



THOMAS MURRAY

# Global Custody Ratings

METHODOLOGY PAPER

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## Global Custody Ratings

### 1. Background

There are over 100 markets worldwide that are open to direct foreign investment. The value of securities held worldwide exceeded USD 63 trillion at the end of 2004. The market saw compound annual growth of 19.7% in the value of domestic equities and bonds over the period 1989 to 1999 (source: International Federation of Stock Exchanges), although this fell back in 2000-2 before increasing again in 2003-4, with the value of equities worldwide increasing 18.3% and bonds 9.3% during 2004.

The global securities services marketplace encompasses the wide range of banking and custody related services that take place after, or downstream from, the point when the decision to buy, sell, borrow or lend a security has been made and executed.

The principal participants, on the wholesale side, are institutional investors (insurance companies, fund managers, pension funds etc) who buy and sell securities from broker dealers (usually investment banks who make a market in the securities). Following the execution of the buy or sell decision, the institutional investor will instruct his global custodian (who is appointed to look after an investor's securities) to settle the transaction. The global custodian will, in turn, instruct his domestic sub-custodian (agent bank in the local market) to settle the transaction locally. Physically, the sub-custodian will orchestrate this in the local market with the broker dealer's local agent bank, and arrange the transfer of securities and cash, usually via the Central Securities Depository (where the securities are actually physically/electronically held in immobilized or dematerialised form) in the market.

Thomas Murray's custody ratings, which cover global custodians, regional custodians and domestic sub-custodians, aim to bring transparency to the process of selecting and monitoring custodians and to facilitate the comparison of different custodians by users and potential users of their services. Historically this area has been rather opaque, even to people familiar with the securities services industry. The custody ratings aim to provide independent assessments on a uniform and fully comparable basis with clear indicators of service quality across the various services provided, together with information on the level of risk intermediation provided by the custodians. The custody ratings are intended to help buyers of custodial services to differentiate between custodians on a standardised basis.



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## 2. Product Summary: Global Custody Ratings

Thomas Murray has developed global, regional and domestic custody ratings products. The global custody ratings products are as follows:

- 2.1. **Public Global Custody Rating.** This is where a global custodian bank commissions a full global custody rating, including an on the ground operational review by Thomas Murray. The rating is an indicator of the bank's ability to deliver core (and added value, where appropriate) custody services to its clients. The benchmark is the terms and service levels offered to the "average client" of the bank, or the standard custody terms and services offered by the bank to all its customers generally. This can be kept private between the bank and Thomas Murray or made public as the bank determines.
- 2.2. **Private Global Custody Rating.** This is commissioned by a particular Thomas Murray institutional client on its global custodian, and is specific to that individual client of the custodian. It reflects the particular terms and service standards offered to that client. This rating remains private between the client, custodian and Thomas Murray and cannot be made public.
- 2.3. **Private Custody Ratings and Operational Benchmarking (PROBE)** is a Thomas Murray product designed to assist institutional investors to monitor the status and ongoing performance of their global custodian on a periodic basis. The product has two components, a private global custody rating and operational benchmarking. The initial private global custody rating is awarded on the basis of the contractual and service position between the custodian and client, as per the private global custody rating above. The service levels that the client actually experiences are then monitored using the benchmarking component. This may affect the ratings that the custodian has been awarded initially as it out or under performs against the contractual obligations and service standards. PROBE remains private between the client, custodian and Thomas Murray, and cannot be made public.



### 3. Public Global Custody Rating Approach

This section details the methodology to produce a full public global custody rating. The differences in methodology to produce a private global custody rating are covered in section 4.

#### 3.1 Public Global Custody Rating (GCR)

The overall public GCR is a business rating, resulting from the application of Thomas Murray's in-depth knowledge of the custody business, processes developed to assist groups to select and monitor global custodians, and knowledge of market best practice.

There are a number of different data sources which feed into a public GCR, including publicly available information (e.g. credit ratings and annual reports), Thomas Murray information (e.g. the results of custodian visits), monitoring for Thomas Murray clients and feedback on custodians to Thomas Murray from clients. In addition, a custodian completes a detailed structured questionnaire.

The structured questionnaire helps to identify the contractual terms and service levels offered by the custodian as standard to all clients. This is the product offering which is rated.

The overall GCR, and the rating of each service or component, is provided on the ratings scale, which runs from AAA (extremely strong), through BBB (adequate) to C (unable to deliver at even a minimally acceptable level). The scale is explained in Appendix A.

Each global custody rating also contains an "Outlook" indicator, which indicates the custodian's ability to deliver core custody services going forward. This "Outlook" view is determined by feedback from the custodian, publicly available information, due diligence visits and monitoring feedback generated either by Thomas Murray clients or on their behalf by Thomas Murray directly. It is explained in Appendix B.

The following steps outline the Thomas Murray approach to generate a Public GCR:

- Preliminary discussions and pre-qualification with custodian
- Sign formal rating agreement
- Work through ratings questionnaire
- Analyse results
- Carry out on the ground operational review
- Produce preliminary rating and report
- Ratings Policy Board approval
- Presentation of results to custodian
- Feedback from custodian
- Confirmed rating and report publication

The Thomas Murray Ratings Policy Board is the decision-making body, which formally reviews the draft rating, rating report and client findings, and approves the rating of the custodian.

In more detail, the main steps in the process are:

#### 3.2 Initial Rating



The process starts with a custodian requesting a rating, entering into a dialogue with Thomas Murray, and signing a formal ratings agreement. Then the custodian provides Thomas Murray with detailed information on all aspects of his custody business through responses to a structured questionnaire, which is combined with the other information available, to help Thomas Murray form a provisional view of the business being appraised.

This view is firmed up by the on-site operational review, which is a structured review of all aspects of the custodian's business that takes one or two weeks on the ground, depending on the complexity and geographical dispersion of the custodian. The operational review confirms the information already provided and deepens Thomas Murray's understanding of the custodian's processes. After the on-site review a draft rating and rating report is developed and reviewed by the Thomas Murray Ratings Policy Board.

Following approval, the rating and rating report are provided to the custodian and feedback is obtained. The rating and rating report are then finalised. It should be noted that the rating and rating report are only made public with the explicit approval of the custodian. Otherwise the rating and rating report remain private between the custodian and Thomas Murray.

In addition to the rating and rating report, a findings report is also produced and reviewed by the Thomas Murray Ratings Policy Board. This gives details of any shortcomings in the custodian's processes which have adversely affected the rating. This findings report is always kept private between the custodian and Thomas Murray.

As part of the initial rating process, an "Outlook" indicator (see Appendix B) and outlook view is developed on the custodian. This outlook is maintained as part of the surveillance process.

### 3.3 Annual Surveillance

Once a public GCR is issued, it is automatically put under surveillance, and will be reviewed at any time if any relevant changes occur to the bank or its custody business. The sources of information for surveillance are feedback from the custodian, publicly available information, due diligence visits and monitoring feedback generated either by Thomas Murray clients or on their behalf by Thomas Murray directly.

The status of the rating at any time is reflected in the "Outlook" indicator (see Appendix B). In the absence of any changes, the rating is formally reviewed on an annual basis. This involves an analysis of any changes or developments to the custodian's business during the year, and whether this impacts the GCR. This is confirmed by the operational review on site. If any new information changes the overall rating or rating of any component, a new rating report is produced, reviewed and approved by the Thomas Murray Ratings Policy Board. Feedback from the bank is sought before the rating and report are finalised.



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#### 4. Private Global Custody Rating Approach

The private GCR is a client specific custody rating based on the contractual, legal and service positions entered into between the client and its custodian. The private GCR is kept confidential between the client, the global custodian and Thomas Murray, and is not made public. The process for producing private Global Custody Ratings is similar to that for a public GCR, except that a client of the global custodian, rather than the global custodian itself commissions it. Most significantly, the private GCR reflects the terms, conditions and service levels peculiar to that client, rather than being the terms offered to all clients generally. Private Global Custody Ratings are also used as part of the Thomas Murray PROBE product.

Where the private GCR is issued as part of a global custody review conducted by Thomas Murray on behalf of the client, the GCR is based on the terms, service levels and representations committed to by the custodian during the custody review, and the due diligence carried out on the custodian as part of the review.

Where the private GCR is not linked to a Thomas Murray selection process, it will be necessary for the custodian to provide information to Thomas Murray by way of responses to a questionnaire, in a similar manner to the public GCR. In addition, Thomas Murray will draw on publicly available information sources to determine the rating. There will not be any operational review carried out on the custodian as part of the private GCR, unless specifically requested and commissioned by the client. A draft rating and report is developed, reviewed and approved by the Thomas Murray Ratings Policy Board. Feedback is obtained from the client and custodian before the rating and report are finalised.

A similar Outlook status (see Appendix B) and outlook view is placed on the private GCR to that on the public GCR.

A private GCR cannot be made public, as the information on which it is based is peculiar to the individual client and has not been validated to the same extent as the public GCR by on the ground operational review from Thomas Murray.



## 5. Methodology

### 5.1 Rating Components

The Thomas Murray global custody ratings take into account the following major components, which are expanded upon in section 6 below.

- ***Credentials***, defined as the custodian's experience in, and commitment to, deliver global custody services together with their management of the business;
- ***Core services***, as revealed by the breadth and quality of the nine core services offered (see below), as well as the custodian's technical ability to deliver the services to a high standard, while minimising risk to the client in providing the services. As well as the overall GCR, there is an accompanying subset of service ratings for each of the nine core services (Settlements, Safekeeping, Income, Corporate actions, Corporate governance, Cash/FX management, Active cash management, Taxation and Securities lending). These consider the quality of the service, the breadth of the service offering and the risk minimisation to the client in providing the service;
- ***Core operations and internal functions***, which includes an assessment of the custodian's IT and communications systems, its operational reporting, the network management function of the custodian, as well as its client relationship management capabilities;
- ***Risk***, which assesses the position of the custodian on Financial, Asset safety, Asset servicing and Operational (procedures and controls) risks.

In addition, to the overall rating and rating of each core service, the other major dimensions (Credentials, Core operations and Risk) are also given a rating, all on the ratings scale, which runs from AAA (extremely strong), through BBB (adequate) to C (unable to deliver at even a minimally acceptable level). The scale is explained in Appendix A.

For public GCR's the information about the custodian that the ratings are based upon, is subject to operational review at the custodian's operational centre(s).

The "first cut" of the ratings is then derived using a scoring model, which evaluates each area against best market practice or best possible outcome as applicable. The scores are weighted, both at individual factor level (for example the number of markets in which contractual settlement is offered) and at overall level (settlements versus securities lending for example). The weighted scores are then summed to produce positions for each rating component and an overall rating. These "first cut" ratings are then subject to analytical judgement and internal review, both informally and formally through the Thomas Murray Ratings Policy Board before being finalised. The rating, overall, is a judgement based on all the factors analysed, not merely an arithmetic exercise. There are circumstances' in which the overall rating is held below the level suggested by the scoring model because of specific factors such as the lack of public credit ratings for the legal entity delivering custody, for example.



## 5.2 Added Value Services

In addition, where the custodian requests it (or the client requests it for a private GCR), a separate rating can be assigned to each added value service that it offers. These ratings are not taken into account in deriving the overall GCR, which considers core services only. They are, however, included in the rating report with appropriate emphasis and are on the same ratings scale as before. The added value services that can be evaluated and rated include:

- Investment accounting and reporting. This is the production of end of period market valuation reports, trading reports, income reports and other accounting statements for the fund.
- Performance measurement and analytics. This is the measurement of how the investments that the fund holds have performed over a period, both overall and at more detailed levels, down to individual investments made.
- Fund Accounting (NAV/Unit pricing). This is the calculation, usually on a daily basis, of the net asset value of a unitised fund (for example an OEIC or unit trust/mutual fund) and the bid and offer price of an individual unit of the fund and the production of the required periodic reporting for the fund.
- Depositary/Fiduciary. This is the discharge of the regulatory fund compliance monitoring services required in the relevant jurisdiction. This includes monitoring the manager, administrator, custodian and other service providers and liaison with the regulator and fund auditors as appropriate.



## 6. Key Evaluation Criteria

These include, for each of the main components of the overall rating, the following:

### 6.1 Credentials

- **Commitment to the business.** The ongoing investment being made to develop the custody business and to enhance the product offering. The significance of the business to the group overall.
- **Experience in the business.** The time the custodian has been involved in the business, the market share that has been built up, the range, depth, geographical diversity and loyalty of the client base.
- **Management of the business.** The quality of the staff, and ratio of clients to client administrators, staff turnover and training.

### 6.2 Core Services

For each of the nine core services, the rating considers the range of the service, the quality of the service and the risk minimisation to the client in using the service, which combine together to produce an overall service rating. Specific areas of interest include:

- **Settlement.** Ability to settle all instruments available in the markets, pre-matching, due date settlement performance, contractual settlement date accounting markets, follow-up with the market and clients on problems and issues. STP rates.
- **Safekeeping.** Segregation of client securities from proprietary assets, willingness to segregate at CSD level in markets where required and possible, ability to safe-keep the full range of instruments, reconciliation processes with agents (and agent to CSD) and vault controls (where applicable).
- **Income.** Range of income information sources, notices to client at all stages, income on beneficial position, paid on due date. Contractual income markets.
- **Corporate Actions.** Range of corporate action information sources, prompt notification to client, with follow-ups for decisions, competitive deadlines, responsibility for execution of instructions given within deadline. Cash paid contractually.
- **Corporate Governance.** Active proxy voting service, with range of information sources and notification timescales and cut-offs, with follow ups for decisions if required. Outcome of meetings notified.
- **Cash Management/FX.** Interest paid on account balances with no tiering of rates, external benchmarking of rates, cash pooling/netting/offsetting, monitoring and reporting on outstanding payments and receipts, deadlines for making and receiving payments. FX rate transparency where custodian or sub-custodian executes.



- **Active Cash Management.** Pooling of accounts and sweeping of balances into a range of instruments, including own and third party short term investment funds, agency treasury services if required and procedures to allow for daily liquidity requirements and management of credit quality of instruments used.
- **Taxation.** Use of relief at source wherever possible, lodging reclaims as required in all markets and following up outstanding reclaims, reporting status to client periodically, notifying client of changes to relevant tax laws and treaties. Keeping client tax documentation up to date.
- **Securities Lending.** Availability of both principal and agent programmes, advice to client of loan movements, reporting of securities availability, and automatic recall or substitution of sales by client of stock on loan. Benefit of income and corporate actions on loaned stock. Client ability to restrict borrowers and collateral taken, full mark to market of loan and collateral positions and collateral adjustment daily.

### 6.3 Internal Operations

- **Reporting.** Availability and timeliness of operational reporting and underlying data. Range of reporting, reporting media and ability to tailor to client requirements.
- **Systems and Communications.** SWIFT capability, both receiving and sending, disaster recovery planning, systems security, level of integration of systems, continuing enhancement of systems. Availability of internet based tools for clients.
- **Network Management.** Sub-custodian selection criteria and process, frequency and extent of reviews, ongoing management of agents, process for new markets, quality and breadth of market information.
- **Client Relationship Management.** Management of the relationship with clients, orchestration of different areas of the custodian, problem resolution and escalation. Periodic reporting of custodian's performance.

### 6.4 Risk

- **Financial.** The financial viability and stability of the custodian and its ability to support long term investment in its business and withstand operational losses. Factors considered include the (long term) credit ratings, balance sheet, insurance coverage and the regulatory capital ratios.
- **Asset Safety.** This is made up of two parts, securities risk and cash risk.
  - **Securities risk:** this is the risk that, in the event of default by the custodian, client securities are treated as being part of the assets of the bank which has gone into default, and therefore available to its creditors, rather than belonging to clients. The rating looks for appropriate segregation and registration of securities and recording in the books of the sub-custodian and global custodian.
  - **Cash risk:** this is the risk that, in the event of default by the custodian, clients are exposed to losses of cash placed with the bank.
- **Asset Servicing.** This is the risk that the client is exposed to a loss due to weaknesses in the custodian's operational infrastructure to which the client assets are vulnerable. There is also the level of responsibility taken by the custodian for information provision on asset servicing events generally, whether the service or information provision is in-house or outsourced. There



is the level of responsibility accepted by the custodian for carrying out correctly all client instructions given within deadline.

- **Operational.** This is the risk that deficiencies in information systems or internal controls, human failures or management errors will result in unexpected losses. Essentially, this is the risk of client loss due to breakdowns or weaknesses in internal controls or procedures at the custodian. Factors to be considered include the level of internal audit, compliance, external audit, external regulatory activity, coverage of the custody operations, and the level of IT disaster recovery and business continuity planning.

## Appendix A

### The Ratings Scale

The full ratings scale is as follows:

|     |   |
|-----|---|
| AAA | The custodian's ability to deliver core custody services is extremely strong                  |
| AA+ | The custodian's ability to deliver core custody services is very strong                       |
| AA  |   |
| AA- |   |
| A+  |   |
| A   | The custodian's ability to deliver core custody services is strong                            |
| A-  |   |
| BBB |   |
| BB  | The custodian's ability to deliver core custody services is less than adequate                |
| B   | The custodian's ability to deliver core custody services is quite weak                        |
| CCC | The custodian's ability to deliver core custody services is weak                              |
| CC  | The custodian's ability to deliver core custody services is very weak                         |
| C   | The custodian is unable to deliver core custody services at even a minimally acceptable level |
| N/A | Service unavailable   |

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## Appendix B

### *The Outlook indicator*

Each rating contains an Outlook indicator, which indicates the custodian's ability to deliver custody services going forward. This Outlook indicator is set using all the sources used to create the rating initially, including custodian visits and monitoring feedback generated either by Thomas Murray clients or by Thomas Murray directly, as well as publicly available information and information provided to Thomas Murray by the bank itself under the surveillance part of the rating agreement.

The Outlook scale is:

- Stable: There are no factors that Thomas Murray is aware of at this time that would affect the custody rating.
- Positive: The factors that Thomas Murray is aware of may result in an improvement in the custody rating.
- Negative: The factors that Thomas Murray is aware of may result in a deterioration of the custody rating.
- On Watch: The factors that Thomas Murray is aware of may result in a change in the custody rating, but the direction of the change is uncertain at this time.