



# More for less?

PENSION FUNDS AND SOVEREIGN WEALTH FUNDS ARE DEMANDING GREATER TRANSPARENCY AND FLEXIBILITY FROM THEIR CUSTODIANS, INCREASING COMMERCIAL PRESSURES ON PROVIDERS. **HUGO COX** TALKS TO TWO LEADING CONSULTANTS AND THE HEAD OF CLIENT DEVELOPMENT, BNP PARIBAS SECURITIES SERVICES, ABOUT HOW THE TWO SIDES CAN MEET

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**CHAIR:** What have been the main recent changes in the behaviour of asset owners and those investing on their behalf. What has this meant for asset servicing providers?

**BEN GUNNEE:** Prior to the Lehman collapse, clients were de-risking their portfolios, employing swaps and other derivatives to hedge out risks like inflation and interest rate moves. This trend was hard for custodians to keep pace with. Since the Lehman collapse, however, the spiralling cost of these instruments has reduced their use. Instead, we are seeing the re-emergence of alternatives, such as hedge funds, infrastructure funds and private equity funds. But this time around, asset owners and their managers prefer the greater transparency offered by managed accounts over traditional pooled fund units. Especially among hedge funds, this means that managers are looking to outsource back office and fund administration tasks, with pressure on fund administrators and custodians to deliver the required transparency.

**SIMON THOMAS:** Asset owners are certainly now prepared to pay more to have their assets managed on a segregated basis. And many larger asset owners have been frustrated by integrated asset managers refusing to offer them the transparency they now want, particularly with respect to pooled funds – failing to disclose which custodians and administrators are being used and why, the precise collateral arrangements and where cash is held. Among asset managers, meanwhile, inferior services from custodians continue to make

ABOVE, SEATED, FROM LEFT:

**Ben Gunnee**  
European director,  
Mercer Sentinel

**Charley Cock**  
Head of client  
development, BNP  
Paribas Securities  
Services

**Simon Thomas**  
CEO, Thomas Murray

▶ it very hard for them to execute hedging strategies should they wish. In Australia, particularly, there is great frustration with providers who cannot provide timely and sufficiently accurate information to allow currency hedging.

**BEN:** In particular, custodians are still grappling with basic issues around valuation. In the case of OTC derivatives, many custodians are still valuing positions for the independent book of record by taking the manager's own valuation. Independent valuation is about employing the right specialists with the right skills, but these staff are expensive: the current model of reducing fees down to the bare minimum makes this very hard.

**CHARLEY COCK:** I agree that asset managers tend to underestimate the costs associated with processing OTC derivatives, as well as those in the wider areas of risk monitoring and performance measurement. In terms of costs, I think there is still too much emphasis placed on the sole safekeeping and transaction fees and not enough on these wider issues of risk management and risk measurement.

**CHAIR:** As the number of asset managers handling investor funds grows, collating information across all of them becomes increasingly difficult. In particular, there are more opportunities for mismatches to occur between trade date accounting and settlement date accounting. Are there benefits to getting a single provider for both?



“Asset owners and their managers now prefer the greater transparency offered by managed accounts over traditional pooled fund units”



“Custodian banks have been aggressive towards smaller clients”



“Clients have realised that some providers are not big enough to support their needs”

**SIMON:** Managers are reluctant to outsource the full set of services, from trade capture and settlement to reporting, because it means they will be bound into using their custodian and unable to leave without facing a difficult process lasting several years. Many large groups are, therefore, less likely to give all processing tasks to a single provider, preferring to use a range of specialists or keep them in-house.

**BEN:** While removing a provider who looks after both elements can be painful, the benefits of choosing the right provider are considerable. It prevents the blame culture that can arise between specialist providers and the custodian in the event of an error. There is considerable demand for solutions that provide greater convergence between the risk report generated by the middle office on the trade day, and that provided two days later by the custodian.

**CHARLEY:** Reconciling trade date accounting required by the front office for managing risk, such as investment risk and counterparty risk, with contractual settlement date accounting needed for efficient treasury and foreign exchange management is a major challenge in its own right. The challenge, and also the opportunity, faced by any custodian is to satisfy the very different and diverging requirements of the client, as defined by the chief investment officer, the chief operating officer and the risk officer. Large asset owners typically outsource the management of some or all of their assets to multiple

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“The custodian’s challenge is to satisfy different and diverging requirements from the client”



outside managers, while requiring a single source of consolidated information for accounting purposes, as well as consolidated risk management.

**CHAIR:** When it comes to the asset safety expected by investors, is there a risk that competition among custodians is pushing them towards guaranteeing risks, such as those associated with a CSD, that they have not generated and cannot measure?

**SIMON:** The risks associated with the market infrastructure, as well as the political and currency risks, should rest with the manager who made the investment decision. After the Madoff fraud, sovereign wealth funds have wanted to understand in greater detail the risk of the sub-custodian as well as that of the global custodian; this is not usually the responsibility of the global agent to guarantee. Some custodians limit their responsibilities to the selection and monitoring of the sub-custodian, with clients using ratings of the sub-agent and CSD to help inform, for example, exactly where assets are held.

**BEN:** When it comes to the sub-network, there is even variation with the same custodian. Different clients may negotiate different levels of sub-custody protection with the same custodian. The main issue is that many clients see custody as an afterthought; they are interested principally in the investment manager and they see the custodian as an unwanted expense. This is driving

them to ask more for less. Despite clients wanting more protection from their custodian, on value-added services as well as core custody, fee considerations often remain the key buying criteria. At some point, providers will start charging more for these services.

**SIMON:** On the other hand, custodian banks have been aggressive towards smaller clients: a number of our clients have had their five-year contracts terminated and new terms imposed. And a number of relationships between major funds and custodians were severely fractured around the enhanced yield from short-term cash investments that were badly managed. This has cost up to USD 50 million for some institutions using enhanced yield funds; these relationships may never be repaired. Banks, as a result, have seen their whole business models put under pressure because lending has stopped, making clear the dependence they placed on interest earnings and cross-subsidy from stock lending and foreign exchange. Clients have realised that some providers are not big enough, in terms of net assets and balance sheets, to support their needs.

**BEN:** Providers will have to be more transparent about what services actually cost; we may therefore see fees going up for core services. Securities lending is a good example of this: when clients suspended securities lending after the crisis, a number of clients were told by their custodian that the fee schedule in other areas, such as core custody, would need to be increased. ■