

## Global Custodian Magazine

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### Custody: The Thomas Murray Custody Ratings: Who Hates Them, and Why

Business is a sphere in which interests, not ideas, contend. Yet even those who merely get and spend cannot remain wholly immune to the spirit of the age, and ours is an age whose appetite for information knows no restraints. Markets, like newspapers, depend on it. Regulators demand it. Politicians see votes in it. If science and liberal egalitarian democracy have one thing in common, it is that it is better to know than not to know. Our world is so awash with information that an army of intermediaries – consultants, accountants, actuaries, regulators and journalists - exists to make sense of it as league tables, standards, scores, ratios, narratives, rankings, and ratings. Lost amid the babble and confusion of infinite matter we long, with the inter-galactic hitchhiker, to know that the answer is 42. In the Information Age, nothing is more useful than this, or more lethal to vested interest: the answer that conquers uncertainty, obliterates nuance, admits of no exceptions, and brooks no argument. And it has now arrived in the world of global securities services, in the shape of the Thomas Murray Global Custody Ratings.

"Increasingly, we found that clients wanted something in summary format to present to the Board for final approval," recalls Derek Duggan, a director at Thomas Murray in London, of the work the consultancy was doing on behalf of institutional investors to evaluate and select custodian banks in the late 1990s. "The challenge was to find a way of bundling up all the key criteria into a shorthand form." Ratings - akin to the credit ratings which are the standard shorthand of the bond markets - were the obvious answer. In 1998 Thomas Murray approached Standard & Poor's. The rating agency was already exploring the scope to rate stock exchanges and central securities depositories (CSDs), and welcomed the chance to work with a specialist partner on rating both CSDs and custodian banks. The two companies commissioned a private research company to test the usefulness and acceptability of the idea of ratings among institutional investors, global custodians, agent banks and CSDs. "Ironically enough, in view of what has happened subsequently, the highest level of interest was among the global custodians," says Duggan. "They were even more interested than the institutional investors, and were keen to commission and publish public custody ratings. The second highest level of interest was expressed by the agent banks. It was only the CSDs that did not want to be rated at all." <sup>1</sup>

More ironical still in retrospect, the main reason custodians welcomed ratings was because they saw them as a powerful counterweight to the client perception surveys – such as the *Global Custodian* agent bank review – which then provided the closest approximation to the answer 42. These they had long disparaged as doing little justice to the splendid quality and infinite variety of their operations. Indeed, when *Global Custodian* first announced its intention in the Fall of last year to publish indicative custody ratings prepared by Thomas Murray

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<sup>1</sup>. The survey led to one prompt decision, which was to drop the idea of rating CSDs. As operators of monopolies CSDs, unlike custodian banks, saw no marketing advantages in purchasing a rating. Instead, Thomas Murray developed the depository risk assessments it sells to fund managers and institutional investors today. Rule 17f-7 of the Investment Company Act - which obliges US mutual fund managers, whose agents in overseas markets are forced to settle and sometimes to hold assets within CSDs, to assess their riskiness – have since enlarged the appetite for this information.

alongside its client perception survey, a senior executive at one of the leading agent bank networks was positively effusive in his enthusiasm for the idea. "Congratulations on your joint announcement!" he wrote. "Look forward to working with you." Just weeks later, he and his colleagues were the leading organisers of a bloc of custodian banks - BNP Paribas, Citibank, Dresdner Bank, HSBC, and Standard Chartered - whose unity, sense of affront and threats to withdraw co-operation from the *Global Custodian* survey process effectively killed the idea of publishing indicative custody ratings in 2002. Privately, many of the bankers involved admit that their doubts about the validity of the ratings process are so great that they would prefer the ratings never be published at all.

What had changed their minds? Doubts first surfaced in 2000, after Thomas Murray and Standard & Poor's had devised a rating methodology and shared it with the custodians as well as institutional clients. "Institutional investors were very supportive, both of the methodology and the usefulness of ratings as a means of comparing one custodian with another," recalls Roger Fishwick, a former executive at Prudential who joined Thomas Murray in 1999 primarily to develop the ratings service. "But the reaction of the custodians was very cautious. There was an intellectual interest in how we proposed to do it, but considerable concern over the practical consequences." The vanity ("we are bound to be AAA") and salesmanship ("this will give us one over the competition") which had fuelled the initial enthusiasm of the custodians for ratings back in 1998 wilted as they realised that the outcome of the ratings process might not necessarily conform with their self-image. Although the banks still lacked any knowledge of how their ratings might compare with those of their peer group, they persuaded themselves that public custody ratings were almost certain to alter - and in an adverse direction - the way fund managers, institutional investors and broker-dealers bought custody and clearing services.

The obvious concomitant of this realisation was that clients and potential clients might attach an undue degree of importance to custody ratings. Those familiar with them certainly regard them as valuable. "We are aware of what Thomas Murray are doing on ratings, and we see them as a useful product," says Frank Curtiss, special projects adviser at Railpen Investments. "They can give us a snapshot view of the relative standing and performance of individual custodian banks. As well as confirming our view of a particular custodian, ratings will also alert us to any potential problems. Anything that casts light on a dark area is a good thing. We hear a lot about transparency these days, but quality of disclosure is what counts, and the more objective it is the better it must be for the client. I would never say that custodians feed clients misleading information but, understandably, they present it in the best possible light and the light most favourable to them. Clients expect objective measurement." Tony Allen, senior operations manager at Hermes in London, agrees with this assessment. "Looking at the problem from the point of view of an investor, we have less and less choice now," he says. "So the more information we have about the remaining custodians, the better. I think the custodians are a bit short-sighted in this respect. They don't share enough information. It would be nice if, instead of having to push them towards greater disclosure, they were a bit more supportive and joined in the process."

In fact, what both Allen and Curtiss particularly value about the work of Thomas Murray is not the ratings themselves, but the surveillance work which accompanies them. It addresses the criticism that a rating is merely a snapshot which cannot, almost by definition, be stable. Credit ratings change, banks merge with each other, or lose staff, or elect to assume sub-custodian risk, or choose to offer custody on a tri-party basis which makes use of a parental balance sheet. So where it has a large enough universe of custodial clients to make valid comparisons, Thomas Murray now delivers a service called Probe. These are monthly or quarterly

operational benchmarking reports to institutional investors, combining a private rating of their particular custodian with a benchmarking of its performance in key areas – settlement fail rates, income collection, tax reclaims, securities lending, fees paid, query handling, investment accounting, STP rates, and so on – against their peer group. The custodians have no objections to furnishing Thomas Murray with the relevant data, mainly because they are already supplying it clients themselves already. Institutional investors, on the other hand, value not only receiving it from an independent source but the fact it is benchmarked against a peer group.

“The custodians also supply us with performance indicators, but they are not exactly objective,” says Curtiss. “Just as we do not rely solely on fund managers to tell us about performance, so we seek independent performance measurement for our custodians. The ratings are just a snapshot, but Probe measures their performance over time. The more we can document and produce an audit trail which shows that we are monitoring custodial risk and performance, the better it is for us.” At present, the surveillance service is private. But any custodian which opts for a public rating will simultaneously elect to submit itself to public surveillance in the same way that Moody’s and Standard & Poor’s monitor issuers for signs of deterioration or improvement in their creditworthiness. This has added to the unease of the custodians about the ratings process, because the published “outlook indicators” [see Box Three] contain threatening words such as “positive” and “negative” and the sinister-sounding “on watch.” “We are concerned that certain terms used might be misleading and lead to unnecessary concern on the part of our clients,” says Colin Brooks, SVP and deputy head of custody and clearing at HSBC in Hong Kong. “For example, use of the term ‘On Watch’ to describe a custodian initially sounds somewhat disturbing. Its use, however, is ambiguous in that it can be used to indicate a pending re-rating either upwards or downwards. Unfortunately the direction of the re-rating does not appear to be indicated.”

Thomas Murray is alive to this concern. “Some people do regard ‘on watch’ as having negative connotations,” acknowledges Derek Duggan. “In fact, being on watch can be a positive sign.” He concedes that there is a subjective or judgmental element in the outlook indicators – regarding this as an inevitable concomitant of any attempt to predict the future - but Duggan is reluctant to alter the terminology, arguing that all of the terms used in the outlook indicators are the ones the traditional credit rating agencies such as Standard & Poor’s and Moody’s have used for years. Ultimately, as with the ratings themselves, the views of client matter more than the views of either Thomas Murray or the custodians. The evidence suggests that they value the private service, and are therefore likely to value the public indicators as well. Frank Curtiss says Probe relieves him not only of the duty of monitoring his two global custodians - a task which he would have to undertake anyway to satisfy the auditors, trustees and regulators of the fund – but fulfils it more cheaply, and delivers more reliable, comprehensive and (importantly) benchmarked information. From next year, he intends to out-source the job in its entirety to Thomas Murray, and stop getting data directly from custodians. He argues that, by channelling data through the consultancy, the custodians will reduce their own workload too.

Though it is never easy to argue against what clients consider valuable, or greater transparency in general, this is not an argument custodians are likely to buy. Though they profess to respect the work of Thomas Murray, and deny suggestions that there is any ill-feeling, the consultancy itself knows that what keeps its business in being is need rather than popularity. Resentment by providers of their control of access to the client is the fate of consultants in every industry, and custody is no exception. Take any global custodian or agent bank, virtually at random, and its sales executives will gripe about how the Thomas Murray

RFP process forced them to invest man-years in divulging detailed information to a supposedly asset-rich custody buyer whose identity was never disclosed because they did not make the short-list. Such anonymity aggravates, and not only for the obvious human reasons, but because it creates a bias towards cautious answers to awkward question to avoid taking on unwelcome clients, unwitting commitment to new investment, damage to existing relationships, or regulatory embarrassment. But Thomas Murray denies that its RFP process is anonymous, except in the rare instances where a client demands it. "The custodians will almost always know exactly who the client is," says Fishwick. "It is extremely rare to do a mandate on an undisclosed basis, and it will only be done if the client requests it. We have not done a single non-disclosed bid in the last three years."

Duggan adds that since Thomas Murray became network manager to Bank of Bermuda last year that it has had to disclose to banks why they fail to secure business. With normal RFPs, he says, the client decides whether banks should be told the reason for failure. But Duggan admits that this creates an opportunity for Thomas Murray to sell further consultancy, in the shape of a comparative report it sells to the banks which failed to secure the mandate. As far as the banks are concerned, this adds insult to injury: Thomas Murray is effectively re-packaging the information they gave to it in the RFP and selling it back to them. The fact that they buy it does not lessen the sense of resentment. (In reality, all of the custodian banks supply information to Thomas Murray and work with it not only on post-RFP analytics, but on populating its agent bank selection and CSD risk management tools.) Indeed, this re-use of data gleaned from the RFP process is now one of the central objections adduced by the custodian banks to the entire ratings process. Fishwick admits that the ratings of agent banks will be based not only on information gleaned from the RFP process, but from the work of the Bank of Bermuda network management team at Thomas Murray as well [see Box One]. He does not apologise for this. "The ratings methodology is grounded in how we evaluate and select both global and domestic custodians," says Roger Fishwick. "A sound rating must be grounded in reality, and the only way to ground a rating in reality is to look at all the information we have. If it were done in any other way it would be entirely theoretical."

Certainly, the Bank of Bermuda contract gives Thomas Murray direct and regular experience of competing agent banks in over 90 markets. The consultancy now employs three network managers, one of which is based in Hong Kong. "The fact we have an operational client acting on the data used to derive the ratings adds to their credibility, rather than detracts from it," says Derek Duggan. "It means we have visited agent banks on the ground in over forty markets in the last nine months alone, and that programme of visits goes on continually." Whether or not using all sources of information leads to more accurate results, the custodians argue that jumbling up data acquired in its various capacities as consultant, network manager and rating agent means Thomas Murray has an inherent conflict of interest. "We have a major fear that Thomas Murray may be both judge of and a party to the ratings exercise," says Charles Cock, head of multi-direct clearing and custody at BNP Paribas Securities Services in Paris. "The commingling of the roles of consultant and neutral assessor, and the basing of conclusions in one sphere on research conducted in the other, makes us very uncomfortable. It is something we feel very strongly about." Colin Brooks of HSBC endorses this view. "Thomas Murray is an industry consultant employed by a number of industry participants in different ways and at different times," he says. "We have concerns that there could be potential conflicts of interest caused by this role and the objective, non-partisan role of analysing and rating industry participants in a competitive survey and with access to sensitive data." Ranjit Chatterjee, market manager at Citibank Global Securities Services in New York, agrees. "We believe there is an inherent conflict of interest in having anybody – no matter how professional – collecting

data from banks for selection and evaluation, and then using the same data for commercial purposes," he says. "We don't think that is the right model."

The custodians also argue that relying on a mixture of RFP and network management data means the information on which ratings will be based is misleading. The Bank of Bermuda, being primarily a fund administrator, is a particular type of client. Thomas Murray counters that - in the eight years which have elapsed since the firm began evaluating and selecting custodians on behalf of institutional clients in 1994 - it has placed assets worth \$1.7 trillion with a variety of banks on behalf of fifty-odd clients, including major insurers fund managers (Axa, Zurich, Prudential and Skandia) as well as pension funds (Hermes, ICI, RailPen and IBM). However, as far as the custodians are concerned, fifty is not a large number. "Thomas Murray have been running a few RFPs on behalf of specific clients," says Charles Cock. "The Thomas Murray clients for which we completed RFPs were not large, or even medium-sized." Both Paribas and Citibank, as the main broker-dealer clearing agents in Western Europe, also argue that Thomas Murray understands little of the clearing business. Indeed, Chatterjee even intimates that Thomas Murray may be using the custody ratings exercise as an information-gathering (and therefore revenue-generating) exercise in an area of which it would otherwise know next to nothing because it does not get involved in the RFP process. "Consultants are not, by and large, used by our broker-dealer customer base," he says. "So there is no easy way for a consultant to get involved in the buying process without going through a mechanism such as this. Thomas Murray have *some* data about how *some* markets operate, and *some* data about how *some* banks operate in those markets, but they do not really have full data. Perhaps this is a useful mechanism for them to get the data. We value the contribution Thomas Murray makes to the investor side of the business greatly, and of course we work with them and will continue to work with them. But they are not really specialists in broker-dealer requirements, which are a large part of our customer base."

Thomas Murray concedes that ratings prepared to inform global custodian bank or institutional buyers of safekeeping and asset servicing products are obviously less relevant to broker-dealers buying transaction settlement, securities borrowing and credit products. "The agent bank ratings are directed primarily at global custodians and institutional investors rather than broker-dealers," admits Fishwick. "That is not to say that, if there was a demand for broker-dealer clearing ratings, it could not be accommodated. We would be perfectly happy to work with the major clearers to develop an appropriate ratings model. But in reality, it is a pretty small market, with only one or two clearers in each market. There is a much bigger market for agent bank ratings." This is an awkward line of argument, implying that Thomas Murray will rate only what it is economic to rate, but it does mean the firm recognises the gaps in its knowledge on the broker-dealer clearing side of the business. It also helps to explain why the agent banking networks most heavily involved in broker-dealer clearing were the most vociferous opponents of publishing indicative custody ratings in *Global Custodian*. But their objections to the Thomas Murray ratings process do not stop at allegations of conflicts of interest and limited understanding of their businesses. They also argue that the sources of information on which the consultancy is relying to prepare its ratings - namely, RFPs banks have completed in the past, plus information derived from the network management role - are flawed.

Thomas Murray has an answer to this: fill in our questionnaire, on-line. Unfortunately, all of the banks at the forefront of the campaign against the publication of the indicative custody ratings - BNP Paribas, Citibank, HSBC and Standard Chartered - have declined to do this. Which means any ratings Thomas Murray derives for the operations of these banks may be based on misleading and out-of-date information the consultancy has collected for other purposes. This

has the advantage for the banks of making it both harder for Thomas Murray to rate them, and easier for them to discredit any ratings which emerge. But the banks claim there are less Machiavellian explanations for their refusal to supply Thomas Murray with accurate and up-to-date information. The first is that it involves too much work. Chatterjee says flatly that the amount of effort required to fill in a detailed questionnaire across eighty markers is simply impossible to justify. Colin Brooks of HSBC agrees. "Thomas Murray says that we can complete a questionnaire on their web site as an alternative to them using the unreliable RFP data," he says. "This, however, requires over sixty pages of questions to be completed per market, covering detailed analyses of capabilities and service standards in many areas of business. It is difficult to understand why such detailed information is required to make the assessment. For a regional agent such as HSBC which covers over thirty markets, it will be an extremely time-consuming task to complete the questionnaire, particularly as most of the questions require more than a simple Yes/No answer - narrative responses are often needed to ensure we are providing a full and accurate picture. We also cannot see how it is possible to verify any of the data that is input and there is therefore the possibility of some participants being tempted to overstate their capabilities at the expense of those giving a more honest description."

This last point is a bit rich. As Terry McCaughey - the former head of HSBC GIS in London and sometime head of European marketing at Deutsche Bank GSS - points out, the traditional RFP contains more lies, exaggerations and evasions than a speech by Tony Blair. "The RFP process has become so routine now," he says. "Banks just have piles of responses, and cut and paste. I am not sure how accurately the database underlying those responses reflects the current status of their product offering. What Thomas Murray is doing is an attempt to bridge that gap, and remove the inequities that have been built into the RFP process." Hermes's Allen adds that he thinks clients fail to help themselves by insisting bidders complete massive and lengthy RFPs, which are then filled with meaningless promises. Ray Lester, executive head of Clydesdale Bank in Glasgow, agrees. "The major institutional investors and fund managers perpetuate the complacency, because they stick to the big-is-best approach rather than use people like us, even though we have a track record, demonstrable financial strength and now a rating," he says. "They could help to create the next big custodian to come along, and ratings might encourage them to push that process along." But Colin Brooks counters that the winners of a mandate secured through the RFP process do at least face the discipline of delivering whatever they promised. "The ratings exercise differs from an RFP in that the winner of an RFP exercise has to stand by commitments made in the RFP response," he says. "There are no such checks and balances from filling in the Thomas Murray questionnaire."

A more fundamental objection to filling in the Thomas Murray questionnaire is that it will necessarily fail to elicit the information it seeks. "We are willing to answer any question and assist to Thomas Murray in any industry analysis, but not to fill in a questionnaire where we do not believe in the methodology," says Cock. "We do not believe any valid conclusions can be drawn from it." The problem, in the eyes of the custodians, is that a rating derived from answers to the questionnaire will be based services supplied to an average client, and the average client does not exist. "When we respond to an RFP, we customise it to the prospect," says Paul Hedges, head of custody sales and relationship management at Standard Chartered. "The proposition we look to supply to our customers is a service which enables them to differentiate themselves to their customers. That is where we add value in the RFP process. If one is being rated generically, none of that will come through. The Thomas Murray process is a bit like a multiple choice exercise, where you do not know who the examiner is." Ranjit Chatterjee agrees. "In a questionnaire, we cannot really take into account the fact that we offer different

sets of services to different clients," he says. Even though BNP Paribas pursues a relatively well-defined group of clients – the major investment banks, plus the top global custodians – Charles Cock says no client proposition is ever like another, so the only meaningful questionnaire to fill in is one completed for a specific client. "Thomas Murray will be extrapolating conclusions from an out-of-the-blue RFP exercise, without us knowing who the client is," says Cock. "When you are asked to fill in a blank RFP without knowing the creditworthiness and profile of the underlying client, you tend to give very generic answers."

Colin Brooks argues that the same consideration renders worthless any information Thomas Murray has obtained through RFPs in the past as well. "We have in the past provided data for a very limited number of RFPs when requested to do so by Thomas Murray on behalf of a client," he explains. "The data is provided on a private and confidential basis and is specific to the particular needs and requirements of the client in question. The data provided is also a snapshot of what we propose to offer clients at a particular point in time. You can well imagine that our service standards and product range in thirty branches change almost daily. Not only is the data only relevant for a specific client, but the shelf life of that data is also extremely short. We specifically state that the information is not to be used for any purposes other than the specific RFP exercise for which it has been provided. We would be very concerned if it was to be used as a means of rating our services." This looks like a telling point. A custody rating has – by definition- to represent what a bank offers to the average client. Since the average client does not exist - different clients are offered different services, in terms of both quality and price, depending on the size of their business and the nature of their needs – but a rating system in which every provider was rated against their best client would make distinctions impossible, the entire concept of ratings is doomed. "The custodians are concerned that ratings would be based on the lowest common denominator, and would therefore be much worse than the terms they were prepared to offer the biggest clients," admits Fishwick. "They do not want to be judged publicly on what they are prepared to offer the average client."

On the face of it, assessing services supplied to the average client does seem to lead to average ratings. After applying indicative ratings to 280 banks, Thomas Murray found that all of them fell into the range between AAA and B – as they must, since CCC means the ability to deliver the core services is absent – and that the overwhelming majority clustered between AA and BBB. In other words, the Thomas Murray custody ratings have the bell-shaped distribution curve characteristic of any random collection of data. Unsurprisingly, the outcome holds true across all the criteria – settlement, internal operations, risk, core services and credentials - which go into making up the overall ratings [see Box One]. If custodians thought about it - a few outstanding banks, a lot of middling ones and a handful of appalling ones – they would probably recognise the distribution as a fair description of what they are actually like. Instead, the question whether such limited distinctions are useful at all. "The ratings ranges are much too wide," says Cock. "When they say a bank lies somewhere between AAA and BBB, they are really demonstrating how difficult it is to come up with a rating system. They need something simpler, because it will be impossible to fine-tune such a detailed ratings scale." Colin Brooks of HSBC has a more fundamental objection. "In terms of ratings used there is no indication as to the distinction between the various rating scores," he says. "For example, how does AA differ from AA+ or A?" Ray Lester of Clydesdale disagrees with these criticisms. "They are using a rating system that is known," he says. "If someone asks what is a AA or AA bank, implicitly they know the quality of the bank. As more banks get rated, there will be a greater range, and people will know exactly what they are buying. Some clients might choose to go for a lower rating and a very cheap price."

Citibank's Chatterjee counters that the bunching of ratings around the norm renders them useless as a guide to action. "In most major markets, multiple players get rated highly," says Chatterjee. "Then the value of ratings becomes more marginal. When an industry is young, ratings have more value. When maturity approaches, quality is no longer the overriding issue. We are not going to be in a situation where we are AAA and our main competitors are BBB." Charles Cock points out that in Europe there are only two serious agent banks competing for business in each market, and that the ratings process will struggle to distinguish between them or add much to common understanding of their strengths and weaknesses. Terry McCaughey disagrees. "People say custody is a commoditised business," he says. "But if that is the case, how come the CSDs have not taken over the job of the agent banks?" Frank Curtiss of Railpen also warns that consolidation in the custody industry is breeding a complacency, of which the contempt for ratings is a part. "Consolidation has its advantages, but it also has its disadvantages," he says. "Once you get an oligopoly this is exactly what can happen. Sometimes, custodians need to be reminded of their competitive weaknesses as well as their competitive strengths. It is pricking for the ego to be embarrassed in public, but it does have its uses." Nor are ratings solely a useful discipline for suppliers. No matter how partial, ratings have their uses for investors. Although no investor would ever buy a corporate bond based solely on a credit rating issue by Moody's or Standard & Poor's, credit ratings are one piece of information investors can use to build up a picture.

But credit ratings are different from custody ratings, says Ranjit Chatterjee. "Rating quality of service is different from rating credit," he says. "It is about how the customer experiences a service. It is not about what is hidden in the balance sheet, or shining light on obscure data. It is about reflecting what the customers feel, and the only reliable ratings are those based on surveys which go directly to the consumers of those services." Thomas Murray admits that its methodology differs from that of the traditional credit rating agencies. "Standard & Poor's ratings are based on a top-down analysis of the financials of the group overall, whereas our methodology is a bottom-up analysis based on operational capabilities," explains Fishwick. Indeed, it was precisely this difference in approach which attracted Standard & Poor's to Thomas Murray. Instead of relying on a mixture of published financial information and interviews with senior management, a Thomas Murray custody rating begins with a detailed analysis of operational capability, and builds up to an overall rating from what it discovers in the innards of the bank. "Which is what appealed to Standard & Poor's," says Derek Duggan. "The bottom-up approach is much more robust than the top-down, good hair day-bad hair day approach of classical credit ratings." In particular, it means that a weighted judgment of quality is applied at the level of the particular service as well as the overall organisation. But this is where Thomas Murray has run into further objections from the custodian banks.

A Thomas Murray custody rating is derived by a clear methodology (see Box One) on published criteria, with which nobody can seriously quarrel. It is only when weightings are attached to each criterion that the trouble starts. Perhaps inadvisedly, Thomas Murray has decided not to publish the weightings. "By publishing them, we would open ourselves up to attack," explains Fishwick. "Banks would start asking, 'how can you say that "x" is only worth a "y" percent of the total?' People will always think that whatever they are best at doing is the most important criterion." This is true. But the banks have set about trashing the ratings process anyway, and failing to publish the weightings has created ample room for custodians to complain that the results are subjective. "There seems to be quite a lot of subjectivity," says Paul Hedges. Others say the methodology results in ratings which bear no relation to reality. "We do not have a sufficient understanding of the methodology," says Chatterjee. "When we saw the indicative data on our own operations, we found that branches were rated using

terminology we couldn't quite understand. The rationale behind the ratings was not clear either. When we saw the data again a couple of weeks later a lot of it was changed, and the rationale for the changes was not clear either." Colin Brooks agrees. "We have no indication of how Thomas Murray would actually make the rating on the basis of the information they have," he says. "We have no idea what methodology would be used and we are therefore unhappy about submitting to an opaque process. Given the large coverage of the survey and the detailed nature of the questionnaires, a massive effort would be required by Thomas Murray to ensure the results are consistent."

Fishwick feels these criticisms are unfair. Custodians are using the granularity of the Thomas Murray ratings process – which he regards as a strength – to discredit it. A provider specialising in providing clearing services to broker-dealers can always argue that the weighting given to settlement is too low, and the weighting given to corporate governance is too high. Publication of the weightings might enable these arguments to be aired. But Fishwick will still not be drawn on the details. What he will say publicly is that the weightings range, roughly speaking, from just 10 percent for the credentials of bank (since anybody uncommitted to custody will not attract many buyers) to 30 per cent for each of core services, internal operations and risk [see Box One]. But he also says that the custodians played a central role in determining the weightings in the first place. "In the early days, we went round the custodians and talked to them about the relative weightings of different factors," explains Fishwick. "We got feedback from them and, as a result, adjusted some of the weightings. And the weightings have not changed since then." He adds that weightings have to be held unchanged until there are significant developments, or they become worthless as guides to change over time, and that shorter-term alterations in bank service offerings are better picked up by the individual scores given to the quality of the core and value-added services provided by each bank [see Box One]. These scores are weighted and summed at four separate and successive levels: the individual questions, groups of individual questions, key evaluation criteria and the overall rating itself.

Thomas Murray has further cause to feel aggrieved about the attitude of the custodian banks: the consultancy was prepared to sacrifice its partnership with Standard & Poor's in order to address their concerns about the potential corruption of their credit ratings by the Thomas Murray custody ratings. "Some custodians were worried that if Standard & Poor's got into the depths of their business on the custody side, and found contingent liabilities they were not previously aware of, that could adversely affect their credit rating," says Fishwick. This concern was not misplaced – Clydesdale, the one bank to undergo a full custody rating so far, has emerged from the process with a lower rating than its parent, National Australia Bank. As a result, Thomas Murray chose to end its alliance with Standard & Poor's. The rating agency retains a 7 per cent stake in the consultancy firm, but the contractual agreement to develop ratings for both CSDs and custodians was ended eighteen months ago, at the end of 2000. Ultimately, the decision to part company with Standard & Poor's was necessitated by the decision of Thomas Murray to abandon the idea of publishing public ratings of custodian banks without consent. This was unavoidable if banks – rather than the institutional investors – were to pay for them. "Standard & Poor's withdrew from a relationship with us because the business model we were settling on was not well-aligned to the high volume, publicly available ratings of the kind the firm generates in the credit area," explains Fishwick. "Without public ratings, it was difficult for Standard & Poor's to see how custody ratings would generate significant, early revenue for them. It was patently obvious to us that ratings were going to be bought, not sold. There was clearly no point in trying to persuade banks that it was in their best interests to be rated publicly, so we decided to wait for banks which saw the advantages of a rating to come

and ask for one." In the meantime, the firm has developed private client ratings for institutional investors looking to appoint a provider. These really amount to no more than a systemisation of the evaluation and selection work Thomas Murray has always transacted on behalf of buyers of custodial services.

But what Thomas Murray needs now is for a bank to opt for a public rating, *pour encourager les autres*. The regional agent bank networks are unlikely to fall into this category, but Thomas Murray says several domestic custodians and a pair of global custodians are also close to accepting a public rating. The immediate incentives for the larger custodians are not obvious. "The custodians are getting bigger, and more complacent," says Hermes's Tony Allen. "Why do we want to do it?' they ask themselves. 'This is the offering - that's it.' They talk about being client focused when they are round the table with us. But then they get up, go away, and forget about it. Yet they are an integral part of our business. If they cock up, we cock up. The smaller players are more accommodating." The large, established players have invested fortunes bringing their businesses to the present pitch, and are more absorbed in retaining and servicing what they have rather growing their business. Ratings can only make that task harder. For these reasons, it is the smaller and more ambitious banks that are more likely to opt for a public rating first. Their challenge is to break into markets dominated by established providers, and they reckon a rating can make that task easier, by emphasising energy, flexibility and modern technology. This is certainly why Clydesdale Bank, which is looking to capture mid-tier pension fund business in the United Kingdom, became the first bank to undergo a full rating process. "We are trying to expand in the marketplace and gain greater acceptance," says Ray Lester, executive head at Clydesdale Bank in Glasgow. "There is still a perception that big is better. Unlike fund managers, who are rated on performance, the only league tables which measure custodians seem to be based on size, and size is not necessarily a measure of quality or ability to deliver. So what we expect to get out of a rating is a greater recognition in the marketplace of the quality of our service offering and our ability to deliver. The higher we lift our rating, the greater our credibility in the marketplace."

Unlike the private ratings, which are tailored to a particular client mandate, public ratings of the Clydesdale kind oblige Thomas Murray to put its own people into banks at the operational level. "In a private rating, we will kick only the tyres which the client wants us to kick, but in a public rating we will kick the tyres at every operational level," says Fishwick. "I have myself spent a week in a bank doing exactly that." Thomas Murray argues that this addresses another criticism made by the custodian banks: that they do not know what they are talking about because they rely on questionnaires rather than talking to clients or visiting operations on the ground. "I am extremely sceptical about the true capacity of Thomas Murray to appraise the true quality and the true product offering of agent banks," says Charles Cock of BNP Paribas Securities Services. "On most occasions in which we participated in an RFP, until very recently, we did not even have Thomas Murray visit us on site. The way they did it was through a questionnaire, occasionally followed by on-site visits. We all know that when someone fills in a questionnaire, if you want to look good, you look good. You have to come on site, talk to the people, ask the questions, let them answer them, and get all of the nuances into your appraisal. You have to kick the tyres. Nobody can come up with a true assessment without an on-site visit, and without kicking the tyres in a professional manner."

This criticism is no longer valid, if the experience of Ray Lester at Clydesdale is anything to go by. "They did the most comprehensive walk-through of our process that anyone has ever done, internally or externally," he says. "I felt confident that, at the end of the process, they had a very good idea of our business and its capability. We really did open ourselves up. It was four full

days of due diligence, and further discussions as follow-up. It is an indication of the maturity of our organisation that we were willing to open ourselves up to such an in-depth analysis of our service delivery capability." Cock admits that he would feel much more comfortable with the ratings process if Thomas Murray consultants spent a week in each of his operations, in the same way as they did at Clydesdale. But Cock argues that Thomas Murray were aiming to publish before the ratings data and process were ready. "It was clearly premature," says Charles Cock. "Thomas Murray had not even been on site in Italy, where we are the number one provider." It has encouraged other custodians to conclude that Thomas Murray was using *Global Custodian* to accelerate the process by which ratings became accepted, and so give the firm access to the information it needed to go beyond indicative ratings. If indicative ratings - the range within which a bank its services were likely to fall - appeared in the *Global Custodian* agent bank survey, ratings as a whole might acquire momentum. The force which the banks exerted to prevent this happening suggests there was something in this. They have certainly encouraged the idea that the management of the magazine was naïve, and risked forfeiting the independence on which their respect for the agent bank survey depended, in order to promote a different assessment tool of no value to the publication but potentially enormous value to Thomas Murray.

This is true, to the extent that once the relationship with Standard & Poor's had broken down, Thomas Murray needed somebody else to distribute its ratings. But it ignores the fact that the agent banks themselves were putting the surveys group at *Global Custodian* under increasing pressure to formalise their intuitive understanding of both the different business models of the various custodian banks and the varying quality of the infrastructure with which they have to work in different markets. Indeed, the primary purpose of the alliance from the *Global Custodian* point of view was to address those concerns. After welcoming the alliance, when it was initially announced in the Fall of last year, the agent banks have since focused on regretting the consequent loss of independence at *Global Custodian* and the late stage at which they were drawn into the process. "People should perhaps have been involved a lot earlier on in the process," says Paul Hedges "The involvement of a third party - in this instance, Thomas Murray as consultants, in collecting valuable and proprietary RFP data which subsequently becomes their property makes us uneasy. The information that agent banks provide to this online database is obviously of immense value to whomever controls it. Bearing in mind that Thomas Murray is a consultant used by a number of global players in gathering their RFP information, it is not difficult to see how a consolidator of this data could benefit from such an arrangement." Concerns about confidentiality are voiced by other custodians too. "Within the securities business there is a high degree of staff movement, with people moving from one organisation to another," says Brooks. "If we were to contribute to the survey it would provide a huge volume of confidential data to a single organisation. What would happen to that data if a Thomas Murray employee moved to a competitor of ours?"

This is really no more than a variant of the conflict-of-interest arguments which the custodians have deployed against the Thomas Murray ratings process. These are clearly held deeply. Deploring the truncation of the independence of the *Global Custodian* agent bank survey rings less true. "The *Global Custodian* survey is valuable because it reflects the views of our customers independently and impartially," says Ranjit Chatterjee. "We rely on it to tell us what to do in what particular area in which particular branch. We think the value would be lessened if we added any other influence on top of the customer feedback. Even if Thomas Murray had wonderful data and a wonderful methodology, we still don't think this would be the best way to do a customer survey." This is an odd perspective, given that the client perception and Thomas Murray data were to be presented separately in the magazine, and there was to be no overlap

between the two processes. Moreover, Clydesdale's Lester says ideas on how to improve performance are exactly what the Thomas Murray ratings process has already delivered for his bank. "In an internal sense, it gave us some key performance indicators about the development path of our business," he says. "We have not only got a real incentive to lift our rating to a higher level, but the process has given us the vital clues as to what we should home in on and improve to lift ourselves into that higher rating. We have put in place an action plan over the next six months to make the difference, and get re-rated."

This is a rare but rational perspective on the ratings question. In a less charged atmosphere, banks and buyers of services from banks would treat both the Thomas Murray custody ratings and the *Global Custodian* agent bank survey for what they are: pieces of information. Valuable pieces, to be sure, but at bottom no more than pieces of information that vendors and buyers need to build up a picture of service quality. For both the client perception and the ratings processes have their limitations. Custodian banks may say what counts is what clients think. But not many of the institutions which complete the *Global Custodian* agent bank questionnaire have intimate knowledge of more than one provider, so the basis of comparison is limited. In electing to publish comparable information from Thomas Murray side by side with client perception scores, *Global Custodian* sought only to improve understanding, and in particular to highlight differences between the self-image of custodian banks (as recorded by the ratings ranges) and their delivery to clients (as recorded by the client perception survey). Coupled with the Thomas Murray data on the quality of local market infrastructure – which is published for the first time in the 2002 *Global Custodian* agent bank survey – this approach ought not only to flatter the deserving in a much more meaningful way, but draw attention to flaws in either methodology. The custodians disagree. "The best way of dealing with the problem of different business models and client bases is to be very direct and ask the custodian banks what they think differentiates them from their competitors," says Chatterjee. "Take the stated objectives of each provider, and then compared it with what they actually achieved in the survey."

Is it too Machiavellian to suggest that custodian banks prefer to divide and rule? Probably. What is certain is that the established custodians are persuaded that they have more to lose than gain from the publication of the Thomas Murray custody ratings, for banks which are as good as they think they are have nothing to fear from a more objective process and greater transparency. Since it is always difficult to argue against transparency and objectivity without appearing self-interested – and especially so in a post-Enron and WorldCom environment – the custodians have preferred to attack the methodology and sources on which the Thomas Murray ratings are based. For now, their official position is that publication of the custody ratings is postponed until they can satisfy themselves that the methodology is sound and the data sources have integrity. But since a number of important banks have declined to furnish Thomas Murray with the information the firm needs to formulate accurate conclusions, it is difficult to conclude that they will ever support the publication of custody ratings. "I don't see these ratings happening," admits Paul Hedges. "Talking to customers and prospects alike, they are looking to differentiate themselves from their competition, and one of the ways they choose to do that is through their RFP process. To automate this process implies the formation of a central RFP agency, and that is not going to happen. The individual RFP will remain."

Thomas Murray is pinning its hopes on support from investors (which value the ratings products), smaller banks (which value the marketing clout of a rating) and global custodians (which have less to fear from a rating than agent bank networks). These three constituencies, particularly if investors can overcome their traditional indifference to custodial complacency, could well feed off each other to drive the ratings process forward. "We would like to see the

Thomas Murray ratings process acquire greater acceptance and credibility in the marketplace," says Ray Lester of Clydesdale. "That way we can get a true league table going. Everybody in the industry is claiming that they can do this and do that. But what the clients need is something they can rely on to tell them what firms can actually deliver." Whatever happens, it will probably happen slowly. Ratings will gradually become another piece of information – perhaps even the benchmark - among the many which buyers of securities services will take into account when deciding which bank and what services to buy. Regulators will look at them too, on grounds of competition as well as investor protection and market integrity. Perhaps rival ratings agencies to Thomas Murray will emerge. And the banks will not only get used to being rated, but start to use their ratings as a source of competitive advantage. Just they like use Moody's and Standard & Poor's already.

## **Box One: The Thomas Murray Global Custody Ratings Methodology**

### Sources of Information

The information on which a rating is based is derived from five separate sources: publicly available information (such as annual reports and credit ratings); feedback from clients of the custodian in question; due diligence visits by the network managers at Thomas Murray; due diligence visits by Thomas Murray consultants on behalf of clients; and data supplied directly by custodians to Thomas Murray.

### Evaluation Criteria

Banks are evaluated in four main areas: credentials, core services, internal operations; and risk. These test the experience and commitment of a bank; the range and quality of services provided by a bank; the quality of the internal processing platform, communications links and network management which underpin its services; and the degree of risk to which assets belonging to a client of the bank are exposed.

### Experience and Commitment

This is judged by action, rather than intent. It is measured by the significance of securities services within the overall revenues of the bank; the willingness to invest continually in the business, in terms of people as well as processing platforms and customer service centres; the size, range and quality of the client base; and staff numbers, quality, training and turnover.

### Core Services

Banks are assessed in nine areas: settlement, safekeeping, income collection, corporate actions, proxy voting, cash management, foreign exchange, tax reclaims and securities lending. Performance in most of these areas is measured numerically, and benchmarked against a peer group, as well as assessed against best practice in the industry.

### Internal Operations

The quality of the infrastructure which supports the delivery of services is assessed in four main ways: access to accurate, up-to-date information which can be manipulated and re-formatted; robust, secure, standardised and automated telecommunications capabilities; the efficiency and management of agent bank networks; and the organisation and effectiveness of client relationship management.

### Risk

Risk is measured in terms of financial strength (credit ratings, balance sheet strength and usage, regulatory capital ratios, and insurance cover); asset safety (segregation and subordination of client assets and sub-custodian and CSD risk); asset servicing quality (such as missed dividends or corporate actions); and operational risks (such as lax internal audit or poor business continuity planning).

### Value-Added Services

To ensure the comparability of public ratings, all banks are assessed and rated publicly on core services only. However, if a bank requests it, Thomas Murray will rate value-added services separately. Typically, functions such as fund accounting and transfer agency, performance measurement and analytics, and transaction cost measurement will fall into this category.

### Box Two: What the Thomas Murray Ratings Scale Means

Scale	Meaning
AAA	The custodian's ability to deliver core custody services is extremely strong
AA+	The custodian's ability to deliver core custody services is very strong
AA	The custodian's ability to deliver core custody services is very strong
AA-	The custodian's ability to deliver core custody services is very strong
A+	The custodian's ability to deliver core custody services is strong
A	The custodian's ability to deliver core custody services is strong
A-	The custodian's ability to deliver core custody services is strong
BBB	The custodian's ability to deliver core custody services is adequate
BB	The custodian's ability to deliver core custody services is less than adequate
B	The custodian's ability to deliver core custody services is quite weak
CCC	The custodian's ability to deliver core custody services is weak
CC	The custodian's ability to deliver core custody services is very weak
C	The custodian is unable to deliver core custody services at even a minimally acceptable level
N/A	Service unavailable

### Box Three: What the Thomas Murray Outlook Indicator Means

Scale	Meaning
Stable	There are no factors Thomas Murray is aware of that might affect the rating
Positive	There are factors Thomas Murray is aware of which might improve the rating
Negative	There are factors Thomas Murray is aware of which might worsen the rating
On Watch	There are factors Thomas Murray is aware of which might improve or worsen the rating