STATE OF THE NATION REPORT

Key Industry Findings From TNF Annual Meeting 2019

Part 1: Custody

The future for custodians is specialisation ~

Direct custody and clearing is easily portrayed as an industry under pressure. Two years of rising asset prices came to halt in 2018, damaging the revenues of banks dependent on ad valorem fees. Though stock markets have recovered since, structural challenges remain intact. Regulation has raised the costs of compliance, capital and liquidity. Network managers are squeezing sub-custodians on costs. Competition for business is no longer confined to rival custodians and central securities depositories (CSDs) but now includes new entrants as well.

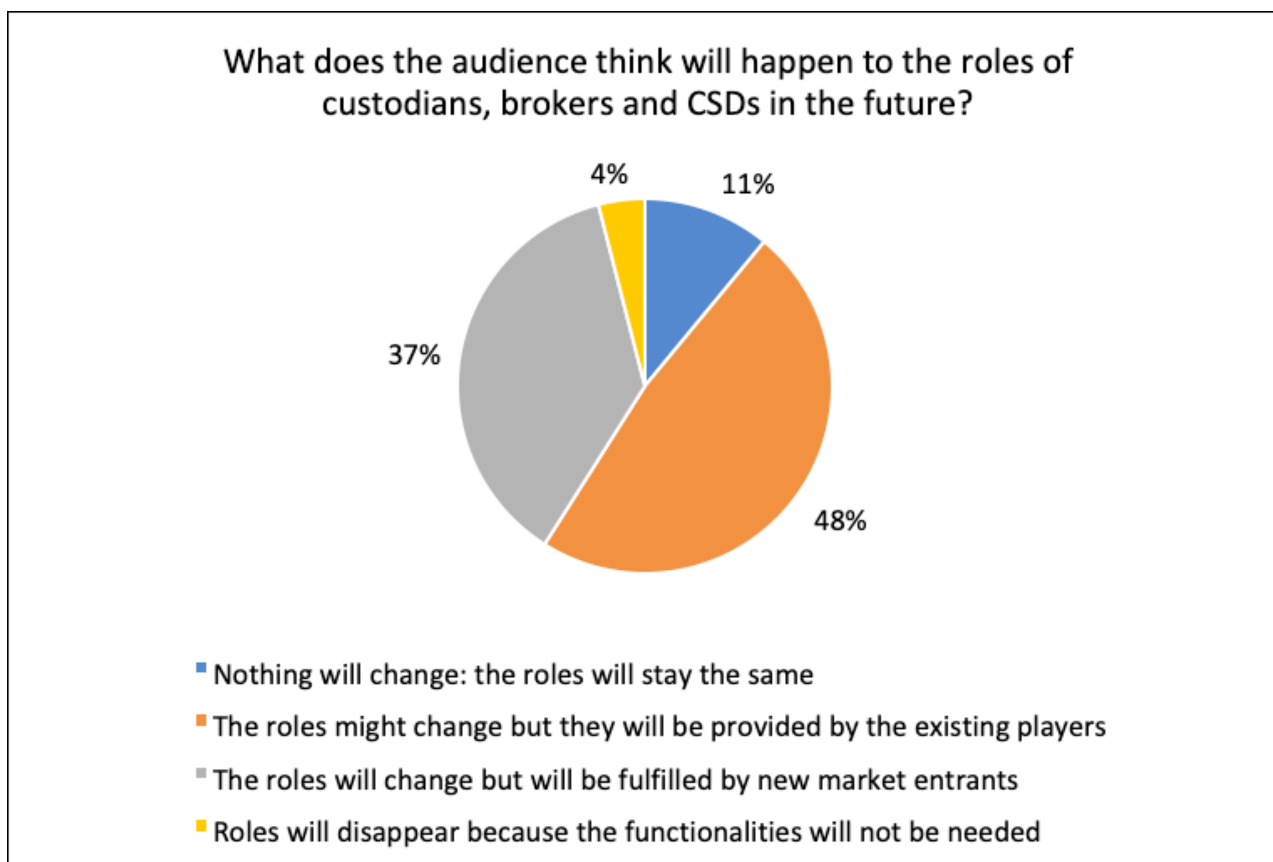

Chart 1.

Yet a poll of the audience taken on the first day of The Network Forum Annual Meeting 2019 (see Chart 1) found a high degree of confidence among delegates that the industry will adapt successfully to the challenges it faces. More than half the respondents thought that their roles would either remain unchanged or evolve to defeat any would-be challengers. One prediction for that evolution is increased specialisation. Investment banks, said a custodian, will withdraw from proprietary trading and revert to an agency role. Market-making will become the preserve of technology. Brokers will choose between research and broking. Custodians will be valued not for safekeeping securities but for managing data flows between issuers and investors.

He added that custodial specialisation in particular is now characterised by a shift in the nature of outsourcing. Having initially outsourced and offshored in a "tactical" way to cut costs, custodians are now outsourcing in a "strategic" way. "Many firms have to shrink to grow," he said. "They are looking to outsourcing partners to help them do more with less." The future of central securities depositories (CSDs) proved harder for panellists to predict. In Europe, for example, CSDs have reacted to the loss of settlement revenues to TARGET2-Securities (T2S) by offering their participants direct access to markets, even on a regional basis, and expanding their services into asset-servicing.

One custodian warned them to consolidate and stick to providing safe and efficient settlement, while another saw them as increasingly credible competitors for regional as well as national mandates. “In reaction to that we are seeing custodians starting to change their business models, unbundle services and really focus on the value-added services,” he said. “So that if a client does want to go direct to CSDs, they can still select certain services from traditional custodians.”

Direct accounts at CSDs threaten custodial intermediation ~

Primary dealers have long held accounts directly at national CSDs. But opening accounts directly at CSDs became widespread during and after the acute phase of the great financial crisis in 2007-08. At the time, buy-side clients as well as their global custodians reasoned that holding assets in a segregated account in their own name at the CSD represented a lower risk to their assets than holding them in an omnibus account operated by a sub-custodian bank. European regulation, in the shape of the asset safety and recovery provisions of the Alternative Investment Fund Managers Directive (AIFMD) and the fifth iteration of the Undertakings for Collective Investment in Transferable Securities (UCITS V) Directive, reinforced this trend towards the use of segregated accounts. But the decisive factor in impelling global custodian banks to open accounts directly at the CSDs was TARGET2-Securities (T2S), the pan-European settlement system.

By bifurcating settlement and asset servicing, T2S made it commercially viable for global custodian banks to open a direct account at a CSD operated by a sub-custodian under a power of attorney, as opposed to holding assets at the CSD through an omnibus account as part of a full sub-custody service. In one model, T2S makes it possible for global custodians to self-clear in T2S markets, while using sub-custodians for asset-servicing in the local markets only.

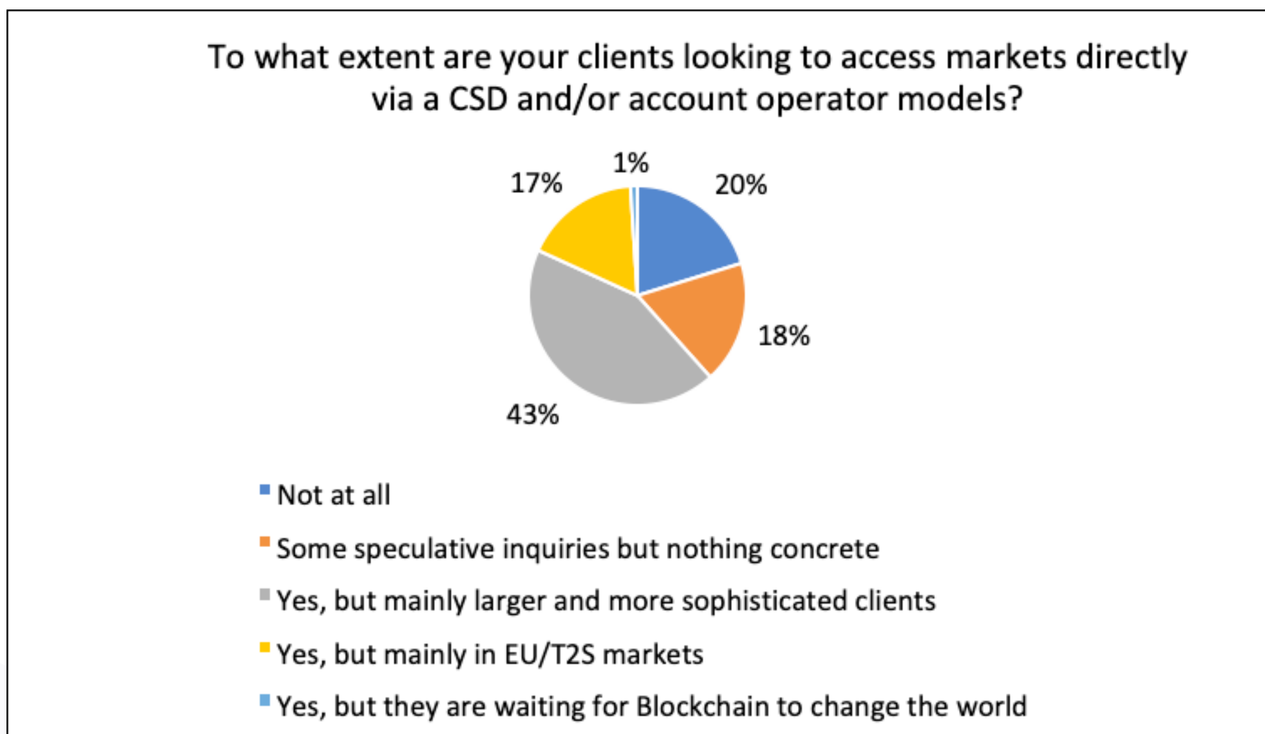

Chart 2.

However, as a poll of the audience found (see Chart 2), interest in CSD accounts is now spreading beyond Europe. “We offer the model in 28 countries around the world now, not just in Europe,” said a sub-custodian. “It has definitely been something we see clients look to more frequently. I do not think it is limited to Europe. We are going to see more of it. It is going to be a core requirement of a sub-custodian, not just in Europe but globally over the next few years.”

The factors at work include mitigation of counterparty risk, the ambition to reduce the costs of running sub-custody networks without increasing concentration risk, access to central bank money and the ability to demonstrate to clients a degree of control over assets at the local level. One panellist argued that a division of labour between global custodians and sub-custodians made sense, because global custodians could never match the asset-servicing expertise of sub-custodians in corporate actions, withholding tax reclaims and proxy voting in different national markets.

This lack of harmonisation and standardisation in national markets in general, and the operating procedures of CSDs in particular, might inhibit the efficiency of the multi-market sub-custodian model, but the logic of a local presence holds true for them too. “When you get into the mechanics, operationally, it is not standardised at all,” said a panellist. “You need market experts, who know the nuances, to operate anybody’s account, whether it is your own or your client’s.”

Drivers and inhibitors of direct accounts at CSDs ~

The same panellist added that it would be imprudent in the run-up to the implementation of the Central Securities Depositories Regulation (CSDR) of the European Union (EU) to adopt the CSD account operator model. “You would not jump to the account operator model while CSDR is in flight, especially with the buy-in regime,” he said. Certainly, a poll of the audience found a majority thought CSDR, unlike T2S, unhelpful in encouraging clients to open accounts directly at CSDs (see Chart 3).

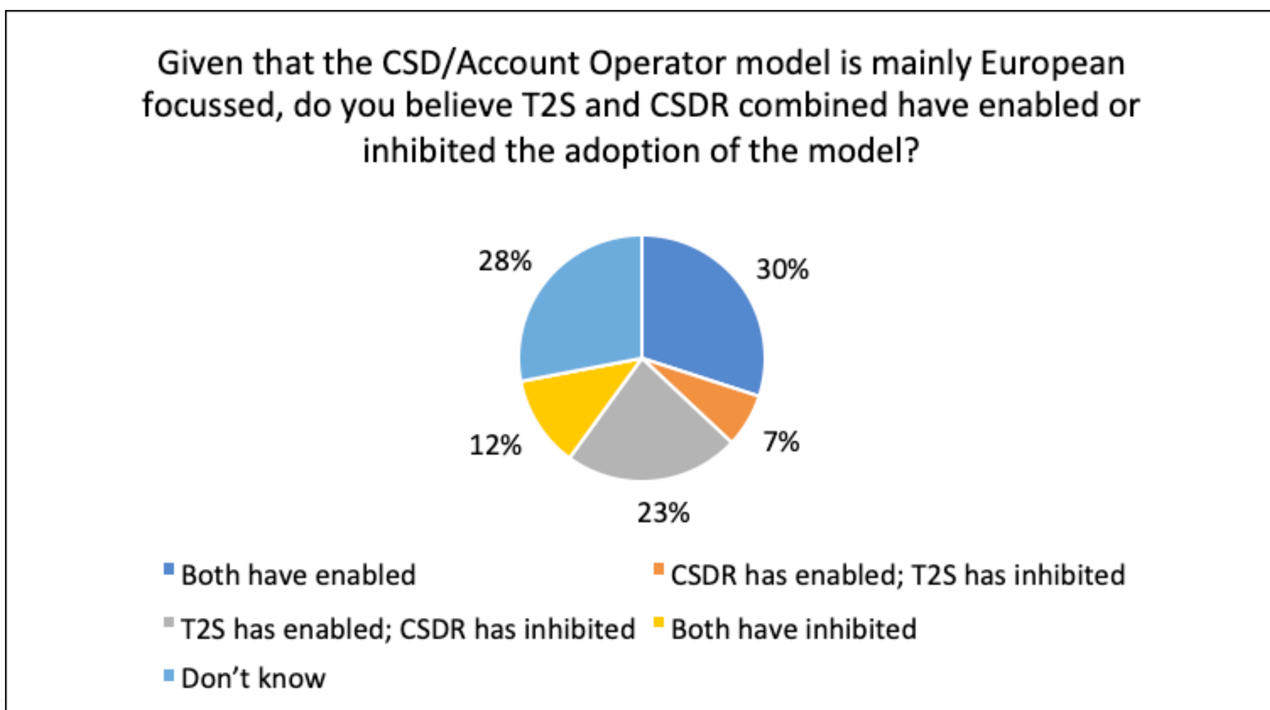

Chart 3.

A multi-market service provider agreed that CSDR was unlikely to encourage adoption of the account operator model. "Not one regulator is looking at CSDR the same way," he said. "We have had to unbundle any synergies we hoped to build within the group. We have, basically, had to go back to the domestic way. Every domestic regulator is using CSDR to protect their home market. I do not think that was the intention of CSDR, but it is the reality we are living through. I do not think we are living in a world where we are going to see more harmonisation."

That lack of harmonisation increases the cost of adopting an account operator model. Which is one reason why, for now at least, direct accounts are - as Chart 2 indirectly suggests – mainly the preserve of the largest and most sophisticated firms. They are often obliged, through holding UCITS or AIFM assets, to make the (not insignificant) investment required.

One panellist thought this cost would remain a barrier to direct account-holding until distributed ledger technology (DLT), of the kind being used by the ASX in Australia to replace the technology platform of its in-house CSD, was widespread at the issuance as well as the settlement level. "The tokenisation of assets may well make the up-front investment that is required a little easier," he said.

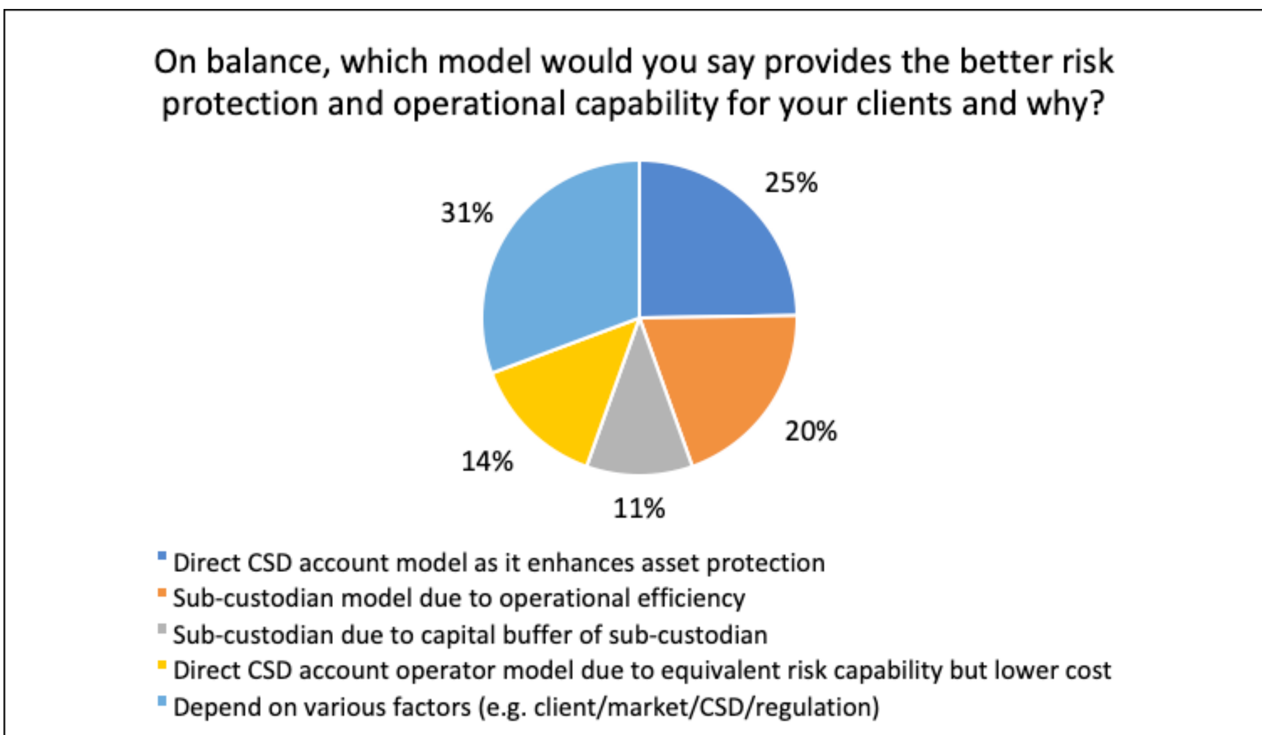

Chart 4.

A poll of the audience found views even divided on whether account operator models were superior to full sub-custody services (see Chart 4). "It tells you how flexible a sub-custodian now needs to be," noted one panellist of the poll. He thought that the success of the account operator model will ultimately be determined by is ability to cut costs. In Europe, he explained, T2S offers direct account holders the benefits of reduced liquidity management costs through cross-market netting.

New pricing models for custody services ~

Intra-day credit is, as it happens, a good example of the way in which sub-custodians are changing how they charge for the services they provide. "Within a traditional settlement fee, historically, there may have been provision of intra-day liquidity that was covered in that settlement price whether you used the liquidity or not," explained a panellist. "One of the advantages of unbundling is that you pay for it if you use it. It is more consumption-based. Those who do not use liquidity will not have to pay for it. Those who do use liquidity will have to pay for it."

Paying-for-what-you-use implied greater transparency as well. The consensus was that settlement fees would in all instances of straight-through processing (STP) fall to zero, net of charges levied by CSDs. "Do people see value in the action of settlement anymore?" asked a panellist. "Not so much. It is very hard to justify a fee for something when you are not necessarily touching it and processing it. Yes, if there is an error and you need to do something about it, we need our repair fees."

In developed markets, pricing is in future likely to be based not on transaction volumes and asset values but on the risks the service covers as well as the unbundled services actually consumed, plus additional charges for repairing unreconciled transactions. "We do need to have an adult conversation, as an industry, about what people are prepared to pay for," said a panellist. But a second panellist countered that there are parts of the world where levels of automation are lower and settlement fees will not contract: the emerging markets.

Emerging market challenges will be operational rather than economic ~

Not everybody agreed. "The emerging/developed market distinction is increasingly irrelevant," he said. "I truly believe that emerging markets have grown in size and become a lot more investor-friendly and are therefore no longer emerging." He added that regular re-classifications of economies in emerging market indices meant many emerging markets had ceased to be "big fish in small ponds and become small fish in big ponds. Re-classifications are not an everyday event but, when they happen, they affect the whole of our industry."

A poll of the audience (see Chart 5) found a striking alignment of attitudes with the factors that emerging market index providers use to determine the maturity of a financial market: size (usually measured by factors such as free float and turnover) and accessibility by investors. But one panellist questioned the utility to investors of the traditional country classifications.

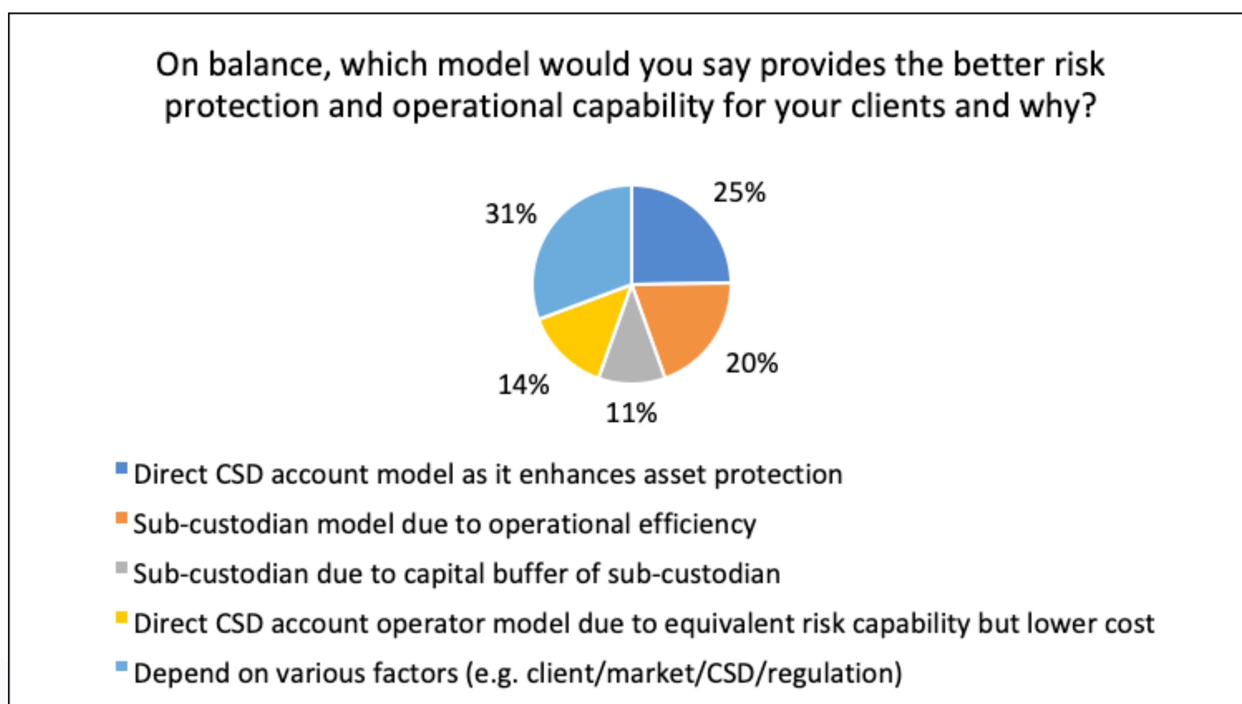

Chart 5.

“What if you have a company that is headquartered in Hong Kong, listed in New York, incorporated in the Cayman Islands and it derives the majority of its revenue from China?” he asked. “Suddenly, the country that this country belongs to becomes a very relevant question all asset managers have to contend with. What if you have an emerging market mandate from a client, and you classify this company as belonging to Hong Kong? Can you include it in the mandate?”

Emerging market sub-custodians, of course, focus less on underlying investment potential than on what makes a financial market investable from an operational perspective – namely, the quality of the market infrastructures and the level of automation. “Things like CSD connectivity and manual proxy voting,” explained a sub-custodian. “That is what we really focus on, to drive scale through process automation and STP.”

However, the upgrades and downgrades of markets to and from the indices do have an operational impact on custodians. A downgrade might push a stock outside an investor mandate or a benchmark, forcing a buy-side client of a custodian to sell. A sub-custodian might easily find itself under-staffed in a market on the cusp of an upgrade, and over-staffed in a market liable to a downgrade, making it difficult to manage surges in volume or volatility.

“Being upgraded requires a lot of focus on government policy and the development of infrastructures to take the right decisions,” noted a panellist. “The same thing happens in a downgrade. We can see liquidity squeezes, difficulties in getting currency out and regulatory concerns and instability.” Even after a downgrade has actually occurred, it can create further turmoil before the market settles into a less volatile pattern.

Fortunately, changes in classification tend to be well-advertised by the index providers. They deliberately avoid springing surprises and consult widely before a reclassification, as they did in the recent re-classifications of the markets in Saudi Arabia and China. The consultations include asking custodians for their opinion of the operational infrastructure of a market. However, a poll of the audience found that surprisingly few members of it had any direct experience of this (see Chart 6).

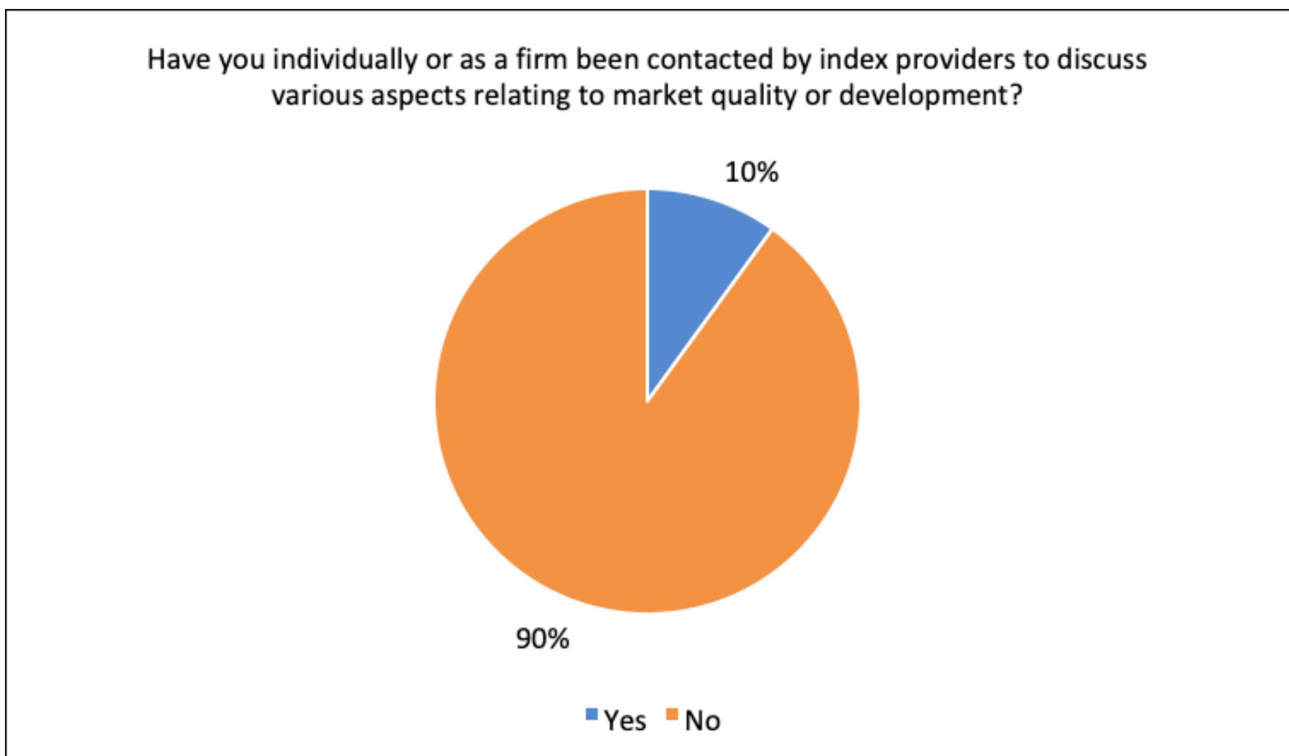

Chart 6.

One panellist thought the explanation must lie in the fact that custodians tend to lobby on behalf of investors seeking infrastructural and operational improvements to a market rather than explaining the shortcomings of markets to ratings agencies – and that this information is then passed on to the agencies by investors. In other words, custodians contribute to ratings changes indirectly.

The same panellists thought sub-custodians should co-ordinate their lobbying efforts more effectively. A poll of the audience endorsed this view. Nearly one respondent in four thought market advocacy an appropriate area for custodians to collaborate (see Chart 7). The logic of a collaborative approach could be extended to consultations with index agencies as well.

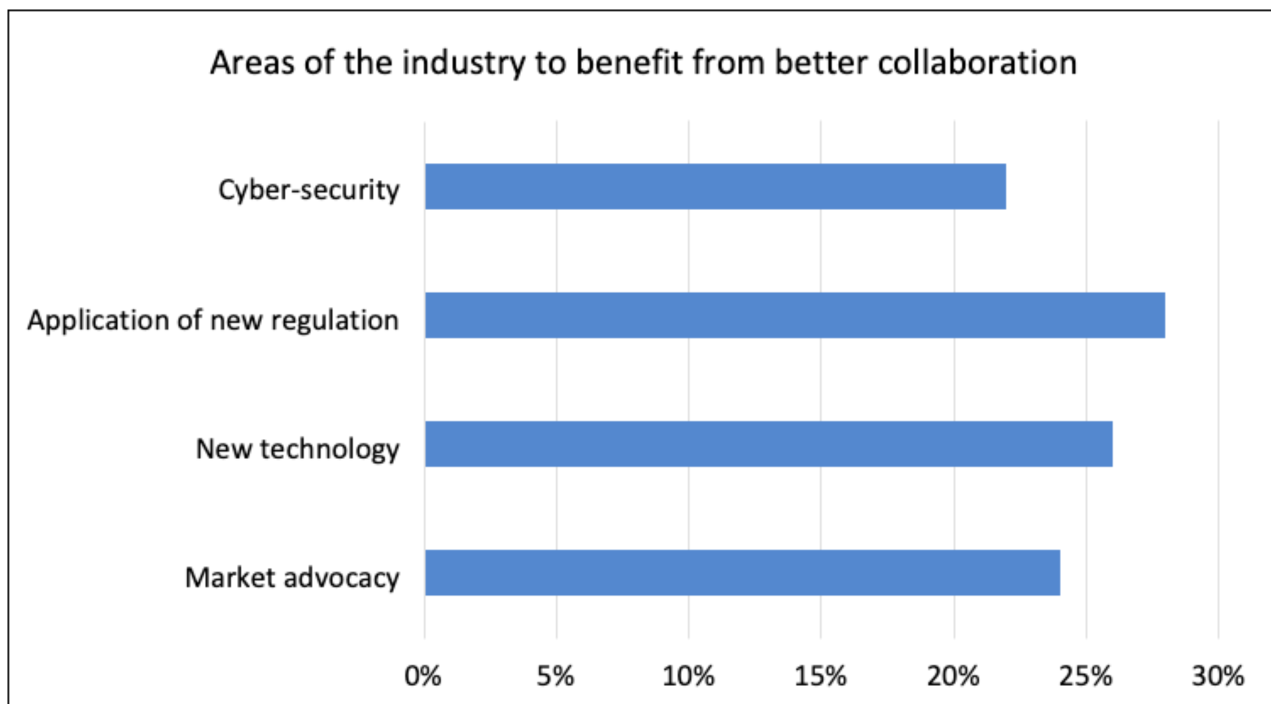

Chart 7.

Certainly, one panellist was concerned that index agencies do not take operational issues into account sufficiently. He also wondered if they weight the right factors appropriately. Another panellist thought the agencies should attach less importance to markets that are investing heavily in infrastructure, and more importance to markets that are increasing transaction flow, since that is what increases operational risk.

Operational risk is of course what sub-custodians exist to manage. Though multi-market sub-custodians try to insulate clients from the vagaries of individual markets with single technology platforms, these have still to be adapted to local market peculiarities. That requires knowledgeable people in individual markets.

"Unless you have got the boots on the ground and have people who understand the market and have the right connectivity to the exchanges, the regulators and the different authorities it is very hard to build a presence in a frontier or emerging market," explained a panellist.

People still matter in securities services ~

In an era characterised by relentless pressure to standardise, harmonise and automate in pursuit of greater efficiency, people remain the principal competitive differentiator for sub-custodians. A poll of the audience found that "client service" ranked ahead (in sequence) of value-added services, technology and even price as the crucial factor in winning business.

As one panellist argued, it is people that give custodian banks control. Good staff help to determine client behaviour and expectations as well as the client experience of the services. "The biggest differentiator that I see, and this has become a mantra for me over the past few years, will be the biological robot," he said. "You and me."

In theory, the human factor is not at odds with increased automation and standardisation. The more efficient a process is, the more time it releases to listen to clients. This also explains why, when the audience was polled on which types of services differentiate a provider, a large majority voted in favour of bespoke services (see Chart 8).

"If [people were] not important, would we be willing to travel twice a year, to meet more or less the same people, and continue the same dialogue?" asked a panellist. "In between we probably see each other ten times more. We would not do that if the human factor was not a very important contributor."

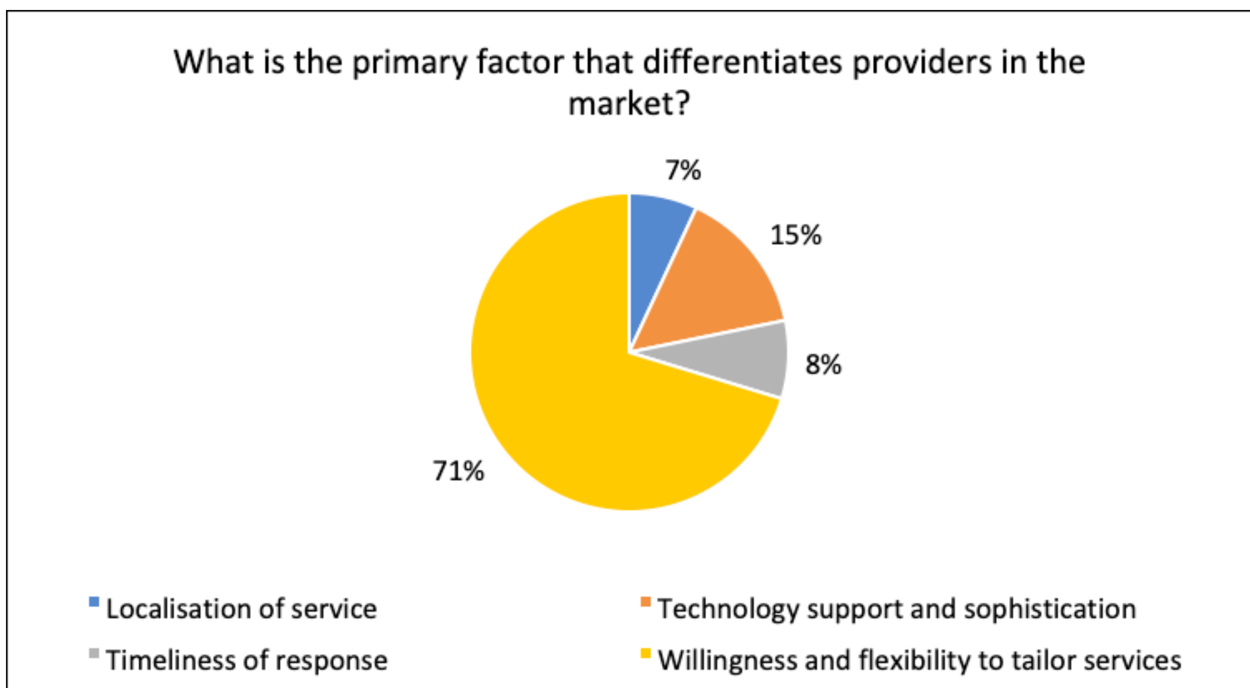

Chart 8.

But the ambition of tailoring services to clients may be at odds with the constant pressure to cut prices, continued the same panellist. "We need to be very careful in cutting to the bone," he said. "Many sub-custodians, especially today, due to the margin compression, have stretched themselves much too thin. If you have an honest opinion that you are going to engage in the client dialogue and adopt most of the things clients want to have, you need to have the manpower and the brainpower to do that. It needs to be a mutual recognition by clients and providers to work together. A lot of hard thinking must happen on the sub-custodian side. If we are going to live up to those expectations we need to be at our absolute best, and we are not at our absolute best if we compartmentalise too much and we are running things just on the basis of cost-efficiency targets."

Similar concern was expressed about clearing. In Europe, for example, competition between 11 central counterparty clearing houses (CCPs) has reduced the average cost of clearing cash equity transactions from 50 cents a trade a decade ago to just 3 cents today. Provided volumes remained high, European CCPs can still more than cover their fixed costs.

But panellists thought prices could fall no further without putting the resilience of CCPs, and their capacity for innovation, at risk. "We need to be careful of a race to the bottom," said one. "Our clients need to be sure we are all still here in five, seven, ten years' time. If we start pricing this business where it does not make sense for our own organisation that has got to stop at some point."

Further consolidation of market infrastructures would be helpful ~

One way to combine financial stability, a continued high level of service and reduced prices is standardisation. In settlement and asset servicing, progress is much slower than anticipated. One panellist noted that in Europe the post-trade recommendations of the Giovannini group, published in reports of 2001 and 2003, were still not complete. Standardised corporate action templates were only now being adopted in Europe, decades after the problem was identified. T2S was announced as long ago as 2006, and migration has only just ended. "I was a much younger man when T2S started 13 years ago, and I will be retired by the time we get securities completed on ISO 20022," said a panellist.

Ironically, T2S has achieved the reverse of what was intended: after an initial reduction, it has recently increased post-trade costs in Europe. Expectations that T2S would spark consolidation of CSDs in Europe were also disappointed, not least because individual countries are trying to protect their national financial market infrastructures.

Yet a poll of the audience suggested CSDs are precisely the area in which consolidation is needed most (see Chart 9). Though commercial imperatives alone can drive consolidation of infrastructure – as they have in parts of western Europe, and the Nordic and Baltic markets – the results are incomplete. Over-capacity is a criticism made of clearing too. "11 CCPs in Europe is too many for cash equities," said a panellist. "How can CCPs survive? It is about scale and efficiency." That implied consolidation.

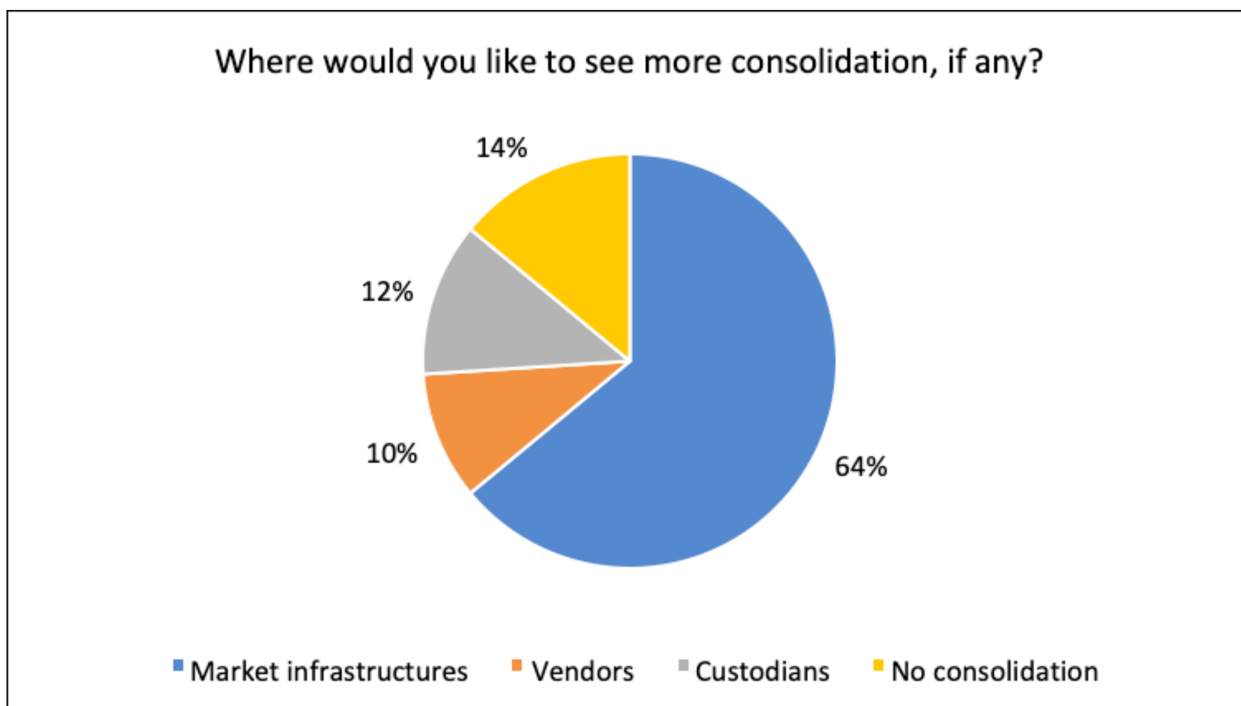

Chart 9.

None of this history persuaded panellists that regulators would be a good choice to accelerate the process of consolidation or standardisation in the industry. Regulators have a tendency, warned a panellist, to over-load the industry with reporting obligations instead. Another thought standardisation was better driven by trade associations such as the Association for Financial Markets in Europe (AFME) and ISITC: "It is a shame that we have to regulate anything in order to get it right."

Consolidation of sub-custodians to continue ~

One topic on which opinion was almost as united was the prospect of further consolidation of sub-custodian banks. One panellist said he had changed job 15 years ago in the expectation that single market providers would cease to offer a service and, although they had not disappeared yet, he remained confident that eventually they would.

"Business is getting more and more tricky for single market providers," agreed another panellist, who argued they could not maintain the necessary level of investment. Where they did not withdraw from the industry, he expected them to be acquired by regional providers. The audience (see Chart 10) agreed by a large majority.

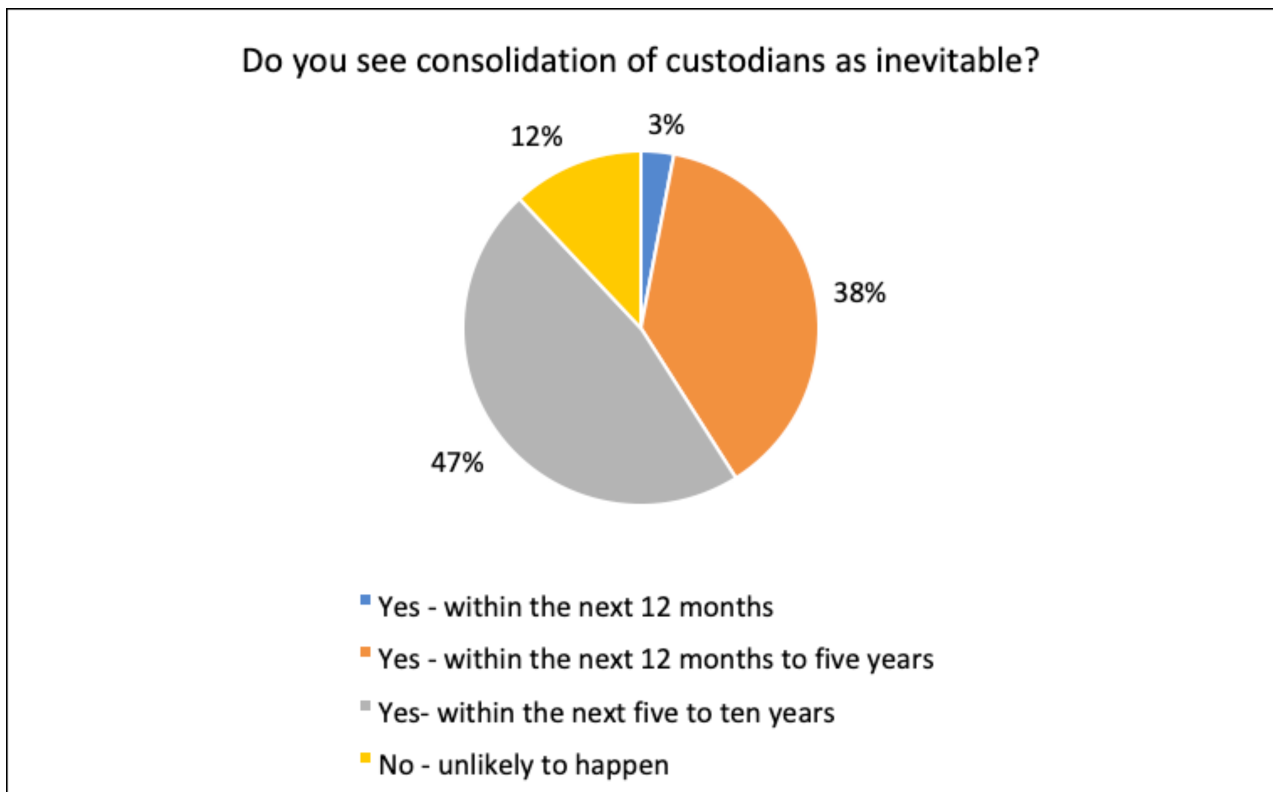

Chart 10.

One sub-custodian drew an important distinction between consolidation of sub-custodians and consolidation of networks of sub-custodians. "There are a lot of obvious benefits to consolidating a network, not least on the financial side," he said. "You can operate under one governing contract, with the country specifics covered on the side. You reap the benefit from best practices being implemented across all the markets. You will after a while be covered by relationship managers that know your business and how to serve you out of different operating conditions."

Another panellist detected a consolidation of relationships on the provider side as well. "There are so many topics that have to be considered in a relationship, from KYC to risk management, that every bank tries not to have too many relationships," he said. "The more you run, the more complicated it gets." A second panellist agreed that banks can no longer be "all things to all people" because there is a risk of "becoming a Jack-of-all-trades and master of none."

In other words, specialisation could become a constructive alternative to exit or consolidation. Collaboration between specialists, for example, offered clients access to the best technology and transaction processing at a lower cost without forcing them to change a banking relationship. But another sub-custodian with experience of partnerships with other banks was sceptical. "They are not usually that long-lasting," he said. "There are so many external factors in a relationship between two banks, that is not the option we see in the market right now."

Copyright © 2019 The Network Forum Ltd. All rights reserved. info@thenetworkforum.net