



For custodians, technology is key—but they'll need to spend just to stay in the game

By Brooke Smith

First and foremost, custodians keep an investor's assets safe and secure. But as pension plans continue to invest in more sophisticated assets—private equity, derivatives and hedge funds—custodians are no longer simply dealing with traditional stocks and bonds. Add to this the G20 goal of having all derivatives cleared through a central clearing party (CCP), and the custodian's job just got a lot more complex—and a lot more expensive.

Gurmeet S. Ahluwalia, managing director, securities and fund services head for Canada, with Citibank, says a robust technology platform is critical to a successful custody offering. In addition to providing more services and capabilities, it's important to have strong technology to improve accuracy. "The more straight-

through processing [transactions conducted electronically without the need for manual intervention] you have, the less possibility there is of transactional errors happening. That requires significant and continued investment in technology."

But what kind of investments are needed? What do custodians need to do to satisfy their institutional investor clients?

An Integrated Experience

From a service standpoint, when clients are looking at a custodian, they're looking at two main elements: the technology platform (where the investor can access all of its positions and transactions) and the network (access to the custodian's network of agent banks around the world).

Let's begin with the network. "You're buying access to the network that's behind the global custodian, and that varies," says Tim Reucroft, director of

TYPES OF | CUSTODY SERVICES OFFERED

	Desjardins Trust	National Bank Trust	The Northern Trust Company, Canada	RBC Dexia Investor Services	State Street	CIBC Mellon Global Securities Services Company	Canadian Western Trust
Pension Custody Services							
Domestic Custody	X	X	X	X	X	X	X
Global Custody	X	X	X	X	X	X	
Pension Payroll	X	X	X	X	X	X	X
Trustee Services	X	X	X	X	X	X	X
U.S. Custody	X	X	X	X	X	X	X
Online Report Services							
Asset and Liability	X	X	X	X	X	X	X
Benefit Disbursement Activity			X	X	X	X	X
Cash Management	X	X	X	X	X	X	
Monthly Transaction	X	X	X	X	X	X	X
Participant Recordkeeping			X	X	X	X	
Performance Measurement			X	X	X	X	
Portfolio Analytics			X	X	X	X	
Securities Lending	X	X	X	X	X	X	

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

research with Thomas Murray (a custodian watchdog). “A lot of people are focusing on that because there are asset safety issues with using third-party sub-custodians.” (For example, if an investor is investing in Greece via a global custodian, who is the sub-custodian? If it’s a BB-rated local bank, you have a problem, Reucroft adds.)

Reucroft says if all of the platforms were the same, offering the same kind of functionality, what ought to differentiate the custodians is the network behind the platform. However, that’s not the case. He explains that when it comes to technology, investors want the “holy grail”: a single platform with *all* applications on it. “Clients want full integration,” agrees Linda Bernard, senior vice-president, North America, with Thomas Murray. “The last thing you want is one system

using one set of F/X prices and another system using another set of F/X prices.”

But clients don’t always get that, for two reasons: time and money.

Arti Sharma, a principal with Mercer Sentinal Group (a dedicated global business group within Mercer Investment Consulting), admits that some custodians have not been able to fully integrate, and this raises further issues. Some custodians are operating multiple platforms, either because of inability to service the various asset classes on one platform, as a result of acquisitions made along the way or due to the different services that a client requires. The question is, Do the platforms update in real time? And are there plans to consolidate across platforms?

Lack of integration may also mean that certain manual operations are necessary. “Those custodians that are not

able to support fundamental custody services or fund accounting through integrated platforms may require manual intervention to update the core platforms—for example, alternative investment strategies or sub-advised investment structures. Integration is critical so that the client can see one consolidated view,” says Sharma. “What we worry about is the day that one person is away and that process of keying in the information into that system got missed. [There’s] a risk element there.”

For custodians that maintain a number of platforms, this can be a costly endeavour. “You may be a large provider in terms of assets under custody; however, if you have multiple technology platforms in every country or multiple regions, or legacy systems through acquisitions, your technology spend is just going to get eaten up across all those various platforms,” says Rob Baillie, president and CEO of The Northern Trust Company, Canada.

RBC Dexia agrees about the importance of the platform. “As a global custodian, we have an enterprise custody refresh program well under way,” says John Lockbaum, managing director, Canada, with RBC Dexia Investor Services. “And we have selected to go to a consistent platform for core custody.”

Reucroft adds that investors rely on the custodian to reconcile all platforms and systems in order to present a unified view. “It’s a bit like a swan,” he says. “It’s nice and graceful on the surface, but underneath, it’s paddling like mad.”

Collateral Management

One major driver of change in the technology space is going to be regulatory. The *Dodd-Frank Act* in the U.S. and the European Market Infrastructure Regulation directive mandate that over-the-counter (OTC) derivatives—securities that trade via a dealer network as opposed to on a centralized exchange—must be cleared through a CCP.

With no central securities regulator in Canada, Sharma says it’s likely that each provincial regulator will eventually adopt concepts similar to the U.S. regulatory reform, but there have been no specific timelines yet. And, she adds, with the majority of OTC derivatives in Canada written by U.S. or European

PENSION ASSETS | UNDER CUSTODY

AS OF JUNE 30, 2011 (BILLIONS)

Company	Canadian Pension Assets Under Custody
State Street	\$386.3
RBC Dexia Investor Services	\$375.0
CIBC Mellon Global Securities Services Company	\$258.0
Desjardins Trust	\$115.2
The Northern Trust Company, Canada	\$83.8

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

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

MUTUAL/POOLED FUND ASSETS | UNDER CUSTODY

AS OF JUNE 30, 2011 (BILLIONS)

Company	Mutual/Pooled Fund Assets Under Custody
CIBC Mellon Global Securities Services Company	\$464.0
RBC Dexia Investor Services	\$455.0
State Street	\$188.1
Desjardins Trust	\$27.2
National Bank Trust	\$24.9

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

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

counterparties, investors will feel the impact of the regulatory changes.

One area where the custodian comes in is helping the investor to optimize its collateral usage. “The problem with OTC derivatives is that some of them may require as much as 10% of notional as margin,” says Reucroft. “I’ve got a swap that’s got a notional of \$100 million, then I’ve got to find \$10 million in margin to put up at the CCP. Where does the \$10 million come from?” Unless the investor has that amount available, it usually means “moving the collateral (as margin) between CCPs on an intraday basis as margins change and positions change,” he explains.

“People will have to put together some pretty funky technology to do all that. It’s going to be quite complicated, and there aren’t going to be many who can do it,” Reucroft adds.

“I don’t think the global custodians have even started to spend on this, but

“Clients want full integration”

— Linda Bernard,
Thomas Murray

8 technology questions to ask your custodian

- 1 | What have your technology budget figures been for the last few years? What are you planning for this year?
- 2 | What percentage of new development is client-driven?
- 3 | How much of your technology funding is allotted to the Canadian platform?
- 4 | Is the custody platform used in Canada the same one that supports clients around the world? If not, how many technology platforms exist?
- 5 | If you use multiple platforms, are there any projects planned to migrate to fewer platforms?
- 6 | Internally, how much of your technology spend is driving efficiency gains versus providing new services and capabilities designed to help meet new regulatory or compliance requirements?
- 7 | What type of interaction is there between your clients and technology? How much of the technology is visible/usable to the client versus used purely by the custodian?
- 8 | What procedures do you have in place to deal with a potential technology breakdown?

when this kicks in at the end of the year to meet G20 requirements, then it's going to be a mad scramble, with a lot of long hours to sort it out and make it happen," says Reucroft.

Bernard agrees, saying that a number of firms are paying attention to the issue. However, "when we've asked for updates from custodians on what they're doing, a lot say they're waiting to see, once everything is final, what they need to do."

Considering the Alternatives

Another way that technology is driving the custody industry is through investment in alternatives. As pension plans increasingly make allocations to more complex investments—hedge funds, private equity, infrastructure and real estate, for example—they expect the technology provided by their custodians to meet that demand.

"We've invested significantly in alternatives over the past several years," says Baillie, "as we've seen a significant trend toward more adoption of all kinds of alternatives."

However, technology is not the only part of this process; there's a people factor, too. Northern Trust has 300 employees in operations alone dedicated to alternatives. "They're working behind the scenes to make sure we're handling instructions appropriately and processing and reporting correctly," says Baillie.

One of the toughest assets for plan sponsors and custodians is private equity, which is very labour-intensive. Forecasting a capital call (the legal right of an investment firm to demand part of the money promised to it by an investor) is an

"We've seen a significant trend toward more adoption of all kinds of alternatives"

— Rob Baillie, The Northern Trust Company, Canada

administrative challenge because it's difficult to predict when the next capital call will occur, and the investor doesn't always have the necessary cash available. Northern Trust has developed a tool that will give clients insights into when a capital call is coming, which allows clients to make the arrangement in advance; otherwise, it can be a bit of a scramble to raise the cash, says Baillie.

Northern Trust's system will also image and process limited partnership statements (a statement from a partner whose liability is limited to the extent of its share in ownership), essentially creating a "paperless" process for an asset class that generates significant amounts of paper. It also automates a number of controls in the processing. "We have added intelligent software to an asset class that is very hard to automate." For example, it will tell us if the capital call has been issued appropriately for all of our clients invested in that particular partnership, Baillie adds.

David Linds, senior vice-president, is an



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business development and relationship management, with CIBC Mellon, says that in dealing with some of these alternatives, the difficult part is the independent valuation. “For many years, for these kinds of alternatives, the pricing was done by the agent—but that’s not independent valuation. One of our jobs is to determine the value of the asset. We’re scanning the globe and identifying legitimate, accurate, reliable sources of pricing valuation.”

Another difficult part is the settlement of these kinds of trades. Some of the very sophisticated derivatives, Linds says, can sometimes be created overnight. CIBC Mellon’s product can handle the valuation, settlement, pricing and management of these assets. Specifically, the valuation service including quantitative in-house models, management of the derivatives lifecycle and the integration of collateral management services to provide end-to-end capabilities for derivative servicing.

Canadian Western Trust (CWT) recognizes that expanding its current product line will require additional investments in technology, says Matt Colpitts, vice-president and general manager with CWT. Though it is not yet in the derivatives business, primarily because of technology limitations, the custodian is looking to change that soon.

Yet while all of the custodians interviewed say their clients are asking for enhanced technology in some way, not all are using the custodian’s current complete offering. Sharma says many of the newer technologies for alternatives, derivatives and risk analytics are built for larger clients. “What [custodians] haven’t done—and every single one is guilty of this—is, they’re not

doing a good job of penetrating their *existing* client base with these new tools,” she says. A custodian’s own client base can provide a source of new revenue if the custodian is proactive in pushing out the new tools, she adds.

However, it’s not that simple. Linds says that out of roughly 1,000 clients, about 100 are using the newer tools for derivatives or hedge funds. For the remaining 900 clients, CIBC Mellon informs them of the available services and provides demos—but there may not be any uptake. “We’re in the investment services business,” Linds says. “It’s not our job to tell the plan to invest in alternatives.” But if smaller plans do want to use them, CIBC Mellon will be ready. “If I’m ready for the \$60-billion pension plan, the product will be there for the small or mid-size [plan],” says Linds.

Baillie agrees that an education process will peak interest but adds that smaller plans are more cost-sensitive. “There’s a cost associated with it. But, in many cases, it’s quite reasonable when compared with the total cost of executing the investment strategy.”

Big Spenders


To keep up with their competitors, custodians are making significant technology investments. Northern Trust spent \$520 million on technology last year. For 2011 to 2013, the organization has budgeted about \$2 billion.

CIBC Mellon’s technology is built on that of its U.S. parent company, BNY Mellon, which invests more than US\$1.5 billion annually into the technology powering both companies’ products and services. Citibank spent about \$450 million last year, half of which was on new development.

State Street, historically, has devoted 20% to 25% of its operating expense budget to technology per year. “We also introduced an IT initiative in 2011, geared toward allocating more resources to development,” says Chris Perretta, executive vice-president and chief information officer with State Street Corp.

RBC Dexia estimates about the same: 25% of its revenue this past year. “That 25% would represent hundreds of millions of dollars to support the ongoing maintenance of all of the technology and the key programs and development work that we have,” says Lockbaum. And despite the headline news of a financially troubled Dexia, a 50% shareholder in RBC Dexia, being helped by France and Belgium, it’s “business as usual,” according to Lockbaum. “The situation with our shareholders has absolutely no impact on our business or on our operations.”

But it’s not necessarily what you spend; it’s how you spend it. “\$520 million—it’s probably not the biggest [number] out there,” says Baillie, “but because we’re maintaining only one system, we actually invest a lot more into new products and services as opposed to just maintenance. Seventy percent of every dollar we invest goes into new products or enhancing products.”

It will take ongoing investment and innovation to remain a key player in the custody business. While the scale of a custodian may be gauged by its assets under custody, some, like Baillie, would argue that’s the wrong measure. “It’s how much scale you get out of your technology investment.” 

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