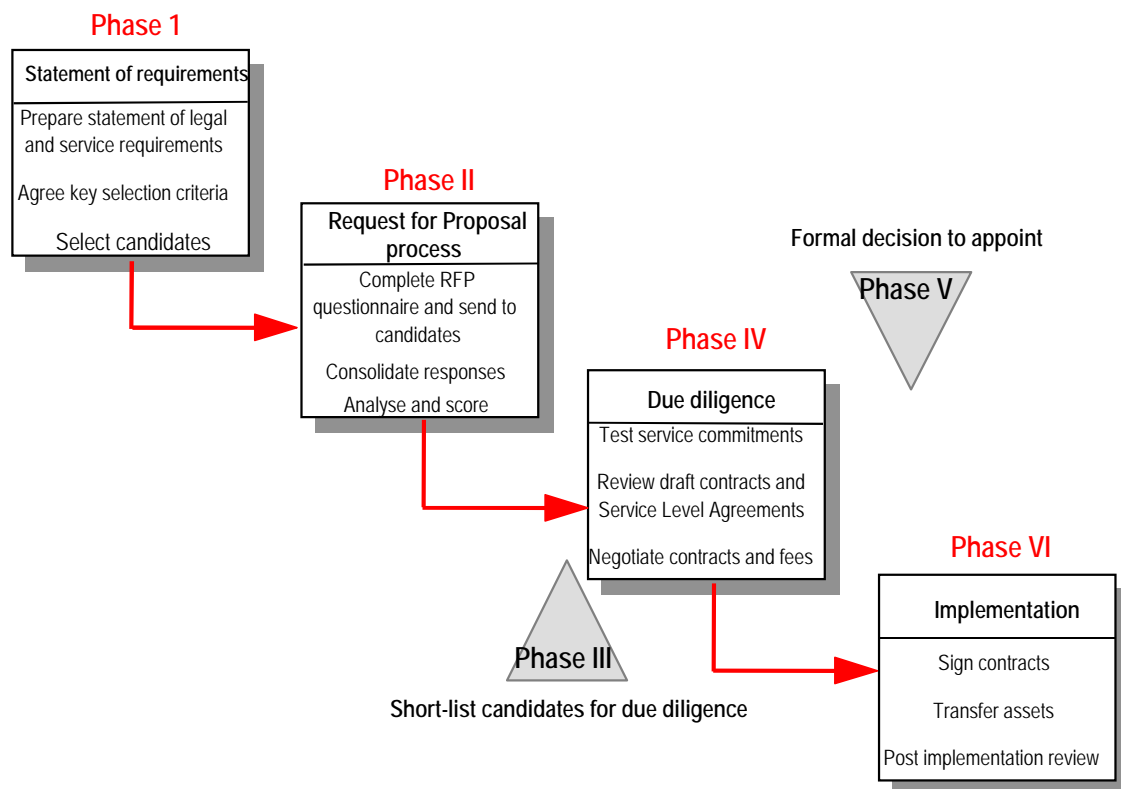
In practise, more than one approach may be applied, thus size or name recognition may be used to generate a long list of candidate banks, to which the structured search approach is then applied.

Another area of debate is whether an institution should use a consultant to assist in the process of selecting a custodian, or should do it all themselves. The use of a specialised consultant can add value to the client in the following ways:

- Consultants can assist the client to gather data for the profile and define requirements in a way that will be most meaningful for the custodian banks tendering processes
- Consultants can provide a structured Request For Proposal (RFP) framework for the client and analyse and compare the responses of different custodians
- Consultants will take the client through a structured process after the RFP through short list, due diligence, contracts, service level agreements and ongoing monitoring.
- Consultants can advise the client on what is best market practise in the different service areas, and what it is reasonable to expect of a custodian.

The important thing is that an institution should retain ownership of the process. At the end of the day, the client must own the decision and the appointment, and use the consultant as an expert witness and facilitator of the process on his behalf.

Provided that sufficient resources are available, the most effective process is the structured search. The main stages can be diagrammatically represented as follows:



Source: Thomas Murray

Phase I involves a review of the investor’s requirements, which assesses the current custodial arrangements against best market practice and identifies the gaps in service delivery and performance. From this review a statement of requirements is developed that is used in the RFP process or to identify improvements needed to the existing Service Level Agreement with the incumbent provider.

If it appears that the clients current provider does not meet the requirements at best market practise, the client may want to conduct a structured search. In this case, the consultant can advise on a “long list” of banks to include, based on his experience. Depending on a clients requirements, Thomas Murray typically looks for up to 10 banks to review, in order to get a good, competitive offering for the client.

Phase II focuses on the development of the RFP. The areas to be covered in the RFP will range from basic services such as settlement and safekeeping through to investment accounting, compliance monitoring, trusteeship and performance measurement. The RFP is then sent out to the long list of banks.

Phase III is the analysis of RFP responses and draft contracts, and a presentation of findings. In this stage a short list of proposed providers is developed and both buyer and suppliers are given the opportunity to get to know each other’s requirements and capabilities better.

Phase IV, V, VI address the finalisation of due diligence, agreement of all documentation and appointment/asset transition.

Subsequent to the appointment, a comprehensive monitoring and service benchmarking process would normally be put in place, which facilitates the ongoing assessment of operational performance against benchmarks agreed in the Service Level Agreement.

Thomas Murray is currently developing a web site, for institutional investors, which will enable institutions to carry through a structured search process on line, in a more automated and efficient way. The site will offer a free “health check” so that clients can see how their current custodial service performs, at a high level, then will offer tools for a more detailed evaluation of problem areas, as well as a more structured and automated search process for clients who decide to reselect custodians.

Custodian Ratings

As part of an effort to promote transparency and comparability in the analysis of custodians and their services, give greater access to evaluation and selection techniques to smaller funds and to provide improved transparency of analysis to the custodians, Thomas Murray has developed Global Custody Ratings (GCR's) and Domestic Custody Ratings (DCR's).

These ratings are intended to be publicly available, and to build on the private rating evaluation of custodians that Thomas Murray does already as part of a selection process. The ratings evaluate custodial offerings on a consistent basis, looking at credentials, basic service provision, internal operations and risk. They are intended to provide the basis of determination as to whether a custodian may be considered as a potential provider of services to an institution, given its own requirements and priorities.

Due diligence and selection from a short list, followed by the negotiation of terms between the institution and the custodian can then be carried out, taking the basic analysis offered under the ratings methodologies as a starting point, rather than having to re-perform the primary analysis of all the potential providers.

Conclusions

The cost of appointing the wrong custodian is potentially enormous when the cost of transition, re-registration, training, legal expenses etc is summed.

The value of making the right appointment based on thorough, objective analysis is realised in the service offering, contractual terms and fees paid. Appointing a custodian based solely on size, name recognition, surveys or recommendations will ensure that the custodians continue to benefit from ill-informed decisions

This will become increasingly important as we see more and more outsourcing of services such as investment accounting and reporting, performance analytics and fund accounting to global custodians as they tailor their products increasingly to individual markets.

The development of new tools such as custodian ratings, and the introduction of web-based processes by consultants such as Thomas Murray, will help to make the selection of custodians a more mainstream activity for institutions, as fund manager selection and asset and liability modelling are already for many.