

Custodians as keepers

John Campbell - 5 Oct 1998

Combining custody with investment administration creates risks

David Bilbé's article in the [Financial News](#) last week assessed the benefits of outsourcing investment administration services to custodian banks. He commended the growing trend among pension funds of employing custodians as master record-keepers to keep an 'independent check' on the fund managers' activity. He also argued that custodian banks are uniquely placed to provide fund managers with the information they need to manage risk more effectively.

Both of these arguments are debatable.

Firstly, it is ironic that the role of the custodian as an independent check on fund managers should be put forward as one of the principal benefits of their role as master record-keepers.

You would clearly be unwise to ask your bank manager to check your bank statement for you, and yet this is, in effect, what many fund managers and pension funds are doing by employing their custodian banks to provide investment administration services. Once custody and investment accounting are combined, the verification and monitoring of the custodian's activity that forms an intrinsic part of investment accounting can clearly no longer be independent.

Most custodians would find it difficult to deny that they make some errors in corporate actions. Because banking is a volume business, it is often not possible to check the accuracy of prices, income receipts and so on, on an individual portfolio basis.

As [Simon Murray](#) of [Thomas Murray](#) pointed out in his article in the [Financial News](#) on September 14 (issue 125), 'some custodians are not even that good at reconciling different sources of information within their own offices'.

While there is no reason to question the integrity of custodians, without the control of independent checking there is undoubtedly far greater potential for investors to suffer due to administrative error. In some instances, the sums involved could be substantial.

If such problems do occur, loss of faith in the custodian can leave pension funds with no alternative but to step up their own monitoring, sometimes to such an extent as to invalidate their case for outsourcing. With the heightened duties of pension fund trustees under the Pensions Act and the recent introduction of



John Campbell

personal liability of directors of fund management companies, the risk of such errors has become even more difficult to tolerate.

The second weakness in David Bilbé's argument is that custodians are, in certain respects, culturally unsuited to supporting the highly dynamic activity of investment risk management.

As David Bilbé acknowledges, the most crucial tool in the management of investment risk is accurate information. But the requirements for accurate information in fund management are far more exerting than they are in banking.

The core business of custodian banks is recording the details of assets held. Their culture is not geared towards providing the kind of fast-changing and flexible information that is needed either to maximise the return on portfolios or to control the activity of individual managers. Even when custodians upgrade their systems to address these challenges, they find it impossible to shift their focus away from accounting on to the broader requirements of portfolio management.

To add to these difficulties, as the custody marketplace continues to consolidate, the choice of custodian banks is diminishing and their clients' power as consumers is weakening. In the global custody market this problem is particularly pronounced. Polarisation has led to the emergence of huge global custodians; 'the trillion club'. The difficulty of striking a cost effective deal with these mega suppliers is exacerbated by the lack of transparency in many custodians' pricing policies, which hinders comparison with other suppliers of the individual services they provide.

None of these arguments, however, can deny the convenience for pension funds of combining reporting and accounting across several different portfolios and fund managers. Pension funds should consider how they can enjoy these benefits without developing too close a relationship with a single custodian and, thereby, placing the diversification of their assets and their independence at risk. Just as they have started to buy custodian services directly, rather than through a fund manager - thereby achieving greater transparency of costs - it would seem logical for them to explore purchasing investment accounting and portfolio administration independently of both their fund managers and their custodians.

Fund managers, meanwhile, must ask themselves whether in today's volatile markets they can depend on information provided by custodians. After all, custodian banks are the final link in the investment process and, as such, the very last people to receive trade data.

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