Global Custody – Key drivers, dynamics and future trends

The global custody industry has attracted its own prophets and naysayers over the thirty years that it has been recognised as a business, nearly all of whom have missed the mark in terms of fulfilment, within timings prophesied. Given that inaccuracy, it's probably unwise to make further predictions that are not based on identifiable trends and fact.

Since its inception as a function of changes to the US Employees Income and Retirement Savings Act in 1974, global custody has been through extraordinary challenges, periods of growth, years of consolidation and more recently a time of renewed involvement. Despite the prophets of the late 80's assertion that there would be no more than four providers in the industry by the turn of the century, there exists more groups who are making a concentrated effort to secure their position in the future of the industry.

If history is a pointer to the future, it is interesting to look back at some of the high profile exits that have occurred in the last seven or eight years and compare that with what we are seeing now. The first real exit came when JP Morgan decided in 1995 that there was insufficient return form the business relative to its other banking activities to justify its continuing participation. At that time few industry watchers would ever have predicted that this flagship bank (and operator of Euroclear) would exit the business, but from that time on it allowed others the freedom to think the unthinkable, and contemplate their own involvement.

Figure 1 below shows what followed.

Many other groups have been lost to the industry through broader consolidations of the underlying bank such as Irving Trust, Manufacturers Hanover and Chemical Banks.

But more recently there has been a notable influx of groups who have seen that the capabilities they have in global custody can be expanded and exploited while others have seen that without a partner they are unlikely to be able to drive their business forward and secure the returns that are available. This group of renewed entrants include the likes of; ABN AMRO Mellon, BNPSS, National Australia (Clydesdale) Bank, Fortis, HSBC, KAS Bank, Royal Bank of Canada.

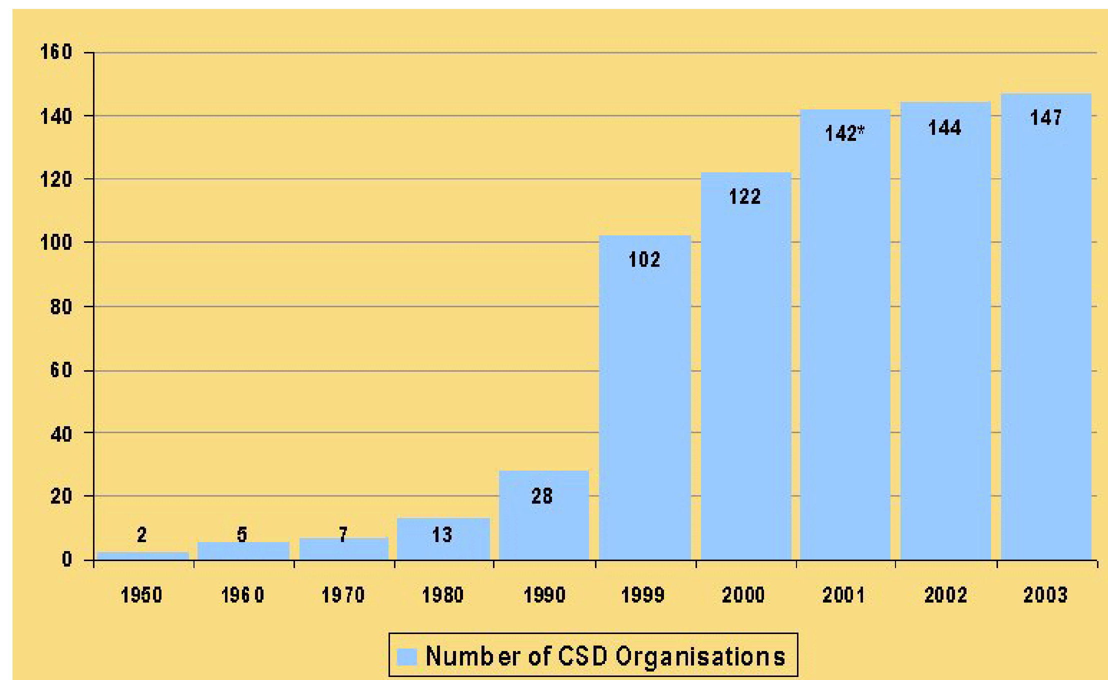
Clearly the current asset manager outsourcing feeding frenzy is prompting more groups to build capability and presence so that when an opportunity arises, they have an equal chance of competing for it. As more groups look to integrate their investment administration and custody decision, it will be important for those custodians who want to be in the business long term to have some material capability and client base.

So what does this tell us about the future?

The first thing it says is that there are many who consider that there is adequate opportunity to make sufficient return on investment to pursue this business either as a long term strategy or as a means to realise value by building up a market position and then conducting a trade sale.

This is all the more interesting given that the industry is receiving more attention from regulators, local and international bodies such as the Myners' review and the Bank for International Settlements review of capital adequacy, in what has traditionally been seen as a low risk, off balance sheet activity.

Equally, the growth in the numbers of Central Securities Depositories and their interest in the domestic custody business together with the expansion of Euroclear and to a similar extent, Clearstream into the whole area of equity processing is in itself not what was envisaged as recently as 10 years ago. The growth in the number of depositories servicing client assets has been significant in recent years as Figure 2 below shows.



As these new entrants have come into the regulators' field of vision, new burdens have been placed on institutional investors and custodian banks alike. In several markets worldwide, it has now become compulsory for investors to be aware of the risks that they are exposed to as a function of their assets being held in a local securities market, and to make an assessment as to whether those risks are within the reasonable limitations set by the fund trustees and the funds' owners.

Depository risk reviews are typically avoided by the custodian banks who prefer from their own risk minimisation perspective, to give depository information rather than a risk assessment.

The whole area of post execution risk is one that has attracted substantially more interest in the last few years and although custodian banks assert that a market infrastructure has never failed and a government would never allow theirs to fail, the regulators like the US Securities and Exchange Commission and the UK's Financial Service Authority have been concerned enough to enshrine such risk assessments into legislation, colloquially known as Rule 17f-7 and the Conduct of Business Rules respectively.

In response to investors' demands for more information on post settlement risk and to assist banks evaluate risks in global markets, Thomas Murray has recently launched the Capital Market Infrastructure Risk Ratings that provide an alpha rating (AAA to C) on the local market infrastructure across 89 markets worldwide. The Capital Market Infrastructure Risk Ratings are a definitive source for tracking risk exposure to local market settlement and custody infrastructure and procedures. Maintained daily, the risk ratings and supporting analysis provide a summary of local capital market post-execution risks.

The essence of the Capital Market Infrastructure Risk Ratings is an overall rating and associated risk exposure assessment ratings (Refer Figure 3) by which each country/market can be compared with others.

Figure 3. Risk Exposure Assessment Ratings Breakdown

Custody & Settlement
- Asset commitment risk
- Liquidity risk
- Counterparty risk

Asset Servicing
- Asset servicing risk

Safekeeping
- Financial risk
- Operational risk

Sovereign
- Sovereign risk

Source: Thomas Murray Ltd

Now while risk ratings and analysis are not in themselves a determinant of who ultimately remains in the custody industry going forward, it is reasonable to expect that as the scrutinisation of risk increases, some groups will be found wanting while others simply decide that the capital required and risk information required by clients is so onerous, that a graceful exit is a face-saving alternative.

Another driver will be the transparency that is being enforced upon providers. The days of wide spreads on foreign exchange and on debit/credit interest rates are numbered and already taking their toll on custodians. Those that price their custody services at a loss expecting to recoup that loss through client disadvantageous rates will be doing themselves no favours.

While the numbers of products available to investors through the custodians has increased to include derivatives clearing, investment accounting, fund administration, performance measurement, transition management, commission recapture and so on, each of these activities will need to be priced profitably to ensure ongoing business sustainability and ultimately for the clients, to ensure that their chosen provider does not outsource their business.

The larger custodians continue to confidently predict that by the end of this decade there will only be 4 or 5 global custodians left and that will no doubt be their continuing warning bark to those smaller groups who might wish to play in this space or who may not be willing to "partner" with a bigger global.

Thomas Murray (www.ThomasMurray.com) is a global firm specialising in the global securities industry and provides evaluation, rating (market infrastructure and custodian) and selection products and services to global, regional and domestic custodians and institutional investors worldwide. Ross Whitehill is Chief Operating Officer of the company.