

Key issues in the selection of appropriate custodial arrangements

Evaluating Custody Providers

The consolidations and withdrawals in the custody industry have made the task of finding the right custodian, and monitoring its performance, commitment, independence and competitive position, increasingly complicated. In recent years, the process of selecting or re-selecting custodians to support large institutions has become considerably more professional in the UK, although it still remains something of a 'Cinderella' industry compared with the selection of fund managers by institutions. The structured approach now being applied to the selection of custodians has become the norm, and has generally replaced the old approaches of either leave it to your fund managers, or talk to one or two custodians you know.

The rapid growth in cross-border investment has highlighted the challenges and issues faced by institutional funds or their agents who are responsible for the safety and administration of invested assets around the world. These include

- o administrative complexity arising out of growth in assets, new instruments and changing asset allocation;
- o need for common reporting and performance standards;
- o concerns about asset safety and risk; and
- o industry consolidation and the impact of Central Securities Depositories ('CSDs') and changing market infrastructures.

It has become critical for institutional funds to carefully review and formally evaluate the provision of clearing, settlement, safekeeping and related securities services in every market where they invest.

Conventional analysis and rankings of securities services suppliers tend to concentrate on two particular features: the size of each supplier, and the quality of service. Size is normally measured by the value of assets under custody. Service quality is evaluated using a mix of benchmark data on operational performance and qualitative feedback from a sample of the supplier's clients. Buyers should be aware, however, that there are limitations with these rankings.

First, the rankings are often based on data provided by the suppliers themselves, or by clients selected by the supplier. Second, rankings of suppliers based on size and quality of service do not address (indeed, do not attempt to address) a number of the key buyer requirements and issues. This includes, for instance, issues relating to a supplier's financial strength, business strategy and commitment, credentials and coverage of services.

Third, and perhaps most awkwardly, many different types of supplier operate in the global securities services market. Positioned at one end of the market are the leading global custodians, who supply a wide range of banking, custody and investment related services, with offices in financial centres around the world. At the other end of the market are the CSDs who supply a narrow range of services within their own country. Positioned in between are hundreds of banks and non-bank suppliers. This diverse group includes, for example, major domestic banks who supply a global custody service for domestic clients investing internationally; asset managers and the ICSDs; such as Euroclear and Clearstream.

It is critical that buyers fully understand the impact that different characteristics have on the level and quality of service that they receive. A number of groups, including Thomas Murray, are introducing ratings of custodians which are aiming to make the differences between the services offered by custodians more transparent.

Assessing Custody Risk

How safe are assets held by custodians? The more optimistic members of the custody community argue that an investor's exposure to custody risk is now minimal because securities are ring-fenced from the claims of creditors, and investment managers are well aware of the need to diversify cash balances. At the same time, the optimists assume that any losses arising from custody operations are covered in contract.

Our experience is that not all securities can be totally ringed-fenced in all markets. Equally, not all cash is, or can be diversified at all times. Further, most custody contracts are clear about the risks that remain with the investor, in the absence of fraud, gross misconduct or negligence by the custodian. There are risks inherent in all clearing, settlement, safekeeping and asset servicing functions, and these risks escalate (in number if not in value) as more assets are invested overseas.

A proper analysis of custody risk must be performed on the different activities and participants in the investment process, including investment managers, brokers, cash payment/FX banks, global custodians, sub-custodians, and local clearing and safekeeping entities such as CSDs. For example, the ownership, capital structure, guarantee fund rules and corporate governance of CSDs worldwide varies significantly and regulators globally are increasingly aware of the 'value at risk' in CSDs. This has prompted regulation, both in the UK and the US, which requires a greater transparency on CSDs and increased due diligence prior to assets being committed to a local agent.

In this connection, Thomas Murray, in association with Standard and Poor's and leading custodians, have been analysing CSDs worldwide and providing comprehensive risk assessment reports highlighting issues faces by investors whose securities are held by CSDs. Many investors do not recognise that their global custodians may only accept responsibility for risk up to the point where assets leave the sub custodian's control, after which time cash and securities committed to the local market infrastructure became the investor's risk.

In the face of growing size, product complexity and geographic coverage of institutional investment, it has become critical for institutional investors to carefully review and formally evaluate the provision of clearing, settlement and safekeeping services in every market of investment. At all times investors must have confidence that they know where and how their cash and securities are held.

Asset protection must be the foundation of the custody industry. Without it, all of the initiatives in the amalgamation of exchanges, proliferation of CSDs and Straight-Through Processing are like the biblical house that was constructed upon the sand.