



IN SAFE HANDS

In the current economic climate, custodians need to secure their practices and protect their clients' assets.

BY BROOKE SMITH

In *Marathon Man*, as Dustin Hoffman squirms and sweats while strapped to a chair in an interrogation room, Laurence Olivier, dental instruments in hand, asks repeatedly, "Is it safe?" That's the big question custodians are getting these days in relation to their clients' assets. "The biggest topic on everybody's mind now, from a custodial standpoint, is safety of assets," says Scott Scobie, general manager with Canadian Western Trust (CWT).

The declining economy and the need for safety was certainly evident in this year's survey of custodians. As at Sept. 30, 2008, pension assets under custody were down across the board. RBC Dexia Investor Services (-13.5%), CIBC Mellon Global Securities Services (-11.0%) and State Street Canada (-4.0%) all showed declines. Although The Northern Trust Company, Canada had a 0.6% increase this year, this is minimal compared to its 12.2% increase in 2007. And Desjardins Trust had a 0.7% increase, but again, this is down from its 1.7% increase last year. State Street took the No. 1 spot this year with \$374.4 billion in pensions assets under custody, followed by RBC Dexia (\$371.0 billion), CIBC Mellon (\$204.1 billion), Desjardins (\$125.1 billion) and Northern Trust (\$54.7 billion).

As with any business, custodians must secure revenues to sustain and grow their businesses. They do this through fees, cash management, foreign exchange and securities lending. But managing these sources of revenues in these economic conditions may have a detrimental impact on a custodian's bottom line.

"The North American market valuations have gone down 40% [in 2008]," says Arti Sharma, senior vice-president, business development and relationship management, with Thomas Murray North America Inc. (a custodian watchdog). "There is a direct correlation on fees that [custodians are] collecting on the portfolios."

Retaining cash is another issue. With interest rates at low levels, custodians are not earning the same levels by keeping cash, which, in turn, will affect the bottom line.

Securities lending has also come under increased scrutiny. However, the trend seems to be more negative in Europe and the U.S., where custodians' clients are starting to pull back from lending. "In Canada, we haven't seen that level of pullback, but there are definitely questions being asked of the custodian," says Sharma.

The market has also put enormous pressure on the investment management community, according to Stephen Smit, chief executive officer (CEO) and president of State Street Canada. "As a rule, [they] are compensated on the value of the assets that they manage," he says. "When you get moves down in equity markets of the magnitude that we saw in 2008, that tends to fall through to the revenue line of most investment management firms."

Amid all the doom and gloom, though, Sharma sees a bright spot. She's referring to the foreign exchange activity where custodians are executing trades for their clients. "The swings in just the Canadian and U.S. dollars in the last few months have been significant, [so] that's one area that, probably, revenues were not impacted as much."

Smit, too, sees some opportunities—for example, in those investment firms that provide fund accounting on an outsourced basis. In the Canadian marketplace, this has traditionally been an in-sourced function, unlike the U.S., where most of the large mutual fund companies have already outsourced their fund accounting to a custodian. "I think we're beginning to see cracks appear with mutual fund complexes in Canada now considering outsourcing the accounting function," he adds.

Global Trends

As a result of shrinking profit margins, the custody industry on the whole may undergo some changes. One negative change that's hitting virtually every industry is downsizing,

and it seems custodians are not immune. Sharma notes that the large parent companies of custodians have had to cut back, too. For example, in November, The Bank of New York Mellon Corp. released a statement that it will reduce its worldwide workforce by roughly 4%—1,800 positions out of 43,000. A month later, State Street Corp. announced its plan to eliminate 1,600 to 1,800 positions, or about 6% of its workforce, and Northern Trust Corp. announced the elimination of approximately 450 positions.

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**– ARTI SHARMA,
SENIOR VICE-PRESIDENT,
BUSINESS DEVELOPMENT
AND RELATIONSHIP
MANAGEMENT, THOMAS
MURRAY NORTH
AMERICA INC.**



While some positions may be eliminated altogether, others may be outsourced. Although this trend has been going on for some time, during a period when cost containment is a priority, Sharma suggests that the industry may see an increased interest in outsourcing to cheaper locations such as India and Malaysia.

Consolidation will also play a part, as it has in the past, but more so in Europe than in North America. Canada has very few players left, says Sharma. “Definitely in Europe, you’re going to see some of the small- to mid-size global custodians think twice about staying in the business,” she says. “They may not be able to keep up with the investments that are required to remain competitive.”

Thomas C. MacMillan, CEO of CIBC Mellon, agrees that the industry will see consolidation globally. However, he stresses that there will be some kind of impact on Canada since most of the major players in Canada are global firms. “If consolidation doesn’t impact Canada, [then] I think Canada falls behind and the pension plans themselves aren’t served well enough.”

Another continuing trend is the movement away from investing in traditional instruments toward investing in derivatives and alternatives. According to bfinance’s 2008 *Pensions & Insurance Survey*, pension fund investors plan to increase their allocations to alternative assets over the next three years. Thirty percent of respondents intend to increase their allocations to private equity, followed by hedge funds and commodities (26% each).

PENSION ASSETS UNDER CUSTODY

Company	Canadian Pension Assets Under Custody as of Sept. 30, 2008 (billions)*	Canadian Pension Assets Under Custody as of Sept. 30, 2007 (billions)*	% Variance
State Street Canada	\$374.4	\$389.8	-4.0%
RBC Dexia Investor Services	\$371.0	\$429.0	-13.5%
CIBC Mellon Global Securities Services Company	\$204.1	\$229.4	-11.0%
Desjardins Trust	\$125.1	\$124.2	0.7%
The Northern Trust Company, Canada	\$54.7	\$54.4	0.6%

* Includes pension assets of Canadian operations’ invested in Canada, the U.S. and non-North American markets.

MUTUAL/POOLED FUND ASSETS UNDER CUSTODY

Company	Mutual/Pooled Fund Assets Under Custody as of Sept. 30, 2008 (billions)*	Mutual/Pooled Fund Assets Under Custody as of Sept. 30, 2007 (billions)*	% Variance
RBC Dexia Investor Services	\$469.0	\$524.0	-10.5%
CIBC Mellon Global Securities Services Company	\$374.6	\$419.4	-10.7%
State Street Canada	\$182.2	\$192.1	-5.2%
Desjardins Trust	\$23.0	\$25.7	-10.6%
National Bank Trust	\$21.3	\$24.0	-11.1%

* Includes assets of mutual/pooled funds of Canadian operations’ clients invested in Canada, the U.S. and non-North American markets.

Source: Companies participating in *Benefits Canada’s* annual Custody Report survey.

10 Questions to Ask Your Custodian

By Linda Bernard

Suppliers and vendors are going into liquidation, employees are being let go and the capital markets have been on a roller-coaster ride since Lehman Brothers filed for bankruptcy. In turbulent times like these, assessing the appropriateness of your custodian is prudent.

Institutional investors are watching the markets closely to see how the effects of these turbulent times will play out. Some banks have announced sizable write-offs; others are reviewing their internal structures and reorganizing. Institutional investors should assess how these factors affect their existing custodial arrangements and consider how “future proof” these arrangements may be.

When reviewing your custody arrangement, you should examine the custodian’s credentials, its delivery of core services (such as corporate actions), its internal functions (such as

network management), the level of responsibility for the loss of assets and cash, and the delivery and transparency of value-added services and fees. Here are 10 questions to ask your custodian during such an assessment.

1 What is the firm’s ownership structure and financial strength?

Today, there is a strong focus on the financial stability of service providers. Knowing the strength of your custodian’s balance sheet and underlying insurance arrangements is important. It’s also important to know if the firm is publicly and widely owned, and if any major shareholders have a direct influence over its strategic direction.

2 Is the contracting party the main operating entity?

In the event of a loss, you want to deal with (or have protection from) the most secure entity—one that is well capitalized with a high credit rating. If

the contracting party is not the main operating entity, then it is wise to seek a guarantee from the parent company.

3 Are cash balances held on your balance sheet?

Unlike securities, cash is fungible and cannot be segregated from a custodian’s assets and liabilities in the event of bankruptcy. Knowing if your custodian acts as principal and holds cash on its balance sheet, or if it is held on the balance sheet of the sub-custodian, will help you to assess your exposure.

4 Have you or your clients had to take losses in your cash funds?

Many clients use various forms of short-term investment funds provided by their custodians to invest short-term cash surpluses or cash collateral arising from securities lending. Ensure that these funds are conservatively managed, and appropriately rated and governed—and that the custodian has not had losses in them. »

IN MEMORIAM



It is with great sadness that *Benefits Canada* informs our readers of the passing of Eric A.T. Innes, Vice Chairman of Fiera Capital. After a courageous battle with pancreatic cancer, Eric passed away peacefully at Princess Margaret Hospital in Toronto, on January 2, 2009.

Starting at McLeod, Young, Weir in 1971 and subsequently moving to the trust environment, Eric was a key figure in the financial management industry. As co-founder of YMG Investment Counsel, he was instrumental in its development into one of the leading full-service investment firms in Canada and its ultimate merger with Fiera Capital.

Eric continued to shape Fiera’s development as Vice Chairman and, until his diagnosis, as Chief Investment Officer.

Eric will be greatly missed by his colleagues at Fiera Capital and the industry they serve. We would like to extend our deepest sympathies to his wife Candace and to his two sons, Brendan and Scott.

“This is going to place increased pressure on custodians to invest in new technology and hire specialist staff,” says Sharma. “Clients are pushing custodians to service them in areas that [they] have traditionally never done before.”

Help Me, If You Can

Despite tighter budgets, consolidation concerns and the need to meet the demand for more non-traditional investments, custodians still have to assure plan sponsors that they’re working for them. That’s particularly true in this economy, when communication becomes all the more important.

“When things are going [well], a custodian is usually seen as a commodity,” says Scobie. “When markets are down, there’s a lot more interest in your custodian again.”

“We’ve heard from clients where custodians have been all over them, communicating what they’ve done to weather the storm, what they’re going to do on a continuous basis—there’s been a lot of dialogue,” says Sharma.

That dialogue has been flowing at CWT, which focuses on the small- to medium-size businesses. CWT communicates with its clients on a daily and weekly basis. “We still have a very personal touch to our relationships,” says Scobie, adding that the company sends out newsletters as well as numerous press releases and emails.

Scobie says the communication has certainly increased in the past year because of the trying times in the markets. In fact, the company’s vice-president and chief operating officer makes more than 100 calls to regional centres and visits at least 100 clients each year. “That’s something new that we’ve implemented because [our clients] want to see more of us,” says Scobie. “Our communication is really geared around the safety of the assets

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5 Are my assets appropriately ring-fenced?

In order to avoid inclusion in the estate of a custodian or sub-custodian in the event of insolvency, securities in each market need to be appropriately ring-fenced. Ensure that this has been done for all markets and that the custodian can offer you maximum protection.

6 What level of responsibility do you take for sub-custodians and agents?

It is important to assess the degree of risk created by the sub-custodian's involvement in holding your assets, settling trades and voting. Know what happens if the sub-custodian is negligent and whether or not you are covered for the direct loss.

7 What level of responsibility do you take for corporate actions?

Having the custodian agree to send you the corporate action notices that it receives from agents and

suppliers is not sufficient. If the information is publicly available in the market, then it should be the custodian's responsibility to provide you with that information in a timely manner.

8 Is the custody arrangement fully transparent?

There should be a transparent fee structure across the full range of core custody and value-added services. Interest should be paid on all currencies and balances at a disclosed rate, linked to an established market formula. Foreign exchange should be treated in a similar manner with an agreed-upon spread by currency and deal size. All contracts should be time-stamped and monitored against a published benchmark.

9 Can you support my organization's future investment strategy and asset mix?

Your current custodian may no longer have the full set of skills and technol-

ogy required to support a complex asset mix that includes investments such as derivatives, hedge funds and fund of funds, infrastructure investment and property. Many of these investments do not involve the custodian actually safekeeping the assets; however, the firm is required to accurately account for them in the financial statements that it produces.

10 What is your long-term commitment to the custody business?

To ensure financial continuity, you need to know if your custodian will be a dynamic player in 2009 and beyond. Find out its overall strategy for growth and business development over the next three to five years, as well as its projected expenditure on investment technology.

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and making sure that our clients know that we're there.”

José Placido, CEO of RBC Dexia, couldn't agree more. “From our perspective, it's really important that we have a disciplined, proactive communication plan with our clients, so when they do have questions, they're receiving accurate information.”

And that accurate information must be delivered promptly. Case in point: when the Lehman Brothers catastrophe hit during the week of Sept. 15, 2008, MacMillan says CIBC Mellon organized a “call tree.” The company made 490 verbal communications (including phone calls and face-to-face meetings) and sent 551 written communications (emails and letters) to clients in that week. MacMillan recalls what one large pension plan told him: “Don't go quiet on me.” Reflecting on the severity of the situation and the importance of communication, MacMillan remarks, “Lehman went down. The concern was that two or three others were going to go down. AIG went in that week. That was not a week to go

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CANADIAN WESTERN TRUST**

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As well as communicating, custodians need to continually ensure that their technology helps clients with reporting of trades and, even more importantly, with risk analysis. “Clients want accurate, timely snapshots of their positions much more frequently,” says Placido. And, as derivatives become more commonplace for the institutional investor, the requirement to process these instruments efficiently falls to the custodians. “[We have introduced a] financial product markup language, a messaging format that allows us to accept and deliver trade messages electronically regardless of our clients’ underlying hardware or software,” says Rob Baillie, president and CEO, The Northern Trust Company, Canada. “This is a huge step toward improving the accuracy and timeliness associated with processing these instruments.”

State Street, too, has invested in derivatives processing capabilities. “That’s an area that is experiencing explosive growth, yet perhaps some of the settlement and clearing procedures supporting that marketplace hadn’t kept up,” says Smit. “We saw a huge backlog of settlements occur in the marketplace in the U.S. in credit default swaps.”

However, all the top-notch technology in the world isn’t going to do any good if clients are confused by all the bells and whistles. “There’s not a lot of value in it if [clients] don’t know how to use the tools,” says Baillie. “That’s why we’re so focused on training and retraining clients.”

Unfortunately, while some custodians are pushing communication, innovation and training, others, Sharma has heard from clients, are remaining silent. “This really shows the client that when the times are good, the custodians are all gung-ho, but when the times are bad, are these the partners we want to be with through good and bad?”

Scobie also suggests that you look at your existing contract. “Fear tends to make you look at your contracts and relationships and see if they’re still working.”

If your custodian is not doing enough to help you, it may be a good time to think about a change. Baillie says financial strength, technology and service should be top priorities in looking for a new custodian. To ensure that you are getting good service and value, Linda Bernard, a senior consultant with Thomas Murray, suggests a list of questions to ask your custodian (See “10 Questions to Ask Your Custodian” on page 17.)

Neither a Borrower Nor a Lender Be?

Certainly one area where custodians have been feeling the pressure from their clients is securities lending. With the falling markets, Sharma says that institutional investors are a little fearful. “Over the years, when the markets have been less turbulent and earnings have been great, people just signed up for lending but never really understood the risks.”

Jeff Kearny, a principal with Mercer’s Sentinel Group (the investment operations consulting team within Mercer), agrees. “A lot of lending has gone on historically without anyone giving much thought to it,” he says. Kearny says some boards have opted to withdraw and educate themselves about lending before re-engaging in the practice. “A number of these institutions are in the public space and certainly don’t want to be seen to be supporting the short side of the market,” says Smit. While there haven’t been many cases of Canadian plan sponsors withdrawing from securities lending, they are approaching the practice with more caution and asking more pointed questions of their custodians.

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THE NORTHERN TRUST
COMPANY, CANADA**



Kearny says, however, that lending promotes efficiency and liquidity in financial markets, and will continue. Smit agrees, adding that additional regulation in the form of increased requirements around disclosure and reporting is likely. “But we certainly don’t think securities lending is going to disappear, by any stretch of the imagination.”

Custodians will also need to review the sub-custodians and counterparties they’re using, says Sharma. “Look at Citigroup, where they’re selling their trust business in Japan. Who would have thought a year ago that you’d be talking about Citibank in terms of, Are they going to survive or not?” she adds. Sharma notes that these counterparties are reviewed on an annual basis, but she believes there’s going to be increased pressure to review these relationships more often and more closely. Placido says that RBC Dexia has been monitoring its counterparties and collateral levels more frequently than in the past. “We have very stringent rules in terms of the companies we do business with, the counterparties we’re reviewing,” he says. Still, with the average global custodian offering sub-custody services in roughly 80 to 107 markets, says Sharma, that is a lot of counterparties to submit to a thorough review, adding more pressure to the monitoring of sub-agents.

There’s also some confusion around short-selling and securities lending practices. “[The] general consensus is that the overwhelming amount of lending that goes on is for settlement coverage, market making, financing or arbitrage strategies,” says Kearny. “Securities lending does not necessarily equal shorting.” Furthermore, Kearny and others are quick to point out that historically, and as academic research has uncovered, short-selling serves a valuable function in the market. “It helps ensure liquidity and can avoid price bubbles,” says Kearny. “If you have a situation where securities become grossly overvalued and there’s no function or ability to short that security, how do you bring the market back into equilibrium? It’s very difficult to do.”

While securities lending has received some bad press lately, MacMillan sees the current scrutiny of the market as a positive. “It’s perfectly reasonable that people are looking at it to identify the risk,” he says. “Is their agent any good? Did the agent have problems with Lehman Brothers?” For MacMillan, securities lending is a conservative activity. “I think most people are going to say [they’re] satisfied with it. We’re seeing that already.” Both CIBC Mellon and State Street say they have had minimal movement from their securities lending programs.

As for market conditions, whatever the impact will be down the road, Baillie believes that the more efficient custodians are going to be well positioned going forward. “Historically, settling trades, the whole back-office notion of processing, was the focus,” he says. “While this is still very important, the business has become all about operating efficiently and adding as much value as we can through technology to help clients interpret their data.”

Yet custodians can’t forget about the bottom line. “We have to manage our business well [and] control expenses, just like every business,” says Baillie. “Clients want good value for money, but they also want their custodian to make money.” And, most important, to feel confident that their assets are secure. **BC**

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