

Evaluation and Selection of Custodians

Ross Whitehall
Chief Operating Officer,
Thomas Murray Limited

Background

AS the value of portfolios invested worldwide increases and the number of markets in which fund managers invest expands, the need for effective evaluation and selection of custodians rises.

While some groups denounce the need for Request for Proposals (RFPs), large funds with sophisticated requirements are increasingly utilising RFPs with comprehensive, objective analysis techniques, supported by clear presentation of facts with linked documentation such as Due Diligence Frameworks, Custody Agreements and Service Level Agreements.

One of Thomas Murray's business activities is the evaluation and selection of custodians worldwide. This business has been involved in reviews of custodians on behalf of banks, insurance companies, pension funds, asset managers and broker dealers involving assets in excess of \$1.5 trillion.

Some people feel that with consolidation in the custody industry, the task of evaluating and selecting custodians has become considerably easier.

Our experience is that in the last five years the task has become considerably more difficult as new providers have entered the market, smaller providers have invested substantially to become competitive and the larger providers have sought to differentiate themselves with new technology, products and services.

Further, the substantial increase in the establishment and use of Central Securities Depositories (CSD) worldwide means that client assets are increasingly exposed to groups other than the custodian's sub custodian network. Rarely will custodians accept responsibility for losses of assets, value or income where the securities are held at the local CSD.

The Securities and Exchange Commission in the US has recognised that the increased exposure of US Mutual Funds to CSDs globally introduces new risks not previously contemplated. They have therefore introduced new legislation, colloquially known as Rule 17f-7 (of the US Investment Companies Act) that requires a proper evaluation of CSDs before funds can be

invested in markets where client securities will be held in the CSD. The UK regulator FSA is currently addressing this issue.

Thomas Murray's response has been to extend its review of CSDs by engaging the support of Standard & Poor's and major banking groups worldwide to develop a Depository Review and Risk Evaluation Service.

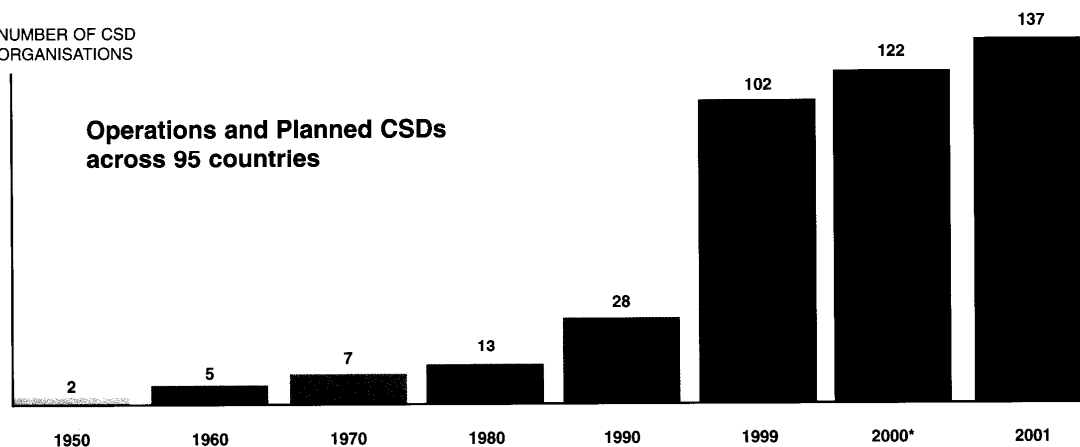
The output reports allow custodians, investment managers and funds themselves to clearly identify the strengths and weaknesses of CSDs and make the appropriate decisions about markets of investment, custodians and sub custodians based on this information.

Process

Going back to the Evaluation and Selection of custodians Thomas Murray typically uses a six phased approach, as shown in the chart on the opposite page.

Phase I is a short sharp review of the investor's requirements, which assesses the current arrangement, matches that against best market practice and determines the gaps (identification of suitable candidates and determination of

NUMBER OF CSD ORGANISATIONS



*Includes 20 operational and/or planned CSDs

Source: Thomas Murray





Phase I

Statement of requirements

- Prepare statement of legal and service requirements
- Agree key selection criteria
- Select candidates

Phase II

Request for Proposal process

- Complete RFP questionnaire and send to candidates
- Consolidate responses
- Analyse and score

Phase IV

Due diligence

- Test service commitments
- Review draft contracts and service level agreements
- Negotiate contracts and fees

Phase V

Formal decision to appoint

Phase VI

Implementation

- Sign contracts
- Transfer assets
- Post implementation review

Phase III

Short-list candidates for due diligence

key evaluation criteria). From this review a statement of requirements is developed that ultimately shapes the construction of the RFP or, if appropriate, required improvement in the existing Service Level Agreement with the incumbent provider.

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.

Phase III is the analysis of RFP responses, presentation of findings, contract review and preliminary due diligence stage. 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 would normally be put in place, which facilitates the ongoing assessment of operational performance against benchmarks agreed in the Service Level Agreement.

Custodian Ratings

In an effort to give greater access to Evaluation and Selection techniques for smaller funds and to provide improved transparency of analysis to the custodians, Thomas Murray and Standard & Poor's have jointly developed Global Custody Ratings (GCRs) and Domestic Custody Ratings (DCRs).

These ratings are designed to evaluate custodial offerings against a minimum standard and provide the basis of determination as to whether a custodian may be considered as a potential provider of services.

Negotiation of terms between the fund and the custodian can then be performed on the basis offered under the ratings methodologies.

Conclusion

The cost of making an inappropriate or incorrect custodian appointment is potentially enormous when the cost of transition, re-registration, training, lawyers' fees etc is added up.

The value of making the right decision based on thorough, objective analysis is realised in

the service offering, contract terms and fees paid. Failure to conduct such analysis and appoint a custodian based on size or the belief that the market has consolidated down to a handful of main providers, will further ensure that the custodians benefit from the uninformed buyers to a extent not sustainable from the more professional fund board and trustees.

Source: Thomas Mur

Thomas Murray is an information, ratings and research company specialising in supporting the investment and global securities services industries. The company provides a range of products and services:

- Investor services - assisting institutions evaluate and select global custodians
- Rating services - working with S&P in rating global and domestic custodians
- Network services - assisting banks operating overseas networks evaluate local markets, associated custodial and settlement risks and analyse and select suitable domestic custodians to act as securities correspondent banks
- Information services - local capital market infrastructure information (>100 markets) and Depository Review and Risk Evaluation Service which includes a risk assessment provided by S&P