



# SEEING CLEARLY

Responding to plan sponsors' risk management concerns, custodians are examining the organization and effectiveness of their businesses and increasing visibility into their operations.

BY BROOKE SMITH

**ROUGHLY** 18 months after the financial crisis, the economic fog is beginning to lift, but custodians still struggle with declining pension assets. In this year's *Custody Report*, State Street Canada—once again securing the No. 1 spot—reported \$354.6 billion in Canadian pension assets under custody, a drop of 5.3% from last year. Right behind is RBC Dexia Investor Services with \$349.0 billion in pension assets, down 5.9% from 2008.

The third and fourth positions offer a bright spot: CIBC Mellon Global Securities Services Company and Desjardins Trust both grew their pension assets under custody, with an 11.7% and 8.2% increase, respectively. The Northern Trust Company, Canada held steady in the No. 5 position at \$54.3 billion, down just 0.7% from last year.

### Getting to Know You

Custodians also have other challenges to deal with. After weathering a difficult period, plan sponsors are concerned about managing risk and are demanding more transparency into custodians' operations. This means, custodians are seeing a renewed interest from plan sponsors in their operations—that is, they want to know just *who* their custodians are. "People are using this crisis to really look at who their providers are and [ask,] Will they sustain this crisis better than others?" says Arti Sharma, senior vice-president, Americas, with Thomas Murray (a custodian overseer). "We've seen movement in the business with clients where they've taken [knowing their custodian] as a reason to

move in the last little while," she says, adding that though this activity has waned, it won't completely disappear in 2010. Ron Robertson, senior vice-president and managing director of State Street's investment servicing business in Canada, says custodians must be more agile, more responsive and more flexible to help their clients.

Getting to know your custodian makes sense—particularly with the looming threat of litigation against another organization's imprudence. Although there have not yet been any lawsuits against custodians in Canada, sponsors have only to look to the U.S. for examples. Last October, the California attorney general's office charged State Street Corp. with fraud, claiming that the custodian had illegally overcharged the CalPERS and CalSTERS pension funds for a number of foreign exchange trades since 2001. State Street says it "categorically denies any allegations of wrongdoing" and will defend itself against litigation. But regardless of the outcome, the incident stresses the importance of transparency. "It validates the point of clients really taking a look at their service providers, the services that they are providing to them, the nature of those services, the value of those services and how they're created," says John Lockbaum, managing director, Canada, with RBC Dexia.

Transparency, Sharma explains, is a theme that plan sponsors will be consumed with for a few years. "We think, post-Lehman and post-Madoff, that area becomes even more critical—what services you're providing, what risk you're assuming and what you're charging for it," she says. Case in point: in January 2010, the Federal Reserve Bank of New York and Stanford University released a report stating that over-the-counter (OTC) derivatives need more central clearing requirements and more transparency.

“You’re going to see our industry move toward finding more fortress-like solutions [for derivatives],” says Lockbaum. For example, he says, since certain aspects of the derivatives instrument markets are more manual in nature, there will be a move to improve technology and enhance straight-through processing rates.

Another example is pricing. Usually, traditional pricing has dual pricing sources, but that’s difficult to do with derivatives. “The move in the industry is to make sure that, from a transparency perspective, we understand how the price was derived—where it came from and that there’s an enhanced validation process,” says Lockbaum. Northern Trust’s latest product, Numerix, does just that. “It allows for pricing of these complex-structured derivatives, which is a challenge in the industry,” says Robert Baillie, president and CEO of The Northern Trust Company, Canada.

Certainly, derivatives will continue to be an area of investment for plan sponsors and a focus for custodians going forward. For example, OTC derivatives transactions at Northern Trust have grown by 30% each year from 2000 through to the end of 2008, says Baillie. He adds that Northern Trust will continue to look at making further enhancements to its OTC derivatives platform, including valuation and risk management.

Custodians are also accelerating their communication efforts. Robertson says there’s not only more communication but also the sharing of best practices. “Clients are coming to us now and asking what we are doing internally to optimize our own operating model.”

### Tech Check

Technology is key for many custodians in delivering access to information. “People want information that much quicker,” says Scott Scobie, general manager of Canadian Western Trust (CWT), adding that monthly or quarterly reports just aren’t acceptable anymore. Scobie says a combination of elements is prompting this trend: the media frenzy over the last 18 months, greater client awareness and the fact that the aging baby boomers managing the pension plans have an increased personal vested interest. Baillie adds that clients want to know which managers are sending automated transactions and which ones aren’t. “Automation can minimize operational risk.”

Web applications provide another way for custodians to reach their clients. State Street’s Web portal, for instance, provides clients with reporting that allows them to view and monitor the activity in their portfolios. But information alone is not enough: Robertson adds that education is key. “A large component of our approach is educating our clients on how to optimize and realize the full benefits of this portal for their specific needs.”

For its part, Northern Trust is currently focusing on mobile technology; specifically, the smart phone. Its smart phone apps provide basic data—common sense information applications such as an exposure report or daily market values—that clients would find most vital. “It’s not designed to completely replicate our online product,” says Baillie, “but it’s meant to give critical information to clients when they’re not in the office.”

Lockbaum says RBC Dexia has a few clients that use mobile technology for end-of-day critical timeliness and accuracy reports. But while he believes there could eventually be a groundswell around this technology, it hasn’t happened yet.

### Sense of Securities

With greater pressure on custodians to be upfront about their operations, the practice of securities lending is still under scrutiny. According to the 2009 *Agent Bank Review for the Major Markets*, program revenues over the last year have declined. Bank

## CUSTODY ROUNDTABLE

*We brought together senior representatives from custody service providers to discuss the issues and trends facing the industry. Here’s what they had to say.*

### How did the custody industry fare in 2009, and what major trends do you expect for 2010?



**J.B. (Bernie) Ward**, director, corporate and group services, Canadian Western Trust

Most plan sponsors stuck to their knitting despite hard economic times and trusted in their investment guidelines. As a result, their plans weath-ered the storm quite well. A major trend we are seeing is increasing recognition and concern about the shortcomings of defined contribution plans, for both the sponsors and the members.



**François Gagnon**, executive vice-president, custody services, Desjardins Trust

Canada, in 2010, will benefit from the slow recovery initiated at the end of 2009. Equity markets will see a slight increase, although not as strong as in 2009. The custody business will face similar challenges in 2010 as in 2009. Interest rates continue to be low, which limits cash management and securities lending opportunities. Transparency, compliance and governance are at the centre of [plan sponsors’] preoccupations.



**Kevin Drynan**, president and CEO, State Street Trust Company Canada

We are certainly seeing signs of recovery; however, we are still operating in a fragile economic environment. Client assets have risen from the market lows, but it is still too soon to tell how close we are to the end of the tunnel....As part of their focus on risk management, clients are reviewing their operating models, which may indicate a renewed interest in outsourcing some investment servicing functions and, in some cases, in-sourcing some functions.

### Given the events of 2008/09, have you noticed greater pressure from your clients for transparency and disclosure?



**David Linds**, senior vice-president, business development and client relationship management, CIBC Mellon

Clients are repositioning their plans to reduce risk and meet more rigorous governance objectives. They are seeking transparency across all asset classes and business relationships to insulate themselves from any further adverse impact on their ability to meet long-term liabilities.

From our standpoint, this means immediate communication of any issues that may have a negative impact on our clients’ investments (e.g., the Lehman Brothers default). Pension plans are also demanding greater detail, accuracy

and flexibility in the delivery of portfolio information to meet more onerous board reporting requirements. And they are looking for greater transparency in securities lending and in over-the-counter derivatives transactions.



**John Folk**, senior vice-president and chief operating officer, The Northern Trust Company, Canada

Clients are increasingly looking for greater transparency and disclosure—not only into the myriad services that a custodian may be providing, but also into the custodian's agent, counterparty and offshoring arrangements, and the associated due diligence efforts and reviews. Clients have shown greater interest in their custodian's financial performance through this tumultuous period, and in the sustainability of its continuing and future investment in its core custody operations and technology.



**Scott R. MacDonald**, head, pensions, financial institutions, client service, North America, RBC Dexia Investor Services

Clients have been increasingly seeking a more detailed understanding of the dynamics of a custodian's business and what they will be getting for their fees, and we expect that to continue in 2010. This includes the risk management processes and tools that custodians use to run their businesses, and clear communication of liability responsibilities....We have also noticed an increase in clients looking to consultants to help evaluate the performance, disclosure and transparency of their custodial partners, but they are still working out how to ensure defensible good governance in the selection of the consultants themselves, which we expect will be an increasing area of focus in 2010.

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### Are you seeing a renewed interest in risk management? What are custodians doing to reduce risk?

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**Folk:** Clients are broadening their focus on transparency in their portfolio holdings and what they're looking for in the analysis of their exposure. Asset liquidity, counterparty exposure and interest rate sensitivity are being viewed at an overall portfolio/plan level, and the requirement for flexibility and timely access to data is increasing accordingly. Custodians are responding with more automation to minimize operational risk, while at the same time helping clients to better understand and minimize their counterparty risk. Until recently, a 30-, 60- or 90-day cash forecast was the norm. But in today's markets, and with more alternative investments in their portfolios, clients are looking for a view on liquidity that includes hedge fund investments and potential capital calls on private equity.

**Drynan:** There is no question that clients are very interested in risk management—more so now than ever before. They are concerned with two primary areas of risk: portfolio management risk and operational risk. Both areas will continue to be important to clients in 2010 and beyond. As custodians, it is our responsibility to ensure that we are transparent with clients about risk and providing them with

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of New York Mellon, for example, had only US\$43 million in lending revenues as of September 2009, compared with US\$155 million in September 2008. And State Street Bank had US\$105 million in September 2009, compared with US\$246 million in September 2008.

In Canada, although custodians did see a drop-off in their securities lending programs, many of their clients have come back. "Although margins are low in these economic conditions, people think that the rewards (the revenues) are worth the risk involved when a program is well managed," says François Gagnon, executive vice-president, custody services, with Desjardins Trust.

During the collapse of the markets, Desjardins Trust had roughly 10% of its clients withdraw from the securities lending program, but 5% of those clients have since returned. Even Desjardins' current clients that are not involved in lending are more interested and open to the idea. "There's more receptiveness on their part to listen to us," says Patricia Tonelli, vice-president, strategic development, custody services, with Desjardins Trust.

"The securities lenders are back," Lockbaum agrees. "What I'm waiting for is the renewed increase in the demand for securities." Still, custodians aren't overly concerned. "Securities lending will continue to be a robust service, an important feature of efficient markets," says Baillie, adding that it continues to facilitate legitimate hedging and provides liquidity to financial markets.

CIBC Mellon, for one, has had a number of discussions with its clients and investment managers to demonstrate transparency in securities lending. "We regularly draw on securities lending benchmarking information available from U.K.-based consultants. [This] allows us to compare the performance of each client's lending activity to their peer group or to the market generally," says Tom Monahan, president and CEO of CIBC Mellon.

For its part, Northern Trust has revamped its securities lending exposure reporting. Through its Web portal, it now provides a securities lending dashboard with data specific to the client, including loan and collateral balances and credit ratings. "This is client-driven," says Baillie, "the kind of information that clients have been looking for to satisfy the need for transparency."

### Show Me the Money

With the decline in securities lending transactions, how are custodians going to continue to grow revenues? In the last quarter of 2008, some custodians, such as Bank of New York Mellon Corp. and State Street Corp., announced cuts to their workforces. However, workforces remained intact last year as custodians looked beyond their own operations to cut costs.

In 2009, Thomas Murray saw an acceleration of outsourcing to inexpensive locations. "[There's] a lot more offshoring into India and Malaysia, [for example,] by custodians to ensure that costs are contained," Sharma affirms.

The larger players in the global custody space—notably, the U.S.-based custodians—are also looking at outside locations as sources of prospective revenue growth. "Those who are preparing or have prepared to expand outside of their own home market will benefit going forward," Sharma continues. "The U.S. market is pretty mature for many of these players, so from a revenue growth perspective, opportunities will be limited. To ensure that they continue to sustain their leadership, they need to look for new opportunities—and these will exist outside of their home market."

In December last year, for example, State Street agreed to acquire Italian banking group Intesa Sanpaolo's securities services business for US\$1.87 billion. A month before, JPMorgan acquired Australia/New Zealand's AUD\$99-billion custody services business.

## PENSION ASSETS UNDER CUSTODY

As of Sept. 30, 2009

Company	2009 Canadian Pension Assets Under Custody (billions)*	2008 Canadian Pension Assets Under Custody (billions)*	% Variance
State Street Canada	\$354.6	\$374.4	-5.3%
RBC Dexia Investor Services	\$349.0	\$371.0	-5.9%
CIBC Mellon Global Securities Services Company	\$228.0	\$204.1	11.7%
Desjardins Trust	\$135.3	\$125.1	8.2%
The Northern Trust Company, Canada	\$54.3	\$54.7	-0.7%

**Note:** \*Includes pension assets of Canadian operations' clients invested in Canada, the U.S. and non-North American markets.

## MUTUAL/POOLED FUND ASSETS UNDER CUSTODY

As of Sept. 30, 2009

Company	2009 Mutual/Pooled Fund Assets Under Custody (billions)*	2008 Mutual/Pooled Fund Assets Under Custody (billions)*	% Variance
RBC Dexia Investor Services	\$397.0	\$469.0	-15.4%
CIBC Mellon Global Securities Services Company	\$378.4	\$374.6	1.0%
State Street Canada	\$168.2	\$182.2	-7.7%
Desjardins Trust	\$24.4	\$23.0	6.2%
National Bank Trust	\$20.6	\$21.3	-3.5%

**Note:** \*Includes assets of mutual/pooled funds of Canadian operations' clients invested in Canada, the U.S. and non-North American markets.

Source: Companies participating in *Benefits Canada's*/CIIN's annual *Custody Report* survey.

### Fewer Fees, Please

Plan sponsors also want to ensure that they are getting the best value for the fees they're paying. Custody fees are inextricably linked with the bundling of services—which, historically, the industry has promoted. But Sharma believes that *unbundling* will become an important issue for clients. If a client wants to leave securities lending, for example, what will that do to the fee structure? she asks. “That’s going to be a huge challenge for custodians, in terms of how they balance between different components and still remain competitive.”

Though custodians are aware of the unbundling trend, they're hesitant to make any promises on the fee scale issue. “From a supplier of services [perspective], I would always like to bundle, but we do custody-only service for some clients,” says Lockbaum. “Depending on the client, the opportunity [and] the deal, we'll look at the marketplace and try to find the very best fit between the opportunity and what we do.”

While bundling services with one global custodian has been the norm until now, Scobie says his clients aren't overly concerned about one-stop shopping these days. “They're willing to have best-of-breed partners and diversify some of their business relationships.” According to Scobie, one large plan sponsor is moving its deferred stock unit plan over to CWT. While the company does not plan to move its large pension assets, it finds service lacking on its smaller plan, he says. “CWT and the sponsor believe it might be a combination of its size, or maybe the people they are dealing with don't understand the intricacies of the plan.”

Tonelli agrees that some clients will consider a best-of-breed approach. But for those that do—typically the mid- to smaller-size plans, where fees are a concern—“multiplying providers is not necessarily the best way to [minimize fees].”

tools to help manage it. Risk management is a dynamic process, and the needs of each client are unique. As the regulatory and market environment continues to evolve, we remain focused on continually developing our risk management offerings so that our clients have access to the best tools and resources available.

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**Where do you see the biggest opportunity for custodians to grow their businesses or make up for lost revenue in 2010?**

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**Gagnon:** The financial landscape is tinted with risk concerns—and justifiably so—and this will continue in 2010, thus the increased interest from our clients in governance, compliance and transparency. We are adapting to those preoccupations by providing tools to facilitate the reassurance of clients and committee members around counterparty risk and operational controls. Education is a key part, and clients welcome any assistance we provide to help them meet their regulatory obligations. Renewed interest in securities lending will be an advantage, as well as an anticipated increase in demand for peripheral value-added services.

**MacDonald:** The recent economic plight has forced pension plans to take a good hard look at all of their business relationships, custodians included. After a period of increased analysis...of all aspects of the business of running a pension plan, we expect a lot of opportunity will come from that increased knowledge and understanding of capabilities. Plan sponsors will gravitate toward those providers that demonstrated an ability to help them and their members, and [who were] able to demonstrate a strong local commitment, creditworthiness and conservative management during the crisis. New opportunities will also come from providing prudent programs like securities lending, as well as from the provision of established outsourcing services such as benefit payments and performance analytics that will allow plan sponsors to manage their risk and allocate their limited resources to core activities.

**For more insights into the issues and trends in the custody industry, go to [www.benefitscanada.com/extras](http://www.benefitscanada.com/extras).**

## Under Review

With all of the financial upheaval in the past year and a half, the custody industry has no doubt that it will see more regulation in the future. It's just a matter of what form that regulation will take.

While the need for a national securities regulator has been widely reported and debated, Robertson says Canada has fared well through the recession. "If you take a look at our banking industry, we stood up pretty well," he says. "I think that was a reflection of [having] a good regulatory environment in place."

Securities lending has already been subject to some restrictions, but that wasn't an ideal solution. "At the height of the crisis, when regulators implemented short-selling rules, it was unclear what the impact might be," says Don D'Eramo, senior managing director of securities finance with State Street in Canada. "We maintain an ongoing dialogue with regulators [in this area]."

And the custodians agree: if increased regulation is necessary, it needs to be clear on what it's trying to achieve. "We haven't been very specific and explicit about what we need more regulation around," says Robertson. "You've heard more about regulation around hedge funds, [but] that will likely have more of an impact in the U.S. versus Canada because there are more hedge fund managers there."

Consequently, there is a great deal of speculation on where the regulations will fall. One area will likely focus on the adoption of the International Financial Reporting Standards, which will come into effect on Jan. 1, 2011. "We are already providing our clients with the necessary accounting data to meet these new rules," says Monahan, "and we are delivering it electronically for greater efficiency."

Others speculate that requirements around due diligence and regulations around derivatives and tax changes may surface. But Lockbaum maintains that regulation is part of the "fabric" of doing business. "What [regulators] want to do is try to create an environment that is not overly burdensome but does create that one more additional layer of comfort around what we're doing as a custodian."

For 2010, custodians will continue to focus on revenues and sustaining their businesses. They'll also work on providing access to information and transparency to meet their clients' needs. With all of this in mind, plan sponsors may be looking forward to brighter—and clearer—days ahead. **BC**

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