THE BANKER

Stand by for the worst

The lack of regulation in global custody is worrying many observers. A disaster would help to focus minds

Global custody is an unregulated area. There are no regulatory or capital-adequacy requirements for global custodians and none are imminent. When authorities are asked about this, they tend to shy away from the issue. But with cross-border trading growing all the time, millions could be at stake if things go wrong.

Says Simon Thomas, recently appointed director of London-based Davis International Banking Consultants: "The main danger is that banks entering global custody will export the problems of the world's banking industry into the securities industry. In addition, there's the danger that institutional funds will find themselves carrying the cost of the failure of 'global custodians' which owe significant sums of money and stock."

In the matrix below Thomas points out the risks which may arise if custodians are not properly structured and controlled. The range goes well beyond normal credit risk involving counterparty exposure, collateral and guarantees. They also cover price and market movements, foreign-exchange exposure and interest-rate risk. There are also worries over management and operational issues involving the reporting of off-balance-sheet instruments, registration, tax claims and financial communications.

The matrix correlates the prime custody activities and risks that those functions involve. The activities are ranked in terms of potential risk areas (one for highest, six for lowest). Most may think that settlement and stock lending pose the greatest threats to custodians but Thomas reckons corporate actions present an even greater danger.

For example, the ability — or inability — to respond to new issues and takeovers can be critical. If deadlines are missed, or shares rather than cash are asked for in a stock issue, the resulting losses can be huge. In emerging markets it can be even more difficult to get information on corporate actions, so the problems can get progressively worse.

International banks have been hit hard on cross-border credit risk as the Third World debt crisis bears testimony. The Basel capital-adequacy guidelines seem to be helping make international banking safer, but they do not take into account the recent growth in off-balance-sheet business (which includes custody).

Should an additional capital requirement be introduced to cover non-credit risk? Says the Price Waterhouse report *Bank Capital Adequacy*, published in July: "It is an open question whether a mathematical formula for capturing non-credit risk is practicable. Some banks argue that the nature of business involving interest and foreign exchange risk, and settlement risk (in particular the speed with which trading positions can change) makes the application of a formal and inevitably complicated formula impractical.

"The additional systems costs are also likely to prove a considerable burden. An argument against increasing the minimum 8% requirement is that this could unduly penalise banks whose exposure to non-credit risk is limited, but at the end of the day it may be that some rather notional additional amount of capital for these risks where they arise may be the only practical alternative."

The question of apportioning dedicated capital for custody is a contentious issue. Some of the biggest custodians, such as Chase Manhattan Bank, Citibank and (to a lesser extent) Midland Bank, already have capital worries: a call for even more capital could cause them major problems. With banks unwilling and regulators unable to focus on the issue, it seems that the inevitable disaster will have to happen before everyone faces up to the risks involved. □

Where the dangers lie

	Market	Credit	Currency	Interest	Operational/ management	Instrument specific
Corporate actions (1)	●	●	●		●	●
Settlement (2)	●	●	●	●	●	●
Stock lending (2)	●	●	●	●	●	●
Safe custody (3)		●		●	●	
Cash (4)		●		●	●	
Foreign exchange (4)		●	●	●		
Dividends (5)		●	●	●	●	●
Reporting (6)	●	●			●	

Source: Davis International Banking Consultants