

Selection of the fittest for survival

By Simon Thomas

Jun 1997

Simon Thomas discusses key issues in choosing a custodian

The rapid growth in cross-border investment has highlighted the challenges faced by institutional funds or their agents responsible for the safety and administration of assets around the world. It has become critical that these groups carefully review and formally evaluate the provision of safe-keeping, clearing, settlement and related securities services in every market where they invest.

The selection process when looking to select an appropriate global custody strategy, should start with an agreed list of selection hurdles, which could include such factors as the candidates' financial strength and credit rating; their credentials and commitment; the quality of their basic systems and services; coverage of value-added services and reporting; strategic partnership potential, and value for money. This can be an extremely effective method of filtering out custodians who should not be included in the final list of request for proposal (RFP) candidates for full-scale analysis. The initial hurdles can be used throughout the exercise, cascading down into a more detailed set of selection criteria.

Institutions that adopt this approach usually arrange the hurdles to suit their own objectives. An appraisal of the financial strength and creditworthiness of a potential candidate is usually carried out right at the start, because it is such a critical factor. On the other hand, the level of pricing tends not to be a key issue at the outset, so this is commonly left out of the initial hurdles.

The result helps to specify a logical sequence of hurdles to be applied to potential candidates. The detailed questions relevant to each hurdle will then be included in the full RFP sent to qualifying candidates.

Traditionally, RFPs ask a large number of open-ended questions. These are sometimes appropriate - "Please describe your procedures for problem resolution in the trade settlements area", is one example. However, they are often unnecessary and may be misleading. They may simply allow respondents to procrastinate or avoid giving direct answers.

Our approach has developed a model RFP with a high percentage of closed questions. Using closed questions has many advantages for both buyers and suppliers, as long as they are properly worded, and generate a transparent response. Most significantly, closed questions make the analysis of responses from different custodians much easier, with more consistent and comparable answers.

The upheavals in the custody industry have made the task of finding the right custodian and monitoring its performance, commitment, independence and competitive position increasingly complicated. The task is made all the more difficult by the limitations of existing rankings of custodians and traditional ways of evaluating global custodians and agent bank suppliers.

Conventional analysis and rankings of securities services suppliers tend to concentrate on two features: the size of each supplier, and the quality of service. Size is normally measured by the value of assets under custody. Quality is evaluated using a mix of benchmark data on operational performance and qualitative feedback from clients. However, buyers should be aware of the limitations of these rankings.

First, they are often based on data provided by the suppliers themselves, or by clients

selected by the supplier. Figures for the size of assets under custody provided by individual suppliers are notoriously open to misrepresentation and manipulation - to such an extent that some major suppliers refuse to provide figures at all. Equally, benchmark data is only as good as the data provided by each supplier, and client feedback only as representative as the sample selected. The results are interesting, and in some cases give valuable insights, but should be treated with care.

Second, rankings based on size and quality of service do not address (indeed, do not attempt to address) a number of the buyer's key requirements. These include, for instance, information relating to a supplier's financial strength, business strategy and commitment, credentials and coverage of services. Although the information may be available on these and other key characteristics, it has not yet been pulled together into a consistent framework.

Third, and perhaps most awkward-ly, many different types of supplier operate in the global securities services market. At one end of the market are the leading global custodians, which supply a wide range of banking, custody and investment-related services, with offices in financial centres around the world. At the other end are the central securities depositories (CSDs), which supply a narrow range of services within their own country. In between are thousands of banks and non-bank suppliers. This diverse group includes, for example, major domestic banks supplying a global custody service for domestic clients investing internationally; asset managers, and the ICSDs, such as Euroclear and Cedel.

It is critical that buyers fully understand the impact that different characteristics have on the level and quality of service that they receive. Take a supplier's network strategy.

The quality of a supplier's agent bank network has a direct impact upon the ultimate level of service provided to its clients. As a number of global custodians have found, a poorly performing agent bank network can seriously undermine their own operations and ultimately their client relationships. Furthermore, because securities and cash are handled directly by third party agents (and in turn by their counterparties), a poorly selected network also brings into question the very safety of client assets. It is perhaps interesting to note that amongst 12 of the leading global custodians, network management staff cover an average of 7.78 markets. What do these staff actually do (or not do)?

The existence of large numbers of network management staff may not be a true indication of the safety and quality of the network they manage.

Custody in all markets has developed into an important issue as it becomes clear that investment in these markets, without solid safe-keeping, settlement and custody, could generate significant administrative problems and in some cases financial losses.

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