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Special Advertising Section GLOBAL CUSTODY *Special Advertising Section*

Who Will Guard the Custodians?

The turbulence of the American banking scene, with its millstones of Third World debt, the demise of many small banks and the savings and loan crisis have caused nervousness among the lay trustees of pension funds.

Terry Pearson, securities adviser to the Royal Bank of Scotland says: "We see ripples, people are concerned about the state of the New York money center banks. Royal Bank of Scotland has been asked to quote and we have one major client in the pipeline. U.S. law is no reassurance to lay trustees."

According to William E. Gundy, executive vice president, Institutional Investor Services, State Street Bank & Trust Co., "We have seen some of that phenomenon. It is a factor, and it would make major investors look hard at who they are selecting. And anyone who is in a questionable or weakened state would have a difficult time competing today."

Top of Agenda

The importance of the issue means it has been raised to the top of the agenda, says Mark Kerns, marketing director for Bankers Trust Master Custody Services, London. "The credit positions of banks is a hot topic. Before, it was a question raised by clients at the end of presentations. Now it is on the table from the outset."

John Morris, division head for investor services at Citibank N.A., feels the concerns are overstated.

"If you look at the legal position — and that is 'are assets at risk if a bank fails?' — the answer is no, because the assets are segregated under a rule called Section 17 (f) 5 (Securities Act 1940) in the U.S., which I think applies to mutual funds. There is a requirement that separation of assets from the bank's own assets is demonstrated."

According to David F. Herman, vice president, Manufacturers Hanover Trust, London, Rule 17 (f) 5 of the U.S. Securities Act 1940 covers mutual funds, but is widely interpreted as covering American pension funds, although it has yet to be put to the test.

The concern expressed by the trustees of pension funds raises the question not just of the security of assets deposited with global custodians but who regulates this sector of the market and what provisions there are if things go wrong.

At a recent IBC conference in Amsterdam, Simon Thomas of KPMG Peat Marwick McLintock, London, expressed the fear that global custody is "an exit route for some banks to save their skins." He warned that under-resourced banks were attracted to the business because of the quality fees in an off-balance-sheet activity. "Things only have to go wrong once or twice," he said, and the smear would pass from global custodians to cross-border investing as a whole. At that stage, he said, "the regulators will take an unwelcome interest. There needs to be a self-regulating industry group to avoid the need for the authorities acting."

Nicholas Didier, president of Morgan Stanley Bank S.A. in Luxembourg, says that while there is no real drive for formal regulation in the global custody market, the global custodian is assuming more and more of a monitoring function. "Clients are looking for watch-dog coverage. We see it as helping the client in performing control and safeguard functions. It is a self-imposed regulation where pension fund statutes determine that an investment manager may not sell short or exceed levels of exposure to certain markets and currencies."

Independent Player

Mr. Didier adds that the regulatory role he expects global custodians to play is already imposed in European Community directives on Undertakings for Collective Investment in Transferable Securities (Ucits) of 1986. He suggests any future regulation could propose a similar watch-dog role for global custodians acting for pension funds and insurance companies. "Here, in the global custodian, is an independent player who will police the rules to which asset managers must adhere. This is nothing new, as due diligence is already required of global custodians in functions like choosing agents and sub-custodians."

Midland's Mr. Miller sees no need for an added layer of regulation. He says custodians are dealing with educated institutional clients.

Jay Carty, is a senior vice president at Boston Safe Deposit & Trust Co., a subsidiary of American Express, with $24 billion under custody. He does not see the need for a regulatory body as most custody functions are covered by banks' fiduciary responsibilities. However, he is surprised there is not yet an industry body which would help to promote uniform standards in global custody.

A spokeswoman for the Securities and Exchange Commission in Washington, D.C. says that while there are no rules at present, the matter is under consideration. A spokesman at the Federal Reserve of New York, the regulatory authority for New York banking, says there are no Federal Reserve regulations dealing with global custody: "It has not been a large issue."

The Securities and Investments Board, London's financial markets watch-dog umbrella, says global custody is an "an unregulated area." The Bank of England concurs and says: "We know global custody is an issue not taken account of in the Basle context." (Basle Committee on Banking Regulations and Supervisory Practices Proposals for Capital Adequacy, published December 1987).

No Regulatory Requirements

Marshall Carter of Chase says there are no regulatory or capital adequacy requirements for global custodians, but banks are regulated for their trust commitments.

"We provide global custody services for different market segments, e.g. company pension funds in a fiduciary trust capacity. But assets under trust are not assets of the bank and therefore don't factor into capital adequacy." Mr. Carter does not envisage the need for separate regulatory authority as long as countries exercise their responsibilities.

However, Chase is not immune from client concern. "We have spent a lot of time with clients to assure them their assets are not part of an American Bank. Clients are asking questions," says Mr. Carter.

He adds that small global custodians and broker/dealers could be a smear on global custody if things go wrong. "If I were an investor, I would ask serious questions about what resources a parent company has and that would go behind a broker. A good global custodian means you will have to stand by deals of millions. We have had to lay $2 million to $3 million on the table till things were sorted out — that is part of our role as intermediaries, especially if it is our error."

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