

Protect Your Assets

Best practices and risk management considerations for institutional investors in selecting, evaluating and monitoring custodians.

BY LINDA BERNARD

Institutional investors are becoming more concerned with ensuring that their custodial arrangements follow best practices and are competitive within the marketplace. They also face regulatory pressures to undertake qualitative and quantitative reviews of their third-party service providers, including custodians, since institutional investors are often required to demonstrate that they have completed due diligence in making their selections.

When reviewing custodial arrangements, here are some of the regulatory, risk and economic issues that institutional investors should factor into their analyses.

Regulatory Issues

Global – The International Organization of Securities Commissions (IOSCO), whose membership regulates more than 90% of the world's securities markets, requires investment firms to conduct suitable due diligence processes when selecting

third-party service providers and monitoring their ongoing performance. IOSCO also suggests using internal and external auditors to monitor, assess and report on third-party service providers.

Europe – The Markets in Financial Instruments Directive (MiFID), which replaced the Investment Services Directive in November 2007, may be one of the most important pieces of financial services legislation introduced in recent years. MiFID provides for a harmonized regulatory regime for investment services across the 27 member states of the European Union, plus Iceland, Norway and Liechtenstein. The directive requires investment firms to exercise due skill, care and diligence when entering into, managing or terminating an outsourcing arrangement. In the U.K., the Financial Services Authority published Conduct of Business Rules requiring all regulated firms to establish and maintain systems for assessing the appropriateness of the selection and continued appointment of their custodians.

U.S. – The Department of Labor (DOL), the Internal Revenue Service and the Pension Benefit Guaranty Corporation jointly developed Form 5500 Annual

Return/Report of Employee Benefit Plan to ensure that plans under the *Employee Retirement Income Security Act* are operated and managed in accordance with prescribed standards. Recent revisions to Form 5500 require detailed disclosure of plan fees and expenses. According to the DOL and the Employee Benefits Security Administration, plan fiduciaries must ensure that service provider fees and other plan expenses are reasonable in light of the level and quality of the services provided. Plan fiduciaries must also be able to assess whether revenue sharing or other indirect compensation arrangements may create conflicts of interest for the service provider that could affect the quality of service, and monitor plan fees and expenses for reasonability on an ongoing basis.

Canada – The Office of the Superintendent of Financial Institutions’s (OSFI) Guideline B-10 requires that all federally regulated entities undertake a due diligence process that fully assesses the risks associated with an outsourcing arrangement. It also specifies that all outsourcing arrangements must be monitored to ensure that services are delivered in the manner expected and in accordance with the terms of the contract. Similar monitoring requirements also exist in the Canadian Association of Pension Supervisory Authorities’ pension plan governance guidelines. And, with the adoption of Bill 30 in Quebec, the amended *Supplemental Pension Plans Act* documents that rules must be followed when selecting, remunerating, supervising or evaluating service providers.

The increased emphasis on benchmarking from a regulatory standpoint suggests that structured ongoing comparison with the marketplace is a best practice for investors. Following the appointment and transition of custody assets, it’s important to review the custodian’s performance against a binding service-level agreement (SLA) on an ongoing basis—an important aspect of the relationship that many institutional investors neglect. Benchmarking against the SLA will determine if service levels are being met, and gathering universe data from an independent source will determine if the custodian’s service levels are in line with accepted market standards.

Risk Factors

The safety of client assets and the extent to which custodians are prepared to mitigate risk should be of prime importance to institutional investors. Risk factors can be divided into two main subcategories: credit risk and operational risk.

Credit Risk – With a major global custodian, the risk of bankruptcy is small. Due to consolidation within the industry, most of the major providers are reasonably well capitalized and are highly rated international banks. However, when it comes to smaller and less well-capitalized custodians, central securities depositories or sub-custodians, the risk of the provider running into financial difficulties remains. For this reason, conducting a financial and business analysis is a crucial part of an institutional investor’s due diligence. Key considerations include the financial viability and stability of the custodian, the ability to support long-term investment in custody and withstand operational losses, credit ratings, the balance sheet, insurance coverage and regulatory capital ratios.

Operational Risk – Pension funds and other institutional investors are exposed to settlement and post-settlement risks at the custodian and market levels. In the case of custodians, funds are exposed to asset safety, asset servicing, financial and operational

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Searching for Skills

By Leigh Doyle

In the increasingly complex world of asset servicing, organizations are responding with cutting-edge technology and by expanding service offerings. Such value-added elements can help their clients understand the ins and outs of foreign exchange or the nitty-gritty of alternative investments, but for custodians, they present a new challenge: finding and keeping talent.

To provide in-depth analysis of new investment strategies, custodians need the right people. José Placido, chief executive officer, RBC Dexia Investor Services, recognizes that moving into these non-traditional areas requires new hires with specific knowledge. “You need to hire folks who can talk about the new assets with plan sponsors.” Michel Prefontaine, vice-president, Desjardins Trust, agrees that the crucial thing is “having the key people who are educated to those projects” to help the clients.

This latest concern for custodians stems from the evolution that the industry has experienced in the last years. “If you look at the definition of an asset servicer today, it is much broader, and includes services such as very sophisticated analytics and support,” says Robert Baillie, chief executive officer, The Northern Trust Company, Canada. With so many new and complicated investment strategies out there, custodians need more and more experienced specialists to provide the value-added services that plan sponsors are demanding.

“One of the biggest impacts we’re seeing on our business is who we hire,” says Baillie. “It’s requiring so much more attention than even a few years ago.”

Unfortunately for custodians, these people with specialized knowledge are very high in demand in many industries. With the capital markets showing no signs of simplifying in the coming years, custodians may need to turn their attention to talent searches to stay competitive.

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risks. Key considerations for asset safety include the risk that, in the event of default by the custodian, the client's securities and cash are not treated as part of the custodian's assets and are therefore not available to creditors. Asset-servicing risks include exposure to weaknesses in the custodian's operational infrastructure and situations where the custodian does not accept full responsibility for providing information on asset-servicing events or for executing client instructions within prescribed deadlines. Other operational risks relate to breakdowns or weaknesses in the custodian's internal controls or procedures, the level of internal audit, compliance, and external audit coverage of custody activities, business continuity planning and testing, and the supervisory bodies that oversee and regulate the custodian.

Custody contracts often contain risk-evasive clauses with incredible protections in favour of the custodian. When challenged, the custodian will generally respond that these clauses aren't likely to be invoked and therefore, that there is no reason for concern. Reviewing the custody and related service contracts against best market practices will help identify areas of weakness and potential exposure to unnecessary and unwanted risks.

Economic Issues

Overcharging for basic and added-value custody services has been an issue for years and has led to a lack of client confidence—particularly if custodians fail to benchmark client fees to the market, apply usurious foreign exchange spreads to executed contracts, charge outrageous interest rates to debit balances and offer little or no interest on credit balances, deploy financial penalties for moving cash away from the custodian and negotiate uncompetitive securities-lending fee splits/arrangements. The custodian will typically reduce fees when the client draws attention to these issues. However, without conducting a fee analysis, it's difficult for the client to know if these fees are reasonable relative to current market levels.

As portfolio values increase and competition for mandates accelerates, institutional investors would be well advised to establish sound evaluation, selection and monitoring processes to ensure that their custodial arrangements meet best market practices and remain transparent and competitive. **BC**

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